IMF Country Report

Montenegro 2013 Article IV Consultation

INTERNATIONAL MONETARY FUND

August 2013
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IMF COUNTRY REPORT

MONTENEGRO 2013 ARTICLE IV CONSULTATION

August 2013

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 2013 Article IV consultation with Montenegro, the following documents have been released and are included in this package:

- The **Staff Report** for the 2013 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on May 20, 2013, 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 July 3, 2013.
- An **Informational Annex** prepared by the IMF.
- A **Press Release** summarizing the views of the Executive Board.

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

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INTERNATIONAL MONETARY FUND

MONTENEGRO

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION

July 3, 2013

KEY ISSUES

Context: The significant buildup of public debt in the aftermath of the collapse of the lending boom in 2008 remains a significant vulnerability. The post-bubble debt overhang in the private sector has been a drag on the economic recovery and could prolong the period of sub-par growth going forward.

Fiscal Policy: The immediate challenge is to reverse the trajectory of rising public debt. Economic activity remains sluggish, but vulnerabilities related to debt—including rollover needs—make it difficult to moderate the pace of fiscal adjustment. A sustained, multi-year fiscal consolidation effort is needed to reduce the public debt burden to an appropriately low level over the longer term.

Financial Sector: The painful downsizing of the banking system is advanced, but limited progress on NPL resolution means private sector balance sheets remain impaired; this contributes to a negative feedback loop whereby sluggish private sector demand is contributing to weak economic activity and a further deterioration of asset quality. Structural impediments that hinder the cleanup of private sector balance sheets need to be removed.

Structural Reform: Energy and tourism have potential to be important drivers of growth, but improvements in the business climate and reduction in infrastructure bottlenecks are essential for these sectors to attract foreign investment. Strengthening property rights, improving contract enforcement, and improving the quality of regulations at the municipal level would also help in boosting investment and medium-term growth.

Approved By
Aasim M. Husain and James Roaf

Discussions were held in Podgorica on May 9–20, 2013. The staff team comprised Mr. Ilahi (head), Mr. Gaertner, Mr. Ioannou, and Ms. Che (all EUR). Mr. Husain (EUR) joined some of the policy discussions) Ms. Martinis (OED) also joined the mission. The mission met with Prime Minister Dukanovic, Finance Minister Zugic, Governor Dakic, other senior officials, banks, private sector representatives, unions, and parliamentarians.

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CONTEXT: ELEVATED PUBLIC AND PRIVATE DEBT

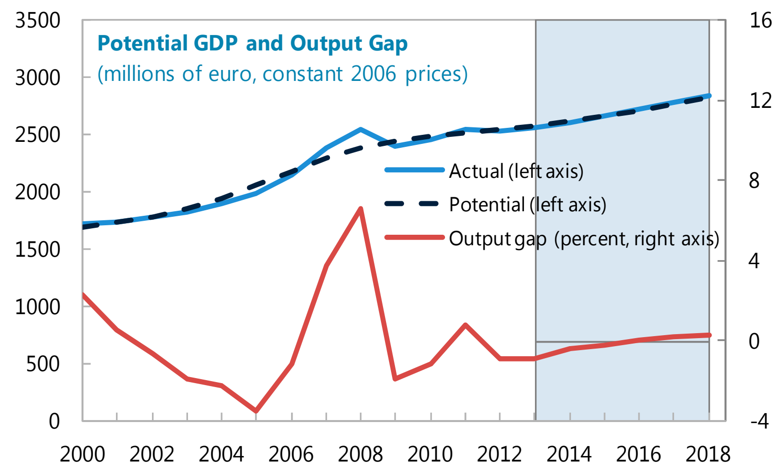
1. **Montenegro is still struggling with the buildup of debt in the aftermath of the collapse of the lending boom five years ago.** Pro-cyclical fiscal policy at the height of the lending boom resulted in large structural deficits that have proven difficult to unwind, yielding a sharp increase in public debt since 2008. There has also been little progress in addressing the private sector debt overhang related to the large stock of bad loans. NPLs remain elevated, and progress in restructuring or recovery of these assets has been limited, keeping the private sector highly indebted and with limited access to financing. This has constrained investment, dampened growth prospects, and left the country entirely dependent on external drivers of growth.

2. **The authorities have a mixed record of implementing recent policy advice in Article IV consultations.** They have embarked on a more serious fiscal consolidation effort in 2012 and 2013 than in the past—a key recommendation in earlier consultations—and their approach toward downsizing and strengthening the financial sector has generally been in line with Fund advice. However, the government continues to find it difficult to develop consensus on addressing the Yugoslav social and subsidy spending legacy, and in dealing with the troubled aluminum producer (KAP).

3. **EU accession appears on track.** Montenegro received official candidate status for EU accession in December 2010, and began accession negotiations in June 2012. Two of the 35 chapters of the EU acquis have been closed and the process is expected to take at least 6–7 years.

RECENT DEVELOPMENTS

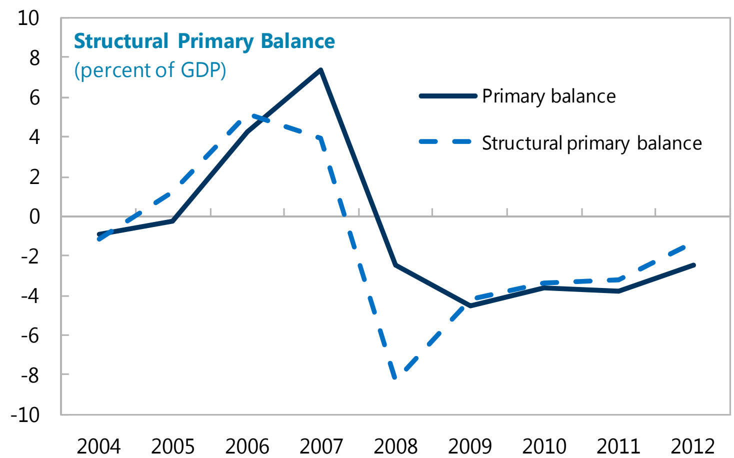
4. **Domestic factors drove output to below potential in 2012.** Tourism and FDI held up relatively well despite the uncertainties in the euro area, and have been the key drivers of economic activity. But unusually severe winter weather constrained output early in the year, while aluminum production fell sharply in the second half of the year as power to KAP was curtailed because of unpaid electricity bills. Inflation rose to 5 percent (yoy) at the end of 2012, as regional drought pushed up food prices, but remains well anchored by the use of the euro, and fell back to 3.2 percent in April 2013. Despite undergoing a sharp adjustment since 2008, the current account deficit was still large, at



18 percent of GDP, though a sizable part comprised imports associated with FDI in the tradable sector.[1]

5. Activity has picked up in early 2013, reflecting good weather conditions. Electricity production rose sharply driven by favorable rainfall, rising 75 percent (year on year) in January–April. The metal sector remained a drag on activity, however, with output contracting by 50 percent (year on year) over the same period, as KAP continued to produce at below 50 percent of capacity. The recovery in retail trade has been relatively modest despite the removal of weather-related bottlenecks so far this year.

6. Public debt continued to rise in 2012 despite a sizable fiscal adjustment effort. There was a nearly 1 percent of GDP improvement in the fiscal deficit in 2012 (2 percent in cyclically adjusted terms), though this primarily reflected cuts in capital spending and transfers. Still, this was insufficient to curb spending as much as planned, and the deficit outturn was 4.3 percent of GDP, well above the revised budget target of 3 percent. Public debt rose by 6 percent of GDP, reaching 52 percent at the end of 2012 (with guarantees, it stood at 63 percent).[2]



7. The 2013 budget targets a further reduction in the fiscal deficit to 2.3 percent of GDP, a structural adjustment of 1¾ percentage points. The authorities have introduced a number of measures to underpin this adjustment—including a freeze on pensions and public sector wage adjustment, and an increase in the personal income tax rate for workers with high salaries. In addition, the recently approved increase in the standard VAT rate from 17 to 19 percent would yield 0.5-0.6 percent of GDP in 2013. In addition, repayment of the remaining loan guarantees to KAP is still under negotiation but now appears unlikely to begin until 2014; this would create additional fiscal space of 0.8 percent of GDP relative to 2012.

8. The banking system has been undergoing a massive balance sheet adjustment. Large deposit outflows immediately following the collapse of the credit bubble in 2008 necessitated a significant downsizing of banks' balance sheets to re-align lending with a more sustainable funding base. Even though parent banks provided support in the immediate aftermath of the crisis, domestic subsidiaries have had to repay these lines in the subsequent period, by scaling back lending and

[1] Staff estimates that without FDI-related imports the current account deficit amounted to 8 percent of GDP in 2012.

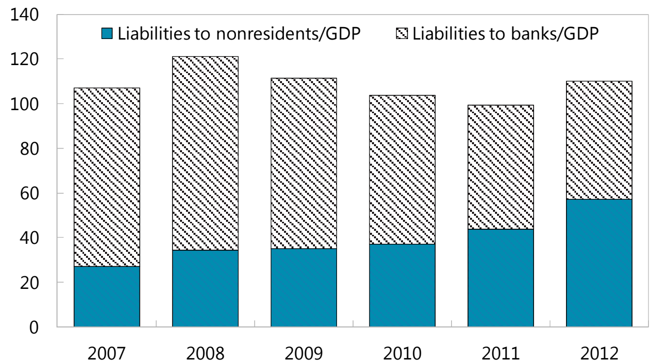
[2] Public debt has risen by a cumulative 23 percentage points of GDP in the past four years, and the near threefold increase in interest bill since 2008 has been one of the fastest in CESEE countries.

aggressively competing for domestic deposits. The resulting balance sheet adjustment at the local bank level is now at an advanced stage, and banks are reaching a position where they have excess liquidity relative to lending opportunities in the domestic market.

9. **Bank credit shrank for the fourth consecutive year, despite a modest recovery in deposits**. The level of credit outstanding fell by 4 percent in 2012, bringing the cumulative post-2008 decline to about one third (Figure 2). Banks continued to repay their foreign obligations; foreign liabilities now account for less than a quarter of total bank assets, for the first time since mid-2007. This, together with a gradual recovery in deposits, has helped lower the system's loan-deposit ratio to below 100 percent (from near 160 in early 2009).

10. **Banks continue to struggle with rising NPLs, while private sector balance sheet cleanup remains unfinished.** Banks have aggressively offloaded NPLs, primarily from the corporate sector, to factoring companies, but the latter have moved slowly with resolution or restructuring of these assets. As a result, private sector balance sheets, particularly those of corporates, remain riddled with high debt. Meanwhile, with the weak economy, asset quality continues to deteriorate—banks' NPLs rose to 17.6 percent at end-2012, from 15.5 a year earlier. The system's capital adequacy ratio is at 14.7 percent.

Private Sector Indebtedness[1]
(Percent of GDP)



[1] Liabilities to factoring companies are included in nonresident liabilities.
Sources: Montenegrin authorities; and IMF staff estimates.

11. **The aluminum processing plant (KAP) has been downsized, but fiscal costs and risks remain.** KAP's workforce has been more than halved in recent years to 1,200 employees, and its share of overall domestic output has dropped from nearly 7 percent in 2005 to less than 2 in 2012. But it has continued to require significant fiscal support in the form of direct subsidies of about 1percent of GDP annually in 2010–12, and has accumulated electricity bill arrears—likely to be a fiscal liability—of about 2 percent of GDP. The government also provided loan guarantees to KAP in 2009 amounting to an additional 5 percent of GDP. The authorities have been seeking to take over the company (originally privatized in 2005) and sell it to a new investor, but have so far been unable to either reach agreement with the current owner or find a new investor. In addition to KAP's poor financial performance, high indebtedness (11½ percent of GDP) and overstaffing, its attractiveness is also hampered by significant investment needs. Since the completion of mission's discussions, the authorities have launched bankruptcy proceedings for the company in the local commercial court.

12. **Montenegro compares favorably to regional peers on business climate, but several key deficiencies remain.** The country ranks 51st out of 185 countries in the World Bank's *Doing Business*, but scores poorly on registering property and dealing with construction permits, where delays have been increasing, especially at the municipal level. An inefficient judicial system, together with unclear and ad hoc rules and regulations, also pose obstacles for investors. The authorities have heightened

efforts recently to reduce the grey economy, by strengthened monitoring and increasing fines for noncompliance.

13. The labor market continues to underperform. A multi-tiered wage setting process hinders adjustment of wages to economic conditions. Limits on the duration of fixed term contracts, in favor of more permanent ones, deter job creation. The unemployment rate has been largely stagnant, close to 20 percent in recent years, with 70 percent of unemployment being long term. Participation remains below 50 percent, partly reflecting early retirements taken by workers in downsized Yugoslav-era enterprises. At the same time, the heavy presence of foreign workers, particularly in tourism, suggests an unwillingness of locals to consider certain jobs. The high unemployment rate at younger age levels also points to a possible supply-demand mismatch of skills in growth sectors.

REPORT ON THE DISCUSSIONS

A. Outlook and Risks

14. There was agreement that favorable weather conditions would support an economic rebound this year. Staff projects real GDP growth of 1½ percent, with relatively balanced risks to the baseline. Good rainfall has boosted electricity production and exports, while there are indications that construction of several new resorts could begin in the fourth quarter, after repeated delays recently. These projects should also provide some support for growth over the medium term, but tourism growth is likely to be modest in the near term because of the weak external environment and emerging capacity constraints, especially at high-end accommodations. In addition, credit is expected to remain stagnant because of impaired private sector balance sheets and risk aversion, while retrenchment in metal output will continue to be a drag on activity.

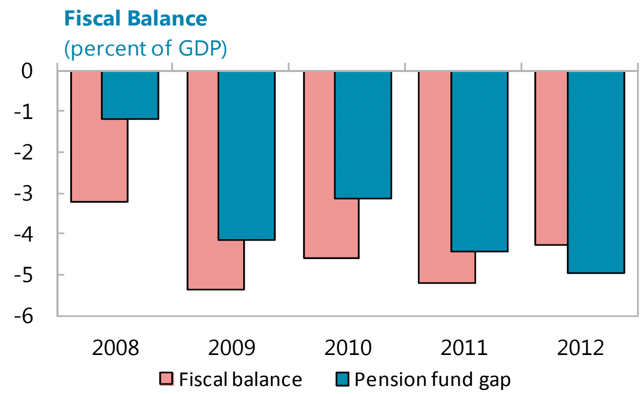
15. The authorities see upside potential relative to this projection. They highlighted the negative impact of last year's severe winter and expect a strong bounce back in the first quarter, relative to last year's low base. They also believe there is scope for stronger growth in tourism, and cited the potential redirection of Croatia-bound Russian tourists to Montenegro because of new EU-related visa requirements in the former.

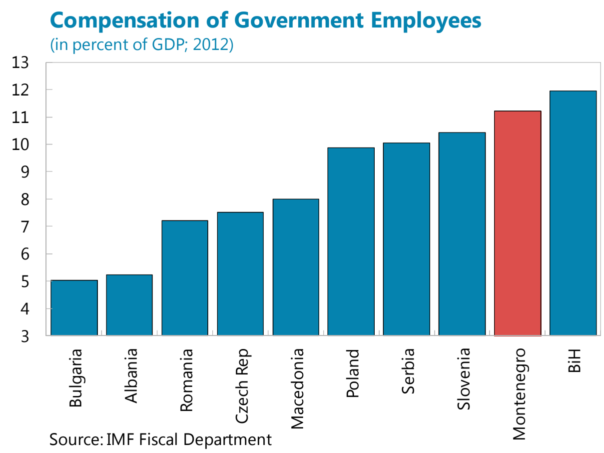
16. Staff and authorities agreed that medium-term growth prospects depended on attracting FDI to develop Montenegro's significant potential. The authorities were optimistic that several large projects were moving into implementation phase. Staff was more cautious on medium-term prospects under the baseline, and emphasized the need to address the business climate issues that have hindered these projects from moving forward. Nevertheless, there was broad agreement that given the very small size of the economy, one or two new investment projects could change the outlook significantly.

17. Staff sees risks to the outlook as tilted to the downside. The rising debt level and recent jump in global risk aversion increase the cost of financing and exacerbate both near and medium term external financing risks (Appendix I).[3] A reemergence of financial stress in the euro area could significantly worsen the outlook for the financial sector, growth and debt sustainability. Over the medium term, a protracted period of slower European growth could affect growth prospects (relative to the baseline scenario; Figure 5). On the other hand, tourism receipts and/or implementation of large foreign investment projects could surprise on the upside; given the small size of the economy, one or two major projects could have a significant impact.

B. Fiscal Policy

18. The run-up in public debt in the last four years represents a significant risk. Montenegro's euroization, thin government deposit cover and shallow domestic financial market leave the country almost entirely reliant on external financing, and vulnerable to shifts in market conditions, especially given a sharp jump in rollover needs in 2015–2016. The key challenge therefore is to reverse the trajectory of public debt to keep rollover needs manageable. Although output fell slightly below potential in 2012, the extent to which the pace of fiscal consolidation can be adjusted to cyclical conditions is constrained by the heavy reliance on external financing on reasonable terms. Benign global financial market conditions until recently had eased near term financing pressures, but the recent increase in risk aversion and a risk of a loss of market access will continue to be a concern as long as financing needs remain elevated.





