INTERNATIONAL MONETARY FUND

IMF Country Report No. 16/79

MONTENEGRO

March 2016

2015 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR MONTENEGRO

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2015 Article IV consultation with Montenegro, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its February 19, 2016 consideration of the staff report that concluded the Article IV consultation with Montenegro.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on February 19, 2016, following discussions that ended on November 3, 2015 with the officials of Montenegro on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on February 8, 2016.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for Montenegro.

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

Selected Issues
Financial Stability System Assessment

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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FOR IMMEDIATE RELEASE
March 8, 2016

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Washington, D.C. 20431 USA

IMF Executive Board Concludes 2015 Article IV Consultation with Montenegro

On February 19, 2016 the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Montenegro.[1]

Montenegro's economy has rebounded in the past year, and strong growth looks set to continue in 2016, at just over 4 percent. The medium-term outlook is boosted by the construction of the Bar-Boljare highway. The government intends to pursue other fiscal incentives and public infrastructure projects to promote economic development and connectivity. However, although the government's growth strategy can bring substantial gains, it also carries sizable risks, notably to the public finances. Montenegro also remains vulnerable to fluctuations in external demand and global financial conditions.

Recent fiscal measures that reduce revenues and ease restraints on current spending add to budget pressures from the highway. Even with relatively high growth, staff projects deficits of around 8 percent of GDP over the next three years, contributing to substantial financing needs. During that time, gross public debt is expected to reach 80 percent of GDP, from 66 percent in 2015.

Increased growth should gradually boost bank profitability and allow lending conditions to ease further. Yet low provisioning and weak asset quality remain concerns, and could hold back credit growth if not properly dealt with.

With shrinking fiscal buffers, and because the economy lacks control over its own currency, the ability to absorb shocks depends crucially on the flexibility and competitiveness of the real economy. Low labor productivity and employment hold back potential growth. In this

[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.

context, the process of aligning labor laws with those of the EU provides an opportunity to improve the flexibility of labor market outcomes, boost participation rates, and reduce informality.

Executive Board Assessment[2]

Executive Directors welcomed Montenegro's strong growth performance and the favorable outlook. However, they noted that the heavy reliance on large infrastructure projects to support growth also poses risks to fiscal and external sustainability. Accordingly, Directors emphasized the need for sound macroeconomic policies to address these risks. They also encouraged the authorities to reduce financial sector vulnerabilities and to implement structural reforms to boost potential growth and increase resilience.

Directors welcomed the authorities' commitment to address vulnerabilities and looked forward to the preparation of a credible fiscal consolidation plan. They underscored the need for immediate and durable consolidation measures to maintain sustainability, contain risks, and preserve market access. In this context, they observed that new pension provisions and social allowances, planned public wage hikes, and strategic tax incentives would add to budget pressures. They called for measures to contain the public sector wage bill, improve the sustainability of the pension system, and strengthen revenue collection to reduce the public debt to GDP ratio to 60 percent of GDP over the medium term. Directors suggested that these policy measures be complemented with a stronger fiscal framework, including detailed medium-term plans and public financial management reform.

Directors noted that the financial system is largely stable, and that bank capitalization and liquidity appear adequate in general. However, the still high level of non-performing loans, low provisioning and bank profitability, and weak asset quality are sources of vulnerability. Directors recommended that policy recommendations from the Financial Sector Assessment Program be implemented to address these vulnerabilities. In particular, Directors noted the need for an independent asset quality review of banks and measures to enhance emergency liquidity assistance. They also recommended that steps be taken to enhance the regulatory, supervisory and resolution frameworks, and to develop the macro-prudential framework.

Directors emphasized that structural reforms should help boost potential growth and competitiveness. Specifically, they noted the need to improve labor market flexibility and the investment environment, and to reduce non-wage disincentives to employment.

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

Montenegro: Selected Economic Indicators						
	2011	2012	2013	2014	2015 Proj.	2016 Proj.
Output, prices and labor market (percent change, unless otherwise noted)						
Real GDP (percent change)	3.2	-2.7	3.5	1.8	4.1	4.6
Nominal GDP (in millions of euro)	3,265	3,181	3,362	3,458	3,641	3,840
Industrial production	-10.3	-7.1	10.6	-11.5	13.7	...
Tourism (Overnight stays)	10.2	4.3	2.8	1.5	15.6	...
Unemployment rate (in percent) 1/	19.7	19.7	19.5	18.0	--	--
Consumer prices (average)	3.1	3.6	2.2	-0.7	1.6	0.9
Consumer prices (end of period)	2.8	5.1	0.3	-0.3	1.4	1.4
General government finances (percent of GDP) 2/						
Revenue and grants	38.5	39.9	41.3	43.5	40.6	42.2
Expenditure	45.3	45.7	47.6	46.1	48.0	51.4
Fiscal balance	-6.7	-5.8	-6.3	-2.6	-7.4	-9.2
Primary fiscal balance	-5.3	-4.0	-4.2	-0.3	-4.9	-6.8
General government gross debt	45.6	53.4	55.2	59.9	66.5	70.5
Monetary sector (end-period, percent change)						
Bank credit to private sector	-13.0	-3.1	2.1	-0.4	2.3	2.7
Enterprises	-20.3	-4.9	0.4	-2.8	2.2	...
Households	-3.2	-1.1	3.7	1.7	2.7	...
Private sector deposits	1.2	7.2	1.3	6.1	9.0	...
Balance of payments (percent of GDP, unless otherwise noted)						
Current account balance	-17.6	-18.5	-14.5	-15.2	-13.3	-18.6
Exports of goods and services	42.3	43.7	41.3	40.1	41.8	39.8
Imports of goods and services	-64.3	-68.1	-61.4	-60.0	-59.7	-63.0
Foreign direct investment	11.9	14.5	9.6	10.2	15.7	12.0
External debt 3/	145.0	155.9	151.5	154.8	152.1	154.8
REER (CPI-based; average change, in percent; + indicates appreciation)	-3.2	3.2	0.8	-2.0	...	...

Sources: Montenegro authorities; and IMF staff estimates and projections

1/ Labor Force Survey (LFS) data.

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

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

INTERNATIONAL MONETARY FUND

MONTENEGRO

STAFF REPORT FOR THE 2015 ARTICLE IV CONSULTATION

February 8, 2016

KEY ISSUES

Strong growth this year looks set to continue into the medium term. The authorities are seeking to accelerate growth and development, mainly through new infrastructure projects, but also with fiscal incentives. Although this growth strategy can bring substantial gains, it also poses sizeable risks, notably to public finances, and also in terms of the allocation of capital and financial stability.

Gross debt has increased substantially over the past year and looks likely to increase significantly, to 80 percent of GDP. Staff recommends immediate and durable fiscal consolidation measures to limit risks to the public finances and to ensure favorable conditions for funding, particularly to the extent that further infrastructure projects would require additional public debt. Fiscal consolidation is also important for improving external balance, especially as the economy lacks independent monetary policy. A credible strategy to safeguard the health of the public finances would address longstanding problems with public expenditures, such as the very high level of spending on pensions and public sector wages. Measures should be supported by strengthening the fiscal framework and public financial management.

Montenegro is still dealing with the fallout of a boom-bust credit cycle, and bank lending remains relatively weak. The acceleration in aggregate demand is likely to improve profitability for most banks, facilitating gradually easier financial conditions. The authorities are considering policies to boost lending, but some of these could have unintended negative consequences. Restrictions on lending rates could reduce credit supply to riskier borrowers, such as small businesses. Attempting to increase lending competition by granting more bank licenses could worsen financial stability. Following the recent Financial Sector Assessment Program for Montenegro, staff recommends an independent asset quality review of all banks—beginning with the weakest—and other steps to bolster the resilience of the financial system.

Improved labor productivity and economic flexibility are crucial to complement the authorities' investment-led growth strategy. Because the country's capacity to absorb shocks is limited by the currency regime and limited fiscal space, the authorities should build on current reform initiatives, such as improving the flexibility of labor market outcomes and continuing to improve the business climate.

Approved By
European Department

Discussions were held in Podgorica October 22–November 3, 2015. The team consisted of Alasdair Scott (head), Christopher Faircloth (both EUR), Yuko Hashimoto, and Deon Tanzer (both STA). James Gordon (EUR), Duncan Last (FAD), Natalia Stetsenko and Bruce Markell (LEG) joined for parts of the mission. The team met with the authorities (central bank, plus Ministries of Economy, Finance, Justice, Transportation, and Labor), private sector representatives (unions, employers, and banks), and international agencies (EC and EBRD).

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CONTEXT

1. **Montenegro is a small economy facing a number of challenges to secure durable and stable growth.** Output is concentrated (mainly in tourism, energy, and hard commodities), exposing it to fluctuations in external markets and terms of trade. The economy also depends heavily on external financing. A rigid labor market restricts the capacity to absorb shocks, while unfavorable demographics and low labor participation hamper growth and pension solvency. Policies are constrained: fiscal space is limited, the Bar-Boljare highway project (Box 1) will substantially increase public debt, and euroization implies no independent monetary policy. Montenegro is seeking EU membership, and a general election will be held in 2016.

Box 1. Montenegro's Highway Project

The Bar-Boljare highway will connect the main seaport of Bar to Serbia. The authorities see major benefits from the project, including regional integration, strengthened trade, and road safety.

Only the first 40 km segment connecting the outskirts of Podgorica with the less-developed northern municipality Kolašin has been costed and budgeted. Construction has been contracted to the China Road and Bridge Corporation (CRBC), at a cost of EUR 809 million (23 percent of 2014 GDP). Payment to the CRBC is to be made in U.S. dollars at the euro/US exchange rate at the time the contract was signed; this implies a fixed cost of USD 1.1 billion, with the foreign exchange risk to be borne by Montenegro. (Euro depreciation since the agreement was struck is estimated to have increased costs in euros by about 5 percent of GDP.) The remaining 136 km of the highway has not yet been costed, but is expected to cost less per kilometer as the first segment presents the most difficult engineering challenges.

China's ExIm Bank will finance 85 percent of the first section (henceforth "the highway") through a 20-year loan, denominated in dollars, with a fixed 2 percent interest rate and a six-year grace period. The authorities have indicated that the remaining 15 percent of the cost will be financed through a combination of cuts in non-highway capital spending and/or additional borrowing, with toll revenues used to help fund repayments once the highway is completed.

Construction officially started on May 11, 2015. The highway will be constructed over a 48-month period. 30 percent of the investment is to be subcontracted to domestic companies.

RECENT DEVELOPMENTS

2. **Economic activity has rebounded.** The tourist season has been buoyant, and construction has been strong after infrastructure investment delays the previous year. Staff forecasts growth to be just over 4 percent in 2015, compared with 1¾ percent in 2014. Inflation averaged 1½ percent last year, after deflation in 2014. But the labor market is not performing as well: nominal wage growth has been flat since 2011, and unemployment and participation rates are around 18 and 55 percent, respectively (Figure 1).

3. Banks' health has improved, but some deficiencies remain (Figure 2). Capital buffers appear adequate on average, but with a high degree of heterogeneity across institutions. Liquidity is ample; many banks now have loan-to-deposit ratios well below 100 percent. But despite high net interest rate margins, profitability remains weak due to high operating costs. Nonperforming loans (NPLs) have declined, but remain high at 14¾ percent of gross loans, or about 40 percent inclusive of loans transferred to asset management companies.

4. Financial conditions are slowly improving. Lending to the private sector increased by 2¼ percent on average in 2015, after a sustained contraction in credit since 2008.[1] Nonetheless, credit growth appears weak when compared with the rebound in growth and high liquidity. Lending rates have fallen in recent months, but margins over funding costs remain elevated on average. Banks remain risk averse, citing persistent problems securing and selling collateral, limited lending opportunities, and weak accounting and reporting practices that make assessing credit-worthiness difficult.

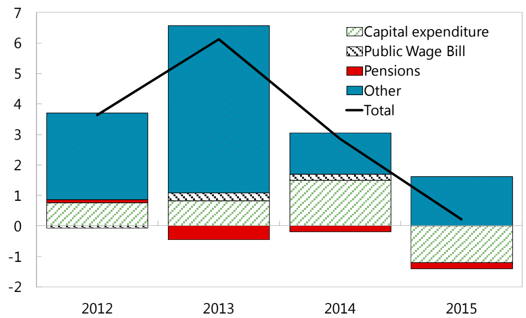
5. External imbalances have narrowed. The current account deficit decreased by about 3 percentage points of GDP in the first three quarters 2015, due to an improved service balance from robust tourism that more than offset a deterioration in the merchandise trade deficit (associated with machinery imports for the highway construction and deteriorating terms of trade). FDI flows have also been robust, at 19½ percent of GDP year to date—almost double that 2014. Official data on external stocks are not available for recent years; staff estimates that external debt will have decreased modestly to 152 percent of GDP by the end of 2015.

6. Revenue gains have slowed, and expenditures continue to stress the public finances (Figure 3)**.** Sizable revenue overperformance in 2014 was matched by equally sizable expenditure overruns of 3 percent of GDP. Implementation of the 2015 budget has also slipped: non-highway expenditure overruns are estimated at 1½ percent of GDP, compounded by modest revenue underperformance.[2] Unanticipated expenditures (e.g., from activated guarantees and arrears that include unanticipated legal rulings against the government) are a persistent problem.[3]

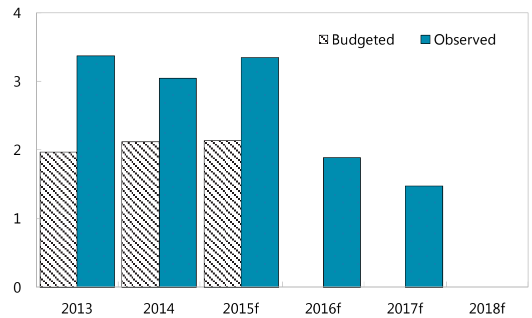
[1] Excluding receivables (which include deposits with other banks) average total loan growth is estimated at about 1 percent.

[2] Notable contributions to the loosening of spending in 2015 came from unfreezing pensions, reducing the emergency consolidation tax rate, and new subsidies for strategic sectors, all of which are set to continue in 2016.

[3] Highway construction delays imply under-spending of planned highway expenditures of around 1 percent of GDP in 2015; this will add to spending over in the following years.

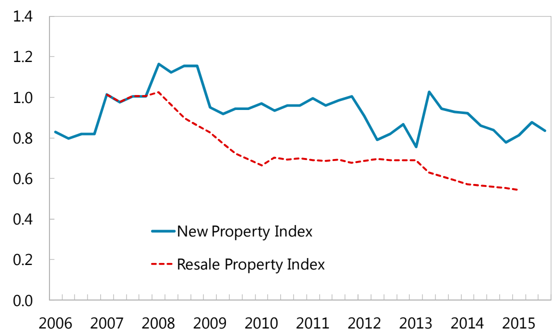


Sources: Montenegrin authorities and staff calculations



Sources: Montengrin authorities and staff calculations

7. The downturn in Russia and the refugee crisis in Europe have had limited impacts. Russia is a major consumer of tourism and purchaser of real estate. Property prices have continued to fall from their crisis peaks, in part because Russian buying has fallen. But foreign visitor stays, including from Russia, have increased by 15½ percent in the year to date; the authorities believe tourists have chosen Montenegro over more volatile destinations. The country has not faced significant numbers of refugees, mainly because geography makes transit more difficult than through other Western Balkan countries.



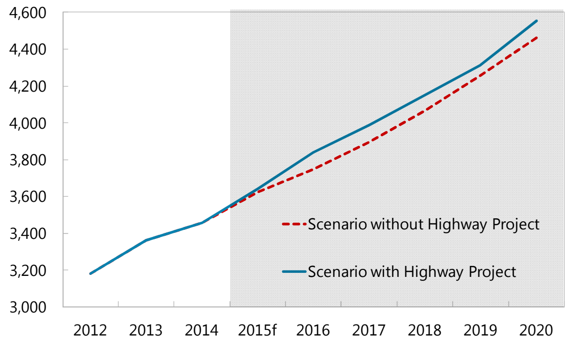
Sources: CBM,MONSTAT and Staff calculations

OUTLOOK AND RISKS

8. The government has adopted a major growth initiative to boost economic development and connectivity. This follows a consensus reached between Western Balkan and European leaders in Berlin in 2014 and is viewed by the authorities as a vital complement to Montenegro's EU accession plans. The authorities want to exploit comparative advantages in tourism, increase strategic transport linkages, and build capacity as a regional energy hub. The highway is but the first of a series of large infrastructure projects to be completed over the next 15 years.

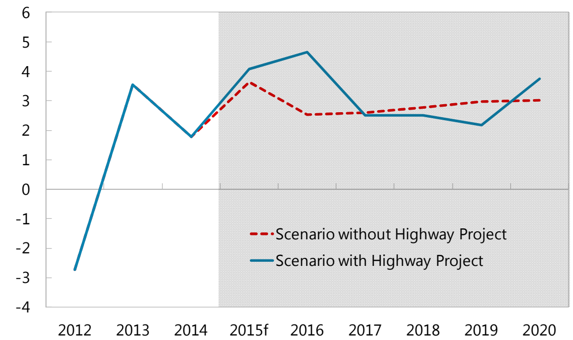
9. Growth is expected to increase, but so too is public and external debt. Staff projects growth of 4.1 percent in 2015, accelerating further in 2016 as highway expenditure increases.

Gross Domestic Product
(in euro millions)



Sources: MONSTAT and Staff projections.

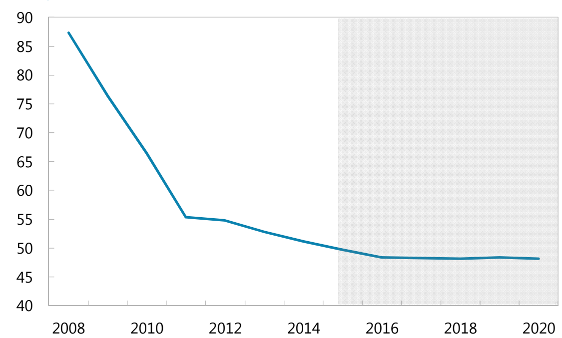
Real GDP Growth
(in percent)



Sources: MONSTAT and Staff projections.

- Tourism and capital-intensive projects will continue to be the main drivers of growth. The highway is assumed to have direct and indirect effects on demand and, when completed, on the level of potential output (Appendix 1).

Ratio of Private Credit to GDP
(in percent)



Sources: Staff estimates

- In the baseline, credit conditions are expected to gradually ease as these projects boost aggregate demand in the rest of the economy, improving bank profitability and allowing more lending to be extended as bank balance sheets strengthen. Credit is therefore expected to increase in line with aggregate demand.

- Low import prices due to recent falls in commodity prices and high unemployment will likely restrain price pressures and help prevent external competitiveness from deteriorating.

- Gross general government debt is expected to increase substantially, from 66 percent of GDP currently to a peak of 80 percent in 2018 (Annex I). As the baseline only includes spending on the first stage of the Bar-Boljare highway and no other major infrastructure projects, debt falls thereafter.[4] Additional projects would affect growth and potentially debt, depending on financing.[5] Funding needs average 12 percent of GDP from 2016 to 2020.[6]

[4] The first stage of the highway is the only infrastructure project that can be costed at the time of writing. Other yet-to-be quantified projects (such as the mooted Trans-Adriatic highway and the second thermal plant at Plevlja) are not included in the projections.

[5] All references to public debt henceforth refer to gross general government debt.

[6] This refers to total funding needs, not unidentified funding needs, and includes highway financing. Without the highway loan, average needs are [9] percent of GDP.

- The current account deficit is expected to average 18 percent of GDP over that period, because of the heavy import content of infrastructure projects and low private saving rates. Hence, external debt is also expected to increase, from its estimated current level of 152 percent of GDP to above 160 percent over the medium term (Annex II).

10. Growth is subject to external and domestic risks (RAM p.32).

- *External risks* are largely to the downside: large public financing needs and reliance on foreign capital expose the country to changes in financial conditions, especially over the next three years as debt escalates. Montenegro is also vulnerable to fluctuations in external demand, especially to tourism, which is substantially dependent on incomes in Russia, Serbia, and the euro area.

- *Domestic risks:* The growth outlook is very sensitive to the implementation of large investment projects. On the downside, delays in their implementation—as seen recently—would undermine growth. However, more investment projects—such as new public infrastructure projects—would boost growth. Such projects could add further pressure on public finances. If sovereign risk premia were to increase; the credit recovery and private investment could be crowded out. Failure to clean banks' balance sheets could also constrain a recovery in credit. Alternatively, a recovery in lending could be associated with an increase in concentration risks, to the extent that banks extend credit to a limited number of credit-worthy clients. Fiscal discipline could wane in the run-up to elections, and public guarantees could severely stress public finances if called.

POLICY DISCUSSIONS

11. Policy discussions focused on risks. Montenegro has substantial infrastructure needs, and public investment could substantially boost growth. However, the authorities' growth agenda comes with risks. Discussions focused on ways to: (i) contain fiscal sustainability risks, (ii) sustainably revitalize credit conditions, (iii) safeguard financial sector stability, and (iv) boost competitiveness and economic flexibility.

A. Fiscal Policies

12. The authorities have taken some steps to contain underlying fiscal pressures. They expressed their commitment to managing debt vulnerabilities in the period ahead. Some notable initiatives include:

- New fiscal rules have converged toward Maastricht criteria, and the authorities' Economic Reform Program (ERP) acknowledges the need to stem the acceleration in public debt.

- Pension reforms adopted in 2011 have increased the average starting age for receiving pensions and decreased the volume of disability pensions.

- The government has fully divested from the aluminum plant KAP. Government guarantees are currently mostly directed to infrastructure and SMEs, although the pace of their recent increase (by two thirds, to 14 percent of GDP) raises concerns that they might be misdirected.

- The authorities intend to improve local government finances, citing room to reduce overstaffing.

13. The 2016 budget shows improving fiscal balances over the medium term. Revenues are expected to increase, although more slowly than nominal GDP. Nominal expenditures will increase substantially from 2016 onwards: new pension provisions and social allowances for mothers with three or more children will add approximately 1¼ percent of GDP in spending; a recently-adopted bill increases public wages by 5–15 percent in 2016; and legislation to tackle the grey economy is still pending. Expenditure levels are assumed to be nearly constant from 2016 onwards across most items. Precise policies to restrain expenditures over the medium term—including on public wages and pensions—are not identified.

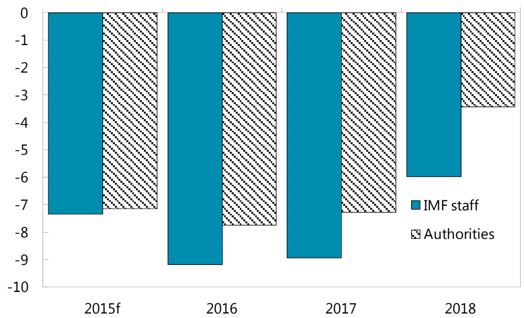
14. Taking into account likely budget pressures, staff projects a substantial deterioration in the public finances.

- Notwithstanding the steps taken to contain fiscal pressures (¶11), the budget will be stressed by expenditure pressures (¶12), and the reduction in the crisis tax rate will further erode the revenue base. Staff expects the general government deficit to increase to 7½ percent of GDP in 2015 and to increase further in the medium term with increased highway spending.

- With substantial refinancing needs, staff projects public debt to reach 80 percent of GDP within three years. Staff's projected deficits and debt are larger than those of the authorities, reflecting slightly weaker average growth and higher nominal deficits.

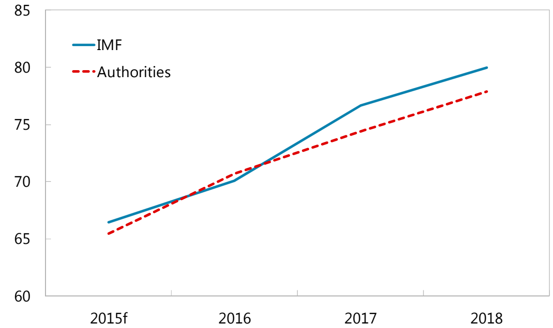
- The depreciation of the euro since the signing of the contract has sharply increased the cost of the project. Over the medium term, the euro is expected to appreciate slightly, somewhat offsetting these cost increases, but interest expenditures are assumed to revert to previous levels.

Fiscal Balance Projections
(in percent of GDP)



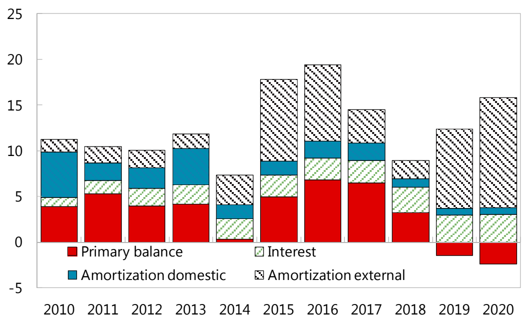
Sources: Montenegrin authorities and staff calculations

Public Debt Projections
(in percent of GDP)



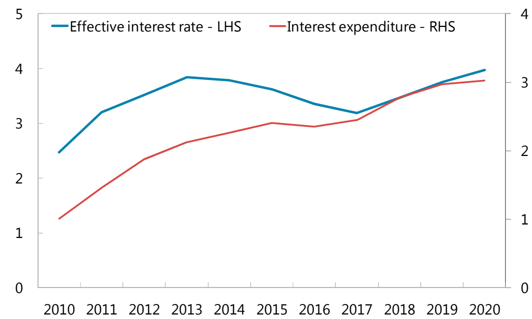
Sources: Montenegrin authorities and staff calculations

Funding needs
2010-2020, in percent of GDP



Sources: Montenegrin authorities and staff calculations

Effective interest rate, Interest expenditure
(in percent, in percent of GDP)



Sources: Montenegrin authorities and staff calculations

15. Infrastructure projects could substantially affect fiscal developments. Growth projections are highly sensitive to the profile of highway spending, given the scale of the expenditures.[7] The authorities intend to raise the remaining 15 percent of the cost of the highway from a combination of offsetting spending cuts, concessions, and tolls. The 2015 eurobond issue was substantially oversubscribed; nonetheless, if new debt financing is needed for the rest of the highway or new projects, then pressure could be placed on sovereign interest rates.[8]

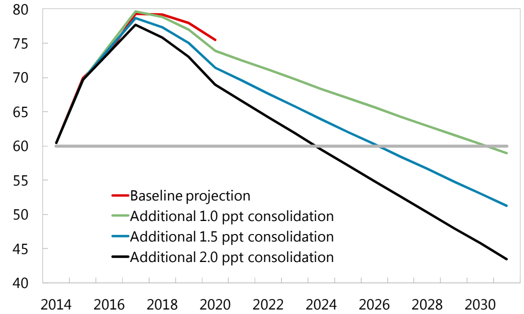
16. To limit risks and maintain favorable conditions for funding, staff recommends additional consolidation. In addition to containing fiscal risks, fiscal consolidation is also important for improving the country's external debt position, especially as the economy lacks independent monetary policy. To illustrate the scale of consolidation that would be needed, staff calculates that new measures from 2016 delivering an extra 1½ percentage point of GDP (with respect to staff's baseline path) and a 1½ percentage point primary surplus sustained after the

[7] Highway spending (adjusted for pre-payments) is projected to be EUR 40, 240, 240, 224, and 65 million from 2015 to 2019.

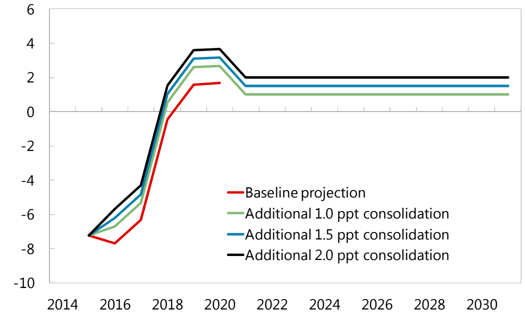
[8] Operating risks could be mitigated by financing via Public-Private Partnerships (PPP), but only if contracts ensure the private sector bears financing, construction and demand risks. Note that debt incurred from a PPP would stay on the public balance sheet to the extent that the government gains the rewards from the asset (in terms of GFSM 2014: if the contract is an "operating lease" instead of a "financial lease").

completion of the highway would bring debt back to 60 percent of GDP by 2026 (the blue lines in the figures below).[9]

Alternative Fiscal Scenarios 2016-2031
(Public debt, percent of GDP)



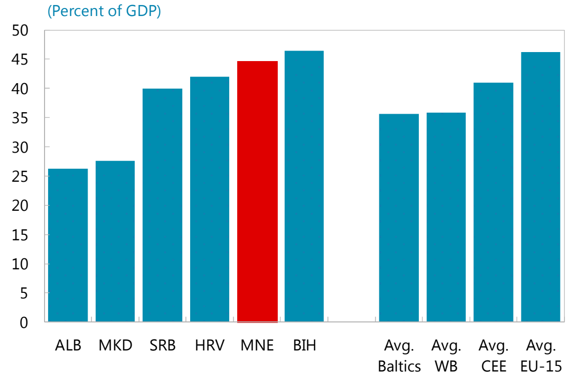
Alternative Fiscal Scenarios 2016-2031
(Primary balance, percent of GDP)



Sources: Montenegrin authorities and Staff estimates

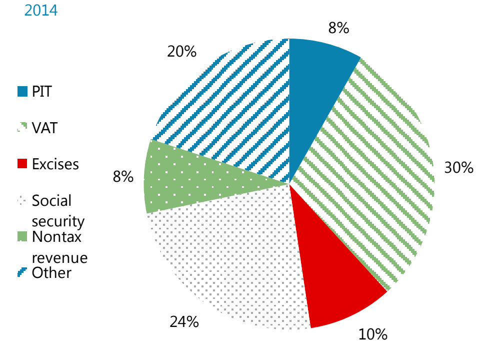
17. Achieving such a consolidation would require addressing weaknesses in social expenditures, public sector wages, and the tax system. With government spending approaching 50 percent of GDP, durable expenditure control is essential, particularly over public sector wages and pensions, which together account for more than half of total spending (Figure 4). Revenue shares are already high, suggesting limits from increasing taxes, but options exist to boost revenues without creating a drag on growth.

Revenue, 2014
(Percent of GDP)



Sources: World Economic Outlook; and IMF staff calculations.

Composition of revenue
2014



Sources: Montenegrin authorities and staff calculations

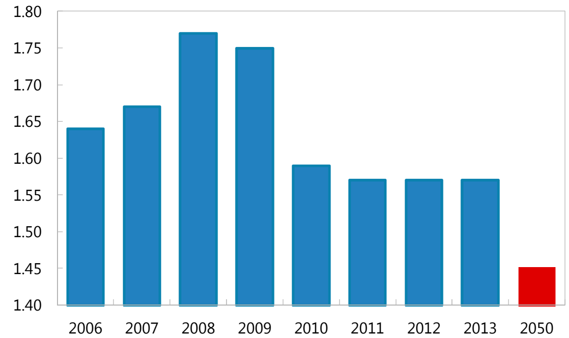
- *Pensions and Social Expenditures:* The pension system is unsustainable on current demographic and labor market trends. Reintroducing a pension freeze would help in the short run, but achieving sustainability will require some combination of accelerating increases in the average retirement age, reducing payments, or increasing contributions (Box 2). New pension and social protection provisions have been passed into law, which worsen the structural deficit; the laws should be revoked.

[9] Montenegro has a fiscal rule that notionally adopts the Maastricht criteria of 3 percent deficit and 60 percent gross general government debt. However, there are no automatic spending caps, and no deadlines for implementing fiscal measures.

Box 2. Pension System Viability

The pension funding gap is large—around 4 percent of GDP—and dominates Montenegro's structural fiscal deficit. The pension system is stretched by high levels of early retirement and low labor participation rates and levels of formal employment.[1] Pressures will increase as population aging depresses an already low dependency ratio to around 1.4 by 2050.[2]

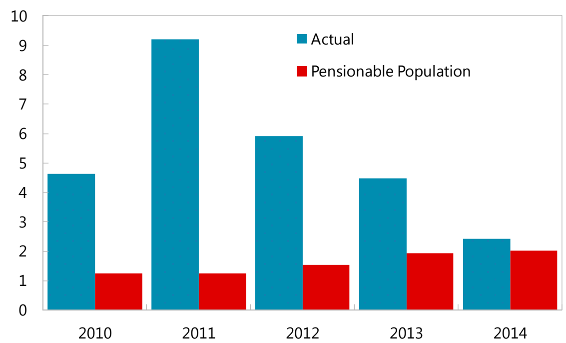
Dependency Ratio
(number of employed vs. number of retirees)



Sources: MONSTAT, PIO, and Staff calculations.

Reforms to improve sustainability have been undermined. A 2011 law phases in a higher retirement age to 67 for both men and women (from 65 and 60, respectively), to be fully enforced by 2024 for men and 2041 for women. More rigorous assessment procedures have been applied to disability benefits. However, early retirement has often been allowed for selected groups, undermining these efforts.[3] Indeed, the growth of old-age pensioners from 2010 to 2014 was more than three times what would have been expected based on demographic trends alone.

