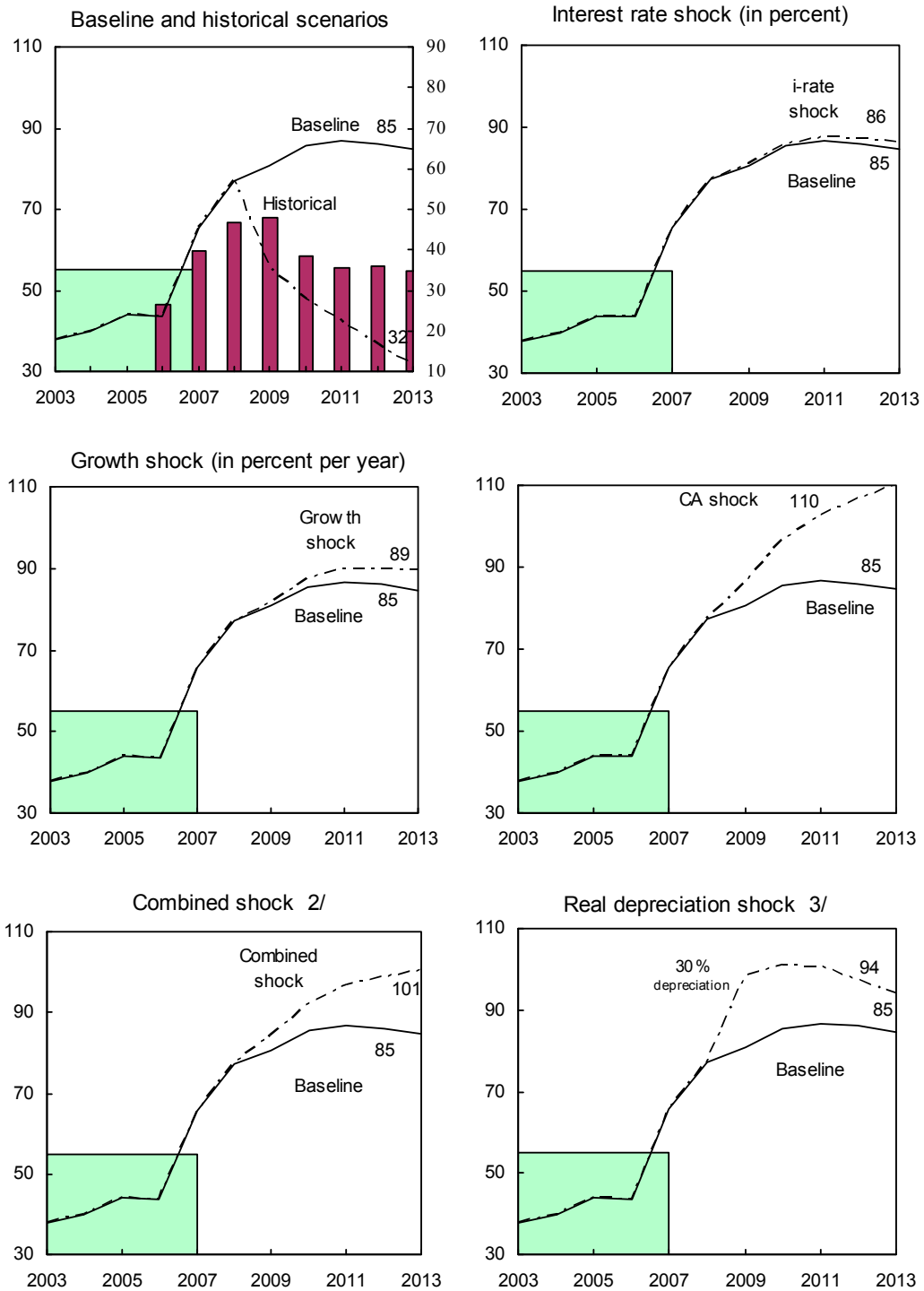


Figure A2. Montenegro: External Debt Sustainability: Bound Tests 1/
(External debt in percent of GDP)



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

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

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

3/ One-time real depreciation of 30 percent occurs in 2009.