Source: IMF Fiscal Department

19. Spending cuts in recent years have been inimical to growth. The reduction in the fiscal deficit in 2012 relied heavily on cuts in capital expenditure, continuing a three year trend whereby the burden of adjustment has largely fallen on capital spending and operations and maintenance costs, while public wages and pensions have been relatively protected. Increases in benefits since the end of the boom have widened the pension financing gap to 5 percent of GDP in 2012, from 1.2 percent in 2008, while the public wage bill remains high, relative both to regional comparators and other small states. The

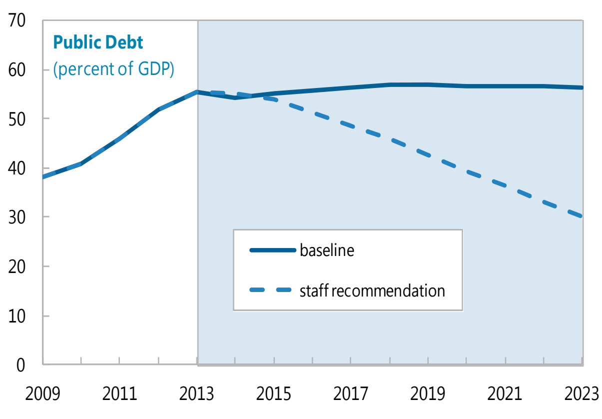
[3] In case of a lack of progress on the international bond, the authorities are likely to attempt to obtain bank loans, as in the past.

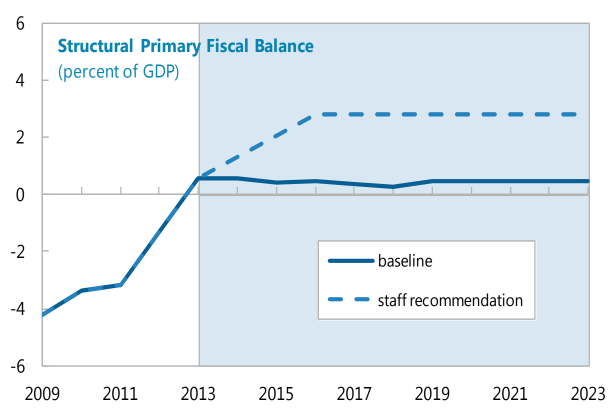
squeeze of capital spending—about 6½ percent of GDP since 2008—has undermined the country's long-term growth potential. To overcome these challenges, the authorities are developing a fiscal rule that would constrain current spending to tax revenues, cap public debt at 60 percent of GDP, and limit annual fiscal deficits at 3 percent of GDP.

20. The authorities are considering a major highway project to enhance domestic and international economic integration. The highway would connect Montenegro to its relatively less developed northern areas and Serbia, but the difficult mountainous terrain means construction costs could be as much as 25 percent of GDP. Various modes of financing appear to be available, including one based entirely on debt.

Staff advice

21. The public debt burden should be reduced to an appropriately low level over the long term through sustained multi-year fiscal consolidation. The lack of an exchange rate instrument and the country's vulnerability to external shocks put extra burden on fiscal policy, and argue for a larger buffer than would be suggested for a typical emerging market economy. Staff advised the adoption of a public debt target of 30 percent of GDP by 2023 with an intermediate target of 45 percent of GDP by 2018, as indicated in earlier announcements by the authorities and one that would eventually return public debt to the 2008 level. Given the difficulties in implementing adjustment targets till this year, and the record of lack of specificity in medium term plans, staff suggested specifying a fiscal adjustment path that would underpin the target, with supporting revenue and expenditure measures. To ensure the fiscal rule is durable, operationally effective in improving fiscal discipline, and consistent with medium term policy objectives, staff advised the authorities to follow simple and permanent fiscal principles, and embed the rule in a well developed medium term framework with a public debt target (recommendations of FAD technical assistance.





22. The fiscal consolidation measures adopted this year are welcome, and should be extended to 2014 and beyond. These measures, combined with an expected one year delay in the repayment of KAP-related guarantees, should yield a fiscal deficit reduction of 2 percent of GDP, and thus allow the authorities to meet their 2013 deficit target and help slow the pace of public debt accumulation. But more needs to be done in future years to put public debt on a declining trend, and additional savings will be required next year to offset expected outlays to repay the KAP-related guarantees. Staff suggested an even adjustment path in 2014–16—a further structural adjustment of ¾ percent of GDP per year, implying an overall deficit target of 2 percent of GDP for 2014 (see alternative scenario). The adjustment is recommended to focus on public wages and pensions.[4] Staff also advised the authorities to utilize any opportunities that may arise in the near and medium term to gradually build up a fiscal reserve to cushion against shocks.

23. High public indebtedness and rollover risks limit the scope for debt financing for the highway project. While such infrastructure investments could improve Montenegro's long-term growth potential, and facilitate the economic integration of its less developed regions, the relatively back-loaded payoff from the project, and the need to maintain financial market access for budget finance and high rollover requirement argue against loan financing. Staff emphasized the benefits of exploring alternative financing arrangements, but cautioned that implicit government commitments in such vehicles would need to be assessed carefully.

Authorities' views

24. The public debt target should be pursued flexibly while conforming to a fiscal rule. The authorities agreed that 30 percent of GDP was a reasonable longer-term debt target, but argued for flexibility in implementation over the near term, to provide scope for the infrastructure investment currently under consideration. They argued that the boost to long term growth potential from the prospective highway project would justify the risks emanating from debt financing for the project.

25. The temporary measures introduced this year may be renewed, but further savings would have to come from structural reforms. The authorities agreed on the need to revisit the pension reforms implemented in 2010 to ensure financial viability of the fund. However, they also emphasized the importance of ensuring adequate benefits for such a vulnerable segment of the population. They saw the ongoing reform of public administration and stepped-up efforts to strengthen tax compliance in the informal economy as beginning to deliver savings over the next several years.

26. Refinancing could mitigate rollover risk. While acknowledging the risks posed by the spike in rollover requirements beginning in 2015, the authorities are keen to refinance some of their earlier issuance to smooth the repayment profile.

[4] The high import propensity and the small and open nature of the Montenegrin economy would likely result in a muted impact of the proposed fiscal adjustment on growth. Studies estimate multipliers of 0.5 or less for such countries, with investment spending having the largest impact and a smaller effect of revenue measures, transfers and current spending. However, the impact could be somewhat higher at a time when output is below potential, access to credit is constrained and, there is no monetary policy offset.

C. Financial Sector Policies

27. Banks continue to struggle with rising NPLs which in turn are impacting profitability and capitalization. In a bid to clean up balance sheets banks have aggressively sold off problem loans to factoring companies, but a considerable stock of NPLs remains on their books. Loan-loss provisions were 40 percent of NPLs at end 2012, with NPLs net of provisions amounting to 68 percent of capital, putting a strain on banks' profitability and capitalization. With the banking system largely foreign-owned, and with some parent banks facing problems, the capacity of parents to support their Montenegrin subsidiaries remains a concern.

28. While banks' balance sheet adjustment is at an advanced stage, credit growth will hinge on private sector restructuring. Limited progress on the restructuring and resolution of NPLs means that corporate balance sheets remain burdened with very high debt (Appendix III). As a result, supply as well as demand for credit remain weak pending resolution of the bad loans. Negative feedback loops may further impact bank risk aversion and credit growth. Staff analysis suggests that while demand factors, emanating from a weak economy, are increasingly pronounced in explaining credit performance, supply constraints are binding determinants of credit (see Box 1). High NPLs and large nonfinancial sector debt run the risk of amplifying the impact of adverse financial shocks on financial stability and the economy.

Staff advice

29. Structural distortions that hinder the cleanup of bank and private sector balance sheets should be removed. There is a need to accelerate collateral execution which is constrained by ad hoc application of the law and lengthy court procedures. Efforts should also focus on ensuring that independent appraisals more accurately reflect current market conditions, strengthening the land registry, and improving the quality of accounting and auditing standards.[5] The implementation of the ongoing World Bank project to facilitate out-of-court settlement and remove regulatory and legal obstacles should also be accelerated.

30. The high level of NPLs, weak profitability, and uncertain prospects for parent support call for stepped up supervision. The authorities should continue to strictly monitor NPLs, enforce adequate provisioning, and undertake regular stress tests in order to assess the need for additional capitalization. In this regard, they should ensure that banks proactively seek additional capital and respond promptly to any shortfalls. The authorities should also continue to strengthen their contingency planning framework and implementation plans in line with recent MCM technical assistance recommendations. The regulatory and supervisory umbrella should be appropriately extended to factoring companies to minimize regulatory arbitrage.

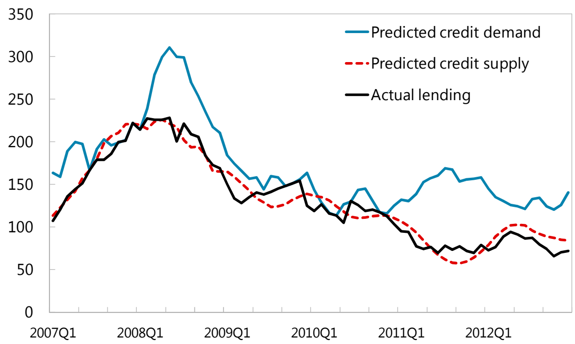
[5] As appraisals may not always reflect prevailing market conditions, factoring companies often end up buying repossessed properties at artificially high prices, which can further delay recovery, and balance sheet clean up.

Box 1. Supply Constraint on Credit in Montenegro[1]

Results from the estimation of a disequilibrium credit demand-supply model confirm the binding role of supply constraints in the period following the 2008 crisis. Prior to the crisis, high credit growth was fueled by increases in both credit demand and supply, with large excess demand that dissipated quickly after the crisis broke. The period 2009-2010 saw both credit demand and supply decline, with the credit market being in broad equilibrium. However, credit supply was the primary constraining factor in the credit contraction.

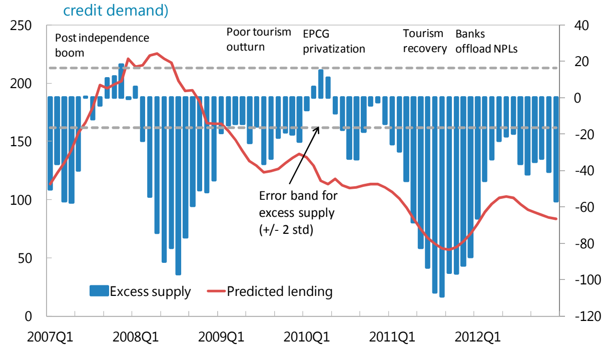
Supply remains a constraint despite significant effort to clear bank balance sheets. With a significant amount of outstanding liabilities having been paid off, and banks having offloaded NPLs to factoring companies, supply has become relatively less of a constraint recently, but the estimates show that supply constraints are still binding in credit outcomes.

Demand and Supply of Credit
(in millions of euros)



Source: Staff estimates

Estimated Excess Supply of Credit
(in millions of euros; excess supply = estimated credit supply - estimated credit demand)



Source: Staff estimates

31. **A more regular pattern of treasury bill issuance should be pursued to facilitate deepening of local financial markets.** The increased liquidity in the banking system could support greater demand for domestic debt and provide a more stable source of government financing, but will need to be accompanied by steps to modernize current auction procedures, including introduction of electronic bidding and settlement. Issuance should expand gradually, given the sharp contraction in bank lending in recent years and concerns about possible crowding out.

Authorities' views

32. The cleanup of private balance sheets could take time. While agreeing on the need to make the judicial process more efficient and predictable, and to tighten the regulation of factoring companies, the authorities attributed the prevalence of unresolved loans primarily to banks' and factoring companies' preference for waiting for higher asset prices over the medium term. They also noted that because of the impairment of private sector balance sheets, the number of eligible buyers of repossessed properties was effectively capped, limiting the volume of property sales.

33. Continued cross-border coordination, even-handed application of macroprudential regulations and good contingency planning has helped maintain financial stability. The authorities noted that they were in constant touch with parents of Montenegrin subsidiaries and their relevant national regulators. They are determined to preserve the integrity of the banking system by ensuring that all banks comply with macroprudential regulations. In this regard, they felt the recent increase in deposit insurance coverage to €50,000 beginning in 2013 further reassured depositors. The authorities consider the current contingency planning framework as adequate, but are working on further refining it, based on MCM's technical assistance recommendations.

34. There may be limits to the extent the domestic treasury bills market could be deepened. The authorities indicated that they had begun to test the Treasury bill market with larger issuance recently, but even a slight increase in the volume of sales was accompanied by a steep increase in yields. With weak credit demand, and banks' search for higher yields, there may be a need to reconsider the maturities offered in the market. They were uncertain if bank interest in domestic treasury bills would be sustained once credit to the private sector picked up.

D. Accelerating Reforms to Boost Medium-Term Growth

35. Potential output appears to be stagnating as investment to realize the untapped potential in tourism and energy has not fully materialized. Output growth in recent years has been driven by tourism; however, the sector appears to be approaching capacity constraints (see Box 2). Montenegro has significant opportunity to develop its tourism as well as become a regional electricity hub, but improvements in the business climate and further upgrading of infrastructure are essential to attract foreign investment into these sectors.

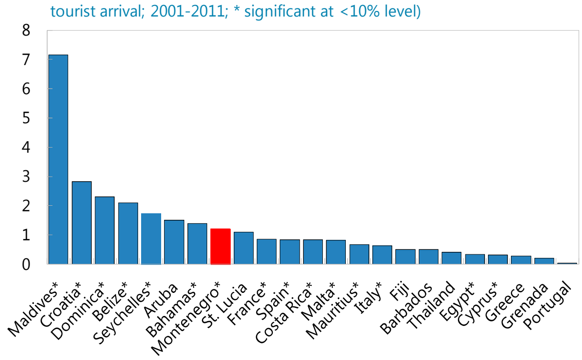
36. Efforts to sustain KAP have distorted resource allocation, and consumed scarce budgetary resources. KAP has been unable to break even because of high input costs, and so far, interventions to support it have failed to put the company on a sustainable footing despite considerable fiscal costs. Staff's analysis, including that in the 2012 Article IV Consultation, suggests that the prospects for a durable long-term solution—one that is subsidy-free and extinguishes outstanding debts and liabilities—are limited, and it appears inevitable that KAP cannot be sustained without unduly burdening taxpayers for years.

Box 2. Tourism and Growth in Montenegro[1]

Tourism has been a major growth driver. Montenegrin tourism has experienced substantial growth in recent years. It accounted for over 70 percent of exports of goods and services in 2012, and GDP growth has closely tracked tourism growth. The volatility of tourist arrivals in Montenegro is one of the lowest among the small states that heavily rely on tourism. Tourism also has a large positive externality on the economy through its effects on ancillary activities. Staff estimates show that a 1 percent increase in tourist arrivals in Montenegro is associated with 1.2 percent increase in GDP.

Tourism Multiplier

(Percentage change in GDP corresponding to 1 percent change in inbound tourist arrival; 2001-2011; * significant at <10% level)

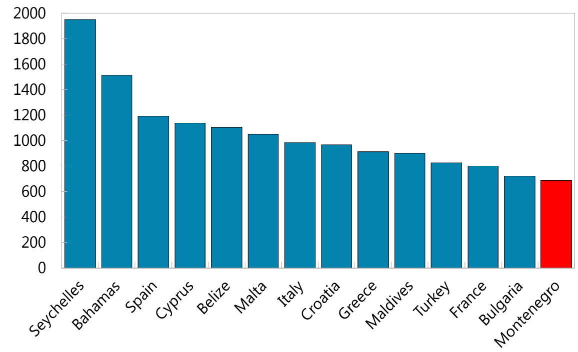


Sources: World Tourism Organization, IFS, and staff calculation

However, the sector's growth momentum is waning. Capacity constraints are beginning to emerge, while the weak economic outlook in the primary tourist markets is likely to put a cap on prospects for further growth. Montenegro earns less per visitor than many other tourism-intensive countries. The earning ability of the sector is limited by the preponderance of unregulated and informal activities that hinder high-quality investments (and fiscal revenue intake). About 8 in 10 tourist accommodations are unregistered rental apartments, and informal businesses offer low-quality services with minimal value added, and without internalizing the negative externalities, including to the environment.

Expenditure per Inbound Visitor

(in USD; 2011)



Sources: World Tourism Organization and staff calculation

For the sector to be a sustainable driver of growth over the mediumterm quality should be upgraded and activities diversified. A broad-based strategy is needed for tourism development, complemented with targeted investments and improved regulation at both central and municipal levels. In addition, Montenegro should strive to extend its visitor base globally and to higher-end visitors, and diversify to noncoastal tourism to lower the seasonal volatility of the country's tourism earnings.[2] However, such a strategy would require investment in tourism-related physical and social infrastructure, and continued improvement in the business climate.

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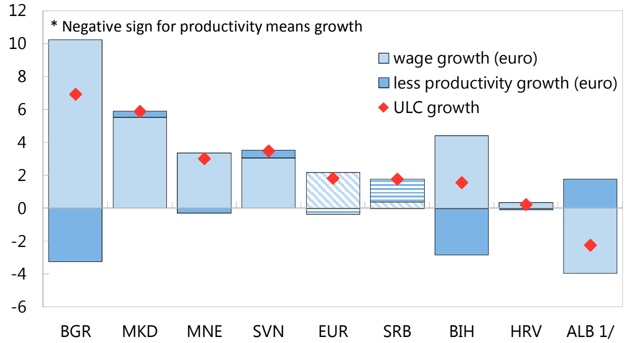
[1] See Appendix IV for more details.