Old Age Pensioners vs. Eligible Population
(Growth in percent)



Sources: MONSTAT, PIO, and Staff calculations.

Raising the average retirement age is the most efficient policy response. Stabilizing pension spending will require some combination of increasing the average retirement age; increasing payroll taxes; and/or decreasing benefits. The most growth-friendly option would be to raise the average retirement age, which could be facilitated by accelerating the phase-in of higher retirement ages or preventing early retirements. However, progress to raise the retirement age would be slow, as many early retirees are already in the system. In the interim, a pension indexation freeze—to be lifted when a broader pension reform strategy is implemented—should be introduced to contain fiscal pressures.

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[1] Currently, the de facto average retirement age is only 61 years for men and 59 years for women.

[2] This is based on the authorities' demographic projections and assumes employment grows at the average rate prevailing in the post crisis period (2008:Q3–2015:Q2).

[3] For example, the recent pension law grants early retirement to employees of bankrupted state-owned enterprises.

- *Public sector wage bill:* The public wage bill is high even compared with regional peers. Staff recommends freezing public wages in the short run, formalizing a 3–1 attrition rule that has intermittently been in place, and reducing numbers of local government employees.

- *Taxes:* Regional competition to attract investment limits the scope to raise corporate income taxes, while keeping personal rates low assists the authorities' efforts to raise participation from very low levels and combat informality. Nonetheless, there are alternatives: small increases in tourist taxes and VAT could bring immediate revenue gains, and tax exemptions for "strategic" sectors should be revoked.[10] Recent decreases in the crisis tax rate could be partially reversed without significant damage to the labor market. The tax base could be broadened by addressing substantial deficiencies in tax administration, such as taxpayer registration, filing and payment enforcement, tax debt management, and taxpayer appeals.

18. Consolidation objectives could be immediately met with a combination of expenditure and revenue measures. Table 1 shows a number of feasible options to meet and even exceed consolidation of 1½ percentage points of GDP. To achieve immediate savings, some revenue measures would be needed, but targeting expenditures—particularly the public sector wage bill and social security expenditures—would be crucial to ensure a durable consolidation.

- Small value added, tourism, and property tax increases could yield immediate gains of about ½ percent of GDP.[11] Restoring the crisis tax rate from 11 percent to its original level of 13 percent—still less than the recent rate of 15 percent—would yield gains of about ⅓ of a percentage point.

- Pension reform, although essential for long-run solvency, would likely have very modest effects over the projection period. But repealing the new social provisions in the 2016 budget would bring substantial savings. Immediate gains could also be achieved through freezes on public sector wages and pensions; these, with the addition of cuts to transfers to public corporations, could deliver fiscal savings of about 1¼ percent of GDP over the medium term.[12]

[10] The authorities are supporting their growth strategy with a wide range of giveaways on taxes on and social security contributions from "strategic" sectors. This raises concerns about fairness, in addition to those about the direct fiscal costs and creeping subsidization of private business.

[11] Raising VAT to a uniform rate of 19 percent could notionally yield gains of 1½ percent of GDP.

[12] Subsidies are significant, but are mostly directed at ensuring EU compliance, so are not assumed to be cut.

Scope for additional fiscal consolidation
(percent of staff baseline projection GDP)

	2016	2017	2018	2019	2020
Taxes	0.9	0.9	0.9	0.9	0.9
Improved collection VAT	0.3	0.3	0.3	0.3	0.3
Property tax increase	0.1	0.1	0.1	0.1	0.1
Tourism tax increase	0.2	0.2	0.2	0.2	0.2
Reinstating PIT crisis rate to 13%	0.3	0.3	0.3	0.3	0.3
	0.9	0.9	0.9	0.9	0.9
Wage freeze (2016)	(0.5)	(0.5)	(0.5)	(0.5)	(0.4)
Social security transfers	(0.9)	(0.9)	(0.9)	(0.8)	(0.8)
Pension freeze (2016 & 2017)	(0.2)	(0.2)	(0.2)	(0.2)	(0.2)
Repealing social laws 1/	(0.7)	(0.7)	(0.7)	(0.6)	(0.6)
Reducing other transfers 2 /	(0.3)	(0.3)	(0.3)	(0.3)	(0.3)
Budgeting for one-off payments 3/	0.2	0.4	0.4	0.5	0.4
	(1.5)	(1.3)	(1.3)	(1.1)	(1.1)
Primary balance	2.4	2.2	2.2	2.0	2.0

1/ New pension provisions and social allowances for mothers with three or more children
2/ Incl. transfers to public corporations
3/ Arrears, guarantees

19. New measures should be spelt out in detail in annual medium-term fiscal plans.

- Such plans should reflect the most likely fiscal revenue and expenditure outcomes of policy measures; anticipate their direct, indirect and hidden costs; and articulate contingency plans to deal with unanticipated shocks. Furthermore, to bolster fiscal credibility and maintain access to funding on the most favorable terms, they should specify how public debt is to be restored below 60 percent, in line with the fiscal rule.

- In support of these plans, fiscal transparency and oversight would be strengthened by establishing an independent fiscal council, developing effective fiscal risk management, introducing program/performance budgeting, and moving to accrual accounting and associated reporting.

Authorities' views

20. The authorities acknowledged risks to the public finances and believe them to be manageable.

- The budget foresees expenditures remaining nearly constant in nominal terms after 2016; discussions focused on the potential for more specific plans to support the budget. The authorities clarified that they expect current expenditure to be kept below current revenue, per the fiscal rules adopted in the budget Law.

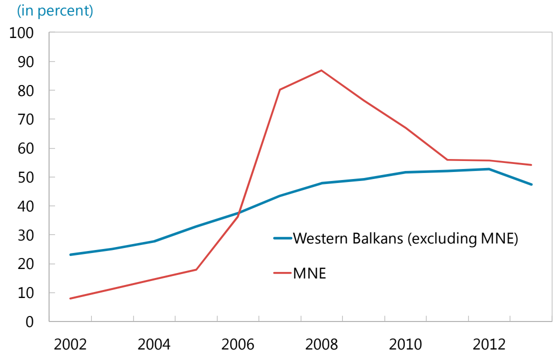
- Staff and authorities discussed key assumptions behind fiscal projections. In addition to different views about prospects for expenditures, the authorities expect growth to average around 4 percent per annum over the medium-term, higher than in staff's projections, and bringing higher revenues than in previous years.

- The authorities presented their views on debt management. Based on market demand seen earlier in the year, they expect continued strong demand for Eurobond issuances, albeit with higher yields over the medium term. However, they would not rely exclusively on raising new debt; in particular, concessions and toll revenues could generate revenues for infrastructure projects and debt repayments.

B. Credit Policies

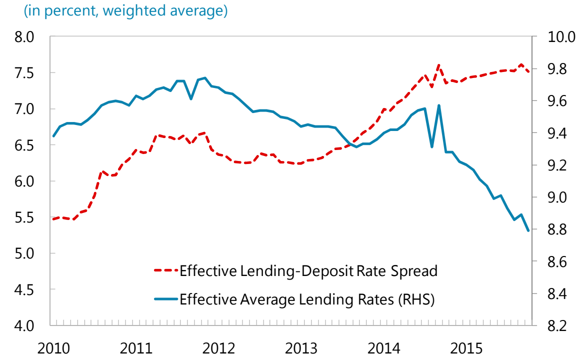
21. The collapse of the lending boom resulted in a long period of deleveraging (see Analysis of Macrofinancial Linkages, Appendix II). Only now does the level of credit appear to be in line with those seen in Western Balkan peers, and the level of private sector indebtedness remains elevated, potentially inhibiting credit demand (Appendix II, section C). In more recent years, banks have sought to restore profitability by raising spreads of lending rates over deposits; hence, lending rates have remained elevated even as deposit rates have fallen. More recently, interest rates have started to fall, but credit growth remains subdued.

Ratio of Private Credit to GDP
(in percent)



Sources: IFS, WEO and Staff calculations.

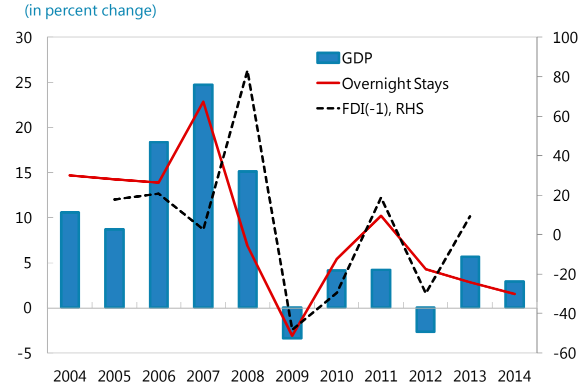
Bank Lending Rates and Interest Margins
(in percent, weighted average)



Sources: CBCG and staff calculations

22. Staff analysis shows that output and credit growth are highly correlated, and the effects of credit shocks on growth are higher than for other Western Balkan and emerging European peers (Appendix II, section D). That said, output growth is largely driven by fluctuations in tourism and foreign direct investment that "bypass" domestic credit conditions. Hence, tight credit has not prevented the recent recovery, but growth could have been stronger if credit conditions were easier.

Nominal GDP, Tourism, and FDI Developments
(in percent change)



23. The authorities regard easing credit conditions further as crucial for growth. They are concerned with persistently high levels of NPLs and average lending rates, which they regard as evidence of market failure. Evidence for excessive rates is mixed. Average lending rates and margins are not out of line with the region. Across individual banks, the four largest banks account for ¾ of the loan market, and some have higher margins than average, suggesting some market power. But in terms of actual credit conditions, lending rates from larger banks tend to be lower, reflecting relatively lower funding costs and scale efficiencies (Figure 5).

24. Policies to boost credit may have unintended negative consequences. The authorities have adopted a voluntary debt resolution framework and drafted a law that caps interest rates on new loans at no more than 33 percent above the six-month weighted average lending rate. They are of the view that encouraging new banks to enter the market would boost competition.[13]

- Many countries have employed interest rate caps, mostly against exploitative rates on unsecured consumer loans. When used as a device to stimulate credit, the effect has often been to reduce formal lending and drive riskier borrowers to unregulated lenders.[14] Concerns over excessive or usurious interest rates call for consumer protection measures rather than general lending rate restrictions.[15]

- Increased bank competition could per se reduce lending margins, but might also induce banks to lend imprudently to preserve or gain market share. With these financial stability concerns in mind, the supervisor should continue to pay rigorous attention to banks' business plans, capital levels, and lending concentration risks.

- The voluntary restructuring law could usefully spur restructuring, but it only applies to a small subset of debtors, which might slow reorganization plans that need to involve all claims. Complementary measures—such as fast-track provisions—could boost the effectiveness of the law.

[13] There are currently 14 banks operating in Montenegro, up from 11 in 2013, for a population of 625,000. A 15th bank license application is under review. Some new banks are entering the market to provide local banking services for firms from the parent's economy making large direct investments; others see long-term returns as the economy expands and are seeking to establish brand presence. The larger incumbent banks show little appetite to take over smaller banks, indicating that any consolidation of the banking sector will be slow.

[14] See "Interest Rate Caps Around the World", World Bank Policy Research Paper 7070.

[15] A centralized reporting system of bank-specific lending rates on the central bank's website could increase transparency and foster competition, as was successfully done in Ecuador.

25. New consumer bankruptcy legislation could impede credit supply and should be amended or repealed. A new law has been passed to increase protection for borrowers. However, the law is now delayed due to the lack of supporting institutional and regulatory infrastructure. Staff is concerned that, if implemented in its current form, the law could undermine the rights of secured creditors, including with regard to enforcement on a bankrupt debtor's house, creating moral hazard and significantly deterring new secured lending (Appendix III).

26. Sustainably reducing lending rates will require reducing lending risks. Staff encourages further progress to reduce lending risk premia that arise from difficulties in assessing the credit-worthiness of potential borrowers and recovering collateral. An encouraging example is the introduction of Public Enforcement Officers (PEOs), who focus only on enforcing court decisions; this has been associated with a significant reduction in enforcement times and is widely regarded by lenders as a significant step to reducing lending risk premia.[16] Lenders indicate that reducing the frequency of changes to laws affecting lending and more consistent and predictable enforcement of existing laws would reduce lending risk premia still further.

Authorities' views

27. The authorities recognized the potential risks from measures to boost credit growth but indicated that all options to improve lending conditions should remain "on the table". Discussions covered factors affecting lending:

- The authorities acknowledged that the voluntary restructuring law applies to a narrow range of impaired loans, but believe the current laws provide room for restructuring of packages of loans. They pointed to a steady reduction in the level of NPLs.
- Staff expressed concerns that interest rate ceilings could further restrict bank lending to small businesses. The authorities consider interest rate caps to have a potentially useful role to play, citing increased lending and declining rates when caps were previously imposed in 2012. Officials emphasized that the draft law is intended to address usurious lending rates.
- The supervisor clarified that the approval of bank licenses depends on meeting licensing conditions. Nonetheless, the authorities recognized staff's concerns about focusing purely on compliance and the potential for new entrants to under-price risks, and judged there to be scope to give greater weight to financial stability considerations when considering applications for new licenses.

[16] In the first nine months of public enforcement officer (PEO) operations, 20381 cases were closed out of 60561 total active cases; 15 percent of EUR 231 million total claims (6½ percent of 2014 GDP) were collected.

- The authorities agreed that legal ambiguities in the new consumer bankruptcy legislation and a lack of enabling regulations are problematic and should be corrected.

- The authorities also agreed that structural factors could affect lending premia. They cited progress in reducing risks, such as procedures that cut down the time taken to enforce court orders and secure collateral.

28. Montenegro is taking steps to enhance its AML/CFT framework but deficiencies exist. The revised AML/CFT law significantly strengthens customer due diligence obligations, and practical steps have been taken to improve the reporting of suspicious transactions. However, reporting requirements are narrowly focused on "transactions," rather than "funds." Adequate and timely information on the beneficial ownership of legal persons is lacking. Due diligence measures should be further enhanced to require reporting entities to establish sources of wealth of beneficial owners on a risk basis. The lack of provisions prohibiting criminals or their associates from holding a significant or controlling interest in certain non-bank financial sector institutions and their functions is problematic.[17]

C. Financial Sector Stability

29. Financial sector vulnerabilities appear low overall, but with exceptions. The mission reviewed key findings of the Financial Sector Assessment Program (FSAP) that was conducted alongside the Article IV consultations. The FSAP assessed system-wide solvency and liquidity indicators as broadly sound. Vulnerabilities relate mainly to high levels of NPLs and/or low provisioning levels. Some banks—mainly domestic—are weakly capitalized and vulnerable to shocks, such as an economic slowdown (see FSSA). Increased bank competition is compressing profitability, with the risk that some banks could lend imprudently to gain market share. Emergency liquidity assistance (ELA) capacity is limited (Annex III).

30. Low provisioning and weak banks are key concerns (Figure 6). Low IFRS-based provisions by some banks suggest overly-positive collateral valuations, and some bank audits have been qualified. Domestic supervisors lack a formal framework that would equip them with the tools to challenge collateral valuations of banks. An Asset Quality Review (AQR) of all banks by independent internationally recognized auditors is recommended to review loan classification and provisioning practices. In the interim, time-bound supervisory action plans (including capital injection by shareholders) should be developed for "at risk" banks. Work on resolution plans—with the objectives of maintaining financial system stability, protecting insured depositors, and minimizing cost to taxpayers—should continue.

31. Although the legal, regulatory, and supervisory frameworks for banking are robust in many respects, there is scope to achieve more effective supervision. This includes improving the identification, measurement, and management of nonperforming assets and

[17] Investment management companies, pension fund management companies, or stock brokers.

liquidity risk. Banks' ability to reclassify problem assets on the basis of the type of collateral is problematic and greater clarity and consistency in the prudential categorization of restructured loans is needed. Priorities for strengthened supervision also include reducing operational, funding, and credit risks,[18] and strengthening banks' governance frameworks for risk management.

32. Euroization presents challenges for safeguarding financial stability.

- Montenegro has unilaterally adopted the euro as currency and unit of account. It is outside of the euro system, and the central bank cannot independently create liquidity on its own. This significantly constrains the ability to provide lender-of-last resort funding in cases of emergency. As it stands, the banking system currently appears capable of handling modest liquidity pressures. But liquidity conditions can deteriorate quickly, and liquidity support from parent banks—another potential liquidity buffer—cannot be counted on in times of crisis (Appendix V).

- Options to bolster ELA capabilities include a dedicated sub-account set up by the finance ministry for use by the central bank, together with objective and quantifiable criteria for public funding in a crisis situation.[19]

33. The EU accession process offers an opportunity to develop a macroprudential policy framework. Macroprudential policies are important given the lack of other monetary policy instruments; currently, reserve requirements are the only actively-used instrument and are of limited effectiveness. Convergence to the EU and European Systemic Risk Board's policies in advance of EU accession is advisable. Staff recommends that the macro-prudential framework be broadened and made fully operational. The potential toolkit should include powers over loan-to-value, debt-service-to-income, and debt-to-income ratios; sectoral capital requirements; and capital buffers. Lending concentration limits should be carefully monitored.

Authorities' views

34. The authorities broadly agreed with the main weaknesses identified by the FSAP and endorsed many key recommendations. They clarified:

- All banks are subject to annual on-site inspections; however, the authorities intend to proceed with an independent AQR of banks and take appropriate actions as needed. Supervisors closely monitor banks' classifications of loans, with a particular emphasis on the borrowers' capacity to repay, and limit the extent to which collateral assessments can be used to improve loan classifications.

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[18] Including sector concentration and concentration through collateral.

[19] Alternatives such as bank fees and pooled liquidity would likely add to costs and be passed on to lending rates (see FSSA and Appendix V). Further analysis is needed to determine the appropriate size of the sub account.

- The central bank agrees that a broader supervisory framework is needed to monitor and address NPLs. It has drafted a law to extend its supervisory remit to factoring, leasing, and credit and guarantee operations.

- The authorities regard euroization as a vital anchor for price and economic stability. The authorities intend to align the central bank law with EU regulations by end 2016 that, because of EU state aid rules, would preclude boosting ELA reserves through an MOF sub account and prevent direct liquidity assistance from the authorities to banks.

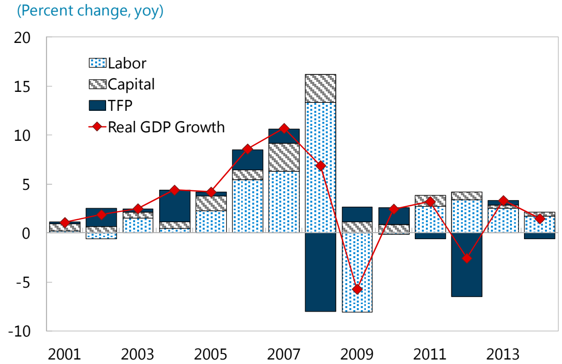
- The authorities saw merit in clarifying and establishing new macroprudential tools in advance of EU accession.

D. Structural Reforms

35. Productivity, flexibility, and competitiveness are persistent concerns. Sustaining Montenegro's large public and external debt burdens requires durable growth and high competitiveness; coping with external shocks, given lack of fiscal and monetary policy space, requires the real economy to be flexible. However:

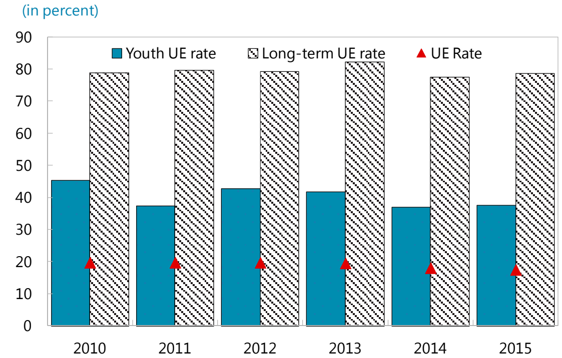
- TFP growth has been weak and Montenegro has relied on labor intensity to achieve growth. However, a declining population and low employment and labor participation constrain potential output.

Growth Accounting
(Percent change, yoy)



Sources: MONSTAT and staff calculations.

Measures of Unemployment (UE)
(in percent)



Sources: Monstat and Staff calculations

- Rigid wage outcomes, persistently high levels of long-term and youth unemployment, and a substantial informal sector suggest that the labor market is not operating efficiently.[20] A high public sector wage bill suggests that public sector jobs are an

[20] The authorities estimate the informal economy to account for 10–20 percent of GDP and employ one third of workers.

attractive alternative to private sector employment. The government funds hiring schemes, but low retention of subsidized workers indicates skills mismatches.[21]

- Labor costs are high relative to Western Balkan and particularly New Member State peers. An estimated current account imbalance of 7–8 percentage points of GDP could imply a real exchange rate imbalance of around 15–25 percent (Appendix VI).

36. Progress on structural challenges has been mixed.

- *Labor markets:* The authorities are in the process of aligning labor laws with those in the EU, which should increase flexibility. The consolidation of the provision of social benefits under the single "social card" could reduce fraud and informality, in addition to lowering costs. Recent collective agreements have reduced severance costs, but non-wage costs—including slow dismissal procedures—remain high; the recent hike in employer social contributions exacerbates this problem.

- *Business environment:* Steady gains have been made to bolster the investment climate (Figure 7). Montenegro's *Doing Business* rankings are comparable with regional peers, but indicate particular shortcomings in tax compliance, starting businesses, registering property, and resolving insolvency.

- *Competitiveness:* Montenegro's export share to the euro area has steadily declined despite euroization. Non price factors, such as relatively high administrative costs and inefficient transportation infrastructure, are likely key contributing factors (Figure 8 and accompanying Selected Issues paper). The authorities are seeking to promote competitiveness and diversification through sector specific incentive schemes (such as tax exemptions), but these are difficult to dismantle and can result in a misallocation of capital. Targeted policies can also have unintended consequences for competition, such as recent labor legislation that substantially restricts the hiring of non-residents and increases costs to the tourism sector.

37. Reforms should continue on improving the underlying conditions for growth.

- Despite recent euro depreciation, Montenegro appears relatively costly compared with its peers. More flexibility in wage outcomes should allow real wages to adjust in line with productivity. To the extent that private employers compete with the public sector, maintaining discipline over the public sector wage bill is important for economy-wide competitiveness. Disincentives for employment (such as onerous dismissal procedures) should be addressed. Subsidies for hiring university graduates could be usefully

[21] On average, only 25 percent of participants are offered permanent employment upon expiry of the nine-month internship program.

redirected toward retraining the long-term unemployed, increasing employment and reducing pressures for early retirement.

- Although steady progress has been made to improve the business and investment environment, certain areas remain bottlenecks. Policies efforts should prioritize: simplifying regulatory frameworks and reducing administrative costs; improving permit and property registration processes; and increasing the efficiency of the judicial system.

Authorities' views

38. The structural reform agenda is evolving. With respect to specific reform initiatives, the authorities explained:

- The new labor law (¶32) is intended to improve labor market flexibility, including by streamlining dismissal and redundancy procedures, but is not expected to be implemented before the end of 2017.
- Subsidized employment programs such as the university graduate internship scheme are important for bridging skills gaps and are yielding results. Vocational training programs for the secondary school graduates have also been launched.
- The consolidation of social welfare benefits will help limit abuse.
- Reforms endorsed in a 2013 action plan to improve and streamline the regulatory environment have been implemented, but there is scope for further improvement.
- The authorities reiterated their drive to boost growth and rural development. To complement the plans for infrastructure spending, they plan to increase financial support to SMEs and professional training, and streamline the business process.

STAFF APPRAISAL

39. Strong growth this year looks set to continue into the medium term. The economy has rebounded strongly. Growth momentum is expected to continue, driven by large capital-intensive projects, and the authorities are pursuing a major initiative to boost economic development and connectivity that will see a substantial acceleration of infrastructure projects.

40. The authorities' growth strategy can bring substantial gains, but also poses sizeable risks. Although infrastructure development is needed, the emphasis on large infrastructure projects carries substantial risks, notably to the public finances. Using fiscal and financial policies to boost growth incentives can also result in misallocated capital. And rapid investment-led growth can contribute to an under-pricing of risk that can undermine financial and fiscal stability.

41. New measures are needed to reduce public debt. Some recent measures raise questions about the ability to sustain fiscal discipline. Staff projects gross general government debt to increase substantially, peaking at around 80 percent of GDP over the next three to four years. Given Montenegro's increasing debt levels—both public and external—and its vulnerability to shocks, the relative inflexibility of the economy, and the lack of independent monetary policy, staff recommends immediate and durable fiscal consolidation measures. To the extent that further public infrastructure projects that are planned by the authorities are to be debt financed, additional offsetting measures would be required to limit risks to the public finances and maintain market access.

42. New fiscal measures should be complemented by strengthening the fiscal framework. Specific aspects would include medium-term fiscal plans, independent fiscal councils, and public financial management reform. Tax administration reforms could broaden the tax base and increase revenues.

43. Financial conditions will improve gradually, but some policies could hold back credit growth. After shrinking for a sustained period, credit to the private sector has increased, although not as fast as might be expected given high liquidity and the rebound in growth, reflecting persistent problems with nonperforming loans, weak accounting and reporting practices, and slow collateral execution. Some policies intended to protect borrowers could have unintended consequences: restrictions on lending rates in other countries have often been associated with reduced credit supply, increasing numbers of banks without sufficient regard to their health could threaten financial stability, and the new consumer bankruptcy legislation could significantly deter new secured lending.

44. The recent Financial Sector Assessment Program for Montenegro identifies a number of steps to mitigate risks to the financial system. These include an independent asset quality review of all banks, specific actions to deal with weaker banks, and enhancing bank resolution planning. Staff also recommends exploring options to bolster lender of last resort capability.

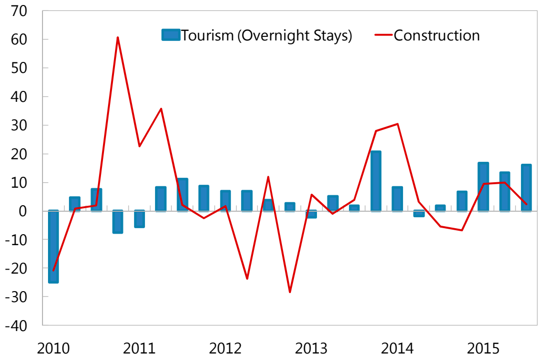
45. Improved labor productivity and economic flexibility are crucial to complement the authorities' investment-led growth strategy. Given the country's capacity to absorb shocks is limited by the currency regime and limited fiscal space, the authorities should build on current reform initiatives, such as improving the flexibility of labor market outcomes, reducing labor market informality, and continuing to improve the business climate (e.g., contract enforcement). Maintaining discipline over public sector wages is crucial to ensuring cost competitiveness.

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

Figure 1. Montenegro: Real Sector Developments

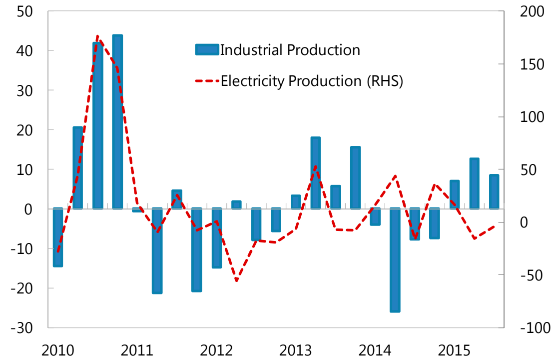
Tourism has been buoyant, boosting construction.

Indicators of Economic Activity
(in percent change, yoy)



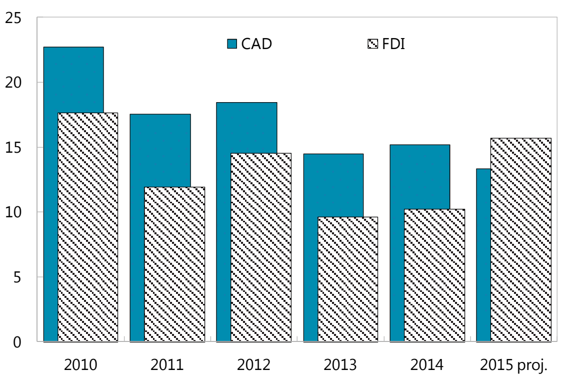
Industrial production is recovering, notwithstanding falling electricity output.

Industrial Production
(in percent change, yoy)



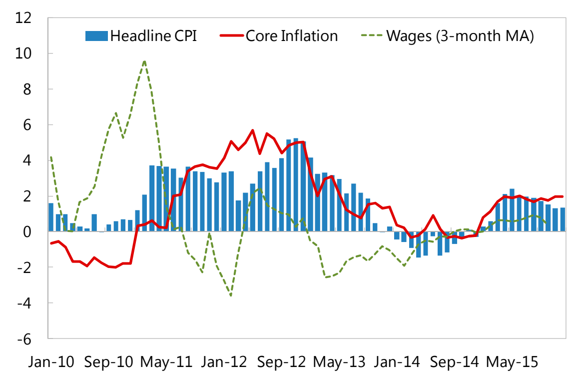
The current account deficit is below its crisis peak and largely covered by FDI, but is nonetheless high.

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



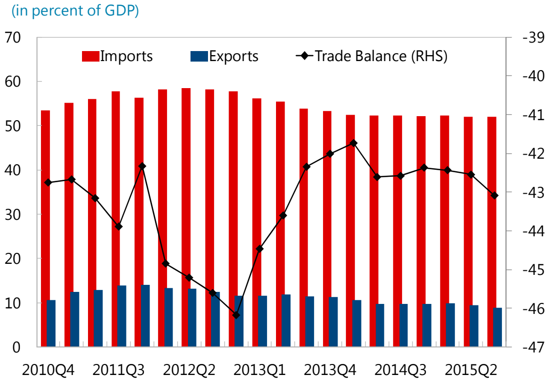
Inflation has returned, but price pressures should remain subdued given restrained wage growth.

Inflation and Wage Developments
(percent change, yoy)



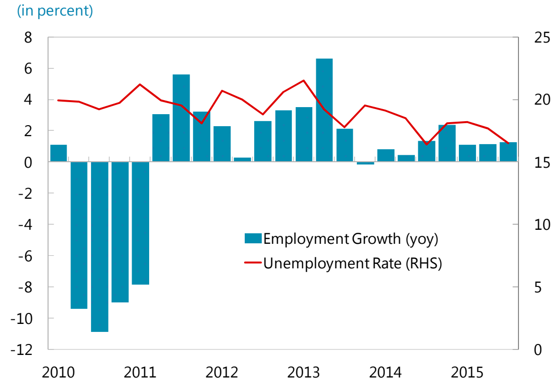
The trade deficit has improved, but remains large.

Merchandise Trade
(in percent of GDP)



Employment gains have improved, but unemployment remains high.

Labor Market Indicators
(in percent)

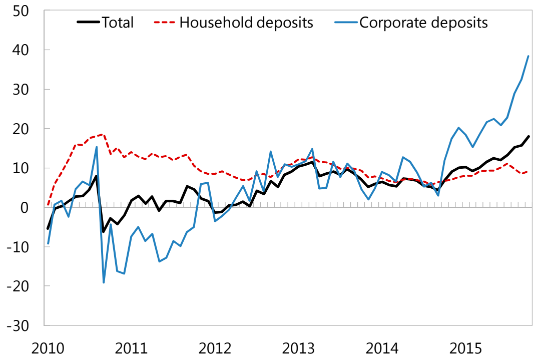


Sources: Central Bank of Montenegro (CBCG), Montenegro's Statistical Agency (MONSTAT), Haver and Staff calculations.

Figure 2. Montenegro: Financial Sector Developments

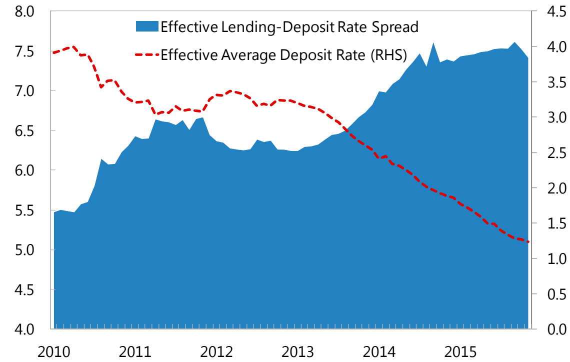
Deposits have recovered after the recession of 2011...

Bank Deposits
(in percent change, yoy)



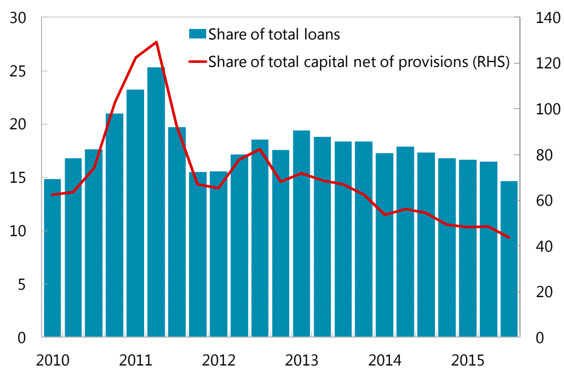
but lending spreads remain near historic high despite falling deposit returns.