INTERNATIONAL MONETARY FUND

REPUBLIC OF MONTENEGRO

Staff Report for the 2008 Article IV Consultation

Informational Annex

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

February 5, 2009

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Annex I. Fund Relations¹
(As of December 31, 2008)

I. Membership Status: Joined: 01/18/07; Article VIII		
II. General Resources Account:		
	<u>SDR Million</u>	<u>% Quota</u>
Quota	27.50	100.00
Fund Holdings of Currency	20.90	76.00
Reserve position in Fund	6.60	24.00
III. SDR Department:		
	<u>SDR Million</u>	<u>% Allocation</u>
Holdings	0.29	N/A
IV. Outstanding Purchases and Loans: None		
V. Financial Arrangements: None		
VI. Exchange Rate Arrangement: The euro is the sole legal tender. A joint LEG/MCM mission is scheduled to undertake a review of Montenegro's exchange system in early February 2009.		
VII. Article IV Consultation: Montenegro is on a 12 month cycle.		
VIII. FSAP Participation and ROSCs: A Financial Sector Assessment Program, initiated in July 2006 jointly with the World Bank, and was concluded during the 2007 Article IV consultation.		
IX. Technical Assistance:		
MFD/FAD	July 2005	Management of Proceeds of Privatization and Review of PFM (Montenegro)
FAD	April 2006	Assessment of state-owned enterprises under the World Bank Public Expenditure Review

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

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

X. Resident Representative: None.

Annex II: Statistical Issues (As of January 16, 2009)

A. Assessment of Data Adequacy for Surveillance

General

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

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

National Accounts

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

Price Statistics

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

Government Finance Statistics

Fiscal data are compiled by the Ministry of Finance (MOF) based on a new GFS institutional classification, and since early 2006, include data for the social security funds and local governments. The chart of accounts introduced in 2001 has been implemented at the local level from mid-2005. Fiscal data reporting suffers from frequent re-classifications, especially, at the level of local governments and social funds. The MOF has recently created a unit responsible for data collection for state-owned enterprises (SOE), but a satisfactory compilation of the public sector fiscal balance requires significant further efforts. Data on stock of local government arrears need to be strengthened. Montenegro does not report government finance statistics for publication in the *Government Finance Statistics Yearbook* or *IFS*.

Monetary Statistics

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

Significant progress notwithstanding, there is need for further improvement. A 2006 mission made recommendations on methodological issues concerning: (i) the exclusion of two banks in bankruptcy from financial reporting (the mission proposed that if these institutions are excluded from the coverage of the monetary survey, a separate table on their monetary accounts could be included in the CBM's Statistical Bulletin); and (ii) treatment of interest accrued but not yet due (which is maintained in aggregate on separate accounts rather than incorporated in the outstanding amount of the financial asset or liability). The recording of Fund Accounts in the CBM's balance sheet also needs to be reviewed for consistency with the recommendations on accounting for transactions with the Fund that were issued by the IMF Finance Department. Appropriate recording of Fund Accounts will permit an enhanced compilation of monetary accounts for the CBM.

Balance of Payments

Balance of payments statistics are compiled by MONSTAT (trade statistics) and the CBM (other current account elements, capital and financial accounts). Significant improvement is needed in data compilation, in particular in external trade, where MONSTAT uses the special trade system for imports, but general trade system for exports. This inconsistency may have resulted in the overestimation of imports. In addition, the classification used by MONSTAT is the Harmonized System (HS), but data are disseminated according to the Nomenclature générale des Activités économiques dans les Communautés Européennes (NACE), on highly

aggregated groups, and with a significant time lag. Some components are likely under-recorded, since a significant proportion of foreign exchange transactions occur through informal channels.

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

In mid-2004, a STA mission assisted CBM staff with the adoption of compilation methodologies consistent with the fifth edition of the *Balance of Payments Manual (BPM5)*. The mission also provided recommendations to improve international trade and external debt statistics through the international transactions reporting system (ITRS). The authorities have implemented many of the mission's recommendations. Following the authorities' request for further assistance, a mission visited Montenegro in September – October 2007. Although it noted substantial progress, inadequate data sources continue to constrain progress in improving balance of payments data. The mission recommended changes on the estimates for merchanting, transactions involving foreign assets and liabilities, and reserve assets, while additional data needed to be collected for travel and direct investment.