[2] Currently 90 percent of Montenegrin tourism is concentrated on the coast, and takes place primarily in the summer.

37. An analysis of the current account and competitiveness points to the need for preventing the erosion of competitiveness and improving the functioning of the labor market. Without an independent currency, competitiveness gains have to come from productivity, business climate, and infrastructure improvements. While the export of tourism services has fared well since 2008, largely because of sustained external demand from abroad, exports from the rest of the economy have performed poorly. Cost competitiveness is an issue. Montenegro's unit labor costs (ULC) is higher than in other countries in the region (except Serbia) and wage growth in 2008–11 has slightly exceeded productivity changes, largely because a multi-tiered wage bargaining process that complicates private sector wage outcomes—ULC has risen by 3 percent since 2008 despite the weak economic environment (see Box 3).

Contribution to Euro Unit Labor Costs

(year-on-year growth rates, 2008-2011)



1/ Latest data from 2010

Sources: Haver, WEO, Staff calculations

Staff advice

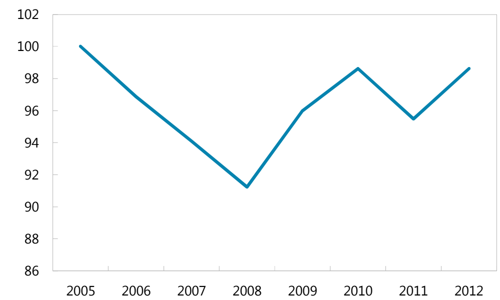
38. Budgetary support for KAP should be discontinued and eventual liquidation pursued under a clear plan. The recent downsizing of the plant is welcome, and while eventual liquidation of KAP, in the context of an appropriate compensation framework for redundant employees, would entail a drag on growth and additional fiscal costs in the short-term, it would also release scarce resources, including energy, for exports and activities in which Montenegro has considerable potential.

39. Further improvements in the business environment are essential. Staff advised the authorities to reduce the frequency of regulatory changes—which investors see as significant obstacles. Streamlining procedures for obtaining business licenses and permits and improving transparency at the municipal level would also help. Staff welcomed recent initiatives to formalize grey economy activities and saw potential for fiscal dividend and growth. Finally, staff encouraged the authorities to strengthen their efforts against corruption and organized crime, including by effectively implementing the AML/CFT regime.

Box 3. Montenegro: External Competitiveness

Export performance has continued to improve, despite modest deterioration in competitiveness, as measured by REER and RULC. The CPI-based REER appreciated in 2012 because of the firming of the euro relative to other currencies, and cost indicators also suggest deterioration as wage growth outpaced modest gains in productivity (especially during 2008–09). Montenegro's share in world exports has risen steadily, however, largely because of resilient tourism demand. This partly reflects a catching up process, as tourist arrivals had dropped off dramatically during the Yugoslav conflict, but also the emergence of a more competitive tourist sector, relative to the rest of the economy.

Real Effective Exchange Rate
(2005=100)



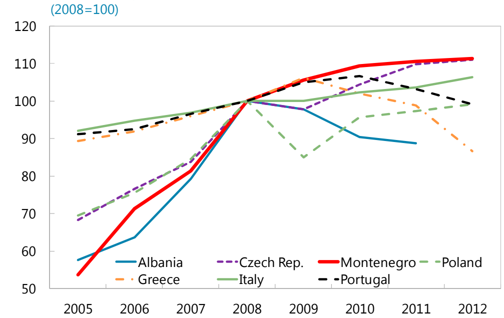
(Source: WEO)

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	-3.0
CA Balance	-16.2	-16.2
Gap	**9.2**	**13.2**

Source: IMF staff estimates
1/ Rahman, Jesmin (2008), "Current Account Developments in New Member States of the European Union: Equilibrium, Excess, and EU-Phoria," IMF Working Paper http://www.imf.org/external/pubs/ft/wp/2008/wp0892.pdf

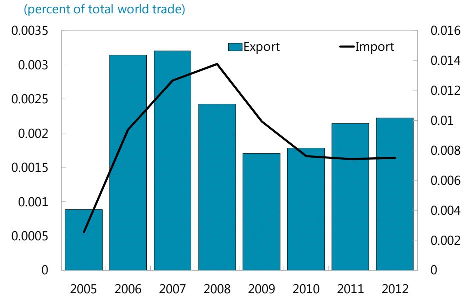
Gross Wage Index
(2008=100)



Sources: IFS and Haver

Recent improvements in the current account have been partially driven by the economic slowdown. Since 2008, the current account deficit has declined sharply as a result of lower imports, driven primarily by credit contraction and the bursting of the asset bubble, as well as cuts in import-intensive capital spending by the government.

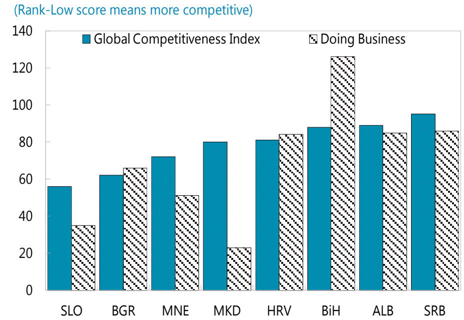
Importance in World Trade
(percent of total world trade)



Sources: DoT Database and staff calculation

Staff analysis of the current account points to an imbalance, but the estimates are subject to considerable uncertainty. There appears to be a prospective medium-term overvaluation of the real exchange rate under the Macroeconomic Balance and External Sustainability approaches. However, data uncertainties (related to errors and omissions in the balance of payment, which amount to about 7 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 imprecise and potentially misleading. Further, while the external current account deficit appears high at 18 percent of GDP, more than half of this represents imports related to FDI.

Structural Competitiveness Indicators
(Rank-Low score means more competitive)



Sources: Global Competiveness Report 2013, Doing Buisiness Database, 2013.

Steadfast implementation of reforms to improve competitiveness in key sectors will be essential. Given the importance of tourism in the economy, and the role it is likely to play in driving growth in the future, continued improvements in competitiveness in the sector will be critical—namely, enhancing infrastructure and quality of services. Continued external stability will hinge on steady growth in tourism and FDI over the medium term. Montenegro's prospective EU accession could play a catalytic role in this regard.

40. Labor market reforms are indispensible for competitiveness and should be accelerated. Staff advised that the collective bargaining system should allow more independent wage setting at industry and firm levels, including by expanding the use of fixed-term contracts (currently limited to a single two-year contract). The design of social protection should be altered so it does not discourage the unemployed from taking up jobs, and labor regulations (particularly those related to limits on fixed term contracts) eased so they do not deter job creation. [6]

41. The quality of economic statistics needs to be improved. While data are generally adequate for surveillance, some weaknesses remain, especially in national and external accounts. Progress has been made over the past year, including through the introduction of quarterly national accounts and improved measurement of tourism receipts, but adequate resources should be made available to ensure effective use of TA in these areas.

Authorities' views

42. The authorities have considered several options for resolving the problems at KAP. They worry about the social and economic impact of KAP closure—they argued that KAP is still the largest employer in the country, and supports a number of ancillary service providers. On the one hand they were optimistic that an agreement could be reached to supply the company with electricity at a price that would allow the company to break even, and that investors could be found to develop higher value added production. However, they also acknowledge the risks with this strategy and were prepared to pursue bankruptcy in the event that such an agreement could not be reached.

43. Various business climate reforms and labor market initiatives have been taken recently. The authorities highlighted recent efforts to adopt a law on spatial planning and reduce the cost of obtaining construction permits. They pointed to a nine-month apprenticeship program introduced this year to help new college graduates gain work experience as an initiative that should help to bridge the gap between skills demanded and supplied in the labor market.

44. Further improvements in economic statistics are limited by budget constraints. The authorities pointed to budgetary limitations that constrain progress in this area. They also emphasized the challenges posed by Montenegro's use of the euro and the nature of tourist activity in accurately measuring the sizes of the grey economy and of cross-border economic activities.

[6] World Bank, 2012, *Montenegro - Preparing for Prosperity: Ensuring Sustainability, Connectivity and Flexibility for Dynamic Growth*.

STAFF APPRAISAL

45. **Montenegro is still struggling with the challenges created by the buildup of debt in the aftermath of the lending boom.** The rapid rise in public debt since 2009 has increased vulnerabilities and left little fiscal space for much-needed investment, while the large stock of bad loans has resulted in a debt overhang in the private sector that constrains investment and growth.

46. **Last year's output contraction was heavily influenced by adverse weather conditions, and a modest rebound is likely this year.** However, scope for tourism to continue to drive growth is likely diminishing in the absence of investment to expand and upgrade capacity, while decreasing output in the struggling aluminum sector will continue to be a drag on activity. Montenegro has significant potential in energy and tourism, but this will require improvements in the business climate to facilitate greater inflows of foreign investment into these sectors, including by strengthening anti-corruption efforts.

47. **A sustained, multi-year fiscal consolidation effort is needed to reduce the public debt burden to an appropriately low level over the medium term.** Financing constraints and the risk of a loss of market access, as highlighted by the recent spike in global risk aversion, will continue to be a concern while financing needs remain elevated. Aiming to return public debt to its 2008 level (as a share of GDP) in 10 years would be appropriate, but the challenges entailed in achieving it would mean sustained fiscal effort in future years. The use of a fiscal rule could help, by providing structure and discipline to fiscal policy, but for this to happen, the authorities would need to ensure such a rule embeds an appropriately ambitious medium term debt target and is operationally viable. The absence of a currency underscores the need for gradually building up a fiscal reserve buffer by opportunistically tapping external financing markets over the near and medium term.

48. **Recent fiscal measures are welcome but more will be needed in future years.** The fiscal consolidation measures adopted for 2013 should stem the pace of debt accumulation, but these will need to be extended into 2014 and beyond in order to put public debt on a declining path. Additional savings will also be required next year to offset expected outlays to repay loan guarantees related to KAP. The growing financing gap in the pension fund has cramped the fiscal space, and serious front loaded reforms are needed in this area to allow savings for 2014 and beyond, including, to meet fiscal contingencies. Efforts to improve the targeting of social spending are welcome, and should be expanded.

49. **Limited progress on NPL resolution has left private sector balance sheets burdened with very high debt, risking a prolonged period of sub-par growth.** It is essential to remove structural distortions that hinder the cleanup of private sector balance sheets, including lengthy and ad hoc judicial processes that delay collateral execution. Efforts should also focus on improving the accuracy of appraisals, strengthening the land registry, and advancing auditing standards.

50. **Moving KAP toward liquidation appears to be the least cost option, one that would also improve resource allocation.** Prospects for a durable long-term solution that allows the company to operate profitably while paying market prices for electricity appear limited, and it seems

inevitable that continuing KAP in its current structure would require further fiscal support—at a time when the authorities are forced to take difficult decisions to raise taxes and curb spending. While liquidation could entail some near term fiscal costs, it would remove the specter of continual subsidies from the budget, release scarce resources that can be employed more productively, including electricity for exports, and permit the parts of the operation that remain viable to be sold to private investors.