Bank Lending-to-Deposit Rate Spread
(in percent)



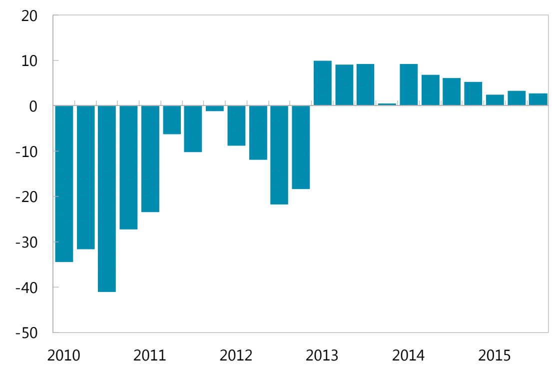
The stock of NPLs has been decreasing slowly due to weak economic conditions and inefficient debt resolution.

Non-Performing Loans
(in percent)



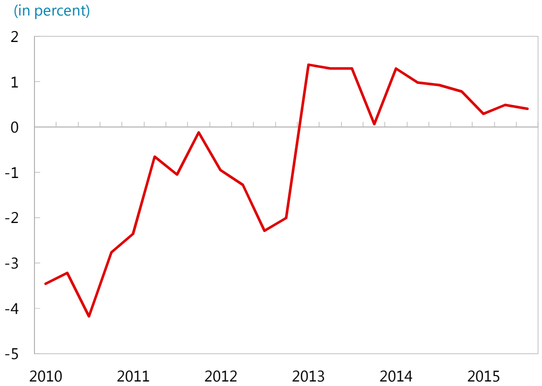
Profitability returned in 2013, but has retreated again...

Bank Net Profits
(in percent of capital, ROE)



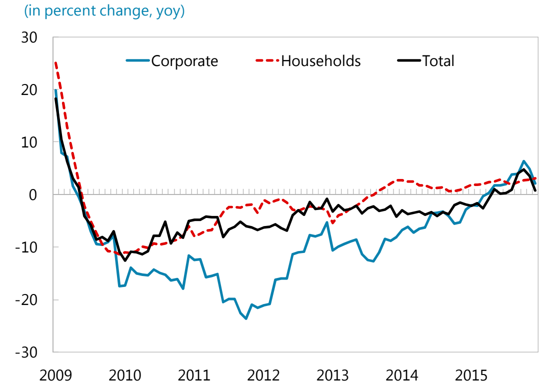
and returns on assets are still very low.

Bank Average Net Return on Assets
(in percent)



Credit conditions have only recently showed signs of recovery.

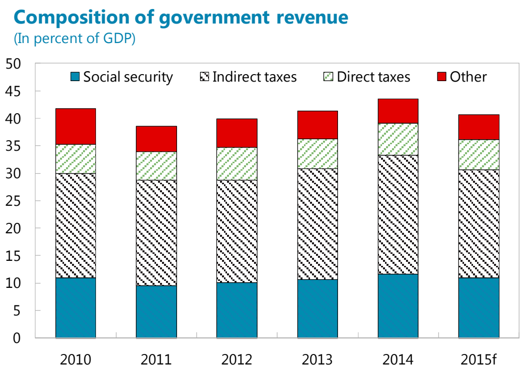
Bank Lending by Sector
(in percent change, yoy)



Sources: CBCG and Staff calculations.

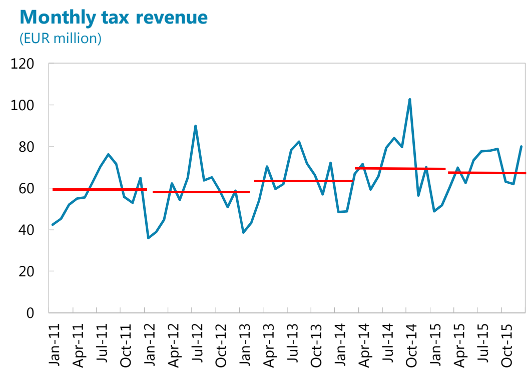
Figure 3. Montenegro: Fiscal Developments

After successive increases, revenue gains have slowed…



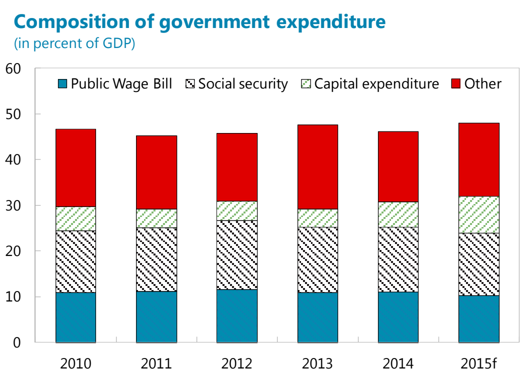
Sources: Montenegrin authorities and staff calculations

largely due to flat tax returns, despite new tax policies.



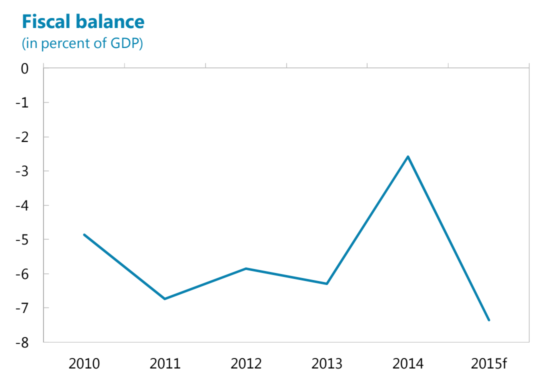
Sources: Montenegrin authorities and staff calculations

Wage restraint and pension freezes have helped consolidate current expenditure in recent years…



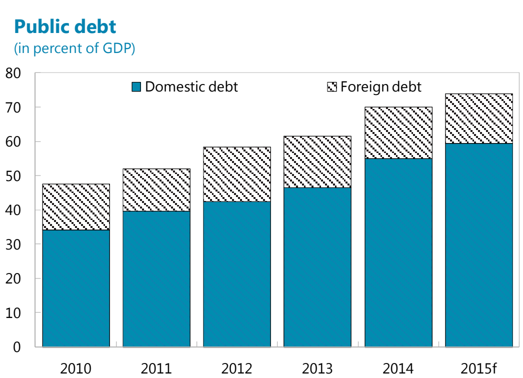
Sources: Montenegrin authorities and staff calculations

but the fiscal balance has deteriorated this year with fiscal slippage and highway spending.



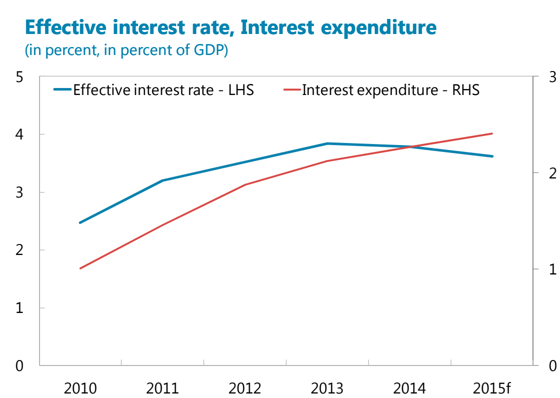
Sources: Montenegrin authorities and staff calculations

Public debt has increased sharply…



Sources: Montenegrin authorities and staff calculations

leading to higher interest payments.



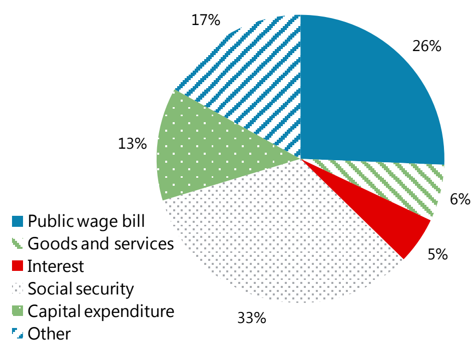
Sources: Montenegrin authorities and staff calculations

Sources: Ministry of Finance and Staff estimates.

Figure 4. Expenditure Pressures

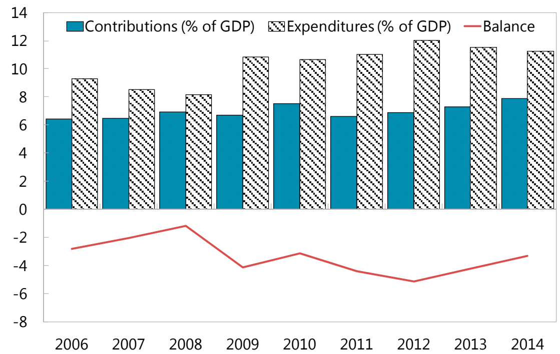
Public expenditures are large and mainly comprise social security and public wages.

Composition of Expenditure, 2014



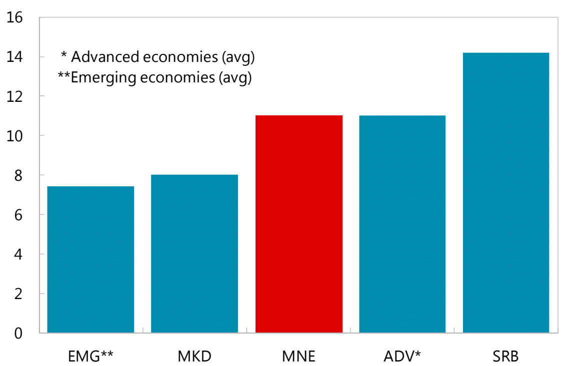
Pension expenditures are persistently above contributions…

Pension Funding Gap
(in percent of GDP)



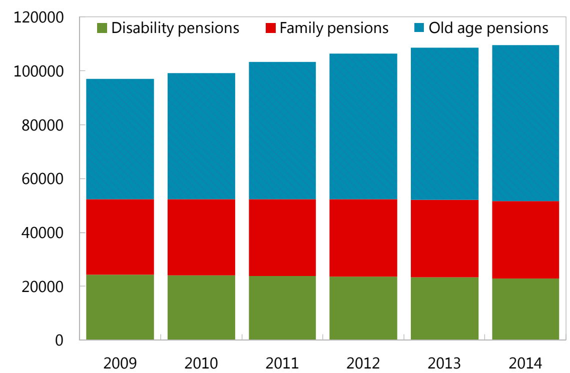
and pension expenditures are high by international comparison…

Pension expenditure
(in percent of GDP)



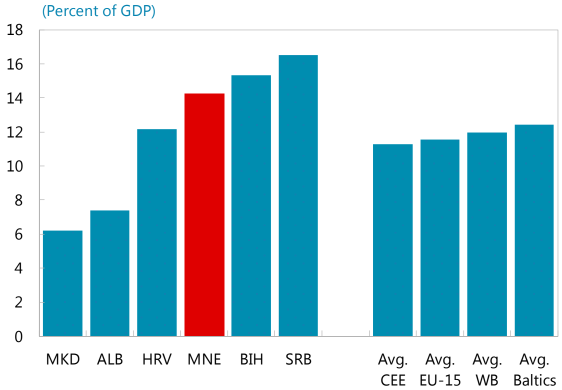
while the number of pensioners continue to rise.

Number of Pension System Beneficiaries



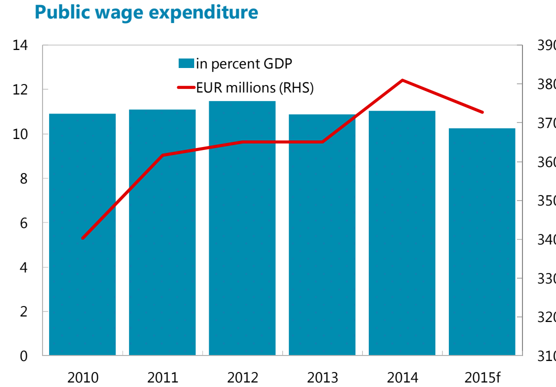
The public sector wage bill is also relatively high…

Compensation of Employees, 2014
(Percent of GDP)



although some consolidation has taken place.

Public wage expenditure

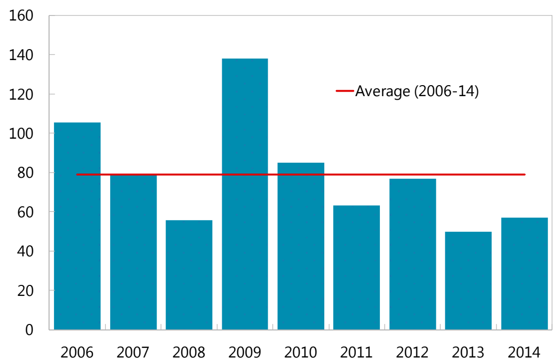


Sources: Ministry of Finance, WEO, and Staff calculations.

Figure 5. Credit Conditions and Competition

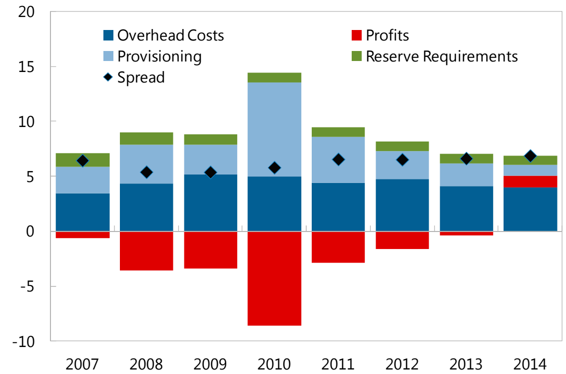
A high proportion of investment is funded externally, limiting lending opportunities for domestic banks.

Ratio of Foreign Direct Investment to Capital Formation
(in percent)



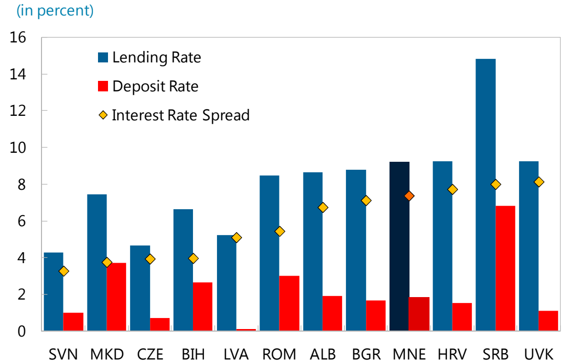
Spreads are driven more by high overhead costs, reflecting low economies of scale, than profits.

Interest Spread Decomposition
(in percent)



Lending conditions in Montenegro are comparable to regional peers.

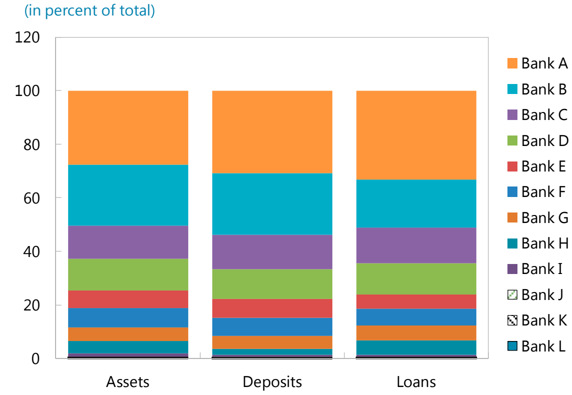
Interest Rates, 2014*
(in percent)



* 2013 for Croatia and Latvia.

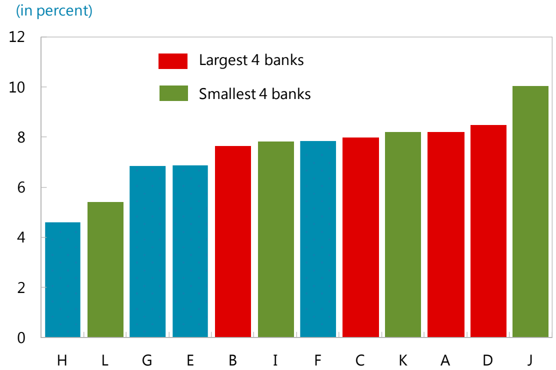
No single lender dominates the market, but four banks account for most lending.

Market Concentration
(in percent of total)



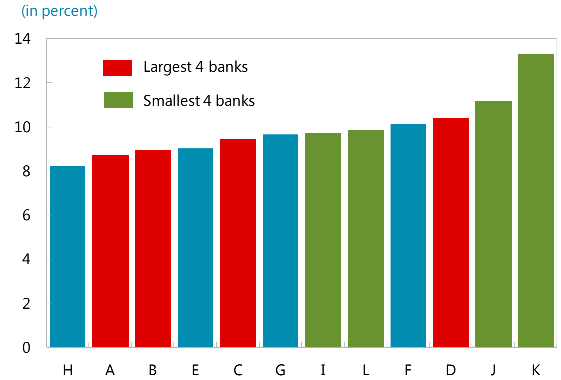
Larger banks typically have higher-than-average lending margins...

Interest-Deposit Rate Spreads by Bank
(in percent)



...but also lower lending rates.

Average Effective Lending Rates, 2013-15
(in percent)

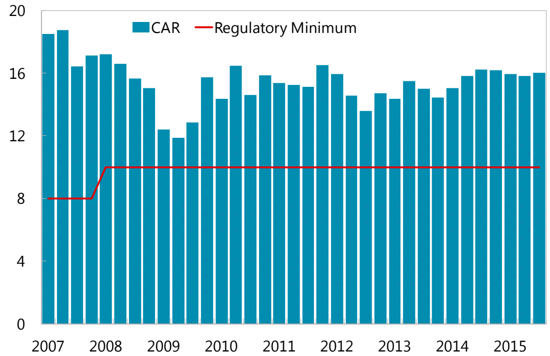


Sources: Bankscope, CBCG and other regional central banks, MONSTAT, World Bank's Doing Business Survey (2014), and Staff calculations.

Figure 6. Montenegro: Banking Sector

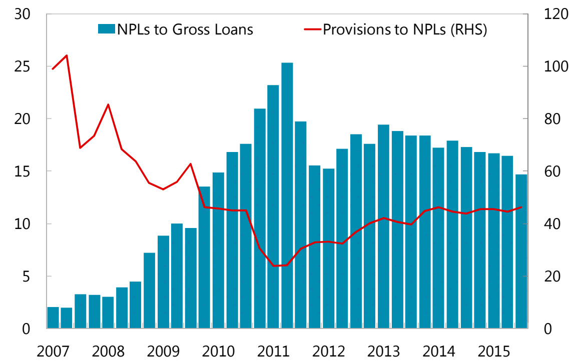
Bank capitalization has been stable…

Regulatory Capital
(as percent of risk-weighted assets)



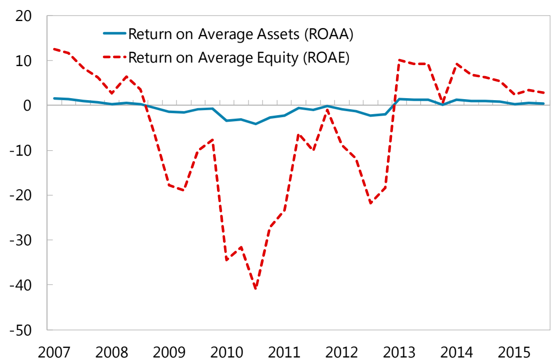
but the quality of assets and degree of loan provisioning is low.

Non-Performing Loans and Bank Provisioning
(in percent)



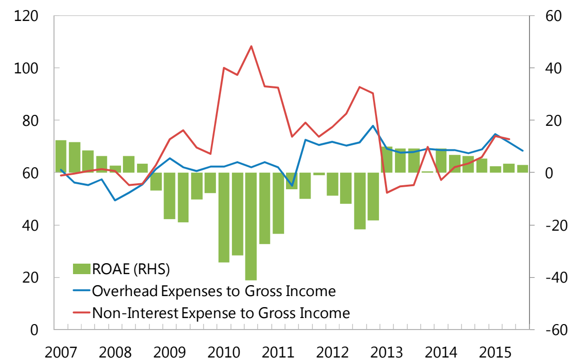
Bank profitability is weak…

Bank Sector Net Profits
(in percent)



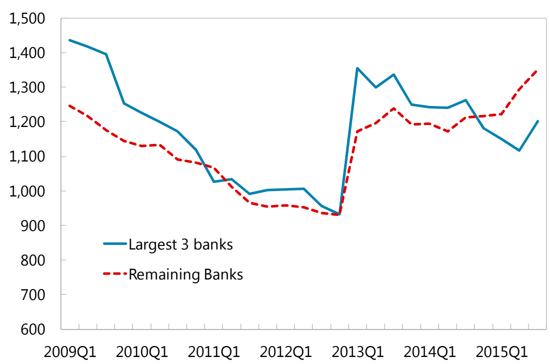
related to high overhead and scale inefficiencies.

Bank Efficiency and Profitability
(in percent)



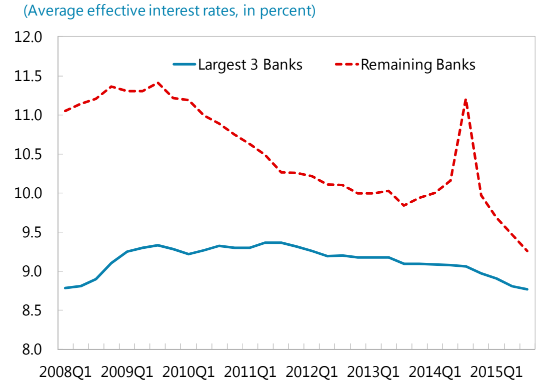
The largest and most profitable banks provide more lending than the rest of the system as a whole…

Loan Portfolios by Bank Size
(EUR million)



and consistently lend at lower rates.

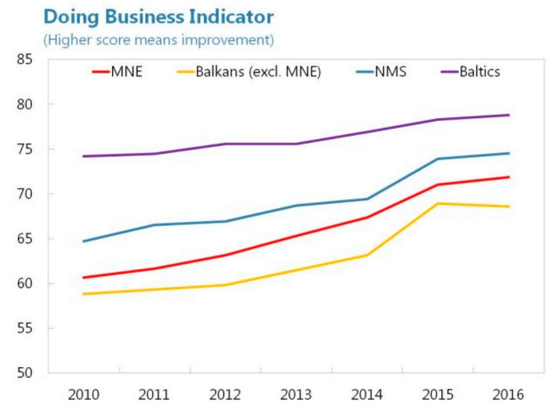
Lending rates by Bank Size
(Average effective interest rates, in percent)



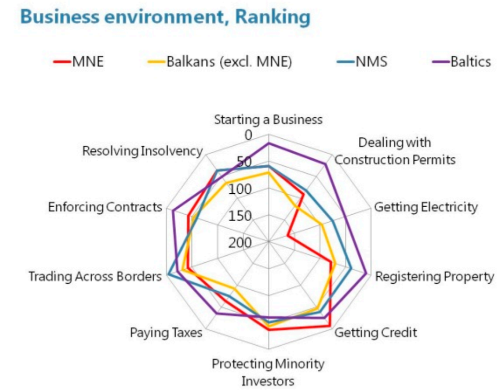
Sources: CBCG and Staff calculations.

Figure 7. Montenegro: Structural Reform Priorities

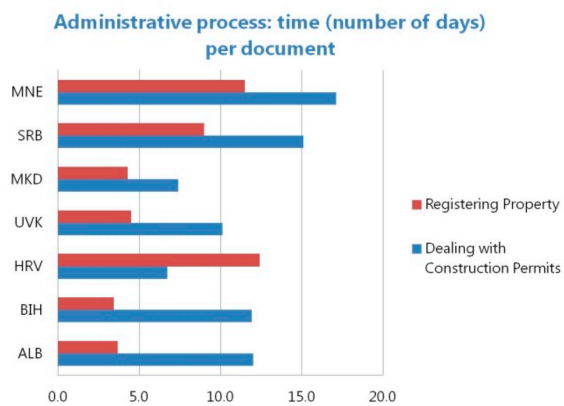
The business environment has improved steadily…



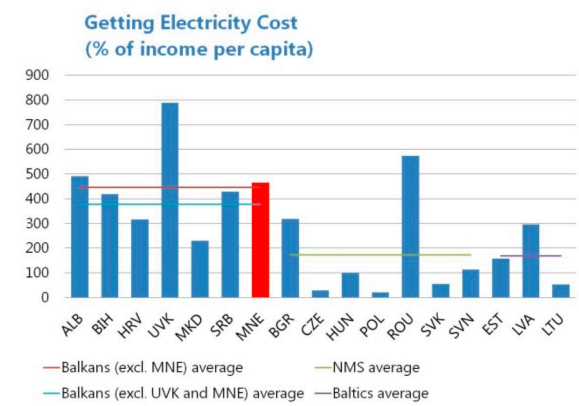
…although further improvements are needed in many areas.



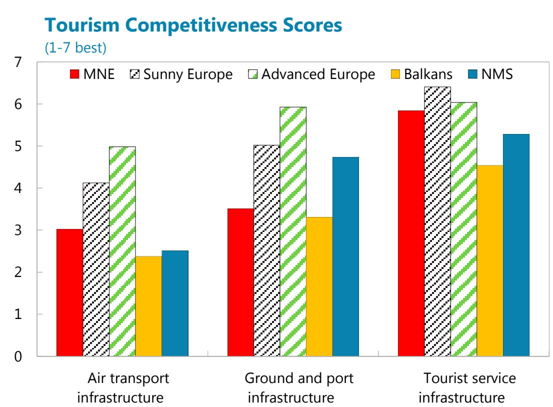
The administrative process is long…



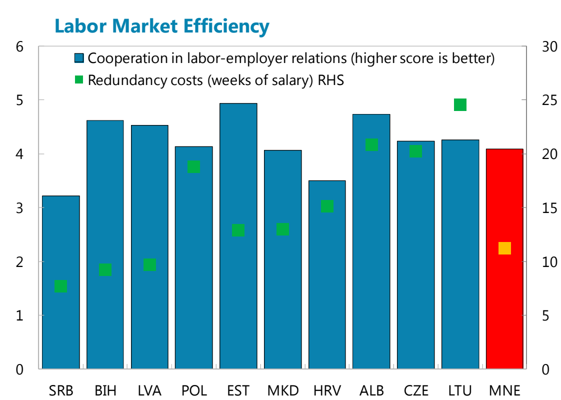
…and setting up a business can be costly.



Tourism sector infrastructure lags peers in transportation.



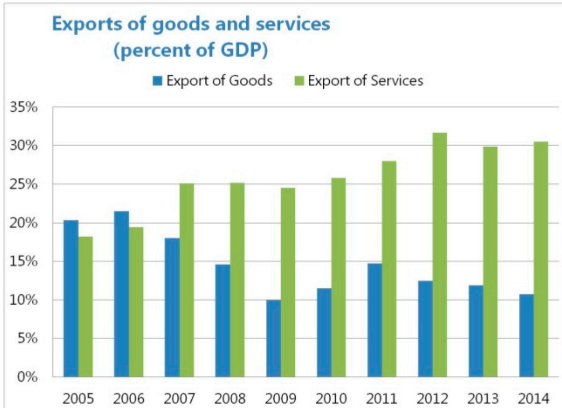
Redundancy costs are now relatively low.



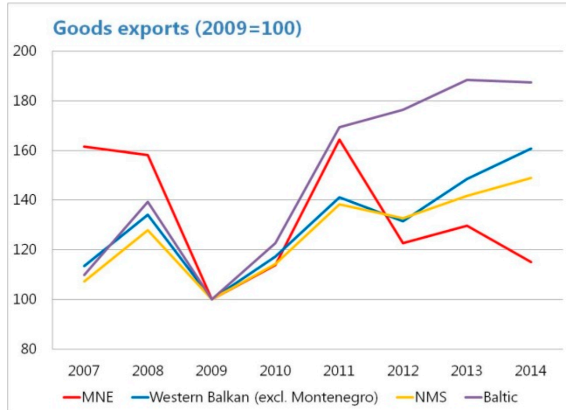
Sources: Doing Business database 2016, World Bank; Travel & Tourism Competitiveness Report (2015), World Economic Forum Global Competitiveness Report (2013–14), and national authorities.

Figure 8. Montenegro: External Sector Challenges

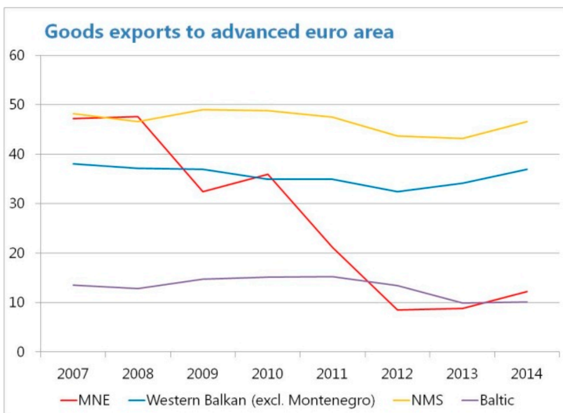
Goods exports have been declining...



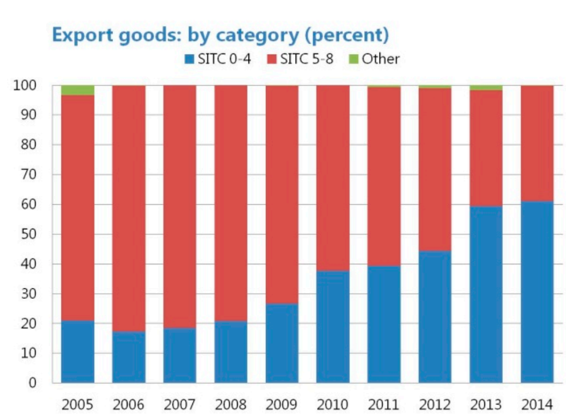
and weak compared to peers.



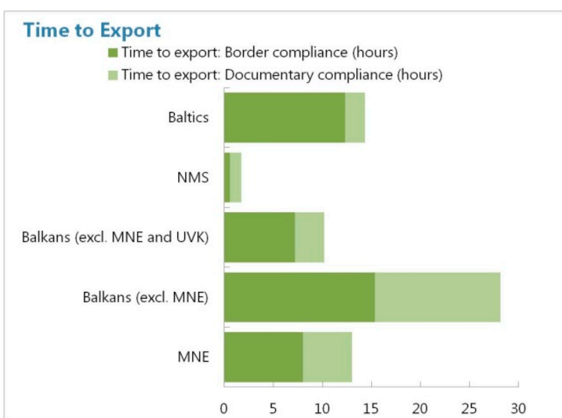
Montenegro has lost export share to euro area...



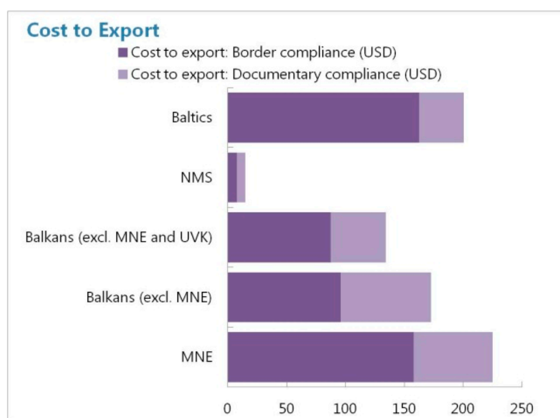
matched by an increasing share of low-value-added products.



High administrative costs for exports...



and high indirect costs also worsen price competitiveness.



Sources: Doing Business database (2016), World Bank; DOT, and national authorities.

Montenegro: Risk Assessment Matrix[1/]

(Scale – High, medium, or low)

Source of Risks	Relative Likelihood[2]	Impact if Realized	Policy Response
1. Structurally weak growth in key advanced and emerging economies	**High** The euro area could face an extended period of low growth, reflecting inadequate structural reforms and weak domestic demand due to high real interest rates, impaired balance sheets, high unemployment, and weak inflation expectations. This could be compounded by limited prospects for emerging market countries that have struggled with inefficient investments and incomplete structural reform.	**High** A protracted slowdown in the EU and neighboring countries could adversely impact the appetite for external and public financing (especially FDI flows and tourism infrastructure developments). Further "low-flation" could be imported from the euro area which, if protracted, would adversely impact debt dynamics, consumption, and bank profitability.	• Let automatic fiscal stabilizers work, within limited fiscal space. • Accelerate structural reforms to increase competitiveness and reduce structural bottlenecks that impede credit to the private sector.
2. Tighter and more volatile global financial conditions	**High** A surge in global financial market volatility and generalized increase in financing costs could be triggered as investors reassess risks. Associated debt sustainability concerns could inhibit market access.	**High** Montenegro is highly reliant on external financing. Gross public financing needs range from 10–20 percent of GDP during the next five years.	• Let automatic fiscal stabilizers work, within limited fiscal space. • Put in place a credible medium-term fiscal consolidation plan that puts debt on a sustainable trajectory.
3. Heightened geopolitical risks associated with Russia/Ukraine tensions erodes globalization and fosters inefficiency	**Medium** Geopolitical events could disrupt global financial flows, trade and commodity markets, as well as lead to a sharp increase in oil prices.	**Medium** Given important tourism and real estate links, a prolonged and intensified downturn in Russia could undermine FDI inflows and thus weaken growth prospects, depress real estate prices, and further limit Montenegro's capacity to absorb shocks.	• Let automatic fiscal stabilizers work, within limited fiscal space. • Speed up structural reforms to improve the business environment and competitiveness. • Accelerate structural reform and policies to facilitate the resolution of problem loans and encourage a revitalization of bank lending.
4. Weakening of fiscal discipline	**Low** The authorities have demonstrated a commitment to fiscal consolidation. But the planned highway is a source of concern. And pressure to raise public sector wages and pensions will remain.	**Medium** Given high and increasing public debt, a loss of fiscal discipline could raise concern over the sustainability of the fiscal position.	• Sustain fiscal consolidation; maintain public wage discipline, reinstate pension freezes, and further strengthen tax administration. • Curtail subsidies, reduce tax exemptions, and divest from loss-making public enterprises.
5. Delays and withdrawals from capital investment projects	**Medium** Ongoing geopolitical tensions, weak administrative procedures on land development, and concerns regarding public fiscal sustainability could threaten capital investments in tourism and industry.	**Medium** Construction and activity associated with large-scale investment projects (both tourism and infrastructure based) are key drivers of growth.	• Put in place a credible strategy to safeguard fiscal sustainability and implement structural reforms to improve the business environment and strengthen mechanisms to fight corruption, including through AML/CFT tools.