B. Data Standards and Quality

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

No data ROSC is available.

C. Reporting to STA (Optional)

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

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

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

Montenegro: Table of Common Indicators Required for Surveillance
(As of January 14, 2009)

	Date of Latest Observation	Date Received	Frequency of Data ⁷	Frequency of Reporting ⁷	Frequency of Publication ⁷
International reserve assets and reserve liabilities of the monetary authorities ¹	June.2008	Aug.2008	M	M	M
Reserve/base money	Dec.2008	Jan.2009	M	M	M
Central bank balance sheet	Dec.2008	Jan.2009	M	M	M
Consolidated balance sheet of the banking system	Dec.2008	Jan.2009	M	M	M
Interest rates ²	Dec.2008	Jan.2009	M	M	M
Cost of living index	June 2008	Aug.2007	M	M	M
Revenue, expenditure, balance and composition of financing ³ – general government ⁴	Sep.2008	Nov.2008	Q	Q	Q
Revenue, expenditure, balance and composition of financing ³ – central government	Sep.2007	Oct.2007	M	M	M
Stocks of central government and central government-guaranteed debt ⁵	Sep.2008	Nov.2008	Q	Q	Q
External current account balance	Jun.2008	Aug.2008	Q	Q	Q
Exports and imports of goods and services	Jun.2008	Aug.2008	Q	Q	Q
GDP/GNP	2006	Mar.2008	A	I	A
Gross external debt	Jun.2008	Aug.2008	Q	Q	Q
International Investment Position ⁶	...	...	NA	NA	NA

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

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

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

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

⁵Including currency and maturity composition.

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

⁷Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Semi-annually (SA), Annually (A), Irregular (I); or Not Available (NA).

Annex III: Relations with the World Bank Group

Montenegro's Development Goals

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

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

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

World Bank Group Strategy

A Joint World Bank-IFC Country Partnership Strategy (CPS) for Montenegro, covering FY07–10 and endorsed by the Bank's Board on June 12, 2007, supports the government's key priorities—viz., to (i) enhance sustainable economic growth, through increasing economic freedoms and strengthening the role of the private sector; (ii) build institutions and the rule of law; and (iii) improve the standard of living of citizens, through efficient education, health and social protection systems. A CPS progress report is scheduled to be presented to the World Bank Boards of Executive Directors in early 2009.

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

Coordination with the IMF has been strong, with cooperation having focused on macroeconomic issues and sectoral ones with a potentially strong macroeconomic impact—more important still after the government’s decision in mid-2007 not to request a Fund-supported program and in light of the increased risks to macroeconomic stability. The Bank, through its ongoing and planned operations, as well its complementary economic and sector work, will continue to provide input on issues such as (i) labor market reforms; (ii) energy sector reforms; (iii) public expenditure, pension and health reforms, with a view to streamlining service delivery, and (iv) an appropriate framework to regulate concession arrangements and potential public/private partnerships, with a view to encouraging investment in a way that would ensure that the government does not accumulate significant contingent liabilities. The Fund has been part of the review process for the second volume of the Public Expenditure and Institutional Review (PEIR), scheduled to be published in late 2008.

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

World Bank Activities

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

Montenegro: World Bank Project Portfolio, End-September 2008
(In millions of U.S. dollars)

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

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

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

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

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

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

and Ulcinj/Ulqin and the tourist areas of Valdanos and Velika Plaža. This phase of the MSTDP will only finance the investments from Lake Skadar/Shkodër to Bar.

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

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

The Bank's assistance has been supported by a standard package of analytical and advisory activities. A *CPAR* and a *CFAA* were delivered in 2002, followed by a *PEIR* and a *Poverty Assessment* in 2003. A *Montenegro Economic Memorandum* was completed in 2005 and focused on macroeconomic issues (particularly public expenditure), labor market reform, the business climate and also synthesized findings of supporting studies of energy. A *PEIR* (2006), a *Debt Sustainability Analysis* (2007), a *Poverty Assessment Update* (2008), two *FSAPs* (2006, 2008), and an Accounting and Auditing *ROSC* (2007) were completed. A second *PEIR* is scheduled to be published in late 2008.

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

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