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

Figure 1. Montenegro: Real Sector Developments

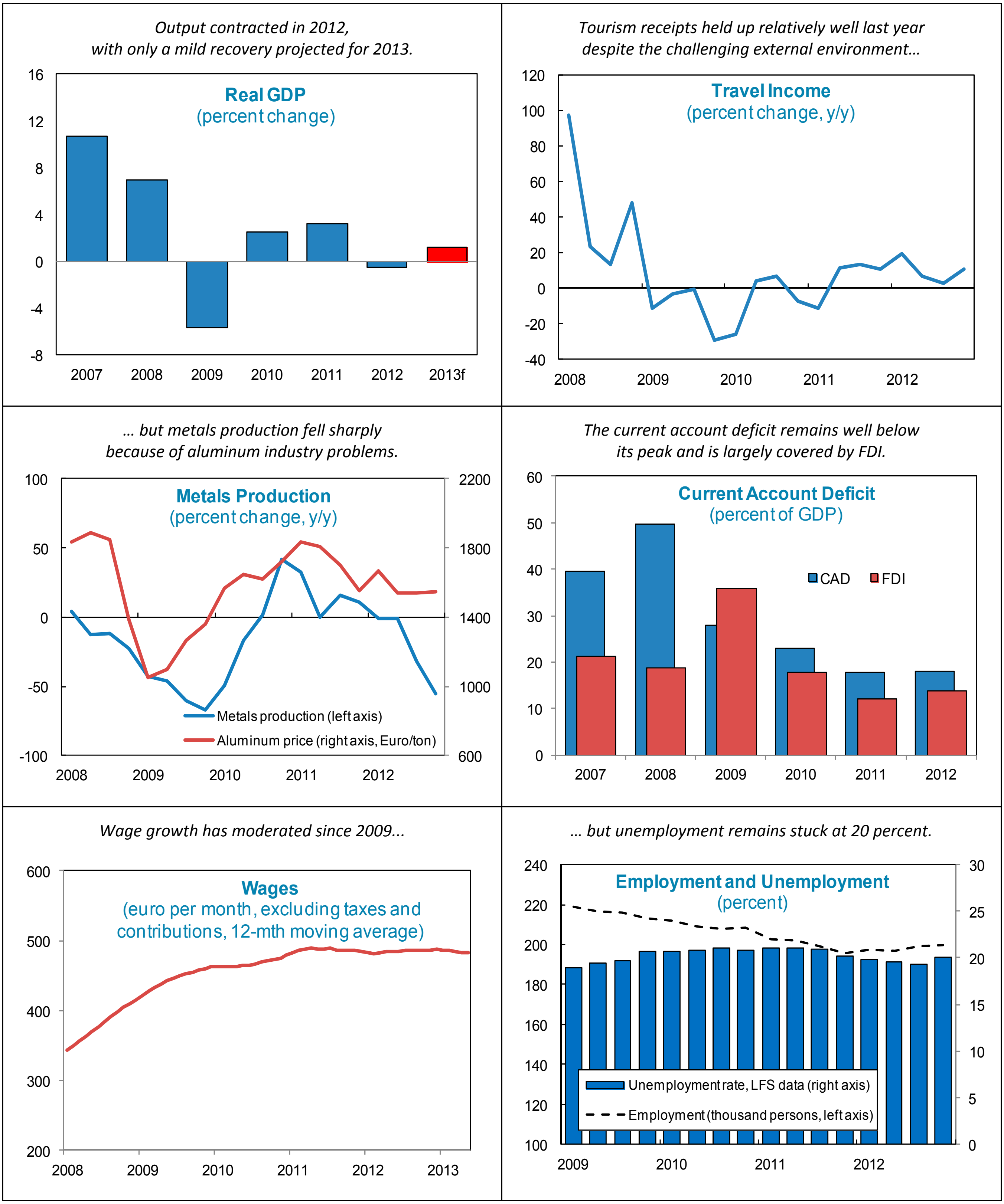


Figure 2. Montenegro: Financial Sector Developments

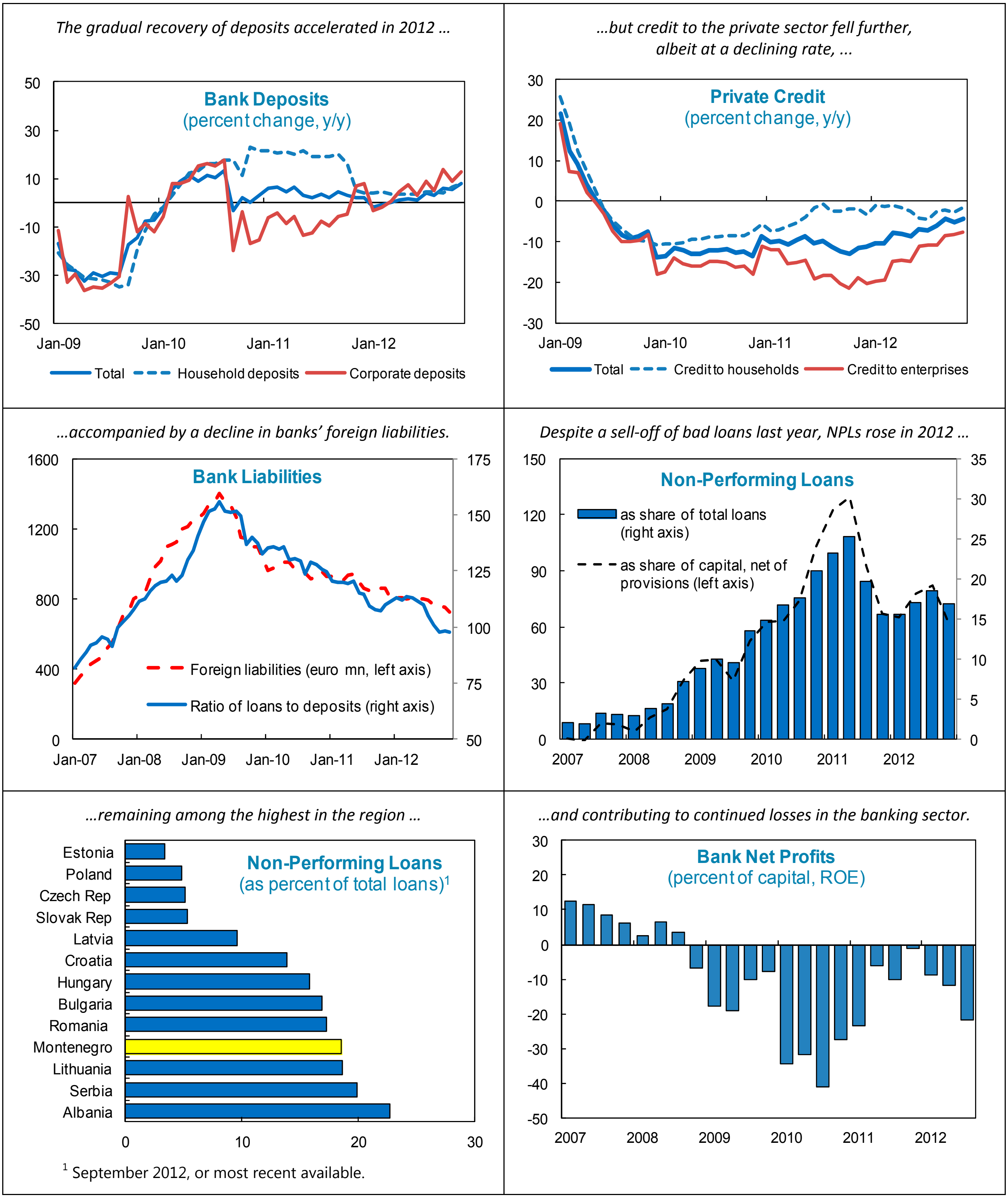
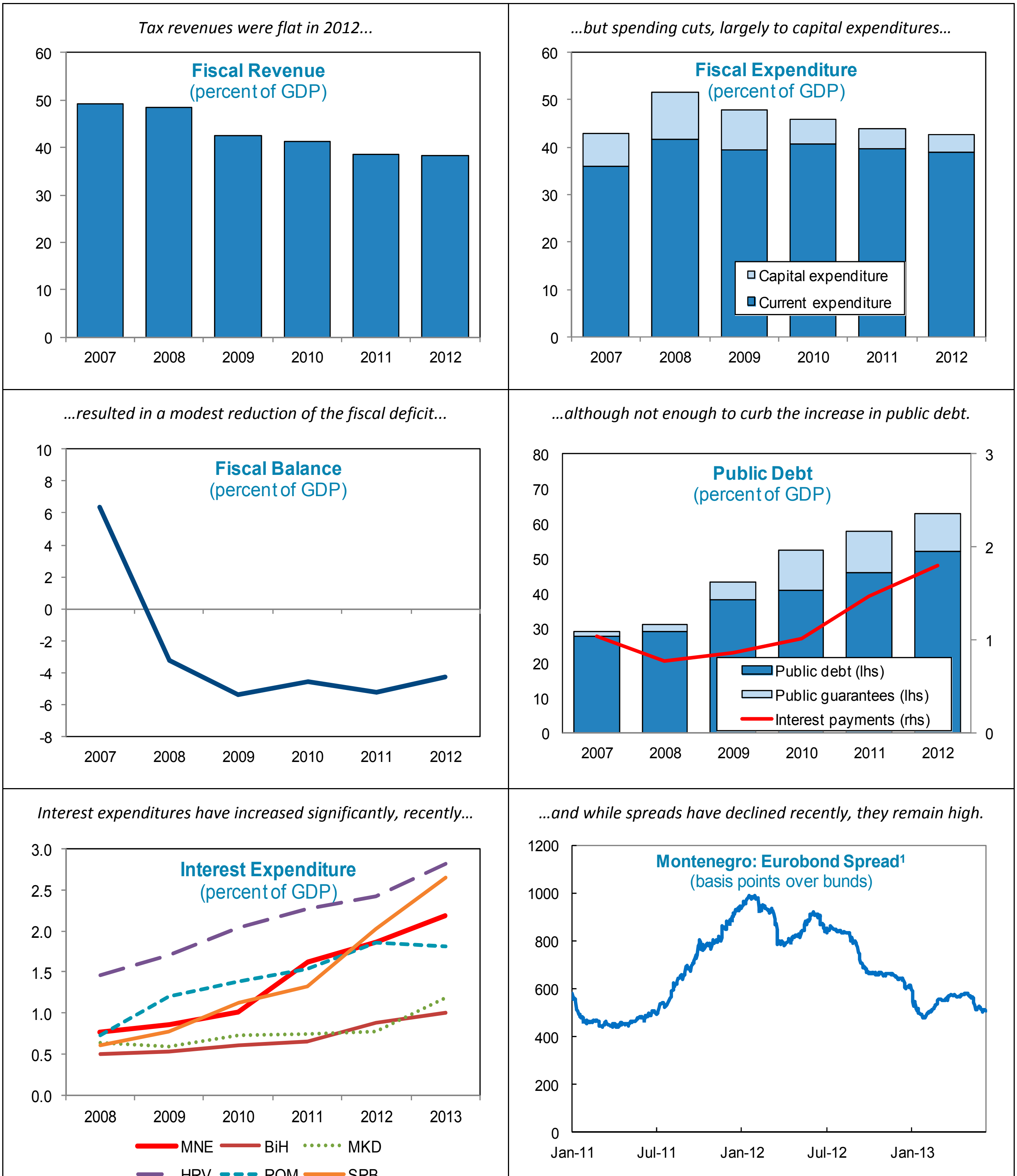


Figure 3. Montenegro: Fiscal Developments



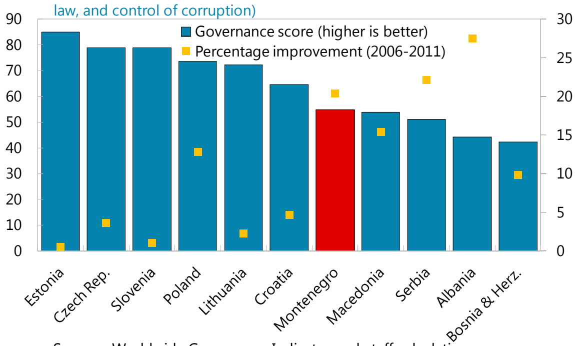
[1] Maturing in 2015.

Figure 4. Montenegro: Business Environment, Labor Market, and Infrastructure

Governance quality is lower than in many CESEE peers, but has shown improvement…

Governance Indicator

(Average score for government effectiveness, regulatory quality, rule of law, and control of corruption)

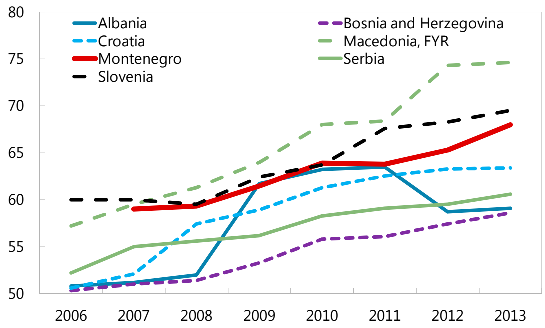


Sources: Worldwide Governance Indicator and staff calculation

… and the business environment is also improving…

Doing Business Indicator

(Higher score means improvement)

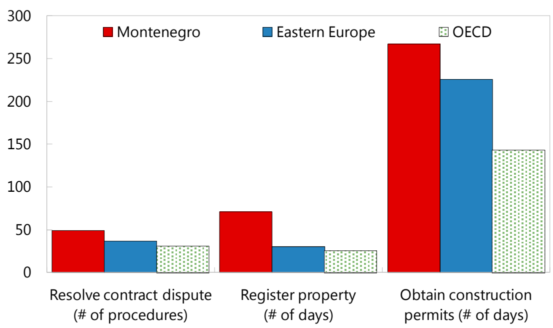


Source: WB Doing Business

… but weaknesses remain in contract disputes, registering property, and obtaining licenses and permits.

The cost to…

(2013)

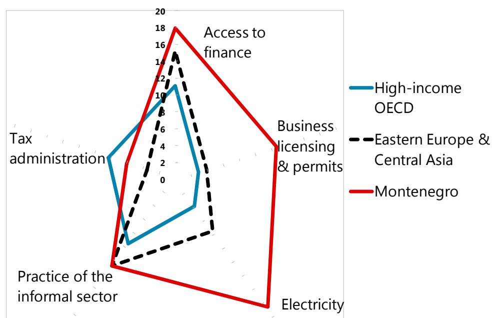


Source: WB Doing Business

To improve the business environment, Montenegro also needs to enhance firms' access to finance and upgrade electricity infrastructure…

Obstacles Faced by Firms

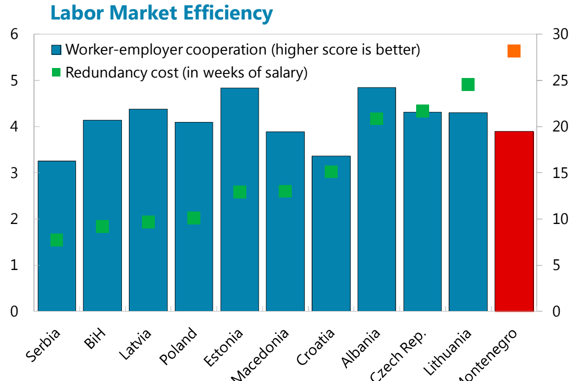
(% firms that acknowledge the issue as a major obstacle)



Source: WB Enterprise Survey

…and lower redundancy costs in the labor market.

Labor Market Efficiency

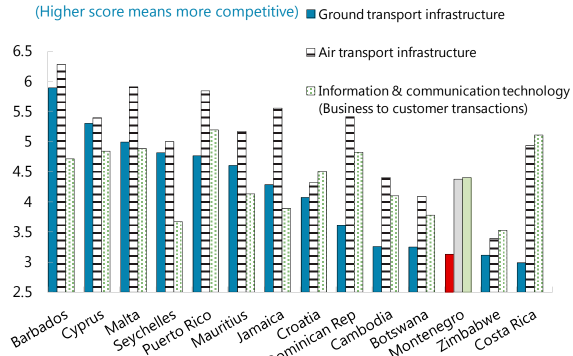


Source: Global Competitiveness Report (2013)

Infrastructure for tourism also needs upgrading to realize the sector's full potential.

Tourism Competitiveness Index

(Higher score means more competitive)



Source: Travel & Tourism Competitiveness Index (2013)

Figure 5. Montenegro: Baseline and Adjustment Scenarios[1]

[1] The adjustment scenario is based on the following assumptions: 1) The closure of KAP in 2014, which results in one-off fiscal costs of 1 percent of GDP, and a temporary drop in output and exports; 2) Fiscal consolidation in 2013–16 and a subsequent reduction in public debt, reflecting an extension of the freeze in pension adjustments and downsizing of the public wage bill initiated in 2013, allowing higher capital spending ; 3) Acceleration of critical structural reforms to improve the business environment, providing the basis for a pick-up in FDI in electricity and tourism, two key areas of comparative advantage; 4) A pick-up in exports beginning in 2015, reflecting increased FDI and supporting faster growth in real GDP.

Table 1. Montenegro: Selected Economic Indicators, 2008–18
(Under current policies)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
						Projections					
Real economy											
Nominal GDP (millions of €)	3,086	2,981	3,104	3,234	3,276	3,411	3,567	3,725	3,894	4,081	4,281
Gross national saving (percent of GDP)	-10.0	-3.1	-2.6	-2.0	-1.5	0.3	1.8	2.7	3.6	4.3	5.1
Gross investment (percent of GDP)	40.7	27.1	22.8	19.5	20.3	21.0	21.9	23.0	23.8	24.6	25.3
					(percent change)						
Real GDP	6.9	-5.7	2.5	3.2	-0.5	1.5	2.2	2.3	2.4	2.6	2.7
Industrial production	-2.0	-32.2	17.5	-10.3	-7.1	…	…	…	…	…	…
Tourism											
Arrivals	4.8	1.6	4.6	8.7	4.8	…	…	…	…	…	…
Nights	6.9	-3.1	5.5	10.2	4.3	…	…	…	…	…	…
Consumer prices (period average)	9.0	3.6	0.7	3.1	3.6	3.4	2.9	2.3	2.3	2.3	2.3
Consumer prices (end of period)	7.2	1.7	0.7	2.8	5.1	3.3	2.3	2.3	2.3	2.3	2.3
GDP deflator	7.7	2.4	1.6	0.9	1.9	2.5	2.4	2.1	2.1	2.1	2.1
Average net wage (12-month) 1/	23.1	11.3	3.5	1.0	0.6	…	…	…	…	…	…
Money and credit (end of period)											
Bank credit to private sector	25.0	-15.1	-8.9	-13.0	-3.1	0.2	1.0	1.6	2.2	2.7	3.0
Enterprises	21.3	-18.0	-11.2	-20.3	-4.9	…	…	…	…	…	…
Households	31.2	-10.7	-5.7	-3.2	-1.1	…	…	…	…	…	…
Private sector deposits	-14.2	-4.1	5.9	1.2	7.2	…	…	…	…	…	…
General government finances (accrual) 2/					(as percent of GDP)						
Revenue and grants	48.4	42.5	41.3	38.5	38.4	38.9	39.0	39.1	39.2	39.2	39.2
Expenditure	51.6	47.8	45.9	43.8	42.7	41.2	42.1	42.3	42.3	42.2	42.2
Overall balance	-3.2	-5.4	-4.6	-5.2	-4.3	-2.3	-3.2	-3.3	-3.1	-3.1	-3.1
Primary balance	-2.4	-4.5	-3.6	-3.8	-2.5	-0.1	-0.5	-0.5	-0.3	-0.2	0.0
Domestic financing (net)	2.1	-3.1	-1.4	0.7	-2.7	-4.7	0.0	-1.2	-0.6	-0.6	-0.4
Privatization receipts	1.2	4.4	0.8	0.5	0.4	0.6	0.5	0.2	0.2	0.2	0.2
General government gross debt	29.0	38.2	40.9	46.0	51.9	55.3	54.1	55.0	55.8	56.4	56.9
General government debt, including loan guarantees	31.0	43.2	52.4	57.8	62.9	65.0	62.7	63.6	64.4	65.0	65.5
Balance of payments											
Current account balance 3/	-49.8	-27.9	-22.9	-17.7	-17.9	-16.9	-16.4	-16.4	-16.3	-16.3	-16.3
Foreign direct investment	18.9	35.8	17.8	12.0	14.1	14.6	15.2	15.9	16.6	17.2	17.8
External debt (end of period, stock)	90.8	93.5	96.4	101.4	108.4	113.3	113.6	115.6	116.4	116.9	117.1
Of which: Private sector 4/	75.2	70.0	67.0	68.5	68.9	68.9	68.6	68.3	67.6	66.9	66.2
REER (CPI-based; annual average change, in percent) (- indicates depreciation)	-3.1	5.2	2.8	-3.2	0.9	…	…	…	…	…	…
Memorandum:											
Aluminum price (€ per tonne)	1,892	1,143	1,644	1,822	1,533	1,495	1,542	1,611	1,687	1,757	1,824

Sources: Ministry of Finance, Central Bank of Montenegro, Statistical Office of Montenegro, Employment Agency of Montenegro; and IMF staff estimates and projections.
1/ 2009 wage data have been adjusted to reflect a change in the methodology by Monstat starting January 1, 2010.
2/ Includes extra-budgetary funds and local governments, but not public enterprises.
3/ 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.
4/ Estimates, as private debt statistics are not officially published.