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

Table 1. Montenegro: Selected Economic Indicators, 2010–20
(Under current policies)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
						Est.		Projections			
Real economy											
Nominal GDP (millions of €)	3,125	3,265	3,181	3,362	3,458	3,641	3,840	3,989	4,152	4,314	4,555
Gross national saving (percent of GDP)	-1.0	1.8	2.1	5.1	4.6	14.6	10.0	9.8	7.5	6.8	8.1
Gross investment (percent of GDP)	21.8	19.3	20.6	19.6	19.8	28.0	28.6	28.9	26.6	22.4	21.7
					(percent change)						
Real GDP	2.5	3.2	-2.7	3.5	1.8	4.1	4.6	2.5	2.5	2.2	3.8
Industrial production	17.6	-10.3	-7.1	10.6	-11.5	13.7	...	...	...	...	...
Tourism											
Arrivals	4.6	8.7	4.8	3.7	1.7	12.7	...	...	...	...	...
Nights	5.5	10.2	4.3	2.8	1.5	15.6	...	...	...	...	...
Consumer prices (period average)	0.7	3.1	3.6	2.2	-0.7	1.6	0.9	1.3	1.6	1.7	1.8
Consumer prices (end of period)	0.7	2.8	5.1	0.3	-0.3	1.4	1.4	1.4	1.6	1.7	1.8
GDP deflator (percent change)	2.3	1.2	0.2	2.1	1.0	1.2	0.8	1.3	1.5	1.7	1.8
Average net wage (12-month) 1/	3.5	1.0	0.7	-1.7	-0.5	0.4	...	...	...	...	...
Money and credit (end of period)											
Bank credit to private sector 2/	-8.9	-13.0	-3.1	2.1	-0.4	2.3	2.7	3.4	4.0	4.4	5.1
Enterprises	-11.2	-20.3	-4.9	0.4	-2.8	2.2	...	...	...	...	...
Households	-5.7	-3.2	-1.1	3.7	1.7	2.7	...	...	...	...	...
Private sector deposits	5.9	1.2	7.2	1.3	6.1	9.0	...	...	...	...	...
General government finances 3/					(as percent of GDP)						
Revenue and grants	41.8	38.5	39.9	41.3	43.5	40.6	42.2	41.9	41.8	42.1	41.8
Expenditure	46.6	45.3	45.7	47.6	46.1	48.0	51.4	50.8	47.8	43.5	42.4
Overall balance	-4.9	-6.7	-5.8	-6.3	-2.6	-7.4	-9.2	-8.9	-6.0	-1.5	-0.6
Primary balance	-3.9	-5.3	-4.0	-4.2	-0.3	-4.9	-6.8	-6.5	-3.2	1.5	2.4
Domestic financing (net)	-0.4	2.5	-0.6	1.4	-0.6	-1.8	1.8	-0.4	-0.3	-0.8	-0.7
Privatization receipts	0.2	0.2	0.2	0.8	0.3	0.3	0.1	0.2	0.1	0.0	0.0
General government gross debt	40.7	45.6	53.4	55.2	59.9	66.5	70.5	77.1	80.4	79.6	76.6
General government debt, including loan guarantees	52.2	57.2	65.4	64.2	69.0	80.8	84.1	90.2	93.0	91.7	88.1
Balance of payments											
Current account balance	-22.7	-17.6	-18.5	-14.5	-15.2	-13.3	-18.6	-19.1	-19.1	-15.6	-13.5
Foreign direct investment	17.7	11.9	14.5	9.6	10.2	15.7	12.0	12.3	12.5	12.5	12.5
External debt (end of period, stock)	141.6	145.0	155.9	151.5	154.8	152.1	154.8	161.4	164.1	163.1	158.7
Of which: Private sector 4/	112.5	112.4	115.2	111.3	109.6	94.8	93.3	92.9	92.2	91.7	89.8
REER (CPI-based; annual average change, in percent)											
(- indicates depreciation)	2.8	-3.2	3.2	0.8	-2.0	...	...	...	...	...	...
Memorandum:											
Nominal GDP Growth (in percent)	4.8	4.5	-2.6	5.7	2.8	5.3	5.5	3.9	4.1	3.9	5.6
Overall balance excluding Highway Project (in percent GDP)	-4.9	-6.7	-5.8	-6.3	-2.6	-2.9	-1.2	-1.3	-0.8	-0.6	-0.6
Aluminum price (€ per tonne)	1,644	1,822	1,542	1,348	1,514	1,549	1,391	1,431	1,475	1,523	1,572

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

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

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

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

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

Table 2. Montenegro: Savings and Investment Balances, 2010–20
(Under current policies; percent of GDP, unless otherwise noted)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
						Projections					
Gross national savings	-1.0	1.8	2.1	5.1	4.6	14.6	10.0	9.8	7.5	6.8	8.1
Non-government	-0.7	5.5	5.2	9.4	3.6	15.9	8.9	8.7	6.5	5.8	7.1
Government	-0.3	-3.7	-3.1	-4.2	1.0	-1.3	1.1	1.0	1.0	1.0	1.0
Gross domestic investment	21.8	19.3	20.6	19.6	19.8	28.0	28.6	28.9	26.6	22.4	21.7
Non-government	16.5	15.2	16.3	15.7	14.3	19.9	16.4	16.8	17.2	17.3	17.5
Government	5.3	4.2	4.3	3.9	5.5	8.1	12.2	12.1	9.4	5.1	4.2
Savings - investment balance	-22.7	-17.6	-18.5	-14.5	-15.2	-13.3	-18.6	-19.1	-19.1	-15.6	-13.5
Non-government	-17.1	-9.7	-11.1	-6.3	-10.7	-3.9	-7.4	-8.1	-10.7	-11.5	-10.3
Government	-5.6	-7.9	-7.4	-8.2	-4.5	-9.4	-11.2	-11.0	-8.4	-4.1	-3.2
Current account balance 1/	-22.7	-17.6	-18.5	-14.5	-15.2	-13.3	-18.6	-19.1	-19.1	-15.6	-13.5
Foreign direct investment (net)	17.7	11.9	14.5	9.6	10.2	15.7	12.0	12.3	12.5	12.5	12.5
External debt	141.6	145.0	155.9	151.5	154.8	152.1	154.8	161.4	164.1	163.1	158.7

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

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

Table 3. Montenegro: Summary of Accounts of the Financial System, 2010–15
(Millions of euros)

	2010	2011	2012	2013	2014	2015 Prel.	2016 Proj.
			I. Central Bank				
Net foreign assets	386	273	318	395	514	641	675
Assets	416	303	348	424	545	674	708
Liabilities	30	31	30	29	31	33	33
Net domestic assets	-321	-191	-227	-297	-408	-525	-553
Net credit to the nonfinancial public sector	-71	-18	-24	-12	-25	-30	-30
Of which: general government	-71	-18	-24	-12	-25	-30	-30
Net credit to the banking system	-277	-207	-237	-319	-416	-525	-564
Required reserves	-134	-129	-129	-150	-171	-196	-210
Giro account	-142	-77	-108	-169	-245	-329	-354
Claims on depository institutions	-1	-1	-1	-1	0	0	0
Other assets net	27	35	34	34	33	31	41
Deposits included in broad money	19	22	31	39	46	55	58
Equity	47	61	60	59	60	61	65
			II. Banking System				
Net foreign assets	-532	-348	-156	-162	-74	-153	-161
Assets	399	456	543	561	613	591	615
Liabilities	932	804	700	723	687	744	776
Net domestic assets	2,327	2,085	2,034	2,170	2,163	2,332	2,501
Net assets held in the central bank	276	206	236	318	415	524	563
Net credit to nonfinancial public sector	-69	37	16	115	80	159	241
Of which: general government	-70	65	62	115	80	159	241
Credit to the private sector	2,076	1,808	1,744	1,777	1,770	1,811	1,860
Other domestic assets	44	34	38	-41	-102	-163	-163
Liabilities	1,795	1,737	1,878	2,008	2,090	2,179	2,340
Private sector deposits	1,349	1,365	1,462	1,481	1,571	1,712	1,834
Other items, net	446	372	415	527	518	467	506
o/w capital	311	305	289	390	441	473	515
			III. Consolidated System				
Net foreign assets	-146	-75	161	233	440	488	514
Net domestic assets	2,007	1,894	1,807	1,873	1,755	1,807	1,948
Net credit to the nonfinancial public sector	-140	19	-9	103	55	129	211
Of which: general government	-140	46	37	103	55	129	211
Credit to the private sector	2,076	1,808	1,744	1,777	1,770	1,811	1,860
Other net domestic assets	71	68	72	-8	-70	-133	-122
Liabilities	1,814	1,758	1,908	2,046	2,135	2,234	2,398
Equity capital of the central bank	47	61	60	59	60	61	65
			IV. Ratios				
Reserves ratio	20.5	15.1	16.2	21.5	26.4	30.6	30.7
Effective required reserves ratio 1/	9.9	9.5	8.8	10.1	10.9	11.4	11.4
Credit to private sector / GDP	66.4	55.4	54.8	52.9	51.2	49.7	48.4
Banks' capital / credit to private sector	15.0	16.9	16.6	21.9	24.9	26.1	27.7
CBCG reserves / bank deposits	30.9	22.2	23.8	28.6	34.7	39.4	38.6
Banks' foreign liabilities / lending	44.9	44.4	40.0	40.0	40.0	40.0	40.0

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

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

Table 4. Montenegro: Balance of Payments, 2010–20
(Under current policies)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
						Projections					
	(Millions of euros)										
Current account balance	-710	-573	-588	-487	-526	-486	-715	-762	-792	-672	-617
Trade balance	-1,267	-1,306	-1,389	-1,329	-1,376	-1,464	-1,662	-1,763	-1,852	-1,808	-1,843
Exports	357	477	392	396	357	329	331	342	356	370	388
Imports	-1,624	-1,783	-1,781	-1,724	-1,734	-1,793	-1,993	-2,105	-2,208	-2,178	-2,231
Services account	464	589	612	653	690	812	772	819	871	939	1,018
Receipts 1/	801	906	998	994	1,031	1,194	1,198	1,264	1,336	1,413	1,513
Expenditures	-337	-317	-385	-341	-340	-382	-426	-445	-465	-474	-495
Income account	-22	26	54	66	46	59	62	64	67	70	73
Compensation of employees, net	150	168	174	185	194	208	219	228	237	246	260
Investment income, net	-172	-142	-120	-120	-148	-149	-157	-163	-170	-177	-187
Current transfers, net	114	117	135	123	114	107	113	118	122	127	134
Government, net	16	6	18	22	24	12	13	13	14	14	15
Other sectors, net	98	112	118	101	90	95	100	104	109	113	119
Capital and financial account	529	302	389	314	243	313	124	300	293	-152	-347
Foreign direct investment, net	552	389	462	324	354	570	460	490	519	539	569
Portfolio investment, net 2/	-12	-16	-25	-38	-196	-488	-135	-140	-146	-152	-160
Other investment, net 1/	-11	-68	-55	26	84	230	-201	-49	-79	-539	-756
General government 2/	209	133	203	37	246	524	-59	115	104	-340	-545
Commercial banks	-176	-205	-192	71	-62	79	8	-1	-9	-9	-7
Other sectors	-44	5	-67	-82	-99	-373	-151	-163	-174	-190	-203
Errors and omissions 1/	198	157	243	250	402	302	289	271	253	234	218
Unidentified financing 3/	0	0	0	0	0	0	336	253	149	439	604
Change in official reserves (- denotes increase)	-17	114	-45	-77	-118	-129	-35	-63	96	152	143
Memorandum items	(percent of GDP)										
Current account balance	-22.7	-17.6	-18.5	-14.5	-15.2	-13.3	-18.6	-19.1	-19.1	-15.6	-13.5
Trade balance	-40.5	-40.0	-43.7	-39.5	-39.8	-40.2	-43.3	-44.2	-44.6	-41.9	-40.5
Exports	11.4	14.6	12.3	11.8	10.3	9.0	8.6	8.6	8.6	8.6	8.5
Imports	-52.0	-54.6	-56.0	-51.3	-50.1	-49.2	-51.9	-52.8	-53.2	-50.5	-49.0
Services account	14.9	18.0	19.2	19.4	20.0	22.3	20.1	20.5	21.0	21.8	22.4
Receipts	25.6	27.8	31.4	29.6	29.8	32.8	31.2	31.7	32.2	32.7	33.2
Payments	-10.8	-9.7	-12.1	-10.1	-9.8	-10.5	-11.1	-11.2	-11.2	-11.0	-10.9
Income account	-0.7	0.8	1.7	1.9	1.3	1.6	1.6	1.6	1.6	1.6	1.6
Current transfers, net	3.7	3.6	4.3	3.7	3.3	2.9	2.9	2.9	2.9	2.9	2.9
Foreign direct investment, net	17.7	11.9	14.5	9.6	10.2	15.7	12.0	12.3	12.5	12.5	12.5
Portfolio investment, net	-0.4	-0.5	-0.8	-1.1	-5.7	-13.4	-3.5	-3.5	-3.5	-3.5	-3.5
Other investment, net	-0.4	-2.1	-1.7	0.8	2.4	6.3	-5.2	-1.2	-1.9	-12.5	-16.6
Errors and omissions	6.3	4.8	7.6	7.4	11.6	8.3	7.5	6.8	6.1	5.4	4.8
Gross external debt 4/	141.6	145.0	155.9	151.5	154.8	152.1	154.8	161.4	164.1	163.1	158.7

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

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

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

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

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

Table 5a. Montenegro: Consolidated General Government Fiscal Operations, 2010–20 1/
(Millions of euros)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
						Projections					
Total revenues and grants	**1,306**	**1,258**	**1,268**	**1,390**	**1,505**	**1,479**	**1,622**	**1,670**	**1,737**	**1,814**	**1,906**
Total revenues	1,278	1,243	1,253	1,380	1,495	1,469	1,590	1,652	1,723	1,800	1,891
Current revenues	1,273	1,238	1,247	1,372	1,488	1,462	1,582	1,644	1,714	1,791	1,881
Taxes	757	795	786	864	950	917	986	1,025	1,070	1,120	1,174
Personal income tax	115	113	110	124	137	131	136	141	147	154	162
Corporate income tax	20	36	64	41	45	47	49	51	53	55	58
Taxes on turnover of real estate	16	16	14	14	15	16	31	32	34	35	37
Value added tax	364	392	355	429	498	456	501	521	544	569	597
Excises	134	143	152	161	156	170	170	176	184	193	202
Taxes on international trade	51	45	29	22	22	23	24	25	26	27	29
Local government taxes	45	44	58	67	71	67	69	72	75	78	82
Other taxes	12	4	4	5	6	6	6	7	7	7	8
Social security contributions	344	311	320	357	401	398	443	460	479	497	526
Nontax revenues	172	132	142	152	137	147	152	158	165	173	182
Capital revenues	5	5	5	9	7	8	8	8	9	9	10
Grants	27	16	16	10	9	10	32	18	14	15	15
Total expenditures and net lending	**1,458**	**1,478**	**1,454**	**1,601**	**1,594**	**1,747**	**1,974**	**2,027**	**1,985**	**1,878**	**1,933**
Total expenditures	1,453	1,474	1,451	1,597	1,604	1,747	1,977	2,029	1,988	1,881	1,936
Current expenditures	652	678	709	671	704	713	721	744	776	813	860
Gross salaries	340	362	365	365	381	373	394	409	426	442	467
Other personal income	25	20	13	15	14	14	15	15	16	17	18
Goods and services	166	158	201	141	148	147	127	124	117	121	127
Current maintenance	33	28	28	24	25	25	26	27	28	30	31
Interest payments	31	48	60	71	78	88	90	98	115	128	138
Rent	9	8	7	8	9	9	9	10	10	10	11
Subsidies to enterprises 2/	40	46	27	18	19	22	23	24	25	26	27
Other outflows 2/	9	9	9	28	30	36	36	37	38	40	42
Social security transfers	424	456	482	483	492	498	558	574	592	611	634
Other transfers	195	156	76	187	185	226	212	213	211	218	229
Capital expenditures	166	136	138	132	189	295	470	482	391	220	192
Repayment of guarantees	0	34	25	107	18	0	0	0	0	0	0
Reserves	16	14	22	16	16	16	16	17	18	19	20
Net lending	5	4	3	4	-10	-1	-3	-3	-3	-3	-3
Overall Balance	**-152**	**-220**	**-186**	**-212**	**-89**	**-268**	**-352**	**-357**	**-248**	**-64**	**-27**
Financing 3/	**152**	**220**	**186**	**212**	**89**	**268**	**352**	**357**	**248**	**64**	**27**
Domestic financing	-14	83	-19	46	-20	-66	70	-17	-11	-35	-32
Use of gov. deposits	38	51	-13	22	-18	-74	61	-14	-23	-33	-34
Net borrowing from other sources	-52	32	-6	24	-2	8	9	-4	12	-2	2
Foreign financing	160	129	198	139	98	324	-59	115	104	-340	-545
Privatization receipts	6	8	6	27	12	10	5	6	6	0	0
Unidentified	0	0	0	0	0	0	336	253	149	439	604
Discrepancy	0	0	0	0	0	0	0	0	0	0	0
Memorandum items:											
Primary balance	-121	-172	-126	-140	-11	-180	-262	-259	-133	64	111
Overall balance excluding loan guarantee repayments	-152	-186	-161	-104	-71	-268	-352	-357	-248	-64	-27

Source: Ministry of Finance; and Fund staff estimates and projections.
1/ Includes republican budget and local governments.
2/ According to GFSM 1986, payments of loan guarantees or related to court rulings are recorded as government expenses.
3/ Financing for the highway is included under foreign financing (including the ExIm loan as well as the remaining 15 percent); unidentified financing is a residual, including all remaining financing needs for which specific sources have not been identified yet--however this does not constitute a financing gap.

Table 5b. Montenegro: Consolidated General Government Fiscal Operations, 2010–20 1/
(In percent of GDP)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
						Projections					
Total revenues and grants	**41.8**	**38.5**	**39.9**	**41.3**	**43.5**	**40.6**	**42.2**	**41.9**	**41.8**	**42.1**	**41.8**
Total revenues	40.9	38.1	39.4	41.0	43.2	40.4	41.4	41.4	41.5	41.7	41.5
Current revenues	40.7	37.9	39.2	40.8	43.0	40.1	41.2	41.2	41.3	41.5	41.3
Taxes	24.2	24.3	24.7	25.7	27.5	25.2	25.7	25.7	25.8	26.0	25.8
Personal income tax	3.7	3.5	3.4	3.7	4.0	3.6	3.5	3.5	3.5	3.6	3.6
Corporate income tax	0.6	1.1	2.0	1.2	1.3	1.3	1.3	1.3	1.3	1.3	1.3
Taxes on turnover of real estate	0.5	0.5	0.5	0.4	0.4	0.4	0.8	0.8	0.8	0.8	0.8
Value added tax	11.7	12.0	11.1	12.8	14.4	12.5	13.1	13.1	13.1	13.2	13.1
Excises	4.3	4.4	4.8	4.8	4.5	4.7	4.4	4.4	4.4	4.5	4.4
Taxes on international trade	1.6	1.4	0.9	0.7	0.6	0.6	0.6	0.6	0.6	0.6	0.6
Local government taxes	1.4	1.4	1.8	2.0	2.1	1.8	1.8	1.8	1.8	1.8	1.8
Other taxes	0.4	0.1	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Social security contributions	11.0	9.5	10.0	10.6	11.6	10.9	11.5	11.5	11.5	11.5	11.5
Nontax revenues	5.5	4.0	4.5	4.5	4.0	4.1	4.0	4.0	4.0	4.0	4.0
Capital revenues	0.2	0.2	0.2	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Grants	0.9	0.5	0.5	0.3	0.3	0.3	0.8	0.4	0.3	0.3	0.3
Total expenditures and net lending	**46.6**	**45.3**	**45.7**	**47.6**	**46.1**	**48.0**	**51.4**	**50.8**	**47.8**	**43.5**	**42.4**
Total expenditures	46.5	45.1	45.6	47.5	46.4	48.0	51.5	50.9	47.9	43.6	42.5
Current expenditures	20.9	20.8	22.3	20.0	20.4	19.6	18.8	18.6	18.7	18.9	18.9
Gross salaries	10.9	11.1	11.5	10.9	11.0	10.2	10.3	10.3	10.3	10.2	10.3
Other personal income	0.8	0.6	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Goods and services	5.3	4.8	6.3	4.2	4.3	4.0	3.3	3.1	2.8	2.8	2.8
Current maintenance	1.1	0.9	0.9	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Interest payments	1.0	1.5	1.9	2.1	2.3	2.4	2.4	2.4	2.8	3.0	3.0
Rent	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Subsidies to enterprises 2/	1.3	1.4	0.8	0.5	0.5	0.6	0.6	0.6	0.6	0.6	0.6
Other outflows 2/	0.3	0.3	0.3	0.8	0.9	1.0	0.9	0.9	0.9	0.9	0.9
Social security transfers	13.6	14.0	15.2	14.4	14.2	13.7	14.5	14.4	14.3	14.2	13.9
Other transfers	6.2	4.8	2.4	5.6	5.3	6.2	5.5	5.3	5.1	5.1	5.0
Capital expenditures	5.3	4.2	4.3	3.9	5.5	8.1	12.2	12.1	9.4	5.1	4.2
Repayment of guarantees	0.0	1.0	0.8	3.2	0.5	0.0	0.0	0.0	0.0	0.0	0.0
Reserves	0.5	0.4	0.7	0.5	0.5	0.4	0.4	0.4	0.4	0.4	0.4
Net lending	0.2	0.1	0.1	0.1	-0.3	0.0	-0.1	-0.1	-0.1	-0.1	-0.1
Overall Balance	**-4.9**	**-6.7**	**-5.8**	**-6.3**	**-2.6**	**-7.4**	**-9.2**	**-8.9**	**-6.0**	**-1.5**	**-0.6**
Financing 3/	**4.9**	**6.7**	**5.8**	**6.3**	**2.6**	**7.4**	**9.2**	**8.9**	**6.0**	**1.5**	**0.6**
Domestic financing	-0.4	2.5	-0.6	1.4	-0.6	-1.8	1.8	-0.4	-0.3	-0.8	-0.7
Use of gov. deposits	1.2	1.6	-0.4	0.7	-0.5	-2.0	1.6	-0.3	-0.6	-0.8	-0.8
Net borrowing from other sources	-1.7	1.0	-0.2	0.7	-0.1	0.2	0.2	-0.1	0.3	0.0	0.1
Foreign financing	5.1	4.0	6.2	4.1	2.8	8.9	-1.5	2.9	2.5	-7.9	-12.0
Privatization receipts	0.2	0.2	0.2	0.8	0.3	0.3	0.1	0.2	0.1	0.0	0.0
Unidentified	0.0	0.0	0.0	0.0	0.0	0.0	8.8	6.3	3.6	10.2	13.2
Discrepancy	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:											
Primary balance	-3.9	-5.3	-4.0	-4.2	-0.3	-4.9	-6.8	-6.5	-3.2	1.5	2.4
Overall balance excluding loan guarantee repayments	-4.9	-5.7	-5.1	-3.1	-2.1	-7.4	-9.2	-8.9	-6.0	-1.5	-0.6
Public debt (gross)	40.7	45.6	53.4	55.2	59.9	66.5	70.5	77.1	80.4	79.6	76.6
Public debt, including guarantees	52.2	57.2	65.4	64.2	69.0	80.8	84.1	90.2	93.0	91.7	88.1

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

1/ Includes republican budget and local governments.

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

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

Table 5c. Montenegro: Consolidated General Government Fiscal Operations, 2010–20 1/
(Millions of euros, GFSM2001)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
						Projections					
1. Revenue	**1,301**	**1,253**	**1,263**	**1,381**	**1,497**	**1,471**	**1,614**	**1,661**	**1,728**	**1,805**	**1,897**
Taxes	757	795	786	864	950	917	986	1,025	1,070	1,120	1,174
Personal income tax	115	113	110	124	137	131	136	141	147	154	162
Corporate income tax	20	36	64	41	45	47	49	51	53	55	58
Property taxes	16	16	14	14	15	16	31	32	34	35	37
Value added tax	364	392	355	429	498	456	501	521	544	569	597
Excises	134	143	152	161	156	170	170	176	184	193	202
Taxes on international trade	51	45	29	22	22	23	24	25	26	27	29
Local government taxes	45	44	58	67	71	67	69	72	75	78	82
Other taxes	12	4	4	5	6	6	6	7	7	7	8
Social security contributions	344	311	320	357	401	398	443	460	479	497	526
Nontax revenues	172	132	142	152	137	147	152	158	165	173	182
Grants	27	16	16	10	9	10	32	18	14	15	15
2. Expense	**1,287**	**1,338**	**1,313**	**1,465**	**1,415**	**1,452**	**1,507**	**1,547**	**1,596**	**1,661**	**1,744**
Gross salaries and other personal income	365	382	378	380	395	387	409	425	442	459	485
Use of goods and services	199	186	229	165	173	172	153	151	146	151	158
Interest payments	31	48	60	71	78	88	90	98	115	128	138
Subsidies to enterprises	40	46	27	18	19	22	23	24	25	26	27
Other current outflows	17	16	16	37	39	45	46	47	48	50	53
Social security transfers	424	456	482	483	492	498	558	574	592	611	634
Other transfers	195	156	76	187	185	226	212	213	211	218	229
Repayment of guarantees	0	34	25	107	18	0	0	0	0	0	0
Reserves	16	14	22	16	16	16	16	17	18	19	20
3. Gross operating balance (= 1 - 2)	**14**	**-85**	**-51**	**-84**	**82**	**19**	**107**	**114**	**132**	**144**	**153**
4. Net acquisition of nonfinancial assets	**161**	**131**	**132**	**124**	**181**	**287**	**462**	**474**	**383**	**211**	**183**
Capital revenue	-5	-5	-5	-9	-7	-8	-8	-8	-9	-9	-10
Capital expenditure	166	136	138	132	189	295	470	482	391	220	192
5. Net lending (+) / borrowing (-) (= 3 - 4)	**-147**	**-216**	**-183**	**-207**	**-100**	**-268**	**-355**	**-360**	**-251**	**-67**	**-30**
6. Net acquisition of financial assets	**-39**	**-55**	**9**	**-45**	**-4**	**64**	**-68**	**5**	**15**	**30**	**31**
Domestic	-39	-55	9	-45	-4	64	-68	5	15	30	31
Currency and deposits	*-38*	*-51*	*13*	*-22*	*18*	*74*	*-61*	*14*	*23*	*33*	*34*
Loans	*5*	*4*	*3*	*4*	*-10*	*-1*	*-3*	*-3*	*-3*	*-3*	*-3*
Equity and investment fund shares	*-6*	*-8*	*-6*	*-27*	*-12*	*-10*	*-5*	*-6*	*-6*	*0*	*0*
7. Net incurrence of liabilities	**108**	**161**	**192**	**162**	**95**	**332**	**-49**	**111**	**117**	**-342**	**-543**
Domestic	-52	32	-6	24	-2	8	9	-4	12	-2	2
Foreign	160	129	198	139	98	324	-59	115	104	-340	-545
8. Discrepancy (= 5 - 6 + 7)	**0**	**0**	**0**	**0**	**0**	**0**	**-336**	**-253**	**-149**	**-439**	**-604**
Memorandum items:											
Primary balance	-116	-168	-123	-136	-21	-181	-265	-262	-136	61	108
Nominal GDP	3,125	3,265	3,181	3,362	3,458	3,641	3,840	3,989	4,152	4,314	4,555

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

Table 5d. Montenegro: Consolidated General Government Fiscal Operations, 2010–20 1/
(In Percent of GDP, GFSM2001)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
						Projections					
1. Revenue	**41.6**	**38.4**	**39.7**	**41.1**	**43.3**	**40.4**	**42.0**	**41.7**	**41.6**	**41.8**	**41.6**
Taxes	24.2	24.3	24.7	25.7	27.5	25.2	25.7	25.7	25.8	26.0	25.8
Personal income tax	3.7	3.5	3.4	3.7	4.0	3.6	3.5	3.5	3.5	3.6	3.6
Corporate income tax	0.6	1.1	2.0	1.2	1.3	1.3	1.3	1.3	1.3	1.3	1.3
Property taxes	0.5	0.5	0.5	0.4	0.4	0.4	0.8	0.8	0.8	0.8	0.8
Value added tax	11.7	12.0	11.1	12.8	14.4	12.5	13.1	13.1	13.1	13.2	13.1
Excises	4.3	4.4	4.8	4.8	4.5	4.7	4.4	4.4	4.4	4.5	4.4
Taxes on international trade	1.6	1.4	0.9	0.7	0.6	0.6	0.6	0.6	0.6	0.6	0.6
Local government taxes	1.4	1.4	1.8	2.0	2.1	1.8	1.8	1.8	1.8	1.8	1.8
Other taxes	0.4	0.1	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Social security contributions	11.0	9.5	10.0	10.6	11.6	10.9	11.5	11.5	11.5	11.5	11.5
Nontax revenues	5.5	4.0	4.5	4.5	4.0	4.1	4.0	4.0	4.0	4.0	4.0
Grants	0.9	0.5	0.5	0.3	0.3	0.3	0.8	0.4	0.3	0.3	0.3
2. Expense	**41.2**	**41.0**	**41.3**	**43.6**	**40.9**	**39.9**	**39.2**	**38.8**	**38.4**	**38.5**	**38.3**
Gross salaries and other personal income	11.7	11.7	11.9	11.3	11.4	10.6	10.6	10.6	10.6	10.6	10.6
Use of goods and services	6.4	5.7	7.2	4.9	5.0	4.7	4.0	3.8	3.5	3.5	3.5
Interest payments	1.0	1.5	1.9	2.1	2.3	2.4	2.4	2.4	2.8	3.0	3.0
Subsidies to enterprises	1.3	1.4	0.8	0.5	0.5	0.6	0.6	0.6	0.6	0.6	0.6
Other current outflows	0.5	0.5	0.5	1.1	1.1	1.2	1.2	1.2	1.2	1.2	1.2
Social security transfers	13.6	14.0	15.2	14.4	14.2	13.7	14.5	14.4	14.3	14.2	13.9
Other transfers	6.2	4.8	2.4	5.6	5.3	6.2	5.5	5.3	5.1	5.1	5.0
Repayment of guarantees	0.0	1.0	0.8	3.2	0.5	0.0	0.0	0.0	0.0	0.0	0.0
Reserves	0.5	0.4	0.7	0.5	0.5	0.4	0.4	0.4	0.4	0.4	0.4
3. Gross operating balance (= 1 - 2)	**0.4**	**-2.6**	**-1.6**	**-2.5**	**2.4**	**0.5**	**2.8**	**2.9**	**3.2**	**3.3**	**3.4**
4. Net acquisition of nonfinancial assets	**5.1**	**4.0**	**4.2**	**3.7**	**5.2**	**7.9**	**12.0**	**11.9**	**9.2**	**4.9**	**4.0**
Capital revenue	-0.2	-0.2	-0.2	-0.3	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2
Capital expenditure	5.3	4.2	4.3	3.9	5.5	8.1	12.2	12.1	9.4	5.1	4.2
5. Net lending (+) / borrowing (-) (= 3 - 4)	**-4.7**	**-6.6**	**-5.7**	**-6.2**	**-2.9**	**-7.4**	**-9.2**	**-9.0**	**-6.0**	**-1.5**	**-0.7**
6. Net acquisition of financial assets	**-1.2**	**-1.7**	**0.3**	**-1.3**	**-0.1**	**1.7**	**-1.8**	**0.1**	**0.4**	**0.7**	**0.7**
Domestic	-1.2	-1.7	0.3	-1.3	-0.1	1.7	-1.8	0.1	0.4	0.7	0.7
Currency and deposits	*-1.2*	*-1.6*	*0.4*	*-0.7*	*0.5*	*2.0*	*-1.6*	*0.3*	*0.6*	*0.8*	*0.8*
Loans	*0.2*	*0.1*	*0.1*	*0.1*	*-0.3*	*0.0*	*-0.1*	*-0.1*	*-0.1*	*-0.1*	*-0.1*
Equity and investment fund shares	*-0.2*	*-0.2*	*-0.2*	*-0.8*	*-0.3*	*-0.3*	*-0.1*	*-0.2*	*-0.1*	*0.0*	*0.0*
7. Net incurrence of liabilities	**3.5**	**4.9**	**6.0**	**4.8**	**2.8**	**9.1**	**-1.3**	**2.8**	**2.8**	**-7.9**	**-11.9**
Domestic	-1.7	1.0	-0.2	0.7	-0.1	0.2	0.2	-0.1	0.3	0.0	0.1
Foreign	5.1	4.0	6.2	4.1	2.8	8.9	-1.5	2.9	2.5	-7.9	-12.0
8. Discrepancy (= 5 - 6 + 7)	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**-8.8**	**-6.3**	**-3.6**	**-10.2**	**-13.2**
Memorandum items:											
Primary balance	-3.7	-5.1	-3.9	-4.0	-0.6	-5.0	-6.9	-6.6	-3.3	1.4	2.4