Table 2. Montenegro: Savings and Investment Balances, 2008–18

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

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
					Est.			Projections			
Gross national savings	-10.0	-3.1	-2.6	-2.0	-1.5	0.3	1.8	2.7	3.6	4.3	5.1
Non-government	-16.4	-5.7	-2.6	0.2	0.6	0.5	3.0	4.1	4.9	5.7	6.6
Government	6.5	2.6	0.0	-2.2	-2.1	-0.3	-1.3	-1.4	-1.3	-1.4	-1.5
Gross domestic investment	40.7	27.1	22.8	19.5	20.3	21.0	21.9	23.0	23.8	24.6	25.3
Non-government	30.6	18.7	17.5	15.3	16.6	17.0	17.8	18.6	19.5	20.2	21.0
Government	10.1	8.4	5.3	4.2	3.7	4.0	4.2	4.4	4.4	4.4	4.4
Savings - investment balance	-50.7	-30.3	-25.4	-21.6	-21.8	-20.7	-20.2	-20.3	-20.2	-20.2	-20.3
Non-government	-47.0	-24.4	-20.1	-15.2	-16.0	-16.5	-14.7	-14.5	-14.5	-14.5	-14.4
Government	-3.6	-5.9	-5.3	-6.4	-5.8	-4.2	-5.5	-5.7	-5.7	-5.7	-5.9
Current account balance 1/	-49.8	-27.9	-22.9	-17.7	-17.9	-16.9	-16.4	-16.4	-16.3	-16.3	-16.3
Foreign direct investment (net)	18.9	35.8	17.8	12.0	14.1	14.6	15.2	15.9	16.6	17.2	17.8
External debt	90.8	93.5	96.4	101.4	108.4	113.3	113.6	115.6	116.4	116.9	117.1

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, 2008–13
(Millions of euros)

	2008	2009	2010	2011	2012	2013
						Proj.
			I. Central Bank			
Net foreign assets	313	369	386	273	318	489
Assets	313	397	416	303	348	519
Liabilities	0	28	30	31	30	30
Net domestic assets	-250	-310	-321	-191	-227	-398
Net credit to the nonfinancial public sector	-11	-96	-71	-18	-24	-137
Of which: general government	-11	-96	-71	-18	-24	-137
Net credit to the banking system	-263	-239	-277	-207	-237	-231
Required reserves	-217	-134	-134	-129	-129	-138
Giro account	-46	-104	-142	-77	-108	-93
Claims on depository institutions	-1	-1	-1	-1	-1	-1
Other assets net	24	26	27	35	34	-31
Deposits included in broad money	12	13	19	22	31	31
Equity	51	46	47	61	60	60
			II. Banking System			
Net foreign assets	-1,007	-712	-532	-348	-156	-64
Assets	250	328	399	456	543	584
Liabilities	1,257	1,040	932	804	700	649
Net domestic assets	2,738	2,446	2,327	2,085	2,061	2,058
Net assets held in the central bank	262	238	276	206	236	230
Net credit to nonfinancial public sector	-265	-115	-69	37	45	55
Of which: general government	-238	-92	-70	65	45	55
Credit to the private sector	2,696	2,276	2,076	1,808	1,742	1,744
Other domestic assets	46	47	44	34	38	28
Liabilities	1,731	1,734	1,795	1,737	1,878	1,993
Private sector deposits	1,328	1,273	1,349	1,365	1,462	1,565
Other items, net	403	461	446	372	415	428
o/w capital	279	332	311	305	289	299
			III. Consolidated System			
Net foreign assets	-694	-342	-146	-75	161	425
Net domestic assets	2,489	2,136	2,007	1,894	1,834	1,659
Net credit to the nonfinancial public sector	-276	-212	-140	19	21	-82
Of which: general government	-249	-189	-140	46	21	-82
Credit to the private sector	2,696	2,276	2,076	1,808	1,742	1,744
Other net domestic assets	69	72	71	68	72	-3
Liabilities	1,743	1,747	1,814	1,758	1,908	2,024
Equity capital of the central bank	51	46	47	61	60	60
			IV. Ratios			
Reserves ratio	19.7	18.7	20.5	15.1	16.2	14.7
Effective required reserves ratio 1/	16.3	10.6	9.9	9.5	8.8	8.8
Credit to private sector / GDP	87.4	76.4	66.9	55.9	53.2	51.1
Banks' capital / credit to private sector	10.4	14.6	15.0	16.9	16.6	17.1
CBCG reserves / bank deposits	23.6	31.2	30.9	22.2	23.8	33.2
Banks' foreign liabilities / lending	46.6	45.7	44.9	44.4	40.0	40.0

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

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

Table 4. Montenegro: Balance of Payments, 2008–18
(Under current policies)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
						Projections					
						(Millions of euros)					
Current account balance	-1,535	-830	-710	-573	-588	-576	-583	-611	-635	-664	-696
Trade balance	-2,025	-1,322	-1,267	-1,306	-1,389	-1,416	-1,462	-1,539	-1,622	-1,721	-1,829
Exports	450	296	357	477	392	393	406	427	447	468	491
Imports	-2,476	-1,618	-1,624	-1,783	-1,781	-1,809	-1,868	-1,965	-2,069	-2,189	-2,320
Services account	371	401	464	589	612	654	693	739	796	857	924
Receipts 1/	776	732	801	906	998	1,052	1,108	1,173	1,250	1,335	1,427
Expenditures	-405	-331	-337	-317	-385	-398	-415	-434	-455	-478	-503
Income account	46	5	-22	26	54	44	38	35	30	31	32
Compensation of employees, net	137	150	150	168	174	181	189	198	207	216	227
Investment income, net	-91	-144	-172	-142	-120	-136	-151	-163	-176	-185	-195
Current transfers, net	73	85	114	117	135	141	148	154	161	169	177
Government, net	9	5	16	6	18	19	19	20	21	22	23
Other sectors, net	64	80	98	112	118	123	128	134	140	147	154
Capital and financial account	1,311	725	529	302	389	536	243	63	101	318	165
Capital account	0	2	0	-3	7	7	7	7	7	7	7
Foreign direct investment, net	582	1,066	552	389	462	498	542	592	646	701	762
Portfolio investment, net 2/	-16	-42	-12	-16	-25	-26	-27	-28	-29	-31	-32
Other investment, net 1/	745	-302	-11	-68	-55	56	-280	-508	-523	-361	-572
General government 2/	-7	141	209	133	203	218	-103	-304	-290	-114	-309
Commercial banks	551	-303	-176	-205	-192	-92	-78	-69	-68	-63	-56
Other sectors	201	-140	-44	5	-67	-70	-99	-134	-164	-184	-206
Errors and omissions 1/	69	190	198	157	243	212	222	232	242	254	266
Unidentified financing	0	0	0	0	0	0	196	463	425	255	449
Change in official reserves (- denotes increase)	155	-85	-17	114	-45	-172	-77	-148	-133	-162	-184
Memorandum items						(percent of GDP)					
Current account balance	-49.8	-27.9	-22.9	-17.7	-17.9	-16.9	-16.4	-16.4	-16.3	-16.3	-16.3
Trade balance	-65.6	-44.3	-40.8	-40.4	-42.4	-41.5	-41.0	-41.3	-41.7	-42.2	-42.7
Exports	14.6	9.9	11.5	14.7	12.0	11.5	11.4	11.5	11.5	11.5	11.5
Imports	-80.2	-54.3	-52.3	-55.1	-54.4	-53.0	-52.4	-52.8	-53.1	-53.6	-54.2
Services account	12.0	13.4	15.0	18.2	18.7	19.2	19.4	19.8	20.4	21.0	21.6
Receipts	25.2	24.5	25.8	28.0	30.4	30.8	31.1	31.5	32.1	32.7	33.3
Payments	-13.1	-11.1	-10.8	-9.8	-11.8	-11.7	-11.6	-11.6	-11.7	-11.7	-11.7
Income account	1.5	0.2	-0.7	0.8	1.6	1.3	1.1	0.9	0.8	0.8	0.7
Current transfers, net	2.4	2.9	3.7	3.6	4.1	4.1	4.1	4.1	4.1	4.1	4.1
Foreign direct investment, net	18.9	35.8	17.8	12.0	14.1	14.6	15.2	15.9	16.6	17.2	17.8
Portfolio investment, net	-0.5	-1.4	-0.4	-0.5	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8
Other investment, net	24.1	-10.1	-0.4	-2.1	-1.7	1.7	-7.8	-13.6	-13.4	-8.8	-13.4
Errors and omissions	2.2	6.4	6.4	4.9	7.4	6.2	6.2	6.2	6.2	6.2	6.2
Gross external debt 3/	90.8	93.5	96.4	101.4	108.4	113.3	113.6	115.6	116.4	116.9	117.1

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

5a. Montenegro: Consolidated General Government Fiscal Operations, 2009–18[1]
(Millions of euros)

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
					Projections					
Total revenues and grants	1266.1	1281.4	1246.0	1259.4	1327.6	1390.5	1455.4	1525.5	1598.6	1677.1
Total revenues	1254.6	1273.2	1237.8	1251.5	1322.6	1385.2	1450.0	1519.8	1592.7	1670.9
Current revenues	1240.5	1265.5	1232.3	1238.7	1313.8	1376.0	1440.4	1509.7	1582.1	1659.8
Taxes	795.7	757.2	794.5	786.0	844.4	885.0	927.7	973.8	1020.5	1070.6
Personal income tax	121.4	115.1	113.2	109.7	114.9	120.2	125.5	131.2	137.5	144.2
Corporate income tax	54.7	20.3	36.1	64.0	42.1	44.0	46.0	48.1	50.4	52.8
Taxes on turnover of real estate	19.8	16.5	15.7	14.4	15.0	15.7	16.4	17.1	17.9	18.8
Value added tax	370.8	364.2	392.2	354.7	425.0	446.3	469.7	495.0	518.7	544.2
Excises	128.7	134.3	143.4	151.8	159.1	166.4	173.7	181.6	190.3	199.7
Taxes on international trade	49.1	50.8	45.3	29.0	22.9	24.0	25.0	26.2	27.4	28.8
Local government taxes	42.3	44.6	44.5	58.2	60.5	63.3	66.1	69.1	72.4	76.0
Other taxes	8.9	11.6	4.2	4.3	4.9	5.1	5.3	5.6	5.8	6.1
Social security contributions	263.9	343.6	311.3	319.4	324.5	339.4	354.4	370.5	388.3	407.3
Nontax revenues	180.9	164.7	126.5	133.3	144.9	151.6	158.3	165.4	173.4	181.9
Capital revenues	14.1	7.7	5.5	12.8	8.8	9.2	9.6	10.1	10.6	11.1
Grants	11.6	8.2	8.2	7.9	5.0	5.2	5.5	5.7	6.0	6.3
Total expenditures and net lending	1425.6	1424.3	1415.0	1399.3	1406.0	1503.5	1577.1	1646.4	1724.0	1808.5
Total expenditures	1462.2	1424.2	1415.8	1400.8	1407.9	1505.4	1579.2	1648.5	1726.2	1810.9
Current expenditures	633.2	658.5	650.6	683.9	637.3	670.3	700.7	731.2	765.9	804.5
Gross salaries	326.1	350.2	361.6	364.9	371.3	384.8	398.0	412.2	427.9	444.6
Other personal income	27.7	24.6	20.2	13.0	17.7	18.6	19.4	20.3	21.2	22.3
Goods and services	174.9	163.1	131.6	178.0	115.7	113.9	118.9	124.3	130.3	136.7
Current maintenance	10.0	32.9	28.2	27.6	25.7	26.9	28.1	29.3	30.8	32.3
Interest payments	25.5	31.4	47.6	58.9	75.8	93.6	102.4	109.5	118.5	129.6
Rent	8.8	8.6	7.7	7.5	8.3	8.7	9.0	9.5	9.9	10.4
Subsidies to enterprises 2/	51.0	39.8	46.4	26.6	15.0	15.7	16.4	17.1	18.0	18.8
Other outflows 2/	9.4	7.9	7.3	7.4	7.8	8.2	8.6	9.0	9.4	9.8
Social security transfers	413.1	423.6	455.5	482.1	491.1	513.7	536.3	560.7	587.5	616.4
Other transfers	148.4	160.6	125.9	68.1	133.0	139.2	145.3	151.9	159.2	167.0
Capital expenditures	251.2	165.8	135.6	120.5	135.5	148.9	162.9	170.3	178.4	187.2
Repayment of guarantees	1.8	0.0	34.1	24.7	0.0	22.0	22.0	22.0	22.0	22.0
Reserves	14.5	15.8	14.1	21.5	11.0	11.5	12.0	12.5	13.1	13.8
Net lending	-36.6	0.1	-0.8	-1.5	-1.9	-1.9	-2.0	-2.1	-2.2	-2.3
Overall Balance	-159.5	-142.9	-169.0	-139.9	-78.4	-113.0	-121.7	-120.9	-125.3	-131.4
Financing	159.5	142.9	167.9	124.1	78.4	113.0	121.7	120.9	125.3	131.4
Domestic financing	-93.5	-42.5	23.5	-88.2	-158.9	1.3	-45.5	-22.2	-23.5	-16.3
Use of gov. deposits	-56.8	66.9	79.3	4.3	-102.9	67.8	9.6	-9.8	-11.1	-11.5
Net borrowing from other sources	-36.7	-109.4	-55.8	-92.5	-56.0	-66.5	-55.1	-12.4	-12.4	-4.8
Foreign financing	123.2	160.3	129.4	198.3	218.3	-103.0	-303.9	-290.3	-113.8	-309.2
Privatization receipts	129.8	25.1	15.0	14.0	19.0	19.0	8.0	8.0	8.0	8.0
Unidentified	0.0	0.0	0.0	0.0	0.0	195.8	463.1	425.3	254.7	448.9
Discrepancy	0.0	0.0	1.1	15.8	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:										
Primary balance	-134.0	-111.5	-121.4	-81.1	-2.6	-19.4	-19.3	-11.4	-6.8	-1.8
Overall balance excluding loan guarantee repayments	-157.7	-142.9	-134.9	-115.2	-78.4	-91.0	-99.7	-98.9	-103.3	-109.4

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.

Table 5b. Montenegro: Consolidated General Government Fiscal Operations, 2009–18[1]

(Percent of GDP)

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
							Projections			
Total revenues and grants	42.5	41.3	38.5	38.4	38.9	39.0	39.1	39.2	39.2	39.2
Total revenues	42.1	41.0	38.3	38.2	38.8	38.8	38.9	39.0	39.0	39.0
Current revenues	41.6	40.8	38.1	37.8	38.5	38.6	38.7	38.8	38.8	38.8
Taxes	26.7	24.4	24.6	24.0	24.8	24.8	24.9	25.0	25.0	25.0
Personal income tax	4.1	3.7	3.5	3.3	3.4	3.4	3.4	3.4	3.4	3.4
Corporate income tax	1.8	0.7	1.1	2.0	1.2	1.2	1.2	1.2	1.2	1.2
Taxes on turnover of real estate righ	0.7	0.5	0.5	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Value added tax	12.4	11.7	12.1	10.8	12.5	12.5	12.6	12.7	12.7	12.7
Excises	4.3	4.3	4.4	4.6	4.7	4.7	4.7	4.7	4.7	4.7
Taxes on international trade	1.6	1.6	1.4	0.9	0.7	0.7	0.7	0.7	0.7	0.7
Local government taxes	1.4	1.4	1.4	1.8	1.8	1.8	1.8	1.8	1.8	1.8
Other taxes	0.3	0.4	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Social security contributions	8.9	11.1	9.6	9.7	9.5	9.5	9.5	9.5	9.5	9.5
Nontax revenues	6.1	5.3	3.9	4.1	4.2	4.2	4.2	4.2	4.2	4.2
Capital revenues	0.5	0.2	0.2	0.4	0.3	0.3	0.3	0.3	0.3	0.3
Grants	0.4	0.3	0.3	0.2	0.1	0.1	0.1	0.1	0.1	0.1
Total expenditures and net lending	47.8	45.9	43.8	42.7	41.2	42.1	42.3	42.3	42.2	42.2
Total expenditures	49.0	45.9	43.8	42.8	41.3	42.2	42.4	42.3	42.3	42.3
Current expenditures	21.2	21.2	20.1	20.9	18.7	18.8	18.8	18.8	18.8	18.8
Gross salaries	10.9	11.3	11.2	11.1	10.9	10.8	10.7	10.6	10.5	10.4
Other personal income	0.9	0.8	0.6	0.4	0.5	0.5	0.5	0.5	0.5	0.5
Goods and services	5.9	5.3	4.1	5.4	3.4	3.2	3.2	3.2	3.2	3.2
Current maintenance	0.3	1.1	0.9	0.8	0.8	0.8	0.8	0.8	0.8	0.8
Interest payments	0.9	1.0	1.5	1.8	2.2	2.6	2.7	2.8	2.9	3.0
Rent	0.3	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Subsidies to enterprises 2/	1.7	1.3	1.4	0.8	0.4	0.4	0.4	0.4	0.4	0.4
Other outflows 2/	0.3	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Social security transfers	13.9	13.6	14.1	14.7	14.4	14.4	14.4	14.4	14.4	14.4
Other transfers	5.0	5.2	3.9	2.1	3.9	3.9	3.9	3.9	3.9	3.9
Capital expenditures	8.4	5.3	4.2	3.7	4.0	4.2	4.4	4.4	4.4	4.4
Repayment of guarantees	0.1	0.0	1.1	0.8	0.0	0.6	0.6	0.6	0.5	0.5
Reserves	0.5	0.5	0.4	0.7	0.3	0.3	0.3	0.3	0.3	0.3
Net lending	-1.2	0.0	0.0	0.0	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Overall Balance	-5.4	-4.6	-5.2	-4.3	-2.3	-3.2	-3.3	-3.1	-3.1	-3.1
Financing	5.4	4.6	5.2	3.8	2.3	3.2	3.3	3.1	3.1	3.1
Domestic financing	-3.1	-1.4	0.7	-2.7	-4.7	0.0	-1.2	-0.6	-0.6	-0.4
Use of gov. deposits	-1.9	2.2	2.5	0.1	-3.0	1.9	0.3	-0.3	-0.3	-0.3
Net borrowing from other sources	-1.2	-3.5	-1.7	-2.8	-1.6	-1.9	-1.5	-0.3	-0.3	-0.1
Foreign financing	4.1	5.2	4.0	6.1	6.4	-2.9	-8.2	-7.5	-2.8	-7.2
Privatization receipts	4.4	0.8	0.5	0.4	0.6	0.5	0.2	0.2	0.2	0.2
Unidentified	0.0	0.0	0.0	0.0	0.0	5.5	12.4	10.9	6.2	10.5
Discrepancy	0.0	0.0	0.0	0.5	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:										
Primary balance	-4.5	-3.6	-3.8	-2.5	-0.1	-0.5	-0.5	-0.3	-0.2	0.0
Overall balance excluding loan guarantee repayments	-5.3	-4.6	-4.2	-3.5	-2.3	-2.6	-2.7	-2.5	-2.5	-2.6
Public debt (gross)	38.2	40.9	46.0	51.9	55.3	54.1	55.0	55.8	56.4	56.9
Public debt, including guarantees	43.2	52.4	57.8	62.9	65.0	62.7	63.6	64.4	65.0	65.5

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.

Table 5c. Montenegro: Consolidated General Government Fiscal Operations, 2009–18[1]

(Millions of euros, GFSM2001)

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
					Projections					
1. Revenue	**1252.1**	**1273.7**	**1240.5**	**1246.6**	**1318.8**	**1381.2**	**1445.8**	**1515.4**	**1588.1**	**1666.1**
Taxes	795.7	757.2	794.5	786.0	844.4	885.0	927.7	973.8	1020.5	1070.6
Personal income tax	*121.4*	*115.1*	*113.2*	*109.7*	*114.9*	*120.2*	*125.5*	*131.2*	*137.5*	*144.2*
Corporate income tax	*54.7*	*20.3*	*36.1*	*64.0*	*42.1*	*44.0*	*46.0*	*48.1*	*50.4*	*52.8*
Property taxes	*19.8*	*16.5*	*15.7*	*14.4*	*15.0*	*15.7*	*16.4*	*17.1*	*17.9*	*18.8*
Value added tax	*370.8*	*364.2*	*392.2*	*354.7*	*425.0*	*446.3*	*469.7*	*495.0*	*518.7*	*544.2*
Excises	*128.7*	*134.3*	*143.4*	*151.8*	*159.1*	*166.4*	*173.7*	*181.6*	*190.3*	*199.7*
Taxes on international trade	*49.1*	*50.8*	*45.3*	*29.0*	*22.9*	*24.0*	*25.0*	*26.2*	*27.4*	*28.8*
Local government taxes	*42.3*	*44.6*	*44.5*	*58.2*	*60.5*	*63.3*	*66.1*	*69.1*	*72.4*	*76.0*
Other taxes	*8.9*	*11.6*	*4.2*	*4.3*	*4.9*	*5.1*	*5.3*	*5.6*	*5.8*	*6.1*
Social security contributions	263.9	343.6	311.3	319.4	324.5	339.4	354.4	370.5	388.3	407.3
Nontax revenues	180.9	164.7	126.5	133.3	144.9	151.6	158.3	165.4	173.4	181.9
Grants	11.6	8.2	8.2	7.9	5.0	5.2	5.5	5.7	6.0	6.3
2. Expense	**1210.9**	**1258.4**	**1280.2**	**1280.4**	**1272.4**	**1356.6**	**1416.3**	**1478.2**	**1547.7**	**1623.7**
Gross salaries and other personal income	353.8	374.8	381.8	377.9	389.0	403.3	417.4	432.5	449.1	466.9
Use of goods and services	184.8	195.9	159.8	205.6	141.4	140.8	147.0	153.7	161.0	168.9
Interest payments	25.5	31.4	47.6	58.9	75.8	93.6	102.4	109.5	118.5	129.6
Subsidies to enterprises	51.0	39.8	46.4	26.6	15.0	15.7	16.4	17.1	18.0	18.8
Other current outflows	18.1	16.5	15.0	15.0	16.1	16.9	17.6	18.4	19.3	20.2
Social security transfers	413.1	423.6	455.5	482.1	491.1	513.7	536.3	560.7	587.5	616.4
Other transfers	148.4	160.6	125.9	68.1	133.0	139.2	145.3	151.9	159.2	167.0
Repayment of guarantees	1.8	0.0	34.1	24.7	0.0	22.0	22.0	22.0	22.0	22.0
Reserves	14.5	15.8	14.1	21.5	11.0	11.5	12.0	12.5	13.1	13.8
3. Gross operating balance (= 1 - 2)	**41.1**	**15.3**	**-39.7**	**-33.8**	**46.4**	**24.7**	**29.5**	**37.2**	**40.3**	**42.4**
4. Net acquisition of nonfinancial assets	**237.2**	**158.1**	**130.1**	**107.7**	**126.7**	**139.6**	**153.2**	**160.2**	**167.9**	**176.1**
Capital revenue	-14.1	-7.7	-5.5	-12.8	-8.8	-9.2	-9.6	-10.1	-10.6	-11.1
Capital expenditure	251.2	165.8	135.6	120.5	135.5	148.9	162.9	170.3	178.4	187.2
5. Net lending (+) / borrowing (-) (= 3 - 4)	**-196.0**	**-142.8**	**-169.8**	**-141.4**	**-80.2**	**-114.9**	**-123.7**	**-123.0**	**-127.5**	**-133.7**
6. Net acquisition of financial assets	**-109.5**	**-91.9**	**-95.1**	**-19.8**	**82.1**	**-88.7**	**-19.6**	**-0.4**	**0.9**	**1.2**
Domestic	-109.5	-91.9	-95.1	-19.8	82.1	-88.7	-19.6	-0.4	0.9	1.2
Currency and deposits	*56.8*	*-66.9*	*-79.3*	*-4.3*	*102.9*	*-67.8*	*-9.6*	*9.8*	*11.1*	*11.5*
Loans	*-36.6*	*0.1*	*-0.8*	*-1.5*	*-1.9*	*-1.9*	*-2.0*	*-2.1*	*-2.2*	*-2.3*
Equity and investment fund shares	*-129.8*	*-25.1*	*-15.0*	*-14.0*	*-19.0*	*-19.0*	*-8.0*	*-8.0*	*-8.0*	*-8.0*
7. Net incurrence of liabilities	**86.5**	**50.9**	**73.6**	**105.8**	**162.3**	**-169.5**	**-359.0**	**-302.7**	**-126.2**	**-314.0**
Domestic	-36.7	-109.4	-55.8	-92.5	-56.0	-66.5	-55.1	-12.4	-12.4	-4.8
Foreign	123.2	160.3	129.4	198.3	218.3	-103.0	-303.9	-290.3	-113.8	-309.2
8. Discrepancy (= 5 - 6 + 7)	**0.0**	**0.0**	**-1.1**	**-15.8**	**0.0**	**-195.8**	**-463.1**	**-425.3**	**-254.7**	**-448.9**
Memorandum items:										
Primary balance	-170.5	-111.4	-122.2	-82.6	-4.5	-21.3	-21.3	-13.5	-9.0	-4.1
Nominal GDP	2981	3104	3234	3276	3411	3567	3725	3894	4081	4281

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

Table 5d. Montenegro: Consolidated Government Fiscal Operations, 2009–18[1]
(In percent of GDP, GFSM2001)

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
					Projections					
1. Revenue	**42.0**	**41.0**	**38.4**	**38.0**	**38.7**	**38.7**	**38.8**	**38.9**	**38.9**	**38.9**
Taxes	26.7	24.4	24.6	24.0	24.8	24.8	24.9	25.0	25.0	25.0
Personal income tax	*4.1*	*3.7*	*3.5*	*3.3*	*3.4*	*3.4*	*3.4*	*3.4*	*3.4*	*3.4*
Corporate income tax	*1.8*	*0.7*	*1.1*	*2.0*	*1.2*	*1.2*	*1.2*	*1.2*	*1.2*	*1.2*
Property taxes	*0.7*	*0.5*	*0.5*	*0.4*	*0.4*	*0.4*	*0.4*	*0.4*	*0.4*	*0.4*
Value added tax	*12.4*	*11.7*	*12.1*	*10.8*	*12.5*	*12.5*	*12.6*	*12.7*	*12.7*	*12.7*
Excises	*4.3*	*4.3*	*4.4*	*4.6*	*4.7*	*4.7*	*4.7*	*4.7*	*4.7*	*4.7*
Taxes on international trade	*1.6*	*1.6*	*1.4*	*0.9*	*0.7*	*0.7*	*0.7*	*0.7*	*0.7*	*0.7*
Local government taxes	*1.4*	*1.4*	*1.4*	*1.8*	*1.8*	*1.8*	*1.8*	*1.8*	*1.8*	*1.8*
Other taxes	*0.3*	*0.4*	*0.1*	*0.1*	*0.1*	*0.1*	*0.1*	*0.1*	*0.1*	*0.1*
Social security contributions	8.9	11.1	9.6	9.7	9.5	9.5	9.5	9.5	9.5	9.5
Nontax revenues	6.1	5.3	3.9	4.1	4.2	4.2	4.2	4.2	4.2	4.2
Grants	0.4	0.3	0.3	0.2	0.1	0.1	0.1	0.1	0.1	0.1
2. Expense	**40.6**	**40.5**	**39.6**	**39.1**	**37.3**	**38.0**	**38.0**	**38.0**	**37.9**	**37.9**
Gross salaries and other personal income	11.9	12.1	11.8	11.5	11.4	11.3	11.2	11.1	11.0	10.9
Use of goods and services	6.2	6.3	4.9	6.3	4.1	3.9	3.9	3.9	3.9	3.9
Interest payments	0.9	1.0	1.5	1.8	2.2	2.6	2.7	2.8	2.9	3.0
Subsidies to enterprises	1.7	1.3	1.4	0.8	0.4	0.4	0.4	0.4	0.4	0.4
Other current outflows	0.6	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Social security transfers	13.9	13.6	14.1	14.7	14.4	14.4	14.4	14.4	14.4	14.4
Other transfers	5.0	5.2	3.9	2.1	3.9	3.9	3.9	3.9	3.9	3.9
Repayment of guarantees	0.1	0.0	1.1	0.8	0.0	0.6	0.6	0.6	0.5	0.5
Reserves	0.5	0.5	0.4	0.7	0.3	0.3	0.3	0.3	0.3	0.3
3. Gross operating balance (= 1 - 2)	**1.4**	**0.5**	**-1.2**	**-1.0**	**1.4**	**0.7**	**0.8**	**1.0**	**1.0**	**1.0**
4. Net acquisition of nonfinancial assets	**8.0**	**5.1**	**4.0**	**3.3**	**3.7**	**3.9**	**4.1**	**4.1**	**4.1**	**4.1**
Capital revenue	-0.5	-0.2	-0.2	-0.4	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3
Capital expenditure	8.4	5.3	4.2	3.7	4.0	4.2	4.4	4.4	4.4	4.4
5. Net lending (+) / borrowing (-) (= 3 - 4)	**-6.6**	**-4.6**	**-5.3**	**-4.3**	**-2.4**	**-3.2**	**-3.3**	**-3.2**	**-3.1**	**-3.1**
6. Net acquisition of financial assets	**-3.7**	**-3.0**	**-2.9**	**-0.6**	**2.4**	**-2.5**	**-0.5**	**0.0**	**0.0**	**0.0**
Domestic	-3.7	-3.0	-2.9	-0.6	2.4	-2.5	-0.5	0.0	0.0	0.0
Currency and deposits	*1.9*	*-2.2*	*-2.5*	*-0.1*	*3.0*	*-1.9*	*-0.3*	*0.3*	*0.3*	*0.3*
Loans	*-1.2*	*0.0*	*0.0*	*0.0*	*-0.1*	*-0.1*	*-0.1*	*-0.1*	*-0.1*	*-0.1*
Equity and investment fund shares	*-4.4*	*-0.8*	*-0.5*	*-0.4*	*-0.6*	*-0.5*	*-0.2*	*-0.2*	*-0.2*	*-0.2*
7. Net incurrence of liabilities	**2.9**	**1.6**	**2.3**	**3.2**	**4.8**	**-4.8**	**-9.6**	**-7.8**	**-3.1**	**-7.3**
Domestic	-1.2	-3.5	-1.7	-2.8	-1.6	-1.9	-1.5	-0.3	-0.3	-0.1
Foreign	4.1	5.2	4.0	6.1	6.4	-2.9	-8.2	-7.5	-2.8	-7.2
8. Discrepancy (= 5 - 6 + 7)	**0.0**	**0.0**	**0.0**	**-0.5**	**0.0**	**-5.5**	**-12.4**	**-10.9**	**-6.2**	**-10.5**
Memorandum items:										
Primary balance	-5.7	-3.6	-3.8	-2.5	-0.1	-0.6	-0.6	-0.3	-0.2	-0.1

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, 2008–12

	2008	2009	2010	2011				2012			
	Dec	Dec	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec
Capital adequacy											
Regulatory capital as percent of risk-weighted assets	15.0	15.7	15.9	15.4	15.3	15.1	16.5	15.9	14.5	13.6	14.7
Capital as percent of assets	8.4	11.0	10.6	10.4	10.6	10.1	10.9	11.0	10.5	9.3	10.3
Asset composition and quality											
Distribution of bank credit by borrower											
Central government, local government, government agencies	1.0	1.3	2.1	2.5	2.6	3.4	4.9	5.4	5.1	4.2	4.8
Funds	0.4	1.2	0.1	0.1	0.1	0.1	0.5	0.5	0.5	0.2	0.2
State-owned companies	1.0	1.9	2.7	3.4	3.4	2.8	2.8	3.2	3.1	3.1	3.1
Private companies, entrepreneurs	59.2	56.4	54.8	52.9	50.7	49.3	47.7	47.2	47.4	47.5	47.6
Banks	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial Institutions	0.8	0.3	0.4	0.4	0.4	0.4	0.5	0.6	0.5	0.5	0.1
Citizens	35.8	36.6	37.1	38.0	39.7	41.0	40.5	40.1	40.4	41.5	41.3
Credit cards	1.3	1.7	2.2	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1
Other	0.4	0.6	0.6	0.7	1.0	0.9	0.9	0.9	0.9	0.9	0.8
Distribution of bank credit by sectoral economic activity											
Agriculture, hunting, fishing	0.6	0.3	0.4	0.7	0.9	1.1	1.2	1.2	1.4	1.4	1.6
Mining and energy	1.6	2.2	2.5	2.4	2.4	1.8	1.8	1.7	1.7	1.7	1.9
Civil engineering	7.2	7.8	8.1	7.9	7.3	7.6	6.7	6.5	6.6	6.8	6.6
Trade	22.6	22.8	22.9	21.5	21.7	20.7	20.7	20.6	20.5	19.9	19.7
Services, tourism	7.7	7.5	7.4	6.8	6.4	6.0	6.1	5.9	5.8	6.4	6.8
Transport, warehousing, communications	3.1	2.6	3.0	3.4	3.3	2.8	3.1	3.4	3.3	2.9	3.0
Finance	2.5	2.4	1.7	1.8	1.5	2.1	2.7	2.9	2.6	2.3	2.2
Real estate trading	4.2	4.4	3.0	2.8	2.1	2.2	2.3	2.1	2.0	1.9	2.3
Administration, other public services	2.0	2.6	3.1	3.4	3.3	2.8	4.3	4.7	4.9	3.8	4.2
Consumer loans	36.4	38.3	39.3	40.1	41.8	43.1	42.6	42.2	42.2	43.6	43.4
Other	12.1	9.1	9.0	9.3	9.3	9.7	8.4	8.8	9.0	9.4	8.4
Asset quality											
Non-performing loans (NPL), in percent of gross loans	7.2	13.5	21.0	23.2	25.3	19.7	15.5	15.5	17.1	18.5	17.6
Provisions, in percent of NPL	55.6	46.3	30.7	23.8	24.0	30.4	32.8	33.2	32.4	36.7	40.2
Provisions, in percent of total loans	4.0	6.3	6.4	5.5	6.1	6.0	5.1	5.2	5.5	6.8	7.1
NPL net of provisions, in percent of capital	32.0	52.5	102.8	122.3	129.1	92.4	66.9	65.2	77.8	82.2	68.0
Earnings and profitability											
Gross profits, in percent of average assets (ROAA)	-0.6	-0.6	-2.7	-2.3	-0.7	-1.0	-0.1	-0.2	-0.6	-1.7	-2.0
Gross profits, in percent of average equity capital (ROAE)	-6.6	-6.9	-27.0	-23.4	-6.4	-10.0	-0.6	-2.2	-5.8	-16.2	-18.1
Net profits, in percent of average assets (ROAA)	-0.6	-0.7	-2.8	-2.4	-0.6	-1.0	-0.1	-0.9	-1.3	-2.3	-2.0
Net profits, in percent of average capital (ROAE)	-6.9	-7.8	-27.3	-23.4	-6.3	-10.1	-1.1	-8.8	-11.9	-21.7	-18.3
Net interest margin 1/	3.8	4.9	4.9	1.2	2.3	3.5	4.8	1.2	2.5	3.6	5.0
Gross income, in percent of average assets	5.1	5.3	5.4	4.8	5.0	4.8	5.2	1.3	2.7	2.8	
Net interest income, in percent of gross income	67.7	74.2	71.6	75.7	71.8	74.3	70.5	75.3	71.3	69.7	73.1
Non-interest income, in percent of gross income	32.3	25.8	28.4	24.3	28.2	25.7	29.5	24.7	28.7	30.3	26.9
Net fee income, in percent of net interest income	43.3	27.2	30.3	26.3	31.1	26.7	28.6	25.3	27.9	31.0	24.2
Trading income, in percent of gross income	3.0	5.7	6.7	4.4	5.8	5.8	9.4	5.7	8.8	8.7	9.2
Aggregate overhead expenses, in percent of gross income	61.4	62.3	64.0	61.9	55.0	72.4	70.7	71.7	70.3	71.4	77.7
Liquidity											
Liquid assets, in percent of total assets	11.2	15.3	19.1	19.4	19.9	23.0	19.9	18.2	19.5	25.2	24.0
Liquid assets, in percent of short-term liabilities	20.9	25.8	32.9	33.5	33.9	39.2	32.8	30.0	31.1	41.8	40.1
Deposits, in percent of assets	60.1	60.3	60.8	61.4	63.6	65.0	64.7	65.0	66.3	69.2	70.5
Loans, in percent of deposits	140.5	131.4	122.9	117.3	111.3	104.2	107.6	109.6	106.2	94.5	94.0
Sensitivity to market risk											
Off-balance sheet operations, in percent of assets	298.5	439.5	429.5	435.4	438.3	454.3	464.0	458.1	458.3	362.2	370.5
Original maturity of assets (in percent of total)											
Less than 3 months	24.7	30.4	34.4	33.6	31.6	24.9	21.5	25.7	27.3	32.7	32.1
3 months to 1 year	23.6	20.5	17.2	18.5	16.7	23.1	28.2	19.8	19.3	23.2	23.4
1 to 5 years	35.0	33.9	33.6	33.1	35.6	36.8	35.4	39.8	38.9	30.9	31.5
Over 5 years	16.8	15.3	14.8	14.8	16.1	15.2	14.9	14.7	14.5	13.2	13.0
Original maturity of liabilities (in percent of total)											
Less than 3 months	32.2	34.7	38.5	38.6	39.5	24.7	21.9	34.9	40.3	37.7	31.3
3 months to 1 year	27.2	32.4	27.1	26.8	26.8	40.9	47.1	34.0	30.8	29.9	27.9
1 to 5 years	31.7	23.5	24.4	26.3	24.5	25.5	23.4	24.3	22.7	25.9	23.8
Over 5 years	8.8	9.4	10.0	8.3	9.3	8.9	7.7	6.9	6.2	6.6	4.3

Source: Central Bank of Montenegro.