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

Table 6. Montenegro: Financial Soundness Indicators of the Banking Sector, 2010–15

	2010	2011	2012	2013				2014				2015		
	Dec	Dec	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep
Capital adequacy														
Regulatory capital as percent of risk-weighted assets	15.9	16.5	14.7	14.4	15.5	15.0	14.4	15.1	15.8	16.2	16.2	15.9	15.8	16.0
Capital as percent of assets	10.6	10.9	10.3	13.7	13.9	13.9	13.4	14.2	14.3	14.2	14.2	14.2	14.1	13.3
Asset composition and quality														
Distribution of bank credit by borrower														
Central government, local government, government agencies	2.1	4.9	4.8	4.5	5.2	6.9	6.7	6.4	6.1	5.5	5.2	4.7	4.2	3.6
Funds	0.1	0.5	0.2	0.0	0.0	0.0	0.0	0.1	0.1	0.2	0.2	0.2	0.1	0.1
State-owned companies	2.7	2.8	3.1	2.4	2.3	2.1	2.1	2.1	2.2	1.7	1.8	1.8	1.7	1.4
Private companies, entrepreneurs	54.8	47.7	47.6	36.8	36.7	34.4	35.7	35.7	36.3	33.5	34.9	36.1	36.9	33.4
Banks	0.0	0.0	0.0	18.6	16.9	18.9	15.8	15.5	15.5	19.5	16.7	14.5	15.1	22.4
Financial Institutions	0.4	0.5	0.1	0.2	0.2	0.2	0.2	0.3	0.2	0.3	0.4	0.6	0.0	0.5
Citizens	37.1	40.5	41.3	33.3	34.3	33.4	35.6	35.9	36.5	35.6	37.2	38.0	37.8	35.3
Credit cards	2.2	2.1	2.1	1.6	1.6	1.4	1.4	1.4	1.3	1.2	1.2	1.2	1.1	1.0
Other	0.6	0.9	0.8	2.6	2.9	2.8	2.6	2.7	1.8	2.6	2.6	2.9	3.1	2.5
Distribution of bank credit by sectoral economic activity														
Agriculture, hunting, fishing	0.4	1.2	1.6	1.4	1.4	1.3	1.5	1.5	1.8	1.8	1.6	1.6	1.8	1.5
Mining and energy	2.5	1.8	1.9	1.9	2.2	2.2	2.0	1.7	1.5	1.4	1.3	1.2	1.5	1.3
Civil engineering	8.1	6.7	6.6	8.9	8.6	8.5	4.9	5.4	5.2	5.3	5.5	5.5	5.2	5.9
Trade	22.9	20.7	19.7	17.3	17.6	15.9	19.0	19.8	20.2	19.7	20.1	20.3	20.2	18.9
Services, tourism	7.4	6.1	6.8	5.5	3.7	3.7	4.0	4.4	4.5	4.1	4.3	4.8	4.5	5.4
Transport, warehousing, communications	3.0	3.1	3.0	3.8	3.6	3.3	3.6	3.0	3.0	2.9	3.1	3.0	3.0	3.4
Finance	1.7	2.7	2.2	2.5	3.0	5.1	2.1	1.0	0.8	0.8	0.8	0.8	0.8	0.8
Real estate trading	3.0	2.3	2.3	1.1	1.1	1.3	1.5	1.2	1.1	1.1	1.3	1.4	1.1	1.1
Administration, other public services	3.1	4.3	4.2	8.8	9.2	9.6	12.0	11.7	11.2	11.0	10.2	9.6	11.2	8.9
Consumer loans	39.3	42.6	43.4	43.5	43.8	43.6	44.5	45.2	45.6	47.1	47.3	47.3	45.6	48.5
Other	9.0	8.4	8.4	5.5	5.7	5.5	5.0	5.1	5.1	4.9	4.5	4.7	5.1	4.4
Asset quality														
Non-performing loans (NPL), in percent of gross loans	21.0	15.5	17.6	19.4	18.8	18.4	18.4	17.2	17.9	17.3	16.8	16.7	16.4	14.7
Provisions, in percent of NPL	30.7	32.8	40.2	42.1	40.7	39.7	44.7	46.3	44.5	43.8	45.6	45.5	44.4	46.2
Provisions, in percent of total loans	6.4	5.1	7.1	8.2	7.7	7.3	8.2	8.0	8.0	7.6	7.6	7.6	7.3	6.8
NPL net of provisions, in percent of capital	102.8	66.9	68.0	71.7	68.6	66.9	62.4	53.5	56.0	54.5	49.3	48.2	48.5	43.7
Earnings and profitability														
Gross profits, in percent of average assets (ROAA)	-2.7	-0.1	-2.0	1.5	1.4	1.3	0.1	0.3	0.5	0.7	0.8	0.3	0.5	0.5
Gross profits, in percent of average equity capital (ROAE)	-27.0	-0.6	-18.1	10.6	9.7	9.5	0.9	2.4	3.5	4.9	5.7	2.8	3.7	3.3
Net profits, in percent of average assets (ROAA)	-2.8	-0.1	-2.0	1.4	1.3	1.3	0.1	1.3	1.0	0.9	0.8	0.3	0.5	0.4
Net profits, in percent of average capital (ROAE)	-27.3	-1.1	-18.3	10.0	9.2	9.2	0.5	9.3	6.8	6.2	5.4	2.5	3.4	2.9
Net interest margin 1/	4.9	4.8	5.0	1.0	2.1	3.2	4.2	1.1	2.2	3.4	4.5	1.0	2.1	3.4
Gross income, in percent of average assets	5.4	5.2	5.2	5.2	5.3	5.2	5.2	5.2	5.2	5.3	5.2	4.6	4.9	7.6
Net interest income, in percent of gross income	71.6	70.5	73.1	69.5	71.0	70.3	68.2	72.0	71.2	70.7	70.2	73.9	72.8	70.0
Non-interest income, in percent of gross income	28.4	29.5	26.9	30.5	29.0	29.7	31.8	28.0	26.0	26.5	26.8	22.0	27.2	30.0
Net fee income, in percent of net interest income	30.3	28.6	24.2	27.8	26.9	31.1	32.5	30.7	30.4	31.1	31.5	24.6	28.7	30.6
Trading income, in percent of gross income	6.7	9.4	9.2	11.1	9.9	7.8	9.7	5.9	4.4	4.5	4.7	3.8	6.3	8.6
Aggregate overhead expenses, in percent of gross income	64.0	70.7	77.7	69.1	67.6	67.9	69.1	68.5	68.7	67.4	68.9	74.6	71.5	68.4
Liquidity														
Liquid assets, in percent of total assets	19.1	19.9	24.0	13.2	14.5	21.2	20.0	18.0	18.8	23.2	22.2	18.6	20.5	28.5
Liquid assets, in percent of short-term liabilities	32.9	32.8	40.1	21.3	23.5	34.1	32.2	29.0	29.6	36.1	35.7	29.9	32.1	44.3
Deposits, in percent of assets	60.8	64.7	70.5	69.9	69.7	71.5	71.6	71.6	72.1	73.5	74.2	74.4	74.9	75.8
Loans, in percent of deposits	122.9	107.6	94.0	114.8	113.4	108.8	105.8	105.5	102.4	99.9	95.1	93.9	92.3	90.9
Sensitivity to market risk														
Off-balance sheet operations, in percent of assets	429.5	464.0	370.5	359.8	335.9	318.8	319.7	312.2	308.2	301.3	293.1	301.2	291.2	268.1
Original maturity of assets (in percent of total)														
Less than 3 months	34.4	21.5	32.1	30.0	39.2	38.8	38.7	35.8	39.3	39.4	43.2	38.8	41.5	45.1
3 months to 1 year	17.2	28.2	23.4	23.3	17.3	18.7	16.6	19.8	17.0	19.0	16.0	18.5	15.3	14.0
1 to 5 years	33.6	35.4	31.5	31.0	30.6	30.0	31.6	31.9	31.4	29.8	28.9	29.7	30.8	29.4
Over 5 years	14.8	14.9	13.0	12.7	12.9	12.6	13.1	12.5	12.4	11.9	12.0	13.1	12.4	11.5
Original maturity of liabilities (in percent of total)														
Less than 3 months	38.5	21.9	31.3	40.9	40.0	41.2	40.4	39.0	42.9	42.5	38.9	31.4	34.1	33.8
3 months to 1 year	27.1	47.1	27.9	31.3	31.7	31.4	31.7	33.8	31.6	32.8	34.0	41.4	40.3	40.9
1 to 5 years	24.4	23.4	23.8	23.6	22.9	22.2	22.9	22.4	21.7	19.6	21.3	21.1	19.7	19.6
Over 5 years	10.0	7.7	4.3	4.2	5.4	5.3	5.0	4.8	3.9	5.1	5.7	6.1	5.9	5.7

Source: Central Bank of Montenegro.

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

Annex I. Montenegro: Public Debt Sustainability Analysis

Despite a sizeable fiscal adjustment in 2014, public sector debt has increased and is projected to rise further, to 80 percent of GDP by 2018, in the baseline. The projected debt trajectory is highly sensitive to shocks, especially a negative real GDP growth shock. Gross financing needs are high.

Baseline and Realism of Projections

- **Macroeconomic assumptions**. Growth momentum is projected to pick up to 4.1 percent in 2015 after a slowdown in 2014. Growth is expected to converge average 3¼ percent. Highway expenditures are assumed to add EUR 243 million to the nominal non-highway GDP path over the period 2015 to 2019 (being EUR 809 million less the assumed 70 percent import content), with an additional contemporaneous multiplier on aggregate demand of 30 percent during the construction phase.

- **Fiscal adjustment.** A sizeable fiscal adjustment was achieved in 2014 following a pension freeze and PIT and VAT rate hikes (including a one-off VAT receipts). In the baseline projections, the primary balance worsens significantly in 2015–17 because of increased highway expenditures, unfreezing of pensions, and persistent arrears and guarantee payments. Non-highway non-interest expenditures decrease modestly from their 2015 budget levels as a share of non-highway GDP in 2016–2020, implying cuts in mainly goods and services spending.

- **Heat map and debt profile vulnerabilities.** Risks from the debt level are deemed high as gross debt passes the 70 percent of GDP benchmark in 2016 in the baseline and increases substantially under several shock scenarios. Gross financing needs go above the 15 percent benchmark. Public debt held by non-residents also constitutes a vulnerability. Growth shocks have a very large impact on the debt profile.

- **Realism of baseline assumptions.** The median forecast errors for real GDP growth and inflation (actual minus projection) in 2005–2014 suggest on average an upward bias in staff's past projections. The median forecast error for the primary balance suggests that staff projections have been too pessimistic on average. With a large projected CAPB adjustment, the key risks are high dependence on external financing and vulnerability to macro shocks.

Shocks and Stress Tests

- **Stress tests indicate that growth shocks would have a substantial effect on the debt path.** Fiscal shocks, cost overruns, and delays related to the highway project would also have a major impact on fiscal sustainability.

Montenegro-specific stress tests

- **Highway shock.** In this scenario, the construction of the highway is assumed to cost 20 percent more (in 2018). Debt increases to 84 percent of GDP, while financing requirements far exceed those under the baseline in 2018.

Standard stress tests

- **Growth shock.** Under this scenario, real output growth rates fall during 2016 and 2017 by one standard deviation (4.9 ppt), also affecting inflation and interest rates. The public debt ratio increases to 99 percent by 2018, while the gross financing needs ratio in 2017 increases 7½ percentage points relative to the baseline. The variance in GDP growth has been increased by the financial crisis—arguably a rare event—but even with a half-standard deviation shock, the debt ratio escalates to 89 percent of GDP.

- **Interest rate shock.** This scenario examines the implications of an increase in interest rates on new debt by 200 basis points (relative to the baseline) in 2016–20. Debt increases by 2½ percentage points in 2020 by this scenario, while financing needs are affected only marginally.

- **Combined macro shock.** This scenario comprises a recession in 2016 and 2017, a 200 basis point increase in interest rates, and a sharp rise in expenditures. It pushes the debt to GDP ratio up to 95 percent of GDP in 2018, and also substantially affects gross financing needs.

- **Financial contingent liability shock.** The shock is equivalent to 10 percent of the size of the banking sector and is combined with a shock to GDP and interest rates. The shock results in a sharp increase in the debt ratio to peak at 97 percent of GDP. Meanwhile, gross financing needs would rise to over 27 percent of GDP in 2016, and stay above the baseline over the medium term.

- **Primary balance shock.** This scenario assumes a revenue shock and a rise in interest rates leading to a two percentage point deterioration in the primary balance in 2016 and 2017. The combined shocks lead to deterioration in the debt ratio by about 5 percent of GDP, while the impact on gross financing needs, is somewhat more than the interest rate shock scenario on average.

- **Real exchange rate shock.** The scenario assumes a 13 percent devaluation in the real exchange rate in 2016. The ExIm loan is issued piecemeal over the course of highway spending. The impact is below 1 percent of GDP, though the impact depends critically on the extent of exchange rate pass-through to inflation.

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

(in percent of GDP unless otherwise indicated)

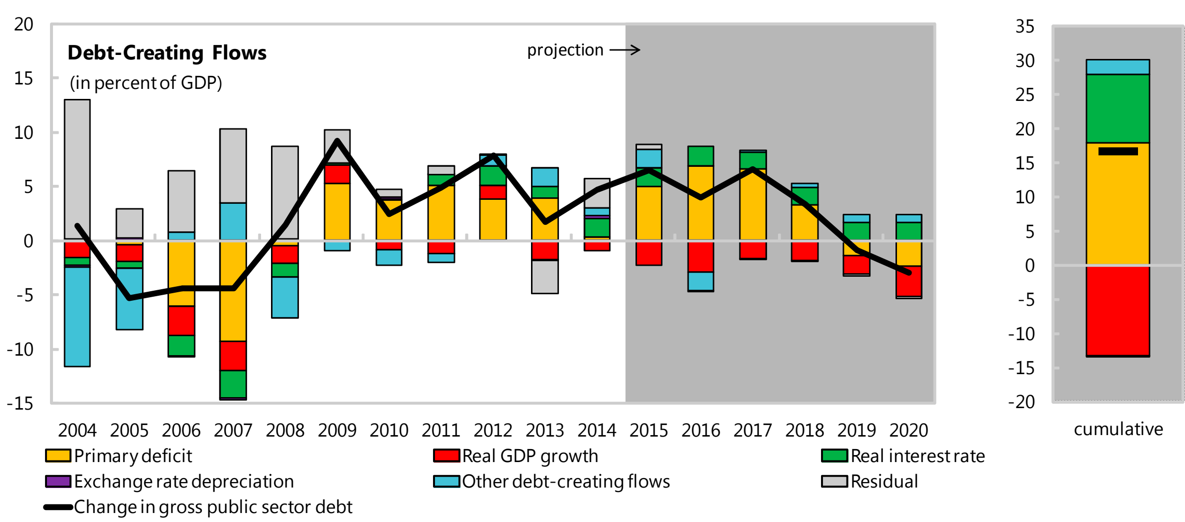
Debt, Economic and Market Indicators 1/

	Actual			Projections					
	2004-2012 2/	2013	2014	2015	2016	2017	2018	2019	2020
Nominal gross public debt	38.2	55.2	59.9	66.5	70.5	77.1	80.4	79.6	76.6
Public gross financing needs	2.4	9.5	5.1	17.8	19.1	13.5	7.5	9.3	11.8
Real GDP growth (in percent)	3.6	3.5	1.8	4.1	4.6	2.5	2.5	2.2	3.8
Inflation (GDP deflator, in percent)	5.1	2.1	1.0	1.2	0.8	1.3	1.5	1.7	1.8
Nominal GDP growth (in percent)	9.0	5.7	2.8	5.3	5.5	3.9	4.1	3.9	5.6
Effective interest rate (in percent) 4/	3.5	4.2	4.2	4.2	3.7	3.6	3.8	3.8	4.0

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

Contribution to Changes in Public Debt

	Actual			Projections							
	2004-2012	2013	2014	2015	2016	2017	2018	2019	2020	cumulative	debt-stabilizing primary balance 9/
Change in gross public sector debt	1.5	1.8	4.7	6.5	4.0	6.6	3.4	-0.9	-3.0	16.7	
Identified debt-creating flows	-3.1	4.8	2.1	6.1	4.1	6.6	3.4	-0.7	-2.8	16.7	
Primary deficit	0.2	3.9	0.3	5.0	6.9	6.6	3.3	-1.4	-2.4	17.9	-0.5
Primary (noninterest) revenue and gr	43.1	41.3	43.5	40.6	42.2	41.9	41.8	42.1	41.8	250.4	
Primary (noninterest) expenditure	43.3	45.3	43.8	45.6	49.1	48.4	45.1	40.6	39.5	268.3	
Automatic debt dynamics 5/	-1.5	-0.9	1.0	-0.6	-1.1	-0.2	-0.3	0.0	-1.2	-3.4	
Interest rate/growth differential 6/	-1.5	-0.8	0.7	-0.6	-1.1	-0.2	-0.3	0.0	-1.2	-3.4	
Of which: real interest rate	-0.4	1.0	1.7	1.7	1.8	1.5	1.6	1.6	1.6	10.0	
Of which: real GDP growth	-1.0	-1.8	-1.0	-2.3	-2.9	-1.7	-1.9	-1.7	-2.8	-13.3	
Exchange rate depreciation 7/	0.0	-0.1	0.3	…	…	…	…	…	…	…	
Other identified debt-creating flows	-1.8	1.7	0.7	1.8	-1.7	0.2	0.4	0.8	0.8	2.2	
Privatization (negative)	-2.0	-1.5	0.2	1.8	-1.7	0.2	0.4	0.8	0.8	2.2	
Contingent liabilities	0.2	3.2	0.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other debt flows	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes 8/	4.6	-3.0	2.7	0.4	-0.1	0.0	-0.1	-0.2	-0.2	0.0	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Long-term bond spread over German bonds.

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

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

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

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

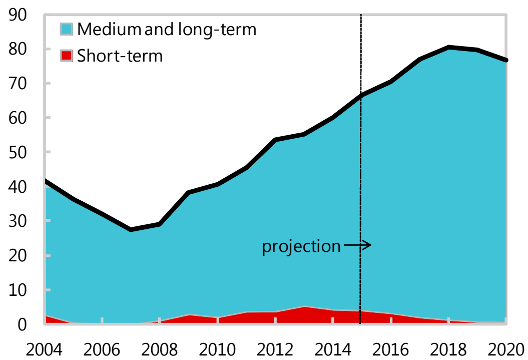
8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

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

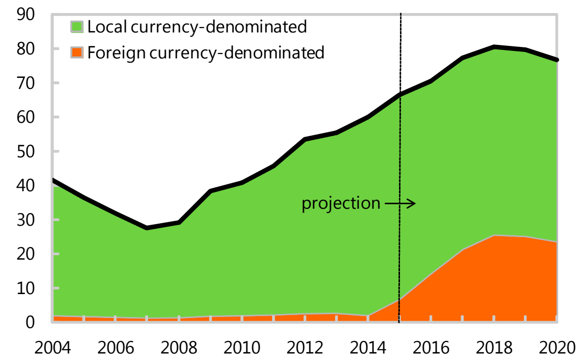
Montenegro: Public DSA - Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(in percent of GDP)



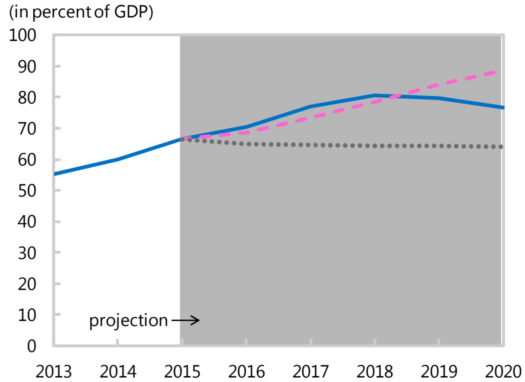
By Currency
(in percent of GDP)



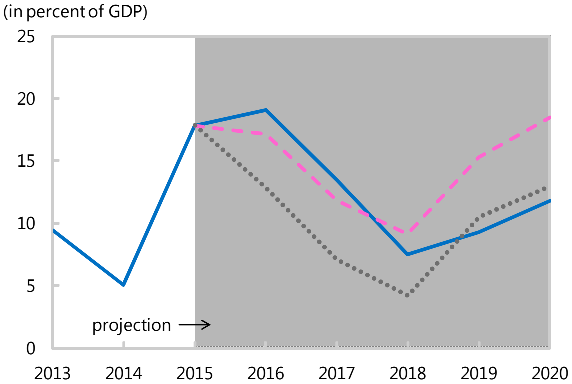
Alternative Scenarios

Baseline Historical Constant Primary Balance

Gross Nominal Public Debt
(in percent of GDP)



Public Gross Financing Needs
(in percent of GDP)



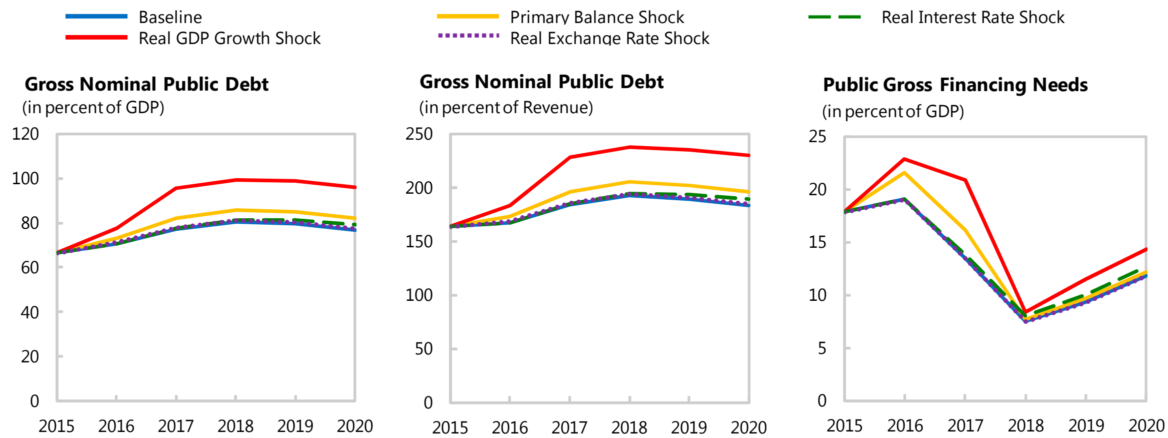
Underlying Assumptions
(in percent)

Baseline Scenario	2015	2016	2017	2018	2019	2020
Real GDP growth	4.1	4.6	2.5	2.5	2.2	3.8
Inflation	1.2	0.8	1.3	1.5	1.7	1.8
Primary Balance	-5.0	-6.9	-6.6	-3.3	1.4	2.4
Effective interest rate	4.2	3.7	3.6	3.8	3.8	4.0
Constant Primary Balance Scenario						
Real GDP growth	4.1	4.6	2.5	2.5	2.2	3.8
Inflation	1.2	0.8	1.3	1.5	1.7	1.8
Primary Balance	-5.0	-5.0	-5.0	-5.0	-5.0	-5.0
Effective interest rate	4.2	3.7	3.6	3.7	3.8	4.2

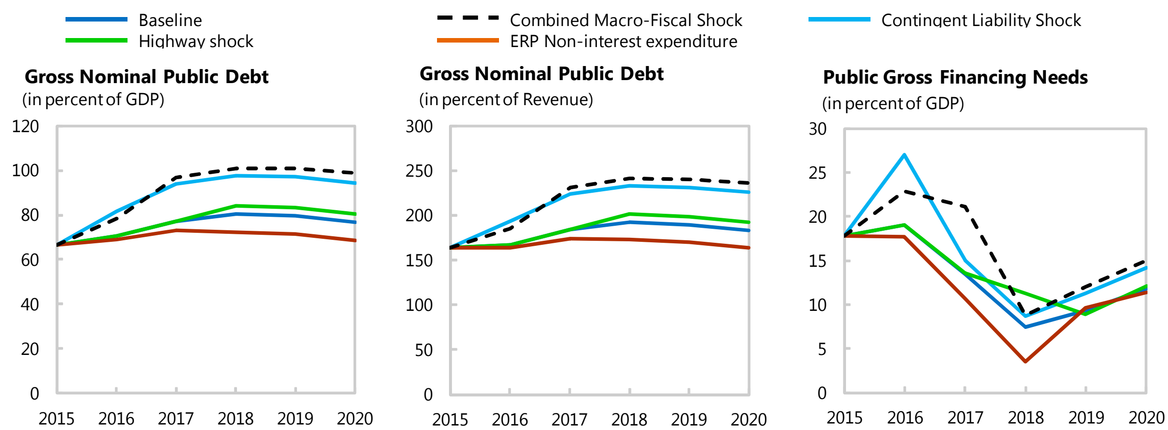
Historical Scenario	2015	2016	2017	2018	2019	2020
Real GDP growth	4.1	3.3	3.3	3.3	3.3	3.3
Inflation	1.2	0.8	1.3	1.5	1.7	1.8
Primary Balance	-5.0	-0.6	-0.6	-0.6	-0.6	-0.6
Effective interest rate	4.2	3.7	3.1	2.9	2.8	2.5

Montenegro: Public DSA - Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions
(in percent)

Primary Balance Shock	2015	2016	2017	2018	2019	2020
Real GDP growth	4.1	4.6	2.5	2.5	2.2	3.8
Inflation	1.2	0.8	1.3	1.5	1.7	1.8
Primary balance	-5.0	-9.4	-9.0	-3.3	1.4	2.4
Effective interest rate	4.2	3.7	3.8	4.0	4.1	4.3
Real Interest Rate Shock						
Real GDP growth	4.1	4.6	2.5	2.5	2.2	3.8
Inflation	1.2	0.8	1.3	1.5	1.7	1.8
Primary balance	-5.0	-6.9	-6.6	-3.3	1.4	2.4
Effective interest rate	4.2	3.7	4.1	4.6	4.8	5.2
Combined Shock						
Real GDP growth	4.1	-0.3	-2.4	2.5	2.2	3.8
Inflation	1.2	-0.4	0.1	1.5	1.7	1.8
Primary balance	-5.0	-9.9	-12.8	-3.3	1.4	2.4
Effective interest rate	4.2	3.8	4.2	4.7	4.9	5.3

Real GDP Growth Shock	2015	2016	2017	2018	2019	2020
Real GDP growth	4.1	-0.3	-2.4	2.5	2.2	3.8
Inflation	1.2	-0.4	0.1	1.5	1.7	1.8
Primary balance	-5.0	-9.9	-12.8	-3.3	1.4	2.4
Effective interest rate	4.2	3.7	3.8	4.3	4.3	4.5
Real Exchange Rate Shock						
Real GDP growth	4.1	4.6	2.5	2.5	2.2	3.8
Inflation	1.2	1.2	1.3	1.5	1.7	1.8
Primary balance	-5.0	-6.9	-6.6	-3.3	1.4	2.4
Effective interest rate	4.2	3.8	3.6	3.8	3.8	4.0
Contingent Liability Shock						
Real GDP growth	4.1	-0.3	-2.4	2.5	2.2	3.8
Inflation	1.2	-0.4	0.1	1.5	1.7	1.8
Primary balance	-5.0	-13.9	-6.6	-3.3	1.4	2.4
Effective interest rate	4.2	4.0	4.2	4.3	4.3	4.5

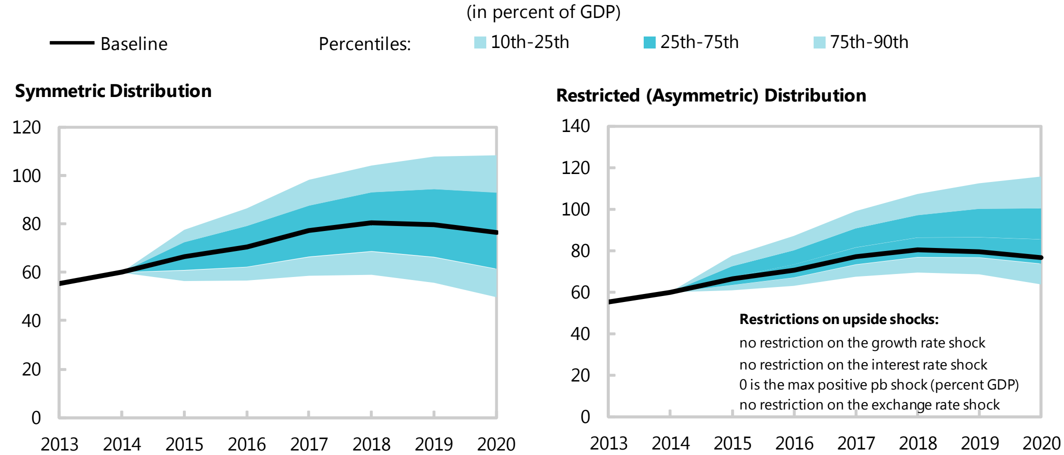
Montenegro: Public DSA Risk Assessment

Heat Map

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

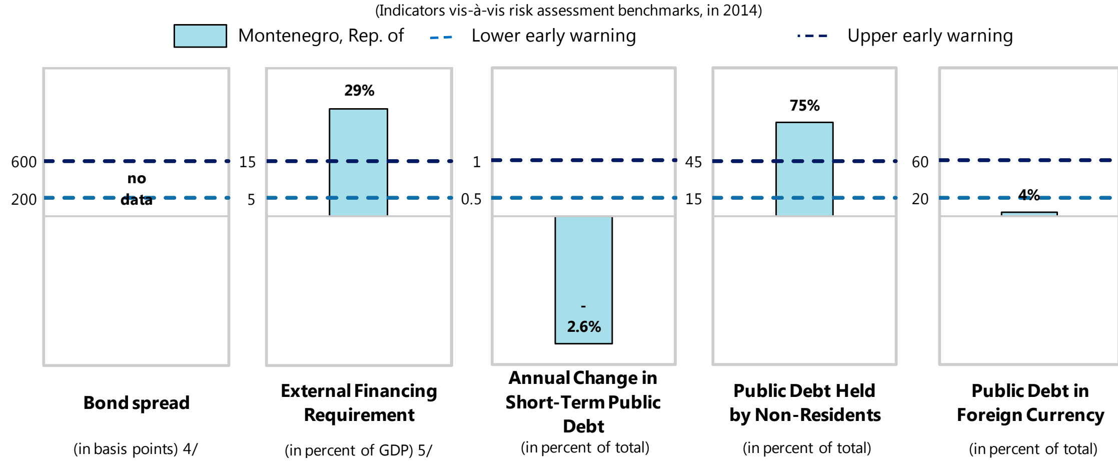
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2014)



Source: IMF staff.