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

Table 7. Montenegro: External Debt Sustainability Framework, 2008–18

(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2008	2009	2010	2011	2012			2013	2014	2015	2016	2017	2018	Debt-stabilizing non-interest current account 6/
1 **Baseline: External debt**	90.8	93.5	96.4	101.4	108.4			**113.3**	**113.6**	**115.6**	**116.4**	**116.9**	**117.1**	**-19.4**
2 Change in external debt	16.7	2.7	2.9	5.1	7.0			4.9	0.4	2.0	0.8	0.5	0.2	
3 Identified external debt-creating flows (4+8+9)	21.2	-4.7	1.4	1.8	2.5			0.7	-1.2	-2.0	-2.9	-3.8	-4.6	
4 Current account deficit, excluding interest payments	46.9	25.0	19.6	13.9	14.5			13.3	12.6	12.6	12.5	12.4	12.4	
5 Deficit in balance of goods and services	53.6	30.9	25.9	22.2	23.7			22.3	21.5	21.5	21.2	21.2	21.1	
6 Exports	39.7	34.5	37.3	42.8	42.4			42.4	42.4	42.9	43.6	44.2	44.8	
7 Imports	93.4	65.4	63.2	64.9	66.1			64.7	64.0	64.4	64.8	65.4	65.9	
8 Net non-debt creating capital inflows (negative)	-18.9	-35.8	-17.8	-12.0	-14.1			-14.6	-15.2	-15.9	-16.6	-17.2	-17.8	
9 Automatic debt dynamics 1/	-6.9	6.1	-0.4	-0.1	2.2			2.0	1.4	1.3	1.2	1.0	0.8	
10 Contribution from nominal interest rate	2.9	2.9	3.3	3.8	3.5			3.6	3.8	3.8	3.8	3.9	3.9	
11 Contribution from real GDP growth	-4.4	5.4	-2.2	-3.0	0.5			-1.6	-2.4	-2.5	-2.6	-2.9	-3.0	
12 Contribution from price and exchange rate changes 2/	-5.3	-2.2	-1.5	-0.9	-1.9			...	...	...	...	...	...	
13 Residual, incl. change in gross foreign assets (2-3) 3/	-4.5	7.5	1.5	3.2	4.4			4.1	1.6	4.0	3.7	4.3	4.8	
External debt-to-exports ratio (in percent)	228.4	271.2	258.4	237.2	255.6			267.3	267.7	269.3	267.2	264.7	261.4	
Gross external financing need (in billions of Euro) 4/	1.8	1.3	1.1	0.9	0.9			1.0	1.1	1.3	1.4	1.3	1.6	
in percent of GDP	59.5	42.9	35.3	28.0	28.8	10-Year	10-Year	28.7	29.9	36.1	36.0	32.0	37.0	
Scenario with key variables at their historical averages 5/								**113.3**	**119.4**	**127.0**	**133.8**	**140.6**	**147.2**	**-21.3**
Key Macroeconomic Assumptions Underlying Baseline						Historical Average	Standard Deviation							
Real GDP growth (in percent)	6.9	-5.7	2.5	3.2	-0.5	3.7	4.6	1.5	2.2	2.3	2.4	2.6	2.7	
GDP deflator in US dollars (change in percent)	7.7	2.4	1.6	0.9	1.9	5.5	3.9	2.5	2.4	2.1	2.1	2.1	2.1	
Nominal external interest rate (in percent)	4.5	3.1	3.7	4.1	3.5	4.1	0.9	3.5	3.5	3.5	3.5	3.5	3.5	
Growth of exports (Euro terms, in percent)	6.1	-16.2	12.6	19.4	0.5	13.0	19.7	4.0	4.8	5.6	6.1	6.3	6.4	
Growth of imports (Euro terms, in percent)	24.9	-32.3	0.6	7.1	3.2	13.3	23.8	1.9	3.5	5.1	5.2	5.7	5.9	
Current account balance, excluding interest payments	-46.9	-25.0	-19.6	-13.9	-14.5	-21.8	13.1	-13.3	-12.6	-12.6	-12.5	-12.4	-12.4	
Net non-debt creating capital inflows	18.9	35.8	17.8	12.0	14.1	14.2	11.6	14.6	15.2	15.9	16.6	17.2	17.8	

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.

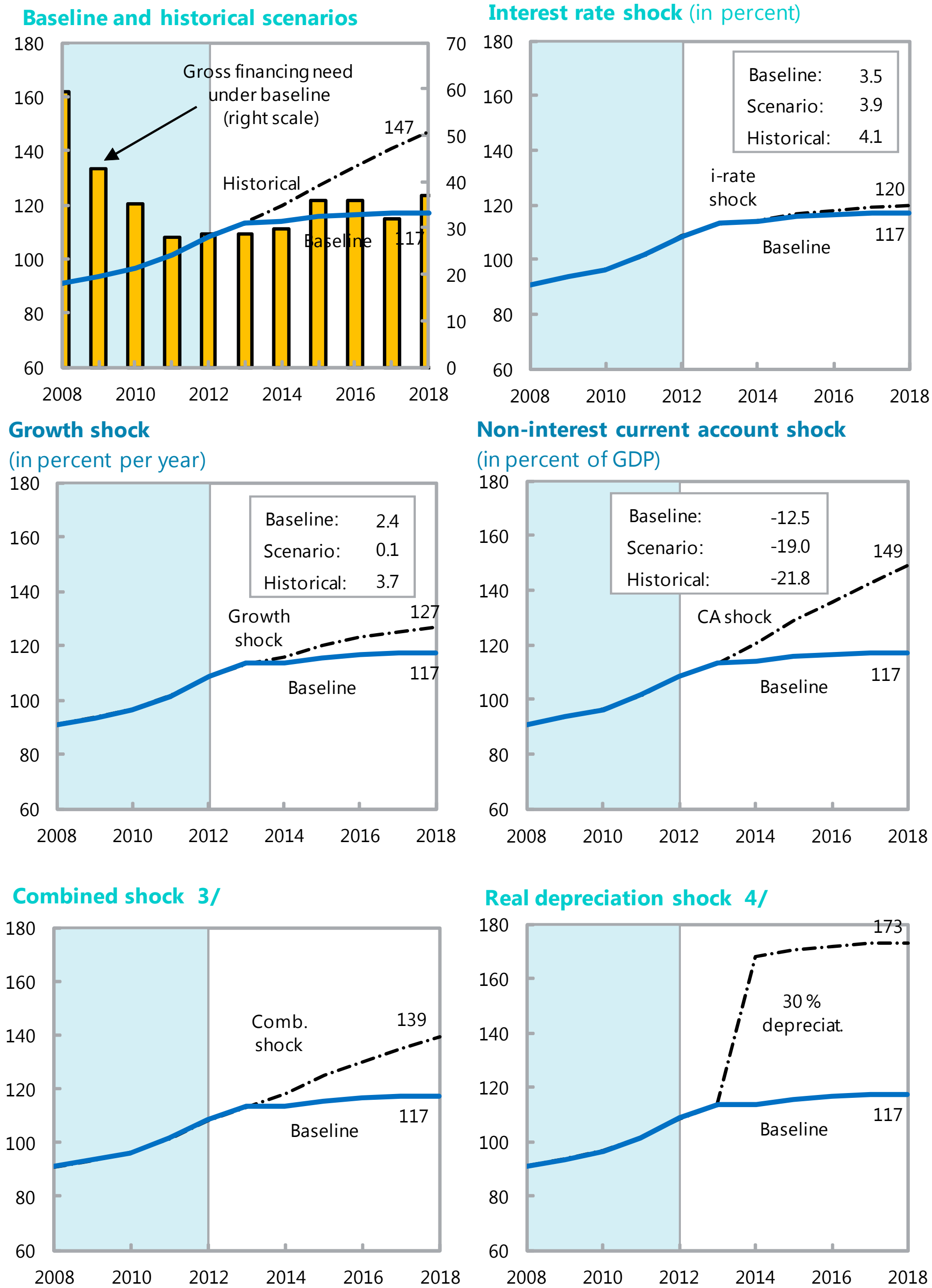
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

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 6. Montenegro: External Debt Sustainability: Bound Tests[1 2]

(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/ 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 2014.

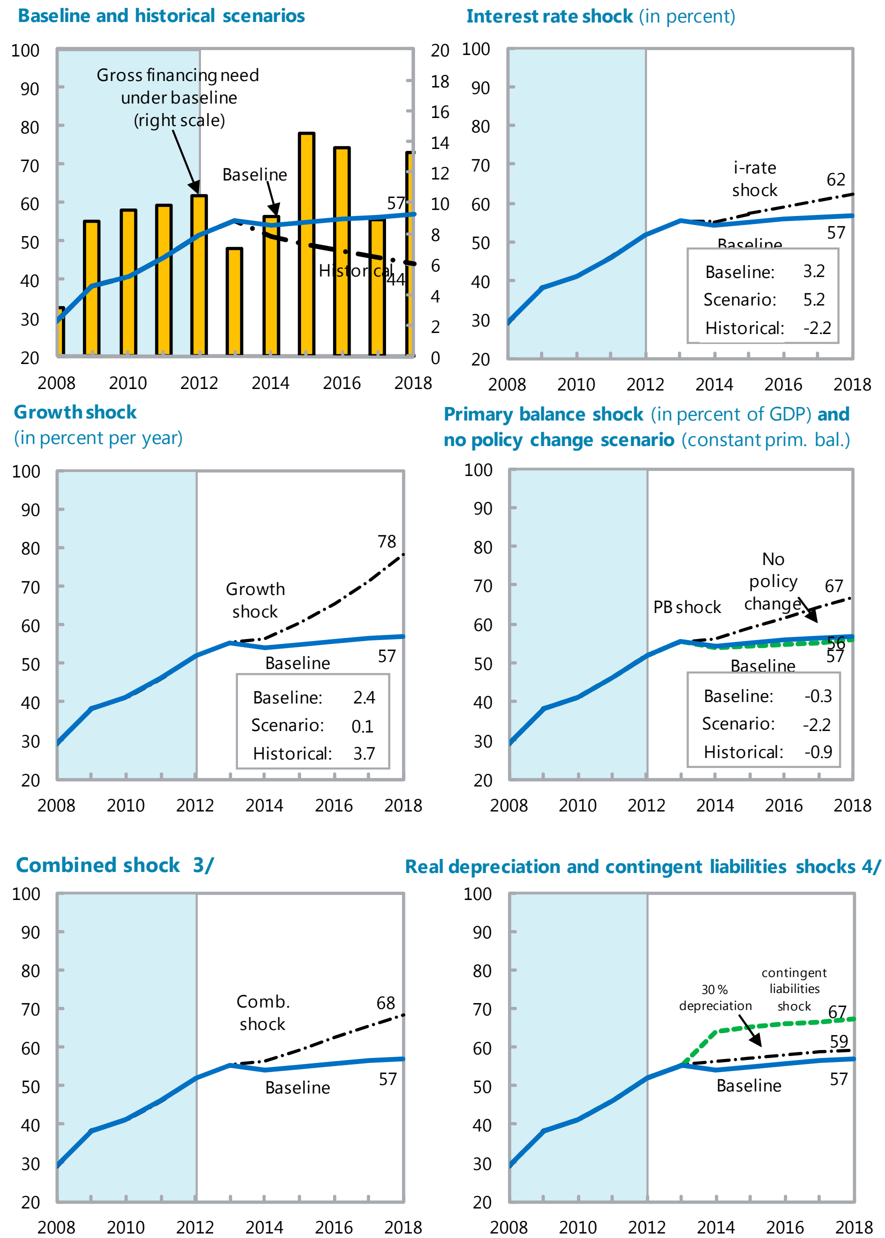
Table 8. Montenegro: Public Sector Debt Sustainability Framework, 2008–18
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Debt-stabilizing primary balance 9/
Baseline: Public sector debt 1/	29.0	38.2	40.9	46.0	51.9	**55.3**	**54.1**	**55.0**	**55.8**	**56.4**	**56.9**	**0.2**
o/w foreign-currency denominated	6.1	6.1	4.5	5.3	4.8	4.6	4.4	4.2	4.0	3.8	3.7	
Change in public sector debt	1.5	9.3	2.7	5.0	5.9	3.4	-1.2	0.9	0.8	0.6	0.5	
Identified debt-creating flows (4+7+12)	2.6	5.4	3.2	4.8	5.6	-0.3	0.2	0.8	0.5	0.3	0.2	
Primary deficit	2.4	4.5	3.6	3.8	2.5	0.1	0.5	0.5	0.3	0.2	0.0	
Revenue and grants	48.4	42.5	41.3	38.5	38.4	38.9	39.0	39.1	39.2	39.2	39.2	
Primary (noninterest) expenditure	50.8	47.0	44.9	42.3	40.9	39.0	39.5	39.6	39.5	39.3	39.2	
Automatic debt dynamics 2/	-2.8	1.9	-0.5	-0.2	1.2	0.2	0.2	0.5	0.4	0.4	0.4	
Contribution from interest rate/growth differential 3/	-2.8	1.9	-0.5	-0.2	1.2	0.2	0.2	0.5	0.4	0.4	0.4	
Of which contribution from real interest rate	-1.2	0.2	0.4	1.1	1.0	0.9	1.3	1.7	1.7	1.7	1.9	
Of which contribution from real GDP growth	-1.6	1.7	-0.9	-1.3	0.2	-0.8	-1.2	-1.2	-1.3	-1.4	-1.5	
Contribution from exchange rate depreciation 4/	0.0	0.0	0.0	0.0	0.0	...	...	...	...	...	...	
Other identified debt-creating flows	3.0	-0.9	0.1	1.2	2.0	-0.6	-0.5	-0.2	-0.2	-0.2	-0.2	
Privatization receipts (negative)	-1.2	-4.4	-0.8	-0.5	-0.4	-0.6	-0.5	-0.2	-0.2	-0.2	-0.2	
Recognition of implicit or contingent liabilities	0.0	0.8	0.9	1.7	2.4	0.0	0.0	0.0	0.0	0.0	0.0	
Other (specify, e.g. bank recapitalization)	4.3	2.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes (2-3) 5/	-1.2	3.8	-0.5	0.2	0.2	3.7	-1.4	0.1	0.3	0.3	0.3	
Public sector debt-to-revenue ratio 1/	59.9	90.1	99.2	119.4	134.9	142.0	138.9	140.8	142.4	143.9	145.2	
Gross financing need 6/	3.2	8.8	9.5	9.9	10.5	7.1	9.1	14.5	13.6	8.9	13.3	
in billions of Euro	0.1	0.3	0.3	0.3	0.3	0.2	0.3	0.5	0.5	0.4	0.6	
Scenario with key variables at their historical averages 7/						**55.3**	**51.2**	**49.2**	**47.3**	**45.7**	**44.1**	**-2.7**
Scenario with no policy change (constant primary balance) in 2013-2018						**55.3**	**53.7**	**54.1**	**54.6**	**55.1**	**55.7**	**0.2**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	6.9	-5.7	2.5	3.2	-0.5	1.5	2.2	2.3	2.4	2.6	2.7	
Average nominal interest rate on public debt (in percent) 8/	3.2	2.9	2.8	3.7	4.0	4.5	5.0	5.3	5.3	5.5	5.6	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-4.5	0.4	1.1	2.8	2.1	1.9	2.6	3.2	3.2	3.3	3.5	
Nominal appreciation (increase in US dollar value of local currency, in percent)	0.0	0.0	0.0	0.0	0.0	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	7.7	2.4	1.6	0.9	1.9	2.5	2.4	2.1	2.1	2.1	2.1	
Growth of real primary spending (deflated by GDP deflator, in percent)	30.0	-12.9	-2.1	-2.7	-3.8	-3.2	3.5	2.5	2.1	2.3	2.4	
Primary deficit	2.4	4.5	3.6	3.8	2.5	0.1	0.5	0.5	0.3	0.2	0.0	

1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.
2/ Derived as [(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = 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 Euro).
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as r - π (1+g) and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as ae(1+r).
5/ For projections, this line includes exchange rate changes.
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
8/ Derived as nominal interest expenditure divided by previous period debt stock.
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure 7. Montenegro: Public Debt Sustainability Bound Tests [1 2]

(Public debt in percent of GDP)



Sources: International Monetary Fund, country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario beir 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 i used to project debt dynamics five years ahead.
3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
4/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2014 with real depreciation defined as nominal depreciation (measured by percentage fall in euro value of local currency) minus domestic inflation (based on GDP deflator).