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

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

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

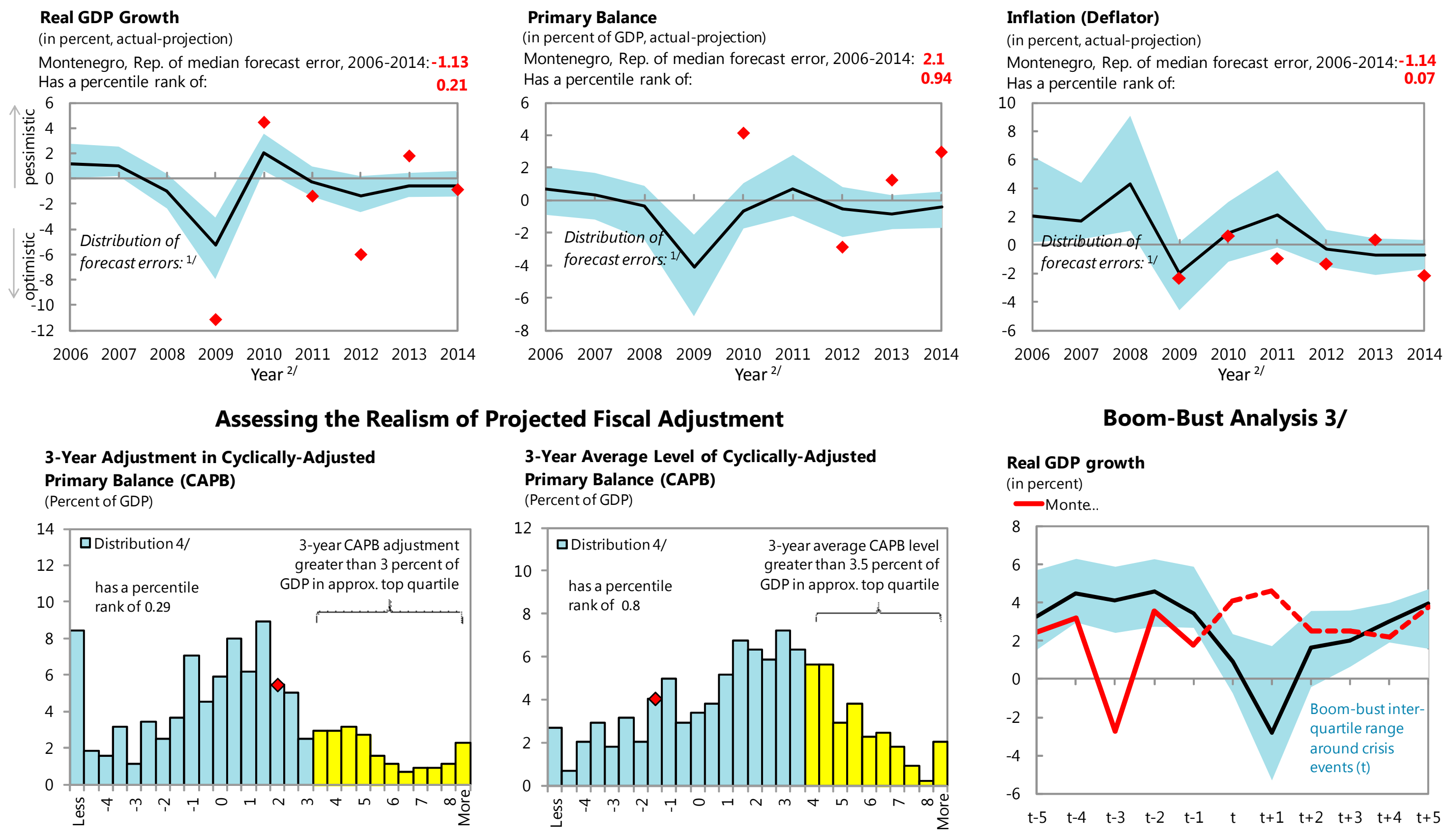
200 and 600 basis points for bond spreads; 5 and 15 percent of GDP for external financing requirement; 0.5 and 1 percent for change in the share of short-term debt; 15 and 45 percent for the public debt held by non-residents; and 20 and 60 percent for the share of foreign-currency denominated debt.

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

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

Montenegro: Public DSA - Realism of Baseline Assumptions

Forecast Track Record, versus all countries



Source : IMF Staff.

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

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

3/ Montenegro, Rep. of has had a positive output gap for 3 consecutive years, 2012-2014. For Montenegro, Rep. of, t corresponds to 2015; for the distribution, t corresponds to the first year of the crisis.

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

Annex II. Montenegro: External Debt Sustainability Analysis

External debt has increased by 17 percentage points of GDP since 2008, to an estimated 155 percent of GDP in 2014. This was driven partly by the sharp increase in public debt, which more than doubled over this period and comprises about 39 percent of total external debt. Under the baseline, external debt is projected to peak at 164 percent of GDP driven by a rapid increase in public debt. The projected debt trajectory is highly sensitive to various shocks, particularly a depreciation of the euro.

Shocks and Stress Tests

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

Standard stress tests

- **Growth shock.** Under this scenario, the baseline real GDP growth profile is permanently reduced by a one-half standard deviation calculated over the recent 10-year period (3.4 percent). This corresponds to an average contraction during 2016–20 of -0.3 percent of GDP, compared with baseline average growth of 3.1 percent. Under this scenario, the external debt ratio increases to 181 percent of GDP in 2020.

- **Interest rate shock.** This scenario examines the implications of an increase in nominal external interest rates on new debt (relative to the baseline) by a one-half standard deviation during 2016–20. Stable average external interest rates historically imply only a modest average increase in interest rates of 13 basis points in this scenario and, consequently, a relatively small increase in the external debt profile to 160 percent of GDP by 2020.

- **Non-Interest Current Account shock**. This scenario permanently increases the non-interest current account by one-half standard deviation in 2016–20. Given historically-high current account deficits, this amounts to an increase of 6¼ percentage points. In the absence of offsetting debt creating flows, external debt increases to 189 percent of GDP by 2020.

- **Combined macro shock.** This scenario comprises a permanent ¼ standard deviation shock applied to the real interest rate, the growth rate, and the current account deficit during 2016–20. The combined shock pushes the external debt ratio to 185 percent of GDP and increases gross financing needs by 28 percent of GDP cumulatively over the shock period.

- **Real exchange rate shock.** The scenario assumes a one-time 30 percent devaluation in the real exchange rate in 2015 applied to the stock of external debt. Second round impacts (in terms of potential increases in competitiveness and improved trade balances) are not taken into account. Given the large stock of external debt, the shock increases the external debt-to-GDP ratio by 70 percent of GDP in 2016. Gross financing needs are correspondingly higher, by about 18 percent of GDP on average over 2016–20 relative to the baseline.

Table 1. Montenegro: External Debt Sustainability Framework, 2010–20

(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2010	2011	2012	2013	2014	10-Year Historical Average	10-Year Standard Deviation	2015	2016	2017	2018	2019	2020	Debt-stabilizing non-interest current account 6/
1 **Baseline: External debt**	141.6	145.0	155.9	151.5	154.8			**152.1**	**154.8**	**161.4**	**164.1**	**163.1**	**158.7**	**-18.0**
2 Change in external debt	-0.7	3.4	10.9	-4.5	3.3			-2.7	2.7	6.6	2.7	-1.0	-4.4	
3 Identified external debt-creating flows (4+8+9)	-1.5	-0.4	7.8	-3.6	0.8			-8.3	-0.1	3.1	2.7	-0.4	-4.7	
4 Current account deficit, excluding interest payments	19.4	13.8	14.9	11.1	12.0			10.3	15.6	16.1	16.1	12.6	10.5	
5 Deficit in balance of goods and services	25.7	22.0	24.4	20.1	19.8			17.9	23.2	23.7	23.6	20.1	18.1	
6 Exports	37.0	42.3	43.7	41.3	40.1			41.8	39.8	40.3	40.7	41.3	41.7	
7 Imports	62.7	64.3	68.1	61.4	60.0			59.7	63.0	63.9	64.4	61.5	59.8	
8 Net non-debt creating capital inflows (negative)	-17.7	-11.9	-14.5	-9.6	-10.2			-15.7	-12.0	-12.3	-12.5	-12.5	-12.5	
9 Automatic debt dynamics 1/	-3.3	-2.3	7.4	-5.0	-1.0			-3.0	-3.7	-0.7	-0.9	-0.5	-2.8	
10 Contribution from nominal interest rate	3.3	3.8	3.6	3.4	3.2			3.0	3.0	3.0	3.0	3.0	3.0	
11 Contribution from real GDP growth	-3.3	-4.4	4.1	-5.2	-2.6			-6.0	-6.7	-3.7	-3.9	-3.4	-5.8	
12 Contribution from price and exchange rate changes 2/	-3.2	-1.7	-0.3	-3.2	-1.6			...	...	...	...	...	...	
13 Residual, incl. change in gross foreign assets (2-3) 3/	0.8	3.8	3.2	-0.9	2.5			5.6	2.8	3.5	0.0	-0.6	0.4	
External debt-to-exports ratio (in percent)	382.4	342.4	357.0	366.4	385.5			363.6	388.5	400.7	402.8	394.8	380.4	
Gross external financing need (in billions of Euro) 4/	1.1	0.9	0.9	0.9	1.0			1.2	1.6	1.5	1.5	1.7	1.9	
in percent of GDP	35.0	27.7	29.6	26.1	29.2			34.0	40.5	37.5	36.6	40.4	42.1	
Scenario with key variables at their historical averages 5/								**152.1**	**153.1**	**155.3**	**154.5**	**153.3**	**153.0**	**-23.3**
Key Macroeconomic Assumptions Underlying Baseline														
Real GDP growth (in percent)	2.5	3.2	-2.7	3.5	1.8	3.8	6.8	4.1	4.6	2.5	2.5	2.2	3.8	
GDP deflator in US dollars (change in percent)	2.3	1.2	0.2	2.1	1.0	5.0	6.7	1.2	0.8	1.3	1.5	1.7	1.8	
Nominal external interest rate (in percent)	2.4	2.8	2.4	2.3	2.2	2.4	0.3	2.0	2.1	2.0	1.9	1.9	1.9	
Growth of exports (Euro terms, in percent)	12.6	19.4	0.5	0.1	-0.1	13.9	25.5	9.7	0.4	5.0	5.3	5.4	6.6	
Growth of imports (Euro terms, in percent)	0.6	7.1	3.2	-4.7	0.4	15.4	34.4	4.8	11.3	5.4	4.8	-0.8	2.8	
Current account balance, excluding interest payments	-19.4	-13.8	-14.9	-11.1	-12.0	-20.4	12.6	-10.3	-15.6	-16.1	-16.1	-12.6	-10.5	
Net non-debt creating capital inflows	17.7	11.9	14.5	9.6	10.2	14.0	10.5	15.7	12.0	12.3	12.5	12.5	12.5	

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

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

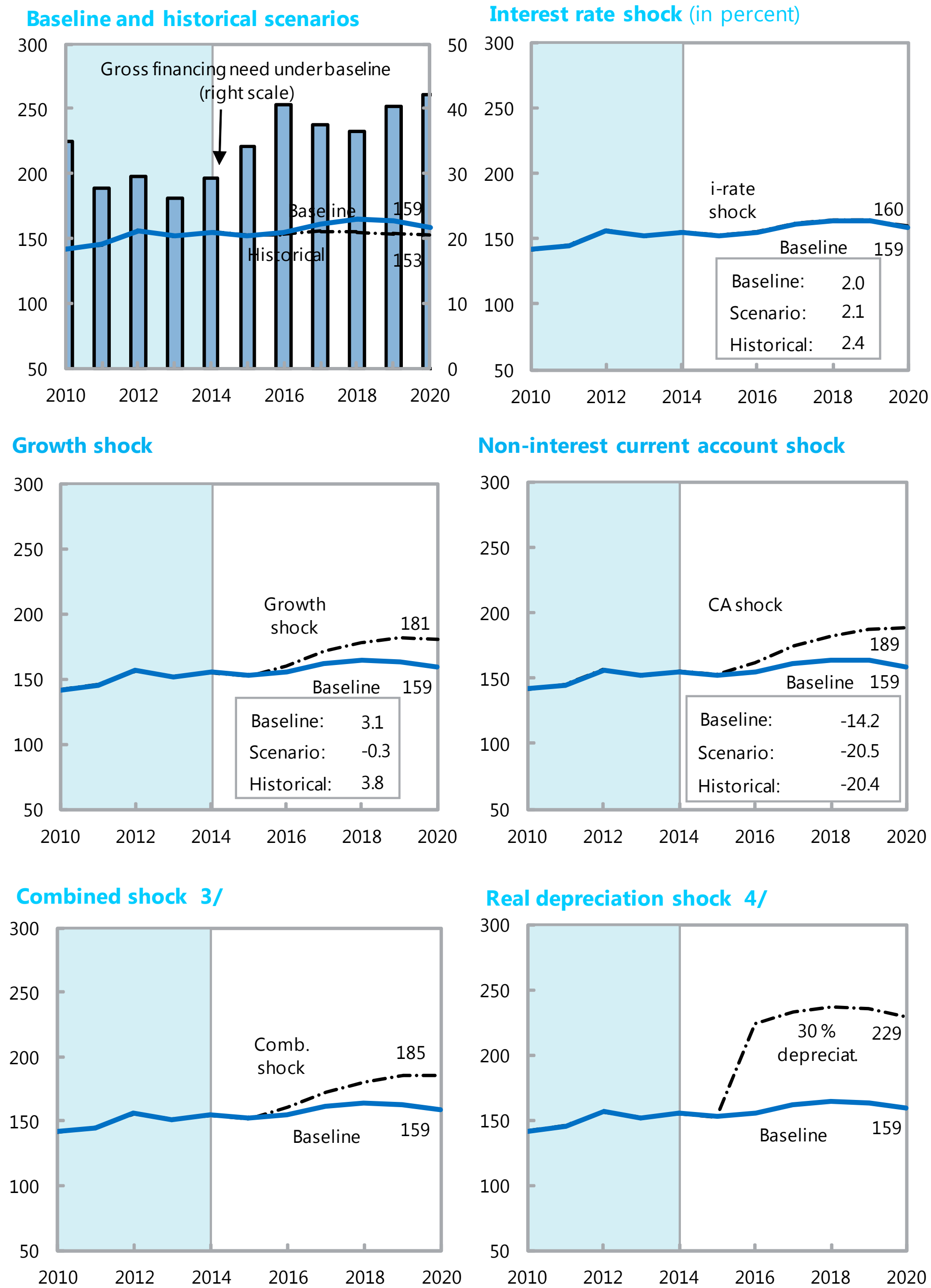
3/ For projection, line includes the impact of price and exchange rate changes.

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

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

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

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

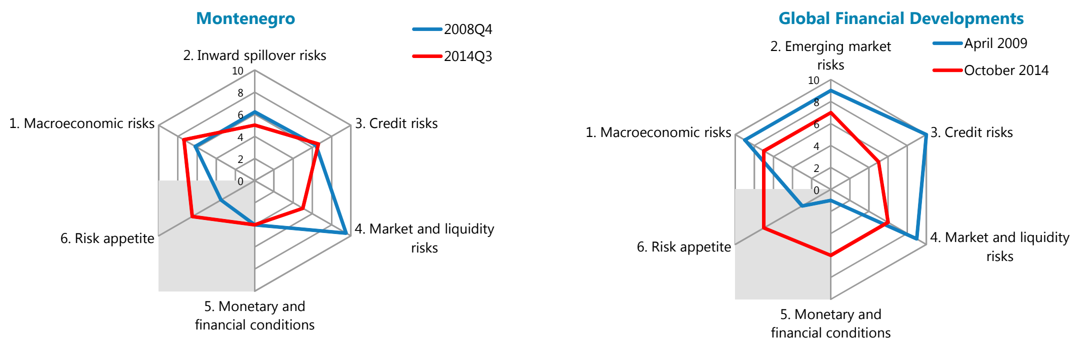


Sources: International Monetary Fund, country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented.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

Annex III. Financial Stability Indicators

The financial sector appears stable and a risk of an imminent deterioration is limited. Although macro-financial indicators have not improved significantly since the financial crisis, developments are not out of line with global trends. Domestic asset prices do not signal imbalances; property prices have been declining, but gradually. Overall financial sector vulnerability is assessed as modest. Risks relate mainly to high NPLs and limited capacity by the central bank for lender-of-last-resort assistance.

Financial Stability Maps



Note: Away from center signifies higher risks, easier monetary and financial conditions, or higher risk appetite.

Montenegro: Financial Sector Indicators Map

	2012Q2	2012Q3	2012Q4	2013Q1	2013Q2	2013Q3	2013Q4	2014Q1	2014Q2	2014Q3	2014Q4	2015Q1
Overall Financial Sector Rating	M	M	M	M	M	M	M	M	M	M	M	M
Credit cycle	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	L	L	L	L
Change in credit / GDP ratio (pp, annual)	-7.2	-5.2	-1.2	2.9	2.0	-0.1	-0.3	-4.4	-3.9	-2.6	-2.7	-2.7
Growth of credit / GDP (%, annual)	-11.4	-8.5	-2.2	5.2	3.6	-0.2	-0.5	-7.6	-6.7	-4.8	-4.9	-4.9
Credit-to-GDP gap (st. dev)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	1.1	0.8	0.6	0.6
Balance Sheet Soundness	M	M	M	M	M	M	M	M	M	M	M	M
Balance Sheet Structural Risk	*M*	*M*	*M*	*M*	*M*	*M*	*M*	*M*	*M*	*M*	*M*	*M*
Deposit-to-loan ratio	94.1	105.8	106.3	80.0	81.4	85.2	86.7	87.2	89.9	92.5	97.1	97.1
FX liabilities % (of total liabilities)	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
FX loans % (of total loans)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Balance Sheet Buffers	*M*	*M*	*M*	*M*	*M*	*M*	*M*	*M*	*M*	*M*	*M*	*M*
Leverage	*L*	*L*	*L*	*L*	*L*	*L*	*L*	*L*	*L*	*L*	*L*	*L*
Leverage ratio (%)	10.5	9.3	10.3	13.7	13.9	13.9	13.4	14.2	14.2	14.2	14.2	14.2
Profitability	*H*	*H*	*H*	*L*	*L*	*L*	*L*	*L*	*L*	*L*	*L*	*L*
ROA	-1.3	-2.3	-2.0	1.4	1.3	1.3	0.1	1.3	1.0	0.9	0.8	0.8
ROE	-11.9	-21.7	-18.3	10.0	9.2	9.2	0.5	9.3	6.8	6.2	5.4	5.4
Asset quality	*H*	*H*	*H*	*H*	*H*	*H*	*H*	*H*	*H*	*H*	*H*	*H*
NPL ratio	17.1	18.5	17.6	19.4	18.8	18.4	18.4	17.2	17.9	17.3	16.8	16.8
NPL ratio change (%, annual)	-32.4	-6.1	13.3	27.5	9.9	-0.8	4.4	-11.2	-4.8	-5.8	-8.7	-8.7

Vulnerability codes:

- High vulnerability
- Medium vulnerability
- Low vulnerability

Sources: Fund staff estimates base on authorities' data.

Appendix I. Spillovers from the Highway Project

The highway can be expected to generate temporary demand spillovers to the rest of the economy during the construction phase and permanent supply effects when completed. The size of these effects is uncertain, particularly for large-scale infrastructure projects. Based on the structural characteristics of Montenegro's economy, projections assume a demand multiplier of 0.3. Empirical studies suggest that effects of public infrastructure works on supply can be sizeable. In Montenegro's case, these gains are only likely to be realized when the Bar-Boljare highway is completed; gains from completion of the currently-planned first phase will likely be more modest.

A. Demand Spillovers during Construction of the Highway

1. The construction of the highway can be expected to generate demand spillovers, to the extent that the increased expenditure generates demand for local goods and services, with conventional "multiplier" effect through the economy. Multipliers are usually thought to be between 0 and 1 for advanced economies, but can exceed 1 in abnormal circumstances, such as when an economy is in a severe downturn or if the monetary transmission mechanism is impaired.[1] Multipliers are typically smaller for emerging and low-income countries, and even negative when public debt is high.[2] Studies suggest that output effects of an exogenous fiscal shock dissipate within 5-years and impacts from a temporary fiscal policy measure do not generally last beyond the duration of the measure itself.

2. Precise estimates of fiscal multipliers for Montenegro are not readily available but can be indirectly estimated. For such countries, Batini, Eyraud, and Weber (2014) propose assigning multiplier ranges to countries based on their structural characteristics. According to Batini et al., structural characteristics found to increase the size of fiscal multipliers include:

- *Low trade openness:* Countries with higher propensities to import (such as Montenegro) tend to have higher lower multipliers because demand "leaks" out through imports (Barrell and others, 2012; Ilzetzki and others, 2013).
- *High labor market rigidity:* Countries with more rigid labor markets (i.e., with relatively strong unions and/or with labor market regulation) have larger fiscal multipliers if such rigidity implies reduced wage flexibility. Rigid wages tend to amplify the response of output to demand shocks (Cole and Ohanian, 2004; Gorodnichenko and others, 2012).

[1] The literature also finds that spending multipliers tend to be larger than revenue multipliers. Based on a survey of 41 studies, Mineshima et al. (2014) show that first-year multipliers in advanced economies average around 0.75 for spending and 0.25 for revenues.

[2] See Estevão and Samake (2013), Ilzetzki and others (2013), Ilzetzki (2011), and Kraay (2012).

- *Small automatic stabilizers:*[3] Larger automatic stabilizers reduce fiscal multipliers, since mechanically the automatic response of transfers and taxes offsets part of the initial fiscal shock, thus lowering its effect on GDP (Dolls and others, 2012).

- *Fixed or quasi-fixed exchange rate regimes:* Countries with flexible exchange rate regimes tend to have smaller multipliers, because exchange rate movements can offset the impact of discretionary fiscal policy (Born and others, 2013; Ilzetzki and others, 2013).

- *Low/safe public debt levels:* High-debt countries generally have lower multipliers, as fiscal stimulus is likely to have negative effects on private demand and increase interest rate premia (Ilzetzki and others, 2013, Kirchner and others, 2010).

- *Effective public expenditure management and revenue administration:* Multipliers are expected to be smaller when difficulties to collect taxes (such as from informality) and expenditure inefficiencies limit the impact of fiscal policy on output.

The authors' proposed "bucket" approach differentiates countries based on the number of structural characteristics according to the table below. More structural characteristics imply a high multiplier range.

Ranges of First-Year Overall Multipliers

Country Category	Multiplier Ranges	Relevant Structural Characteristics
Low multiplier	0.1–0.3	0 to 3
Medium multiplier	0.4–0.6	3 to 4
High multiplier	0.7–1.0	4 to 6

3. **This approach implies a relatively low multiplier for Montenegro.** Only two structural factors that would imply a higher multiplier clearly apply: labor market rigidity and a quasi "fixed" exchange rate. Since the default is zero, this puts Montenegro in the low multiplier range. Nor is Montenegro currently operating below capacity, which can be an argument for increasing the size of the multiplier. On this basis, the projections assume a demand multiplier during the construction phase of 0.3.

B. Productive Impact of the Highway Project

4. **The completed highway can be expected to generate positive supply effects,** to the extent that it adds to the economy's productive potential by creating better opportunities for private business growth. IMF research on the macroeconomic effects of public infrastructure investment for advanced and developing countries (2014 October World Economic Outlook)

[3] Automatic stabilizers are considered small if the ratio of public spending to nominal GDP is below 40 percent, which is not the case in Montenegro.

shows that public investment shocks have statistically significant and long-lasting effects on output. Specifically, the average effect of a 1 percent unanticipated shock to public infrastructure spending is a 0.4 percent increase in the level of output after the first year, increasing to 1.5 percent after 5 years. (NB: the literature does not argue for an increase in the potential growth rate.)

5. A conservative supply effect is assumed for the first stage of the Bar-Boljare stage of the highway. As with the demand multipliers, the effects differ depending on economic circumstances. The impact can be expected to be weaker i) during periods of high growth or when the economy is running at or close to capacity; ii) in countries that exhibit a low degree of public investment efficiency; and iii) when public investment is budget neutral (rather than debt financed).[4] The first two characteristics apply to Montenegro. In addition, the full effects on supply will likely only be realized when the entire highway from the coastal port of Bar to the Serbian border is completed, along with connections within Serbia itself. In view of these considerations, staff assumes the productive boost upon completion of the first segment of the highway is only likely to be 20 percent of the level effects found in the WEO.

C. Incorporating the Highway into the Projections

6. Because the highway spending is so large (in terms of the size of the Montenegrin economy), it is treated specifically when making projections. The first step is to evaluate actual spending on the highway (as compared to drawdown in debt) for each year. The highway contract stipulates that 30 percent of the project be sourced locally, with the rest spent on imported goods and services, The total value added of the highway during the construction phase is estimated at around 1½ percent of non-highway GDP on average during 2015–2019. Demand spillovers apply to the net value added of total expenditure. Supply effects, however, apply to the entire value of the installed capital stock, regardless of whether that is from local or imported inputs.

[4] Empirical evidence for emerging markets suggests that debt-financed public spending is associated with higher and more volatile sovereign risk spreads than tax-financed spending (Akitoby and Stratmann, 2008). For further discussion of the links between public debt, public investment, and growth, see Ostry, Ghosh, and Espinoza, 2014.

Appendix II. Analysis of Macrofinancial Linkages

Financial development in Montenegro ranks relatively well within the Western Balkan region, but lags that of more advanced emerging European economies, suggesting growth benefits from further financial sector deepening. Similarly, financial inclusion is in line with incomes, but there is room for improvement, particularly in reducing disparities related to gender, the level of education, and region. The process of balance sheet repair is ongoing—the private sector remains highly indebted, with the degree of leverage for corporates being especially high. This constrains the prospects of a sustained strong credit-led recovery and also leaves the country vulnerable to shocks. A simple VAR model for Montenegro suggests that credit has a strong effect on output, compared with some regional and European peers.

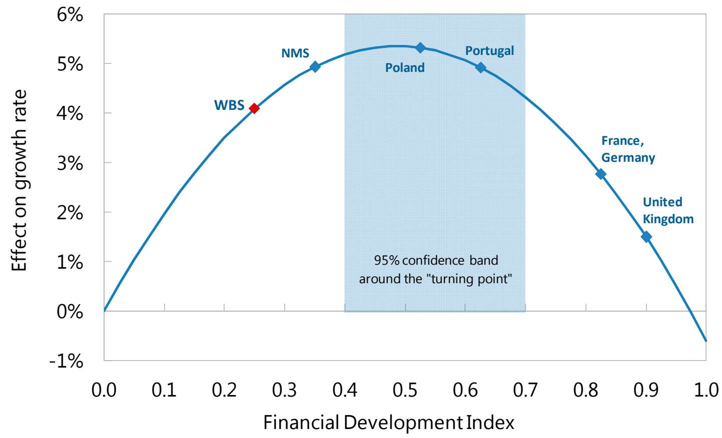
1. Montenegro's experience of boom and bust draws attention to macrofinancial linkages. This appendix looks at the role of the financial system in promoting growth and welfare and, in particular, the effects of credit. It looks first at the link between Montenegro's level of financial development and growth, and then turns to the related issue of financial inclusion and welfare. Both of these issues are secular; the analysis then turns to the questions of the cyclical effects of recent deleveraging pressures and, with a view to future prospects for growth, the role of credit in the business cycle.

A. Financial Development

2. Theory and evidence suggests a trade-off between financial development and growth. In theory, more efficient and extensive financial systems should boost economic growth. At very high levels of credit and with large financial sectors, the frequency of booms and busts could increase, and human capital could be diverted away from potentially more productive sectors toward the financial sector. Indeed, empirical analysis by the IMF indicates that there is a significant bell-shaped, relationship between financial development and growth.[1]

[1] See Sahay, R., et al.,"Rethinking Financial Deepening: Stability and Growth in Emerging Markets," IMF Staff Discussion Note (SDN15/08), International Monetary Fund, Washington, D.C.

Financial Development Effect on Growth



Sources: IMF staff estimates

3. Increased financial development would likely be associated with higher growth. The estimated degree of financial development among Western Balkan States is well below the optimal level for growth, and below that of New Member States. The level of financial development in Montenegro, calculated using a proxy, appears to be similar to the rest of the Western Balkans. Hence, notwithstanding the severity of the boom-bust cycle that Montenegro experienced, more financial development would be consistent with higher growth.

Financial Development Index by Region

(index from 1-0; 1 indicates full development)

	Index
Western Balkan States (WBS)	**0.27**
Montenegro 1/	*0.26*
Albania	*0.23*
Bosnia and Herzegovina	*0.27*
Croatia	*0.42*
Kosovo 1/	*0.23*
Macedonia	*0.28*
Serbia	*0.22*
New EU Member States (NMS) 2/	**0.38**
Other EU countries	**0.72**
United States	**0.87**

1/ Proxied by the ratio of corporate credit to GDP.

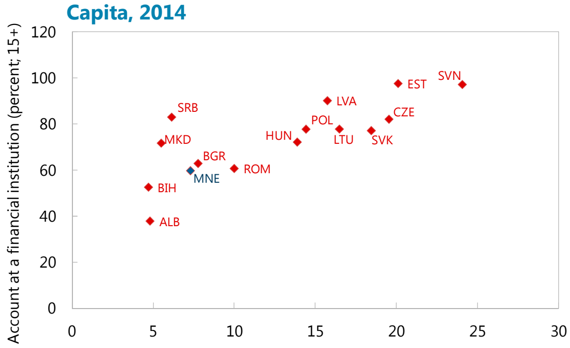
2/ Comprises of Central Eastern European (CEE) states (Bulgaria, Czech Republic, Hungary, Poland, Romania, Slovakia, and Slovenia) and Baltic countries (Estonia, Latvia, and Lithuania).

B. Financial Inclusion

4. The level of financial inclusion in Montenegro is consistent with its level of development. Financial inclusion is an important means to reduce poverty and increase personal opportunities. Access to financial services in Montenegro has improved in recent years. Adults that report having an account at a formal financial institution (a bank, credit union, cooperative, post office, or microfinance institution) have increased by nearly 10 percent over the past three years to 60 percent—close to the average prevailing in the Western Balkan region. While this lags progress achieved in new EU member states (NMS) [2]—where on average about 80 percent of adults maintain a bank account—the degree of financial penetration in Montenegro is in line with what might be expected given the size of the economy.

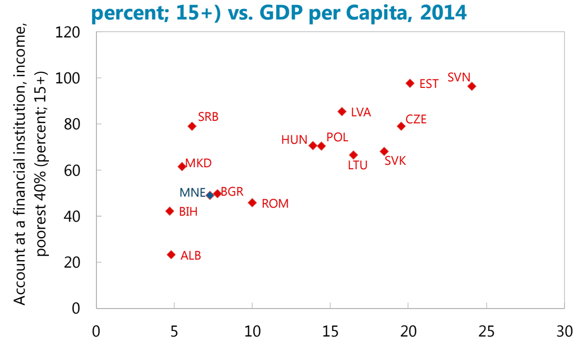
[2] WBS refers to Western Balkan States (Albania, Bosnia and Herzegovina, Croatia, Kosovo, FYR Macedonia, Montenegro, and Serbia). New Member States (NMS) comprise of Bulgaria, Czech Republic, Hungary, Poland, Romania, Slovakia, and Slovenia. Baltic countries are Estonia, Latvia, and Lithuania.

Accounts at a Financial Institution (15+) vs. GDP per Capita, 2014



Sources: Demirguc-Kunt et al., 2015; and World Economic Outlook.

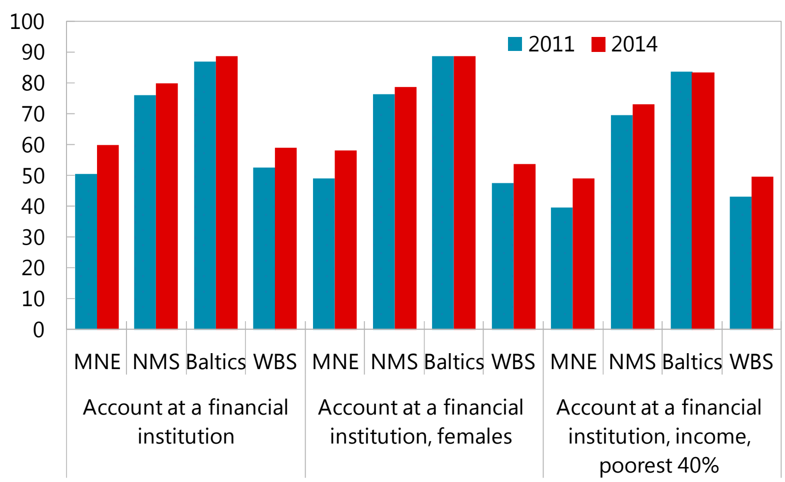
Accounts at a Financial Institution (Poorest 40 percent; 15+) vs. GDP per Capita, 2014



Sources: Demirguc-Kunt et al., 2015; and World Economic Outlook.

5. However, there are many differences in financial inclusion across different groups in Montenegro. Although financial deepening advanced rapidly in Montenegro during 2006–08, the poor were not primary beneficiaries, with only half of the population among the bottom 40 percent of incomes having access to some kind of financial institution. This compares to two thirds of the top 60 percent of the population, comparable to the average for the Western Balkan region.

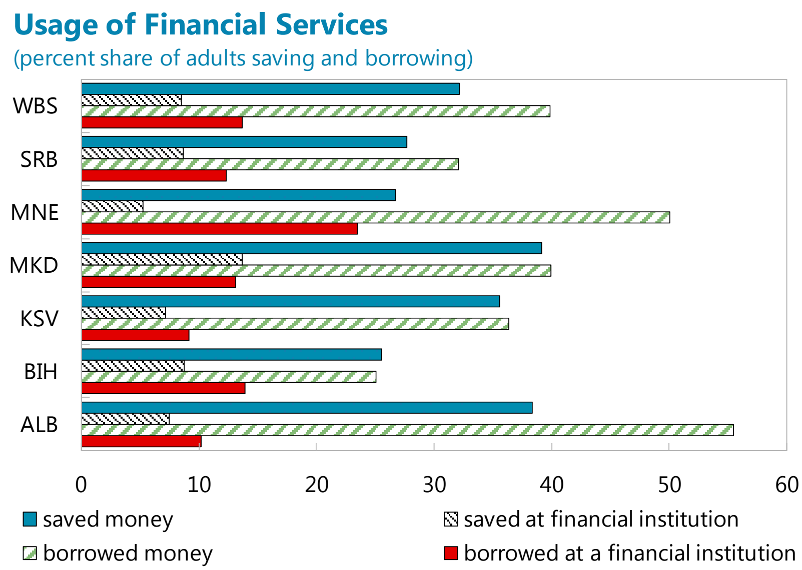
Share of Adults with an Account at a Financial Institution
(in total percent of adults, 15+)



Sources: Demirguc-Kunt et al., 2015

6. There are also disparities by gender, level of education, and region. Women have less access to finance than men, to much the same extent as the rest of the Western Balkans. The difference in inclusion between those living in rural and urban areas, while expected, is one of the highest in the WBS region. Adults with a secondary or higher education are, on average, more than twice as likely to have an account as those with a primary education or less.

7. The use of formal savings instruments remains one of the lowest in the region, but borrowing from financial institutions is very high compared with the regional average. Informality in saving and borrowing is extensive.

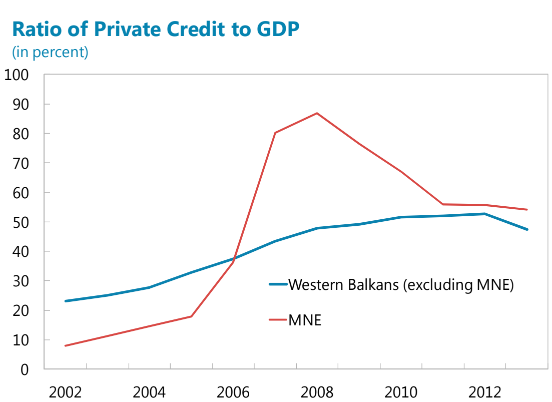


Sources: World Bank's Global Findex

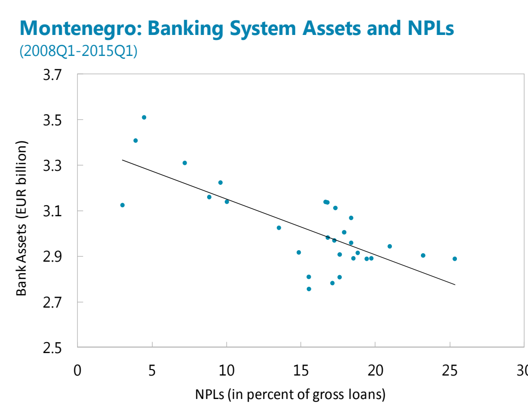
8. As nominal GDP increases, the level of financial inclusion overall can also be expected to increase. However, the heterogeneity of financial inclusion across segments of Montenegrin society suggests an important role for policies that address informality and education to improve financial literacy.

C. Private Sector Indebtedness and the Credit Environment

9. Credit conditions in Montenegro have been persistently tight in the post crisis period. The banking sector experienced a surge in bad loans, triggering a prolonged period of balance sheet downsizing. Corporate lending now stands at 55 percent of its pre-crisis level; household lending has held up better at 85 percent.



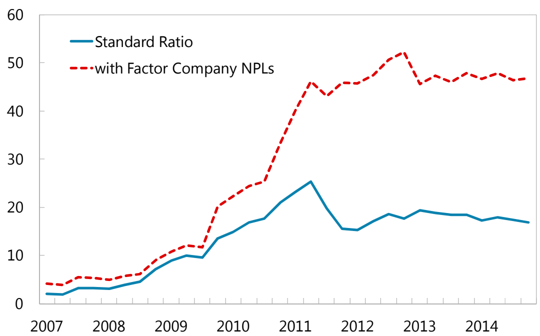
Sources: WEO and staff calculations.



Sources: CBM and Staff calulations.

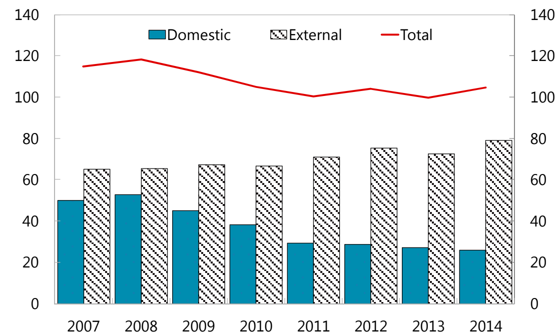
10. Corporate balance sheets remain impaired despite banks' attempts to tackle NPLs. The decrease in corporate liabilities to domestic banks has been largely offset by rising indebtedness to nonresidents, partially reflecting the transfer of EUR 720 million worth (21 percent of GDP) of NPLs from bank balance sheets to asset management companies belonging to parent banks. However, the lack of a vibrant secondary market for distressed assets and slow judicial proceedings has disrupted companies' resolution. Indeed, the ratio of NPLs remains high, at 14¾ percent—about 40 percent when adjusted for impaired loans held by AMCs. All in all, total indebtedness of the corporate sector has only declined by about 1½ percent in nominal terms relative to the pre-crisis peak.

Non-Performing Loan Ratios
(in percent of gross loans)



Sources: CBM and Staff calculations

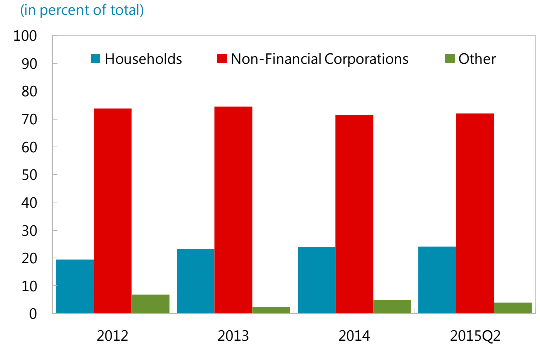
Corporate Indebtedness
(in percent GDP)



Sources: CBCG, MONSTAT, and Staff estimates

11. Progress in cleaning household balance sheets has also been limited. Household domestic liabilities have only declined by about 15 percent relative to the pre-crisis peak, about one-third the percentage point adjustment observed in the corporate sector. Anecdotal accounts indicate banks and AMCs have been reluctant to aggressively pursue collateral claims against individuals given social sensitivities and perceptions of judicial bias in favor of borrowers.

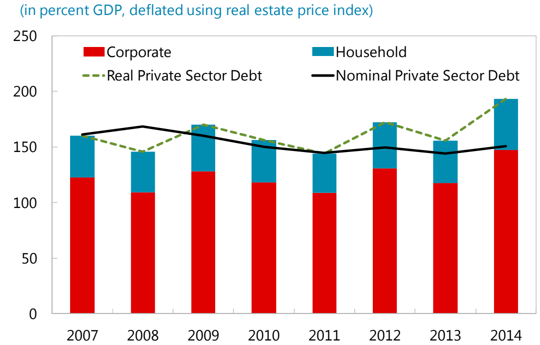
Share of Non Performing Loans by Sector
(in percent of total)



Sources: CBM and Staff calculations

12. Real private sector indebtedness is estimated to have increased since the crisis. Data on private sector assets are unavailable in Montenegro, but real estate prices can be used as a proxy given the importance of property as collateral. When deflated using a housing price index, real private sector indebtedness is

Real Private Sector Leverage
(in percent GDP, deflated using real estate price index)



Sources: CBCG, MONSTAT, and Staff estimates estimated to have increased relative to pre-crisis peaks.[3] The high degree of private-sector leverage that currently remains limits prospects for a strong and sustained credit-led recovery, and calls attention to the need to clean up banks' balance sheets (see measures recommended by FSAP, Appendix IV).

D. The Effects of Credit on Output

13. Credit growth in Montenegro is highly correlated with contemporaneous economic activity. The correlation is the highest among Western Balkan states, and noticeably larger than the correlations in CEE, Baltic, and developed European states.

Correlations of the Change in Private Credit and GDP Growth (at varying lags) by Region

	t-3	t-2	t-1	t	t+1	t+2	t+3
Western Balkans (WB)	**0.053**	**0.138**	**0.268**	**0.677**	**0.570**	**0.299**	**0.214**
Albania	-0.065	0.292	0.295	0.632	0.606	0.763	0.694
Bosnia and Herzegovina	0.119	0.129	0.399	0.880	0.640	0.415	0.415
Croatia	0.227	0.722	0.576	0.857	0.753	0.591	0.356
Kosovo	-	-	-	-	-	-	-
Macedonia, FYR	-0.233	-0.008	0.548	0.823	0.365	0.061	-0.054
Montenegro, Republic of	-0.089	-0.032	0.387	0.890	0.735	0.060	-0.056
Serbia, Republic of	0.362	-0.272	-0.596	-0.021	0.318	-0.096	-0.073
WB (excluding Montenegro)	*0.082*	*0.172*	*0.244*	*0.634*	*0.537*	*0.347*	*0.267*
CEE	**0.323**	**0.398**	**0.560**	**0.695**	**0.460**	**0.075**	**0.161**
Baltics	**-0.145**	**-0.126**	**-0.118**	**0.500**	**0.700**	**0.300**	**-0.135**
European Union	**0.214**	**0.257**	**0.453**	**0.604**	**0.341**	**0.042**	**0.017**

Bank lending is especially important for the construction, retail, and tourism sectors:

Montenegro: Correlations between Credit growth and Growth in selected sectors (at varying lags)
(Baseline period is 2006-2014)

	t-1	t = baseline 1/	t+1
Agriculture vs. Private Sector Credit	0.3078	0.4089	0.6070
Mining vs. Private Sector Credit	-0.0229	0.0068	-0.1469
Manufacturing vs. Private Sector Credit	0.1987	-0.0563	0.3078
Electricity and Water vs. Private Sector Credit	-0.0572	0.2549	0.2309
Construction vs. Private Sector Credit	0.5806	0.9593	0.2696
Wholesale & Retail Trade vs. Private Sector Credit	0.6493	0.8805	0.1114
Hotels and Restaurants vs. Private Sector Credit	0.2911	0.8213	0.5865
Transport and Storage vs. Private Sector Credit	0.5206	0.5784	0.5865
Financial Intermediation vs. Private Sector Credit	0.0909	0.1237	-0.1159
Real Estate vs. Private Sector Credit	0.4483	0.1625	-0.0468

1/ change in period is applied to production components of GDP.

[3] The property price index for new dwellings prepared by MONSTAT was used. While this measure is limited to new property construction, it captures regional differentiations which are relevant given a high degree of property market segmentation. An internal Podgorica-specific property price index that captures re-sale properties prepared by the CBM estimates a 50 percent post-crisis real estate price correction implying an even larger degree of real indebtedness.

14. However, such high correlations do not provide conclusive evidence of the causal effects of credit shocks on economic growth—they could be driven by strong demand effects from nominal activity to credit, rather than the other around. To deal with this simultaneity problem, a VAR of nominal GDP growth, private sector credit growth, and CPI inflation is estimated using quarterly data from 2005:Q2 to 2014:Q4. A single lag was found to provide the best fit. Estimated coefficients are significant at conventional levels for GDP and credit growth, and carry the expected signs. The model captures about half of the variation in the data, but alterative specifications that included FDI and tourism indicators did not improve fit.

Table 1. VAR Analysis - Montenegro

	GDP	Credit	Inflation
GDP(-1)	-0.317**	0.008	-0.007
Credit(-1)	0.804*	0.904*	-0.015
Inflation(-1)	-1.182	-0.062	0.711
Constant	7.360*	0.437	0.508
Adjusted R-squared	0.48	0.81	0.58

* significant at 5 percent probablity value.
** significant at 10 percent probablity value.

Memorandum 1/

GDP is nominal GDP
Credit is to the private sector
Inflation according to consumer prices

1/ All data is quarterly and variables in percent change (yoy).

15. Orthogonalized impulse responses suggest that a 1 percent shock to nominal private sector credit growth causes a 0.2 percent increase in GDP growth, increasing to 0.3 percent, before declining gradually. Over five years, the accumulated impact of the 1 percent growth rate shock is a 3 percent boost to the level of nominal GDP (Figure 1).

16. This effect is relatively large, in comparison to regional peers. To answer this question, the same VAR specification was estimated for Croatia, Serbia, and Poland. A comparison of impulse responses shows that the immediate impact of a credit shock is indeed larger in Montenegro (Figure 2). This finding is consistent with the greater severity of Montenegro’s boom-bust cycle, and, at least in the cases of Croatia and Poland, with the relative levels of financial development.

Table 2. VAR Analysis - Selected Countries

	Dependent Variable GDP			
	Montenegro	Croatia	Serbia	Poland
GDP(-1)	-0.317**	0.805*	0.493*	0.757*
GDP(-2)		-0.081		0.498*
GDP(-3)				-0.606*
Credit(-1)	0.804*	0.143**	0.150*	0.294*
Credit(-2)		-0.075		-0.403*
Credit(-3)				0.174*
Inflation(-1)	-1.182	0.444**	0.158	0.589
Inflation(-2)		-0.830*		-1.363**
Inflation(-3)				0.747
Constant	7.360*	0.685	0.884	1.344
Adjusted R-squared	0.48	0.85	0.44	0.79

* significant at 5 percent probablity value.

** significant at 10 percent probablity value.

Memorandum 1/

GDP is nominal GDP

Credit is to the private sector

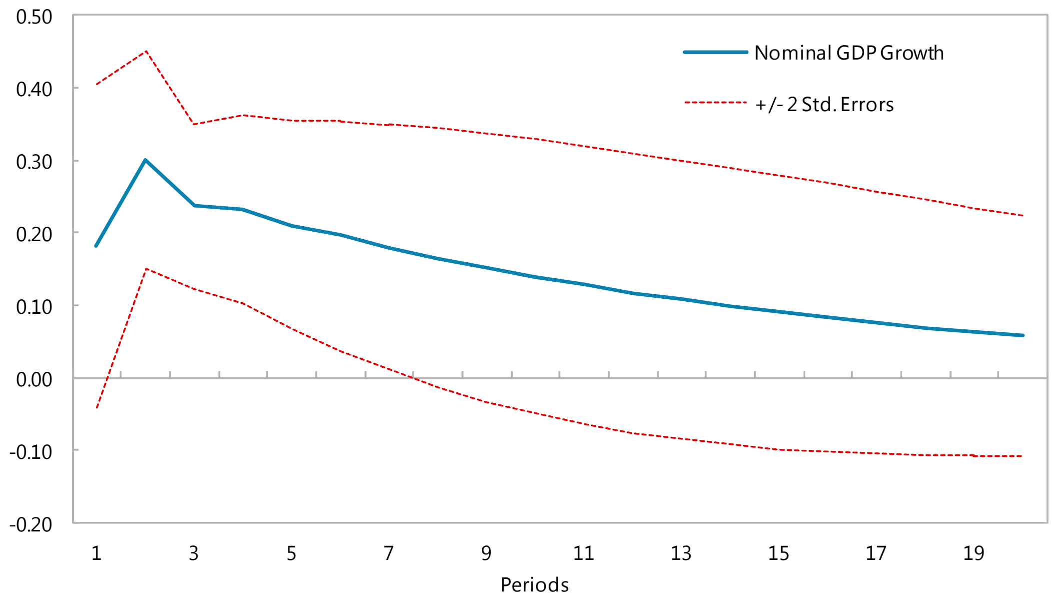
Inflation according to consumer prices

1/ All data is quarterly and variables in percent change (yoy).

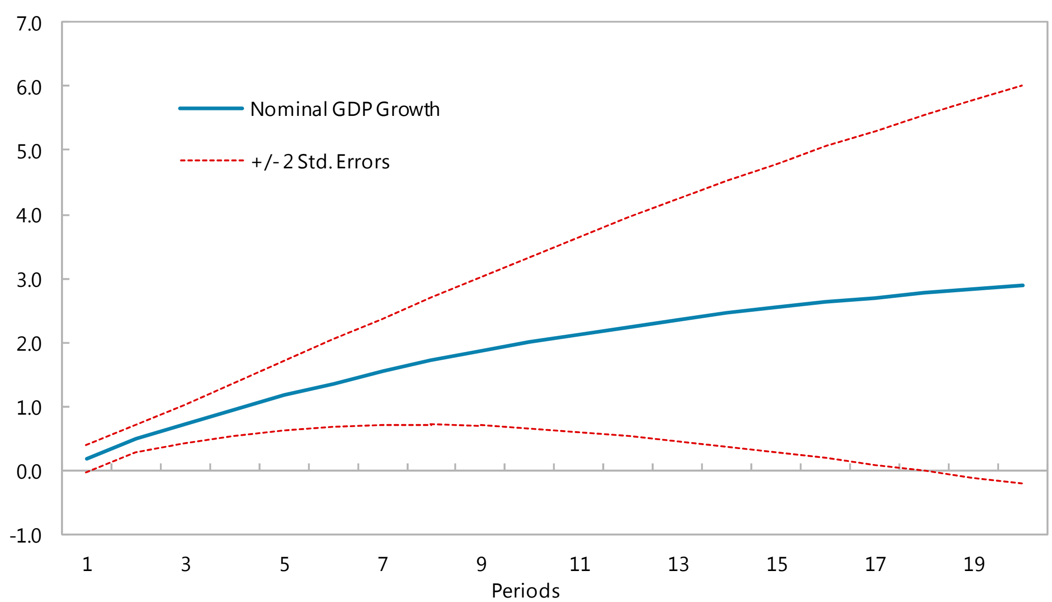
Hence, the analysis suggests that boosting credit would likely be associated with a boost in output.

Figure 1. Montenegro: Impulse Response Analysis

Impulse Response of GDP Growth
(in percent change to a 1-percent change in credit growth)



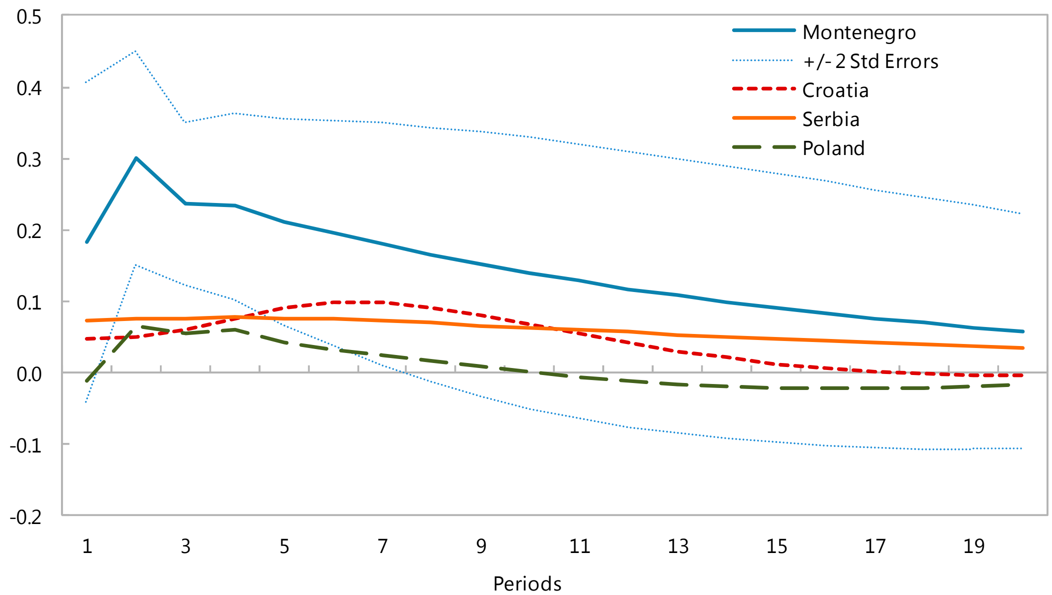
Accumulated Impulse Response of GDP Growth
(in percent change to a 1-percent change in credit growth)



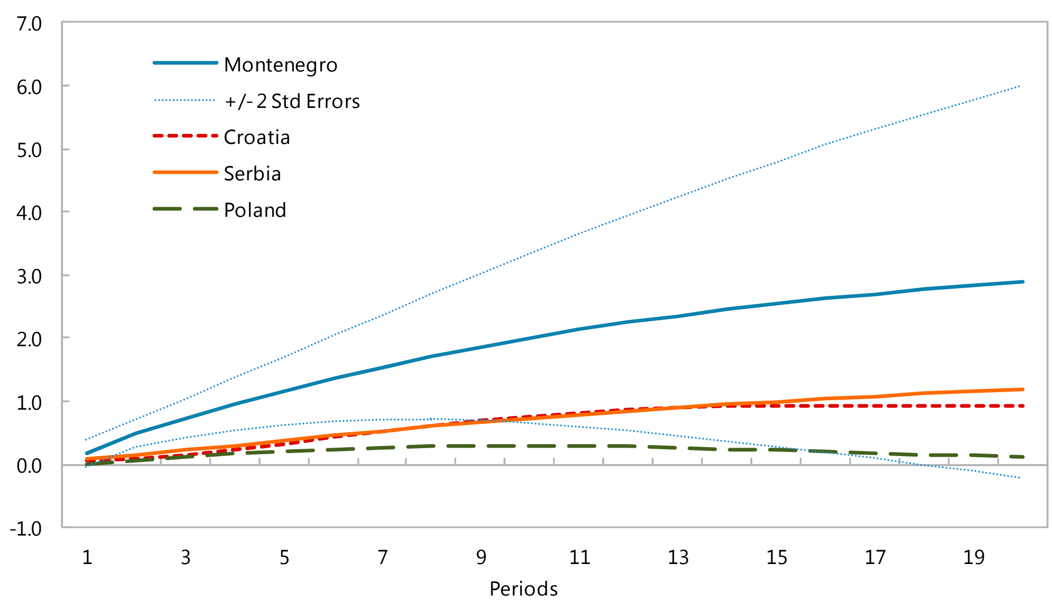
Source: CBCG, Monstat, and Staff estimates.

Figure 2. Cross-Country Comparison: Impulse Response Analysis

Impulse Response of GDP Growth
(in percent change to a 1-percent change in credit growth)



Accumulated Impulse Response of GDP Growth
(in percent change to a 1-percent change in credit growth)



Source: Country Authorities and Staff Estimates

Appendix III. Recent Legal Reforms to the Debt Restructuring Framework[1]

The authorities have undertaken a number of measures to strengthen the supervisory and debt enforcement framework. The most recent include changes to the enforcement regime and adoption of a personal insolvency law. The former have been generally well received, although their effectiveness remains to be tested. The new personal insolvency law, however, raises a number of concerns.

A. Consumer Insolvency Law

1. **The new consumer insolvency law is problematic.** In August 2015, Montenegro introduced an insolvency regime for natural persons that, despite some good features, has critical deficiencies. Positive features include provision for a mandatory forum of pre-insolvency debt mediation and court-supervised debt discharge (i.e., "fresh start") for debtors after a set repayment period. However, the law suffers from a number of critical deficiencies that undermine its ability to achieve the objectives of an effective personal insolvency regime. Among other concerns, the law is ambiguously drafted, which has caused stakeholders to reach inconstant and often contradictory interpretations.

2. **The law undermines secured creditors' rights**. Some stakeholders raised concerns that a broad reading of the law would suggest that mortgage lenders would permanently lose the ability to foreclose on the debtor's primary residence. A more restrictive reading would appear to exclude mortgages from the law, but even that reading presents circumstances under which the mortgage creditor could lose its secured rights and thereby become unsecured.

3. **There is also no consensus as to whether the law should be applied to existing debt, or only to debt contracted after its effective date.** The constitutional principle of non-retroactivity of laws, as applied in Montenegro, could prevent the applicability of the new law with respect to debt contracted prior to the law's entry into force. Should this principle be applied to the law, however, the law could never achieve its proclaimed objective of providing current consumers debt relief from distress they are now experiencing due to the bursting of the housing bubble.

4. **Aside from existing ambiguities, the law cannot be implemented in the near future because of the need for enabling regulations**. In addition to requiring the creation of a supporting infrastructure (e.g. a mediation service, special insolvency fund), the law requires the government to prepare regulations to align the law with the existing institutional framework. The law, however, contains no deadlines for the drafting of these measures. In addition to these preconditions for implementation, some stakeholders, including the Ministry of Justice, are currently considering constitutional challenges to the law that might result in its full or partial

[1] Prepared by Natalia Stetsenko (LEG) and Bruce Markell (LEG External Consultant).

repeal or in significant changes. If these challenges are unsuccessful, and in the absence of changes to design and clarification of ambiguities, the law could have adverse effects on general credit discipline, create moral hazard, and potentially raise the cost of credit.

5. To provide proper incentives and a better balance between debtor/creditor rights, the law would require significant changes in addition to supporting institutional infrastructure. As a first step, the authorities could conduct a comprehensive assessment of credit market and institutional infrastructure necessary for building a well-functioning personal insolvency regime in Montenegro. In this regard, ensuring the reliability financial information about debtors is of critical importance.

B. The Enforcement Framework

6. Montenegro passed a number of changes to its debt restructuring and enforcement framework in 2014. Most notably, the reforms allow an expedited procedure for debt collection through public enforcement officers.

7. Although the public enforcement officer reform shows promise, some strengthened supervision and oversight may be necessary. Banks were broadly satisfied with the reform. Other parties, however, expressed concerns that public enforcement officers have been overzealous in their efforts to collect debts, given that their compensation is linked to the amount collected. Certain weaknesses in the system allow instances of unintentional multiple collections of the same debt, creating additional complications and appeals. More experience with the system may be necessary before a full evaluation can be made. Further measures such as tightening licensing and educational requirements and strengthening oversight and supervision could be warranted.

8. Overall, weak institutions and inconsistent application of laws appear to be the main obstacles to effective debt resolution and enforcement in Montenegro. Lending institutions report that delays in collection activity are often due to the courts' and public agencies' lack of competence, which provides many opportunities for appeal and delay. These institutional weaknesses, combined with low demand in the real estate market, continue to cause low recovery rates in debt restructuring and realization of collateral.

Appendix IV. Main Findings and Recommendations from the FSAP

An FSAP mission took place during September 1–15. Mission findings were generally consistent with issues raised in previous Article IV reports. Montenegro still suffers from the collapse of the lending boom in 2008. Stress tests indicate that domestically-owned banks are particularly vulnerable to shocks. Action to deal with weak banks is needed to maintain financial stability. Weak profitability and the large NPL overhang constrain prospects of a credit-led recovery. Given policy constraints due to euroization, there is a need to strengthen the financial safety net, particularly with a streamlined emergency liquidity assistance framework and tested contingency planning.

1. **There is scope to strengthen legal, regulatory, and supervisory frameworks for the banking sector, which dominates the financial system.** The main areas for improvement in banking supervision include: (i) identifying, measuring, and managing nonperforming assets and liquidity risk; (ii) reducing concentration in credit, operational, and funding risks; (iii) strengthening banks' governance framework for risk management; and (iv) introducing effective consolidated supervision.

2. **System-wide solvency and liquidity indicators appear broadly sound, but significant pockets of vulnerabilities among domestically-owned banks exist.** Some banks are deemed below the regulatory minimum capital adequacy ratio (CAR) after provisioning rates are adjusted to reflect credit risks. Undercapitalized and weak banks should be put under intensive Central Bank of Montenegro (CBM) supervision. The CBM should also develop and adopt time-bound supervisory action plans and bank-specific resolution plans. An independent bank system asset quality review (AQR) is needed to accurately gauge bank health and the adequacy of provisioning.

3. **Intensified bank competition and a slow economic recovery are weighing on banking sector profitability.** Intense competition in the banking sector has compressed interest rate spreads to levels threatening banks with higher funding/operating costs and weaker client bases. Analysis of lending spreads indicates they are driven by costs (overheads and provisions) rather than a lack of competition. The authorities should therefore refrain from introducing caps to lending rates that, in the current context, is likely to restrict credit and lead to an undesirable mispricing of risks. The approval of new bank licenses could be harmful in this context and require a rigorous evaluation of both the business plan and potential spillovers to the sector from increased competition.

4. **Reducing the large stock of NPLs is necessary to strengthen bank balance sheets although is not sufficient to reinvigorate credit growth.** There are shortcomings in the NPL resolution framework related to under-provisioning and regulatory forbearance. Banks may need to raise additional capital in order to absorb the losses inherent in NPLs. The recently enacted Law on Voluntary Restructuring of Debts could be broadened to include a wider set of loan

categories. At the same time, the recent Law on Consumer Bankruptcy needs to be amended as it could negatively affect the collection of existing NPLs, as well as the issuance of new loans secured with mortgages. In order to analyze, regulate, and monitor the NPL problem in its entirety, nonbank credit institutions and asset management vehicles need to be brought under CBM oversight.

5. The macroprudential policy framework needs to be developed. However, neither the CBM nor the Financial Stability Council (FSC) has been vested with the authority to mitigate systemic imbalances. In preparation for Basel III, sound liquidity risk management standards as the first line of defense against liquidity pressures should be prioritized. A macroprudential framework should be established and made fully operational, underpinned by broader and more focused cooperation among the relevant agencies.

6. The financial safety net and crisis management framework should be strengthened. A comprehensive bank resolution framework is lacking. ELA funding is constrained due to euroization. The funding of resolution measures are not clear with respect to the Ministry of Finance and prohibited for the Deposit Protection Fund. And while there are contingency plans in place, the FSC and the financial agencies are not giving continued attention to updating and testing these plans.

Table 1. Montenegro: FSAP Key Recommendations	
Recommendations	**Term 1/**
Financial System Resilience	
• Prepare and implement time-bound supervisory action plans for vulnerable banks	I
• Conduct Asset Quality Review for all banks to determine adequacy of provisions	I
Financial Safety Net	
Failure Resolution Regime (prior to the transposition of the BRRD that is scheduled for 2017)	
• Set strict and objective criteria for determining systemic importance of banks to determine eligibility for capital support	NT
• Strengthen resolution funding options	NT
• Organize a dedicated resolution unit within CBM and initiate bank-specific resolution planning, prioritizing weakest CAMEL-rated banks (CBM)	I
Deposit Protection System	
• Implement risk-based contributions and shorten payout term	NT
Liquidity Support	
• Streamline ELA policies and procedures, and strengthen safeguards to protect CBM's financial autonomy in case of ELA	NT
Systemic Crisis Preparedness and Management	
• Strengthen FSC's focus on its crisis preparedness and management mandate complementing its financial stability mandate	I
Financial Oversight	
Macroprudential Policies	
• Introduce a macroprudential mandate taking into account the institutional setup and establish pertinent policies and toolkit consistent with EU/ESRB framework	MT
Banking Oversight	
• Tighten prudential norms for identification, classification, and re-classification of nonperforming assets	NT
• Improve the regulatory and supervisory framework for liquidity and credit risks	I
• Introduce effective consolidated supervision	NT
Insurance Oversight	
• Adopt risk-based supervision	I
• Incrementally implement Solvency II	NT

Financial Market Infrastructure Oversight	
• Implement risk mitigation measures to minimize liquidity risks in the RTGS system and to eliminate possibility of partial unwinding in the DNS system	I
• Strengthen CBM's oversight function over FMI	NT
AML/CFT	
• Finalize national risk assessment and ensuing action plan, and ensure that high ML/TF risks are adequately mitigated	I
Resolution of NPLs	
Insolvency and Creditor Rights	
• Strengthen the voluntary debt restructuring framework	I
• Amend personal bankruptcy regime to clarify creditors' rights regarding existing and future loans secured by mortgages	I
Financial Sector Development Agenda	
Financial Inclusion for Individuals and SMEs	
• Strengthen the legal and supervisory framework for leasing, factoring, and other non-bank entities providing credit, with the view to promoting a level playing field	NT
• Enhance market conduct supervision and disclosure of loan terms by all entities providing credit, as an alternative to introduction of interest rate caps	I
• Strengthen the IDF's oversight, corporate governance and business model	NT
Financial Market Infrastructure	
• Expand the coverage, granularity, and timeliness of information collected and distributed by the CBM's credit registry	NT
• Establish a National Payment Council and implement a comprehensive national strategy to increase usage of retail electronic payment instruments	NT
Corporate Financial Reporting	
• Adopt new accounting and auditing legislation consistent with EU norms	I
• Introduce simplified financial reporting standards for SMEs and improve verification and publication of reported financial statements by tax authorities	NT
1/ I-Immediate" is within one year; "NT-near-term" is 1–3 years; "MT-medium-term" is 3–5 years.	

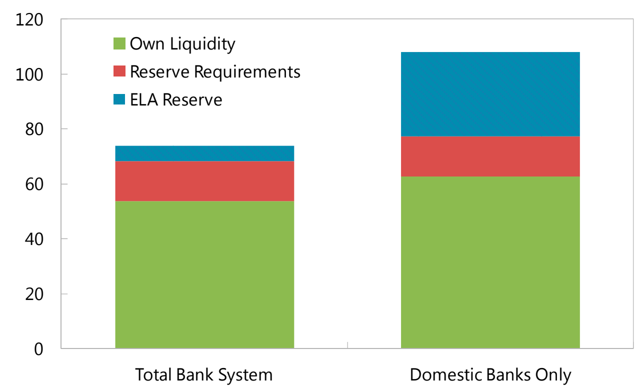
Appendix V. Reserve Adequacy

Although there are sufficient buffers to absorb modest liquidity pressures, Montenegro's emergency liquidity assistance (ELA) capacity is low and constrained by euroization. Because liquidity conditions can change rapidly and support from parent banks is not assured during a liquidity crunch, the authorities should explore options to boost ELA capacity, preferably through a dedicated ELA sub-account set up by the Ministry of Finance for use by the central bank.

1. **ELA options are constrained.** Montenegro is one of 13 IMF members that have adopted a foreign currency as legal tender. The main benefit of using another country's currency is a strong monetary anchor, but the arrangement imposes operational challenges for the central bank (CBCG), as ELA is constrained. In the event of a liquidity shortfall, the CBCG's current options to provide liquidity assistance would include: borrowing from liquid banks in the system; borrowing from abroad; allowing illiquid banks to draw down the required reserves (RR) for a short period; and drawing down designated ELA reserves (i.e., CBCG capital). However, only the latter two options are directly within the CBCG's control and they do not constitute traditional ELA tools. CBCG capital, were it to be drawn down, would need to be replenished after a crisis with an infusion of public resources.

2. **The banking system is currently liquid**—excess reserves cover about [50] percent of short-term liabilities for the banking system as a whole. CBCG capital provides a small additional buffer of around 5 percent of short-term bank liabilities. Including required reserves, the combined liquidity buffer (own assets, CBCG capital, and RR) increases to nearly 75 percent.

Emergency Liquidity Buffers
(in percent of short-term deposits)



Sources: CBCG and Staff Calculations

3. **Access to parent bank liquidity provides an additional potential buffer.** Two-thirds of bank system deposits are held by subsidiaries of banking groups located in the euro area (whose parent banks can access ECB facilities), which provides a potential additional liquidity buffer. In the event that subsidiaries receive liquidity support from parents, the effective liquidity coverage for domestic banks increases substantially. CBCG capital is estimated to account for about 31 percent of short term deposits of domestic banks and coverage, which increases to 93 percent when banks' own liquidity buffers are included (108 percent including required reserves).

4. **On this basis, ELA reserves currently appear adequate, but this situation could change quickly.** Foreign liquidity support for subsidiaries cannot be relied upon, especially if the shock triggering deposit outflow emanates from abroad. And the CBCG's capital endowment is fixed, implying that ELA coverage will decline as bank liabilities grow over time.

5. The authorities should therefore take advantage of this relative period of calm to establish mechanisms to bolster ELA capacity. Options include:

- A *bank fee or premium*. Capital surcharges based on systemic importance are increasingly being used in other jurisdictions However, larger banks in Montenegro are already bearing significant costs (in the form of regulatory provisioning standards), mainly to offset potential concerns about weak banks. Banks already pay premiums to support the deposit insurance fund; increased fees would likely be passed on in lending rates, to the detriment of investment.

- A *pooled liquidity arrangement* for ELA, funded by banks. This option was evaluated by the FSAP team and found to be problematic because of the high share of foreign-owned banks in Montenegro: parents of foreign-owned banks would be unlikely to be willing to provide liquidity to less liquid, mostly domestically-owned banks.[1]

- Establishing *contingent credit lines* with foreign banks. This is a conventional option, and does not impose fiscal costs. But it would carry greater-than-average coordination costs, given the range of central banks that supervise parent banks of Montenegrin subsidiaries.

- *Letters of comfort* should be obtained from foreign-owned banks' parents, committing them to provide liquidity in times of stress.

- *A dedicated ELA sub-account* at the central bank established by the Ministry of Finance and under the central bank's control. The size of an ELA account and mechanisms by which it is to be funded would require further consideration within the context of broader fiscal policy objectives.

6. Of these options, establishing a dedicated account is preferred. While the size of such an account and its funding requires further analysis and needs to be accommodated within the broader fiscal policy framework, preparatory steps can be taken. Specifically:

- Rules for the use of public funding in crisis situations should be clearly defined, including through the adoption of explicit policies that set strict, objective, quantifiable, and measurable criteria for determining whether a bank is systemically important.

- The use of public funds should be explicitly recognized as a last resort. Provisions for liquidity and capital support should clarify that: i) shareholders and hybrid capital and subordinated debt holders fully absorb losses; and ii) shareholders be fully written off prior to any government capital support.

[1] Moreover, this additional financial burden for banks comes on top of a future bank resolution fund in line with the Bank Recovery and Resolution Directive and a potential increase in deposit insurance contributions, which could undermine easing of credit conditions.

Appendix VI. External Competitiveness

Montenegro's external balances are characterized by persistent current account deficits funded mainly by FDI inflows. In the absence of an independent currency, the burden of adjustment will fall substantially on cost competitiveness. Costs have stabilized in recent years, and Montenegro fares well in rankings on tourism, a substantial part of its exports. But costs overall are nonetheless higher than regional peers, and falling shares of world and euro area trade are concerning.

1. Montenegro has run persistent current account deficits that suggest competitiveness problems. Staff analysis using the Macroeconomic Balance and External Sustainability approaches suggests current account deficits are about 6 percentage points larger than would be implied by the norm. Data uncertainties (related to errors and omissions in the balance of payments, which average about 7½ percent of GDP), the short length of the time series, and the volatility associated with small countries make point estimates from a CGER-type analysis highly imprecise.[1] Nonetheless, the analysis raises the question of weakness in cost competitiveness.

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

	Macroeconomic Balance Approach	External Sustainability Approach
CA Norm 1/	-7.0	NA
NFA-stabilizing CA	NA	-7.4
CA Balance	-13.5	-13.5
Gap	**6.5**	**6.1**

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

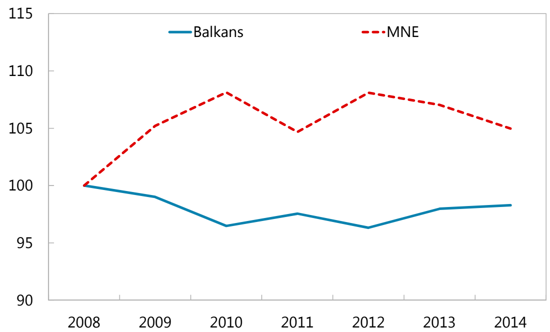
2. Cost measures support concerns over competiveness.

- The CPI-based REER has depreciated against other Western Balkan currencies, due to nominal euro depreciation, and nominal wage growth pressures have been subdued. Nonetheless, further real depreciation could be needed: an estimated current account imbalance of 7–8 percentage points of GDP could imply a RER imbalance of 15–25 percent.

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

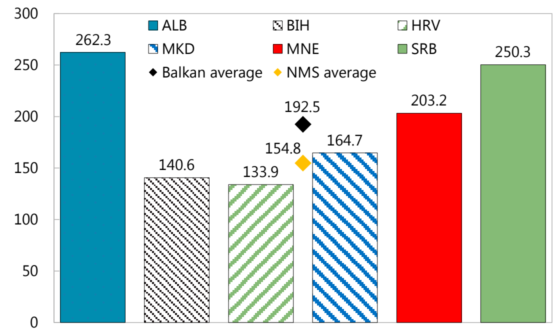
- Unit labor costs are slightly above the average for the Western Balkans and far higher than the level of New Member States, suggesting a further need for productivity improvements to increase competitiveness.

Real Effective Exchange Rate
(Index, 2008=100)



Sources: INS database; and IMF staff calculations.

Real Unit Labor Costs, 2014
(Index, 2005=100; Euros)



Sources: Haver Analytics; WEO database; and IMF staff calculations.

3. **Costs remain important for tourism.** Montenegro's service exports have been robust, driven almost entirely by the tourism sector. Montenegro's tourism competitiveness ranks well, in particular the travel environment and infrastructure areas, compared with other countries in the region. Staff analysis indicates that services demand has a high income elasticity, but price competitiveness is important too. As conventional tourism tends to have low productivity growth, maintaining an advantage in tourism will depend on a combination of maintaining costs and providing higher value-added services.

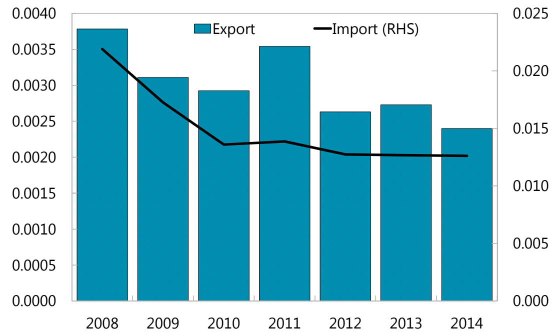
Travel & Tourism Competitiveness Scores
(1-7; the higher score is better)

	Overall ranking	Enabling environment	Policy and enabling conditions	Infrastructure and transportation	Natural and cultural resources
Spain	5.3	5.3	4.7	5.7	5.6
Cyprus	4.2	5.3	4.4	5.1	2.3
Italy	5.0	5.0	4.1	5.2	5.6
Malta	4.2	5.4	4.6	4.8	1.8
France	5.2	5.4	4.3	5.6	5.7
Germany	5.2	5.8	4.4	5.5	5.2
Switzerland	5.0	6.0	4.5	5.8	3.6
Montenegro	**3.8**	**5.0**	**3.9**	**4.1**	**1.9**
Albania	3.2	4.7	3.6	3.0	1.6
Croatia	4.3	5.1	4.3	4.5	3.2
Macedonia, FYR	3.5	5.1	3.7	3.4	1.7
Moldova	3.2	4.9	3.7	2.7	1.4
Slovak Republic	3.8	5.1	4.2	3.6	2.4
Slovenia	4.2	5.2	4.4	4.4	2.6
Czech Republic	4.2	5.3	4.5	4.6	2.4
Hungary	4.1	5.3	4.8	4.1	2.5

Source: Travel and Tourism Competitiveness Report (2015), World Economic Forum.

4. Reducing non-price costs will also be important. Montenegro's share in world goods trade fell further in 2014 to its lowest since independence. Staff analysis suggests that part of this can be attributed to reduction in aluminum exports with the partial shutdown of the KAP smelter. Nonetheless, the analysis also suggests that non-price factors are important obstacles to improved trade performance (see Selected Issues Paper).

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



Sources: DoT Database; and staff calculations.

INTERNATIONAL MONETARY FUND

MONTENEGRO

February 8, 2016

STAFF REPORT FOR THE 2015 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By

The European Department
(In Consultation with Other Departments)

CONTENTS

FUND RELATIONS

(As of December 31, 2015)

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

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

SDR Department:	**SDR Million**	**% Allocation**
Net cumulative allocation	25.82	100.00
Holdings	26.35	102.03

Outstanding Purchases and Loans: None.

Latest Financial Arrangements: None.

Projected Obligations to Fund (In millions of SDR):

	Forthcoming				
	2015	2016	2017	2018	2019
Principal	0.00	0.00	0.00	0.00	0.00
Charges/Interest	0.00	0.00	0.00	0.00	0.00
Total	0.00	0.00	0.00	0.00	0.00

Implementation of HIPC Initiative: Not Applicable.

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

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

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

Latest Article IV Consultation: Concluded on January 23, 2015 (IMF Country Report No. 15/26).

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

Technical Assistance in the Past 12 Months:

Department	Timing	Purpose
FAD	Oct-15	Tax Diagnostic Tool Assessment
STA	Oct-15	National Accounts Statistics
FAD	Oct-15	Public Financial Management
STA	Aug-15	Balance of Payments Statistics
FAD	Mar-15	Tax Administration
STA	Feb-15	National Accounts Statistics

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

Resident Representative: None.

WORLD BANK GROUP RELATIONS

1. **Montenegro joined the World Bank Group (WBG) as an independent country in January 2007.** The Bank had implemented a program of lending and analytical work for Montenegro for most of the period since the State Union of Serbia and Montenegro joined the WBG in 2001. Six projects are currently active, 5 IBRD and one EU Trust Fund. with the Montenegro's second Country Partnership Strategy (CPS) for the fiscal years 2011–15 ended in June 2015. The Board approved the CPS Progress Report in May 2014 extending the CPS by one year through FY15 as both CPS pillars—(i) strengthening institutions and aligning them with European Union (EU) requirements in areas critical for longer-term competitiveness in global markets; and (ii) improving environmental management—remained highly relevant, and the additional year facilitated the delivery of the planned lending program. Also, with uncertainties in the fiscal framework and public investment program, an additional year was deemed helpful in gaining greater clarity on the likely medium-term macro-fiscal framework that would underpin a new Country Partnership Framework (CPF) currently under preparation. The CPS Completion and Learning Review (under management review) assessed the CPS Development Outcome as Moderately Satisfactory. The overall IBRD delivered program amounted to US$262 million, while IFC committed two long-term finance projects totaling US$26.5 million in the infrastructure sector.

Montenegro: World Bank Project Portfolio, December 2015

Project Name	Date, Board App	Net Comm Amt ($m)	Total Percent Disb.	Percent Disb. Ratio FY16 (as of Dec2015)
Higher Education and Research for Innovation and Competitiveness	01/24/2012	15.98	46.1	10.7
Energy Efficiency	12/09/2008	16.20	69.6	33.1
Montenegro Institutional Development and Agriculture Strengthening	04/21/2009	15.70	83.0	50.9
Montenegro Institutional Development and Agriculture Strengthening (GEF)	04/21/2009	4.00	83.9	33.9
Land Administration and Management	12/09/2008	16.20	81.4	28.2
Industrial Waste Management and Cleanup	09/19/2014	68.90	3.5	0.2
		136.98	**36.8**	**6.1**

2. **Within the CPS FY11–FY15, the IBRD Board approved five IBRD loans to provide selective support to two key CPS priorities.** The CPS originally envisaged a series of two financial sector development policy operations (DPOs). In light of post-crisis needs, the second DPO was converted into a larger financial sector policy-based guarantee (PBG) that supported a comprehensive program of measures designed to strengthen the banking sector, address its vulnerabilities, and bolster its resilience to possible future shocks. This support also led to advisory work on nonperforming loans (NPL) resolution. Additional countercyclical stimulus was considered through a Public Expenditure DPO, but did not materialize in FY13–14 given the remaining weaknesses in the medium-term fiscal framework. New investment lending was approved for a Higher Education/R&D project (US$16 million), Energy Efficiency Additional Financing (US$6.8 million) and an Industrial Waste Management and Clean-Up Project (US$69 million). The

committed portfolio has doubled since to US$137 million in 2015. About 63 percent of these commitments remain to be disbursed. The Systematic Country Diagnostic from September 2015 identified the following priority objectives as fundamental for the achievement of the twin goals in Montenegro, around which the new Country Partnership Framework (CPF) will be designed:

(i) Strengthening resilience to shocks and volatility;

(ii) Reducing unemployment and inactivity, in particular amongst the young; and

(iii) Facilitating private sector development.

3. **Pipeline projects in the new CPF for FY16–20, which is under preparation, include** (i) a Revenue Administration Reform Project building on the recent tax administration assessment that aims to increase the effectiveness and efficiency of tax administration as well as reduce the cost of compliance for the taxpayer; (ii) a second Health Improvement project that aims to provide a support for financing reforms and governance for quality in the health sector, and (iii) additional financing for the ongoing Institutional Development and Agriculture Strengthening project

4. **Cooperation with the IMF has been good, particularly in the areas of macroeconomic and financial sector policies.** Bank and Fund teams coordinated closely during the preparation of the Financial Sector DPL and Policy-Based Guarantee in 2011 and 2012 and the TA on NPL resolution, as well as on the FSAP update in 2015. The World Bank Group, through its ongoing and planned operations, as well its complementary economic and sector work, will continue to provide input to the IMF on issues such as (i) public expenditure, including pension and health reforms; (ii) business climate and competitiveness, including labor market reform and the resolution of nonperforming loans; (iii) public sector institutions and fiduciary reviews, (iv) agricultural assessments; and (v) statistical capacity building and poverty monitoring. The Fund and Bank staff have sought each other's input in internal review processes.

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

Title	Products	Provisional Timing of Missions	Expected Delivery Date
1. Fund work program	Article IV staff report	Fall 2015	January 2016
2. Bank work program	Systematic Country Diagnostics Pension System TA Revenue Administration Project	February 2015 March 2016 January 2016	January 2016 June 2016 Feb 2016
3. Joint work program	None	None	

Prepared by World Bank staff. Questions may be addressed to Carla Pittalis, Sr. Country Officer (cpittalis@worldbank.org) and Gallina A. Vincelette, lead economist Western Balkans (gvincelette@worldbank.org).

STATISTICAL ISSUES

MONTENEGRO—STATISTICAL ISSUES APPENDIX

As of December 16, 2015

I. Assessment of Data Adequacy for Surveillance

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

Real Sector Statistics: The Statistical Office of Montenegro (MONSTAT) suffers from resource constraints and limited capacity.

National Accounts: MONSTAT compiles annual production and expenditure accounts in current and previous year's prices. The production GDP estimates are reconciled with the expenditure GDP estimates through the supply and use framework (i.e. reconciling supply and use). The quality of the annual GDP is good. Montenegro started disseminating quarterly GDP by production using an indirect method in 2012, but the methodology has room for improvement. The estimates are compiled at an aggregated level (mostly NACE section level). The accuracy of the short term statistics needs to be improved, mostly for agriculture, and construction. Recent national accounts TA missions have focused on developing robust quarterly GDP estimates by expenditure approach. Quarterly GDP estimates have been compiled for 2010-2014; the official dissemination took place in March 2015.

Price Statistics: MONSTAT compiles and disseminates a monthly consumer price index that broadly follows international standards. Little progress has been made improving the producer price index (PPI). Improvements needed include developing a total output PPI; expanding index coverage to include services and construction; and updating index calculation methods. There is need to improve the industrial production index.

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

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

Montenegro does not report *GFSM 2001* based data to the IMF. The March 2013 GFS TA mission recommended updating the table on the institutional structure of the public sector to facilitate consistency among producers of official statistics. It was also recommended to establish a migration plan to phase in the *GFSM 2001* framework and to start publishing quarterly budgetary central government data in the *IFS*.

Monetary and Financial Statistics: The Central Bank of Montenegro (CBM) reports monthly monetary statistics covering the CBM balance sheet and the balance sheet of commercial banks only. However, the monetary data are not reported in accordance with STA's Standardized Report Forms and, thus, follow the older format.
Montenegro does not report Financial Soundness Indicators to the IMF.

External sector statistics: Balance of payments statistics are compiled by the CBM and follow international reporting standards. External sector statistics have benefited from improvements undertaken by MONSTAT to improve coverage, valuation, and classification of merchandise trade statistics. Data on imports and exports in the BOP are compiled according to the special trade system. The CBM adjusts export and import data from MONSTAT from CIF to FOB basis. The biggest challenge to the BoP statistics is the coverage of transactions through the informal economy. .Although current account statistics have been revised recently, errors and omissions are still large and with a persistent positive sign, largely due to an underestimation of the export of tourism services. The CBM has made progress in improving the recording of transactions via the ITRS by refining the transactions coding system and increasing interaction with commercial banks. However, the ITRS remains inadequate for recording a broad range of balance of payments transactions such as reinvested earnings and trade credits. Further, the ITRS records transactions on a cash basis, whereas balance of payments transactions should be recorded on an accruals basis. The CBM still needs to undertake a small number of direct surveys of enterprises to supplement the data received through the ITRS, and prepare comprehensive documentation on compilation methods and data sources. The CBM is reporting BoP statistics under the presentation of the sixth edition of the *Balance of Payments and International Investment Position Statistics Manual (BPM6).*

The CBM has received TA on International Investment Position (IIP) statistics, but does not yet disseminate these data.

The January 2013 TA mission on External Sector Statistics identified the following action items: (i) the compilation and regular dissemination of the IIP and external debt statistics; (ii) the revision of the compilation of the flows in currency and deposits assets by other sectors; and (iii) the improvement of the currently estimation procedure for the item Compensation of Employees (credit).

II. Data Standards and Quality

Participant in the Fund's General Data Dissemination System (GDDS) since December 2011. The latest update of metadata and GDDS plans for improvement were in 2015.	No data ROSC available.

Table of Common Indicators Required for Surveillance

(As of December 16, 2015)

	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]	Nov-2015	Dec-2015	M	M	M
Reserve/Base Money	Nov-2015	Dec-2015	M	M	M
Central Bank Balance Sheet	Nov-2015	Dec-2015	M	M	M
Consolidated Balance Sheet of the Banking System	Nov-2015	Dec-2015	M	M	M
Interest Rates[2]	Nov-2015	Dec-2015	M	M	M
Consumer Price Index	Oct-2015	Nov-2015	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Sept-2015	Dec-2015	Q	Q	Q
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	Oct-2015	Nov-2015	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Sept-2015	Dec-2015	Q	Q	Q
External Current Account Balance	Q3-2015	Nov-2015	Q	Q	Q
Exports and Imports of Goods and Services	Q3-2015	21-Nov-2015	Q	Q	Q
GDP/GNP	Q2-2015	Sept-2015	Q	Q	Q
Gross External Debt	--	--	NA	NA	NA
International Investment Position[6]	--	--	NA	NA	NA

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

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

[3] Foreign, domestic bank, and domestic nonbank financing.

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

[5] Including currency and maturity composition.

[6] Includes external gross financial asset and liability positions vis-à-vis nonresidents.

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

Statement by Menno Snel, Executive Director for Montenegro and Zorica Kalezic, Advisor to Executive Director February 19, 2016

The authorities broadly concur with staff's appraisal and agree with the thrust of the recommendations outlined in the Article IV report and FSSA. On behalf of the Montenegrin authorities, we thank the Article IV staff and the FSAP team for the constructive and fruitful discussions during the missions' visit. They resulted in the comprehensive documents, which provide the authorities with useful recommendations and guidance for their future policy decisions. The authorities pursue an investment-led growth strategy, which brings benefits, but also challenges. Growth rebounded strong, with robust rates to maintain over the medium term, while the fiscal position deteriorated. Given the context of a small and open economy, vulnerable to external shocks and heavily reliant on external financing, the authorities share staff's concern on the public debt's risk profile. The authorities are committed to introduce further, sizable fiscal consolidation adjustments. In addition, the authorities are strongly focused on raising productivity. However, the authorities are aware that the upcoming elections, planned later this year, may affect the momentum of reforms' implementation. The financial sector is liquid and solvent, but prone to distress. The credit contraction finally slowed down and the reduction in non-performing loans (NPLs) shows that the quality of financial assets significantly improved.

Economic Outlook and Risks

Growth remains resilient over the medium term. GDP growth reached 4.1 percent in 2015, due to strong growth in fixed capital investment and service export. The authorities expect this growth pattern to continue over the medium term, averaging at 3.7 percent for 2016-2018. The authorities expect a stronger fiscal impulse from the in 2015 postponed construction work on the highway for the years 2017 and 2018, which will push growth somewhat above staff's forecast of 2.5 percent in both years. Growth remains primarily driven by large investment projects in infrastructure, connectivity, and tourism. Recent data on tourism in 2015 give confidence that the robust tourism inflows will remain in the coming years. The excellent results of the 2015 tourist season were also the main factor behind the narrowing of the current account deficit. However, this is expected to widen again because of upcoming construction-related imports. Inflation is expected to remain stable against the backdrop of suppressed oil prices and moderate private consumption recovery. Wages were flat for 2011-2015 in nominal terms, but are expected to grow moderately in 2016.

The Montenegrin authorities are attentive to the risks and potential negative spillovers that could come from a weakening in demand from the EU and regional geopolitical tensions. The biggest concern is that these risks may affect tourism and the cost of financing. The authorities are working progressively on market diversification, especially in tourism (which accounts for 20 percent of GDP), resulting in Montenegro being assessed (in the WTTC Report) as the third fastest growing destination in the world. Moreover, the authorities are pressing ahead with a five-year consolidation plan that should rebuild fiscal space and put debt on more comfortable footing. At the same time, the authorities will restrain from any new large capital spending based on full project financing or sovereign guarantee issuance. It is worth noting that the Eurobond issuance in 2015 was oversubscribed, maintaining an upward sloping yield to the maturity curve. In addition, sovereign rating agencies have already absorbed information in their estimations about the substantial financing needs Montenegro will encounter during the highway construction.

Fiscal policy

The authorities are taking steps to address underlying fiscal vulnerabilities and recognize the need for urgent and sustained consolidation to absorb the substantial financing needs. The authorities are aware that fiscal space is scarce and will remain constrained during the highway construction, however, they feel this project will have a sizable and permanent positive effect on potential output. The consolidation measures introduced narrowed the overall deficit from -5.9 in 2012 to -3.1 percent of GDP in 2014. Although the fiscal deficit is expected to rise sharply in the short term, the authorities agree with the staff that a close to balanced budget can be expected by 2020.

Given that the level of public debt in 2015 exceeded the "Maastricht" limit, the authorities will soon propose to the Parliament a medium term fiscal consolidation plan with contingency scenarios. This plan should ensure reduction of the public debt over a five-year horizon, contributing to convergence to the "Maastricht" ceiling by 2025. In this regard, the authorities requested TA from the IMF to receive input and build up the necessary capacity to be able to enforce the Law on Budget and Fiscal Responsibility and the fiscal rules provisions.

On the revenue side, Montenegro started the growth-supportive tax system; shifting from a policy of taxation predominantly on income and profit to a consumption taxation. Measures for 2016 include an increase of the health insurance contribution rate, the introduction of tax on gains from gambling and coffee and an increase in excise duties on cigarettes and mineral oils. Adding to staff's table (page 14-Article IV) on the scope of additional fiscal consolidation, authorities would like to outline two recent measures. First, a recently introduced regulation allowing tax collection on illiquid but solvent tax debtors, which will increase fiscal revenues (on top of staff's projections) by at least 0.5 p.p./p.a. of GDP over the medium term. Second, in order to strengthen the financial position of the municipalities, the authorities adopted amendments to the Law on Tax on Immovable Property, which enables the municipalities to generate more tax revenues.

On the expenditure side, the authorities are taking actions in addressing social expenditures, public sector wages, and pension system sustainability. The recently introduced social protection laws (especially the Law on Social and Child Protection) are under careful review because of the adverse fiscal effect and the already low labor participation. The authorities will ask for its revocation. While emphasizing that the nominal public wages (and related pension bill) remained virtually flat in the period 2011-2015, the authorities stay open to staff's idea of reinstating a productivity based anchor for the public wage bill. Moreover, the number of public sector employees will be reviewed. As an interim measure, pensions will be adjusted to the average wage and current inflation.

Given the limited fiscal space, the authorities streamline and prioritize recurrent capital spending. The main focus is on projects filling obvious infrastructure gaps with the highest value for money, playing a catalytic role in growth enhancing and job creation.

With regards to PFM capacity strengthening and the public finance transparency, the authorities adopted the ESA 2010 Implementing Strategy as well as the Strategy for Transition of Public Sector to Accrual Accounting in 2015. Given the capacity constraints, the authorities will rely on TA for the Strategies' efficient implementation.

Public Debt Sustainability

The authorities share the underlying assumptions of staff's DSA, although with a somewhat lower baseline peak. In light of medium term capital spending, the authorities forecast public debt to peak to 77.9 percent of GDP in 2018, while expecting somewhat lower financial needs compared to staff. The authorities' foresee stronger growth assumptions for 2017-2018, because of the highway construction, and a higher level of fiscal discipline, especially because of the assumed improvement in tax collection. The authorities are mindful of risks that could deteriorate the debt profile, especially risks related to an adverse growth scenario, further balance deterioration, interest rates on newly issued debt, and highway-related cost overruns. The authorities remain attentive to the high public debt elasticity on growth changes. In order to prevent primary balance shock, as previously highlighted, the authorities are working on a medium term fiscal consolidation plan, with contingency scenarios that would protect the primary balance from the current balance "slippages" in the medium term. The authorities believe that a reliable medium term fiscal consolidation plan, coupled with leveraging new debt financing on international markets with alternative sources such as policy based financing, could ease the impact of a potential interest rate hike. Finally, the risk of delay in the project implementation of the Bar-Boljare highway or the related cost overruns remain in the domain of possible, however, the pristine track record of the constructor in almost eighty countries and ample penalty triggers, that could be activated in that case, are reassuring.

Structural policies and business environment

The authorities' primary goal is to improve labor market flexibility and overcome rigidities. In order to leverage knowledge of best global practices, the new WBG CPF (Country Partnership Framework) for Montenegro envisages projects which will address the lack of flexibility in the labor market and high labor market costs, mismatches between education, skills and labor market needs, and the weak labor participation. A new drafted Labor Law aims to significantly lower the employer's cost of firing while streamlining dismissal and redundancy procedures. The new CPF builds upon 'Montenegro Development Directions 2015-2018' which outlines structural policy guidelines to achieve smart, inclusive and sustainable growth.

Montenegro is making steady progress in improving the business environment. In the 2016 Doing Business indicators, Montenegro made particular progress in the area of construction permits (advanced by 51 positions over the course of two years) and paying taxes. In order to accelerate further reforms related to the business environment, the authorities will amend and improve the monitoring of the Action plan - "Regulatory guillotine" that should accelerate reforms in areas that are lagging behind such as access to energy, starting a business, protection of minority investors, and resolving insolvency.

The authorities agree with staff that non-tariff barriers hamper trade flows. The non tariff barriers issue is work in progress and correlates to the EU Acquis alignment. For example, in 2015 the COFACE started issuing the SME excellence certificate in Montenegro, enabling local businesses and their potential partners, to verify company's business profile and creditworthiness. This initiative promotes successful integration of Montenegrin SMEs in regional and EU markets by enhancing market transparency.

Financial sector policies and addressing financial stability risks

The authorities broadly share staff's assessment of the resilience of the financial system and its vulnerabilities. The banking system, with ample liquidity and comfortable capitalization levels, is still under stress because of weakened assets quality due to the crisis, which put a drag on credit growth and profitability. Staff's recommendations have been duly noted and the authorities are working on the action plan based on the FSSA's conclusions. This action plan will build upon the already developed strategy for alignment of the domestic regulatory framework with the financial sector Acquis from the EU.

The high levels of NPLs are reduced, while the lending channel was moderately unlocked. The leading financial stability risk, the high NPL, is reduced to 12.47 percent in

December 2015, almost half compared to the post real-estate boom level of 25.3 percent in 2011. The authorities attribute the strong NPL reduction in 2015 to four reasons: 1. the recently introduced structural regulatory measures, 2. the uplifted growth prospects, 3. continued deleveraging of the banks and 4. the increased banking competition. The authorities are committed to continue to treat NPLs in a holistic manner while considering the FSAP team's recommendations. The CBM created a draft Law on Financial Factoring, Lease, and Credit and Guarantee operations which should put the remaining non-banking stocks of NPLs under strict supervision of the CBM. The authorities will analyze modalities for independent asset quality reviews.

Notwithstanding staff's view that increased bank competition could lead to vulnerabilities, the authorities believe that the competition had a positive impact on interest rate spreads, market depth, consumer inertia, and access to finance. With 14 banks Montenegro is below the average of its smaller European/regional MIC peers. The authorities follow the legislation governing bank licensing and market access, which is fully aligned with the EU practice (Directive 2006/48/EC). If a strong institutional framework is in place, financial stability and banking competition can coexist. Therefore, in order to compensate for still strengthening the supervision, the CBM vigilantly monitors banks that might be under cost funding distress, or practice ominous risk taking behavior in light of the increased competition and curbing interest spreads.

At this moment, the authorities are not considering reintroduction interest rate caps. They highlight that interest rate caps are not considered as a credit growth policy measure, but rather as an instrument to restrain further protraction of NPLs, restricting market access to clients with enormous risk premiums and high probability of default. The authorities note that the recently adopted Personal Bankruptcy Law is currently under review. With regards to the financial safety net, the authorities' welcome the guidance on establishing of the Resolution Unit within the CBM.

The authorities support the staff's suggestion that the macroprudential framework and systemic liquidity should be enhanced. The authorities will analyze which of the suggested macroprudential measures are effectively calibrated to circumstances and country-specific characteristics of the Montenegrin financial system. As staff rightly noted, systemic liquidity management is bounded by euroization, while the existing liquidity crisis management framework has only recently come to fore. The current large liquidity buffers offer the authorities a period for adjustment to the new liquidity risk management standards, in line with Basel III requirements.

The authorities welcome the staff's assessment that banking and insurance oversight frameworks are significantly progressed in alignment with the Basel core principles and the EU Acquis, and agree that further improvements are warranted. As already noted, the authorities developed a time bound strategy committed to full alignment of the regulatory framework with the EU Acquis and the Basel principles, including provisions referring to recommended enhanced credit risk assessment and development of prudential limits on large exposures. The authorities will consider recommendations on transitional strategy referring to gradual introduction of Solvency II regulation in the insurance oversight framework.

Staff notes that Montenegro is taking active steps to enhance its AML/CFT, but significant room for improvement remains. The authorities acknowledge remaining gaps and highlight that according to the MONEYVAL cycle assessments, Montenegro has been making constant progress, especially in the area of money laundering offences. The authorities underscore that banks, insurance companies, MFIs and their supervisory authorities are fully provisioned to prevent criminals or their associates from holding or being the beneficial owners of a significant or controlling interest. The remaining legislation gap refers solely to recently introduced Voluntary Pension Funds (constituting tail end part of Montenegrin financial market).