Appendix I. Risk Assessment Matrix[1]

Risk	Relative Likelihood	Impact if Realized
1. The international bond issue planned for 2013 does not move forward.	**Medium** Montenegro has found it very difficult to access external capital markets during several periods over the past 18 months. Eurobond spreads are currently at roughly 520 basis points, but were between 800–1000 basis points for most of 2012. This risk is likely to remain over the medium term as well.	**Medium** Deposit buffers are thin, and the small domestic capital market leaves Montenegro heavily reliant on external sources for budget financing through the projection period. A shift in market conditions would likely force Montenegro to take more expensive direct bank loans, putting further upward pressure on interest costs.
2. The government commits to continued fiscal support to a new investor in KAP.	**Medium** The authorities continue to seek a new investor who could revive the fortunes of KAP. The company is not viable at market electricity prices, however, and has heavy indebtedness, over employment and large investment needs. Any investor is likely to demand financial assistance to deal with these obstacles.	**Medium** Additional expenditures associated with commitments to KAP would jeopardize the authorities' ability to deliver the needed medium-term fiscal adjustment and exacerbate financing pressures.
3. A protracted period of slower European growth.	**Medium** The damage to potential output from the financial crisis may be deeper than expected; or deleveraging may have a more severe impact on real activity.	**Medium** A protracted regional slowdown would likely have an adverse impact on FDI and tourism, which are expected to be key drivers of medium-term growth in Montenegro.
4. Renewed downsizing of the banking sector.	**Medium** Although the banking system appears to be stabilizing, the sector as a whole remains loss-making and NPLs continue to rise. Foreign parents, facing pressures in their home markets, could resist possible demands for further capitalizing Montenegrin subsidiaries.	**Medium** A further contraction in bank lending would be a drag on investment and would likely stall economic recovery.

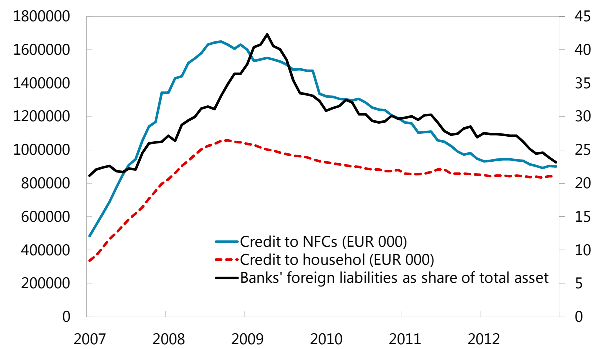
[1] The RAM shows relatively low probability events that could materially alter the baseline discussed in this report. The relative likelihood of risks listed is the staff's subjective assessment of risks surrounding this baseline.

Appendix II. The Role of Supply and Demand in Explaining Credit[1]

The prolonged credit contraction in Montenegro since the crisis is primarily supply driven, including recently, notwithstanding the efforts to clean bank balance sheets.

1. **Bank lending in Montenegro has contracted significantly since the collapse of the lending boom in 2008.** After a cumulative increase of more than 900 percent during 2005–2008, the level of outstanding credit has shrunk by more than one third from its peak level until the end of 2012. By end-2012, outstanding credit to nonfinancial corporate (NFCs) was 45 percent below its peak level in 2008, while the stock of credit to households fell by 20 percent over the same period. This partly reflects the sale of a large volume of NPLs by banks to factoring companies during 2010–11. Though the speed of credit decline has moderated recently as these transactions have slowed, credit continued to contract in 2012, falling by 3.5 percent.

Domestic Credit and Foreign Liabilities



Source: IFS

2. **Supply factors appear to have played a critical role in the credit contraction.** On the supply front, banks were faced with a large loss of deposits following the abrupt end of the lending boom: from August 2008 to April 2009, the level of deposits in the banking system fell by nearly 40 percent. While parent banks stepped up their support for their subsidiaries in Montenegro in the short-term in order to ensure that they were able to meet liquidity needs, these credit lines have been repaid over the past several years. As a result, subsidiaries have been forced to realign their lending with their domestic deposit base: foreign liabilities as share of banks' assets fell from over 40 percent in early 2009 to 23 percent in 2012. A tightening of lending standards is also a likely contributor to the shrinking credit supply, as banks have become more cautious in light of the steady deterioration of loan performance and the large stocks of NPLs. On the demand side, the economic slowdown and uncertain outlook, and excessive debt overhang are likely to have weakened firm and household demand for credit.

3. **A disequilibrium model that explicitly distinguishes credit demand from supply factors is used to assess the actual determinants of credit growth.** The estimation equation for credit demand and supply are, respectively:

[1] Prepared by Natasha Che, Matthew Gaertner, and Suchanan Tambunlertchai.

$$C_t^D = \alpha_1 + \alpha_2 i_t + \alpha_3 credit\_GDP_{t-1} + \alpha_4 \Delta tourism_t + \alpha_5 construction_{t-1} + \alpha_6 \Delta retail_t$$

and

$$C_t^S = \beta_1 + \beta_2 \Delta i\_margin_t + \beta_3 deposits_{t-1} + \beta_4 foreign\_liability_{t-1} + \beta_5 NPL_{t-1} + \beta_6 i_t$$

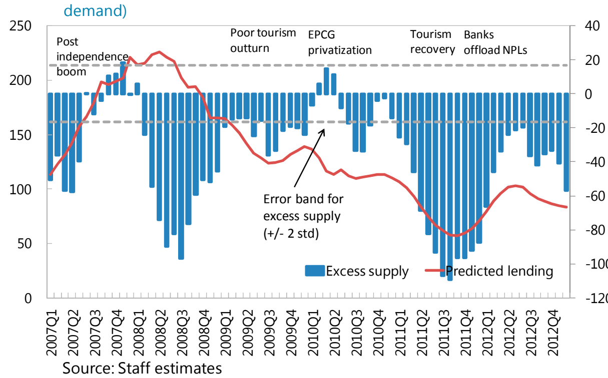
where the factors that affect credit demand are represented by lending rate, lagged credit to GDP ratio, growth in tourism and retail activities, and new construction orders; and the factors affecting credit supply are the lending rate, changes in bank profit margin, domestic deposits, banks' foreign liabilities[2], as well as NPL ratio.

	Estimated Coefficient.	Standard Error	z-stat
		Demand equation:	
i_t	-0.04	0.00	-13.4
$credit\_GDP_{t-1}$	-0.01	0.00	-20.2
$\Delta tourism_t$	0.01	0.00	47.5
$construction_{t-1}$	0.33	0.01	47.5
$\Delta retail_t$	0.01	0.00	23.2
		Supply equation:	
Δi_margin_t	-0.00	0.01	-0.58
$deposits_{t-1}$	1.19	0.26	4.65
$foreign\_liability_{t-1}$	0.29	0.11	2.6
NPL_{t-1}	-0.07	0.00	-19.3
i_t	0.08	0.02	5.2
Log likelihood	82.0	AIC	-1.9

4. **The estimation results suggest that the credit contraction in Montenegro in recent years remains supply related, despite efforts to ease bank balance sheets.** Prior to the crisis, high credit growth was fueled by increases in both credit demand and supply, with the former generally outstripping the latter. This resulted in large excess demand, which then diminished quickly following the crisis. The period 2009–2010 saw both credit demand and supply decline in conjunction. The credit market was in broad equilibrium, but supply remained the primary constraining factor for actual credit. While supply constraints have eased somewhat since the beginning of 2012, largely because of removal of NPLs from bank balance sheets, they remain binding in determining credit outcomes.

Estimated Excess Supply of Credit

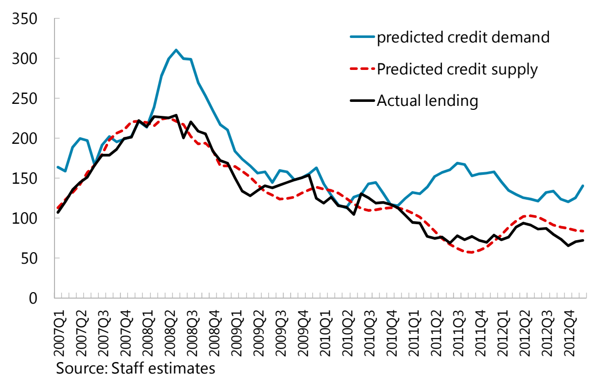
(in mn EUR; excess supply = estimated credit supply - estimated credit demand)



Source: Staff estimates

Demand and Supply of Credit

(in mn Euro)



Source: Staff estimates

[2] It is possible that banks' foreign liabilities are affected both by domestic credit demand and by parent banks' funding conditions. To make sure the variable only captures the foreign funding factor, we conducted an instrumental variable estimation and used the sovereign CDS spreads of the parent banks' home countries as instruments for foreign liabilities.

Appendix III. Evolution of Sectoral Balance Sheets and Vulnerabilities[1]

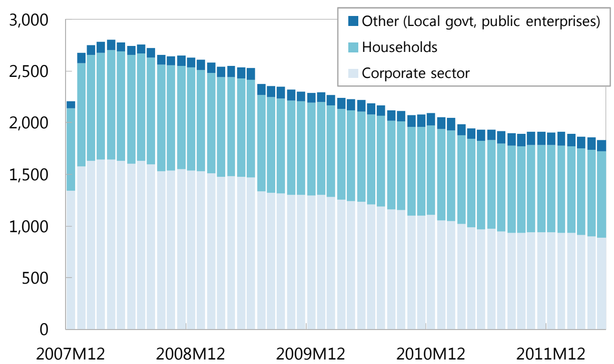
While the process of balance sheet repair is ongoing in Montenegro, vulnerabilities in private sector balance sheets are elevated, casting doubts on the prospects for speedy recovery of credit and economic growth.

A. Commercial Banks

1. **Commercial bank balance sheets have been downsized in the aftermath of the crisis**. Despite a gradual recovery in domestic deposits since the drop associated with the post 2008 crisis, banks have been downsizing and shrinking their balance sheets in order to align their lending to a more sustainable funding base.

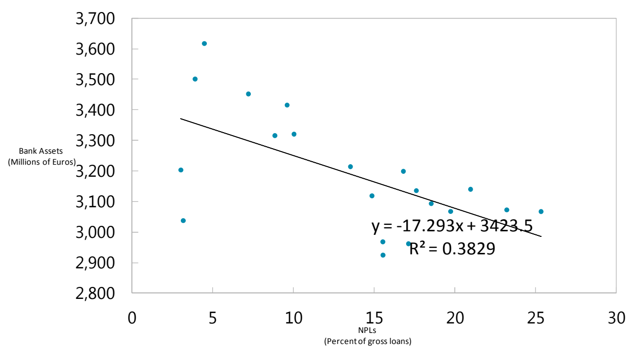
2. **On the asset side, bank credit has been on a steady decline in the aftermath of the global financial crisis**. In large part, the decline in credit and banking system assets is related to the accumulation of nonperforming loans (NPLs) over time. The sharpest decline has been in corporate credit which currently stands at only about 55 percent of its pre-crisis level. On the other hand, household credit has declined less rapidly, with credit now accounting for near 80 percent of its pre-crisis peak (see below).

Composition of Bank Credit
(Millions of Euros)



Sources: Montenegrin authorities; and IMF staff estimates.

Banking System Assets and NPLs, 2007-12



Sources: Montenegrin authorities; and IMF staff estimates.

3. **On the liability side, banks have steadily reduced their nonresident liabilities**. This decline reflects in part financial difficulties faced by parent banks. Nonresident liabilities are now about 60 percent of their pre-crisis level. Domestic deposits have recovered gradually but still remain below the pre-crisis level. Deposits are currently about 15percent lower than they were at their

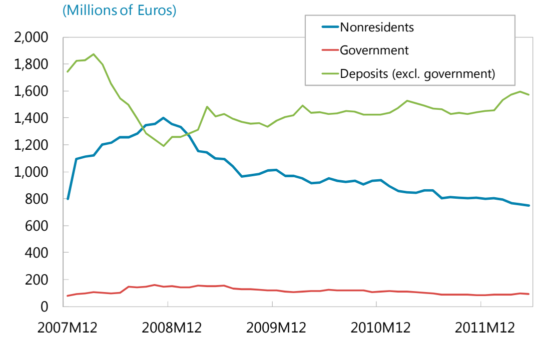
[1] Prepared by Iacovos Ioannou.

pre-crisis peak, suggesting that the adjustment process may be incomplete.

B. Corporate Sector[2]

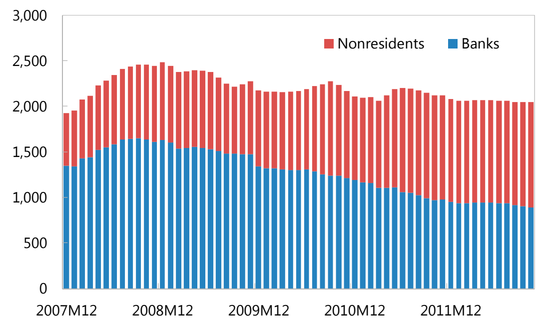
4. The corporate balance sheet remains impaired, but the composition of corporate liabilities has shifted over time. Total indebtedness of the corporate sector has declined modestly, by about 16 percent relative to the pre-crisis peak. While corporate liabilities to banks have declined over time, liabilities to nonresidents have increased considerably, largely because of banks' sale of NPLs from bank balance sheets to asset management companies. Corporate liabilities to banks are currently less than half of their pre-crisis level. Unless there is a sizable restructuring of corporate debt, balance sheets will likely remain impaired, dimming the prospects for a sustainable credit recovery.

Commercial Bank Liabilities
(Millions of Euros)



Sources: Montenegrin authorities, and IMF staff estimates.

Corporate Sector Indebtedness
(Millions of Euros)

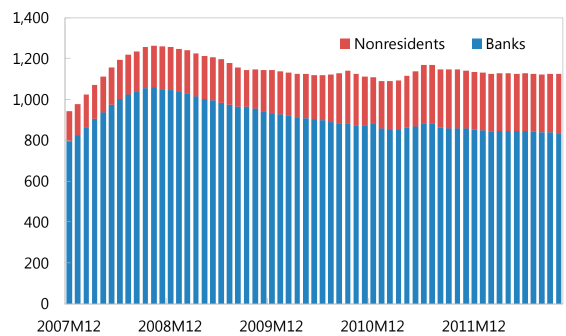


Sources: Montenegrin authorities; and IMF staff estimates.

C. Household Sector

5. There has been even less progress in cleaning household balance sheets, though the need for balance sheet repair may have been less than in the corporate sector. Household liabilities are overwhelmingly to banks. They have declined by only about 20 percent relative to the pre-crisis peak, about half the percentage point reduction compared to the corporate sector. The smaller reduction may be attributable to fewer bank sales of household NPLs. A split of NPLs between corporate and households indicates that most NPLs are in the corporate sector. Regardless, there is some evidence of banks' reluctance to aggressively pursue collateral execution against individuals because of social sensitivities. Judges' bias in favor of borrowers may have also been a factor behind the smaller balance sheet correction.

Household Indebtedness
(Millions of Euros)



Sources: Montenegrin authorities; and IMF staff estimates.

[2] Corporate and household balance sheet data are incomplete.

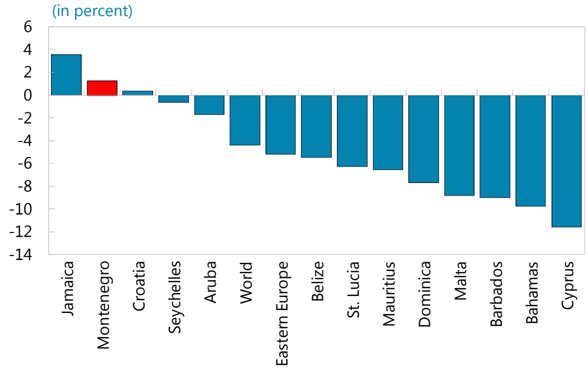
Appendix IV. Tourism Development and Its Macroeconomic Impact[1]

Tourism has become the main engine of growth in Montenegro in recent years, but the sector's momentum appears to be slowing as capacity constraints emerge. To fully realize the potential of a more diversified tourist sector in Montenegro, there is a need for investment to upgrade and expand capacity and relieve infrastructure bottlenecks.

1. **Tourism has experienced tremendous growth in Montenegro in recent years.** Tourism was a thriving sector during the Yugoslav era, but the number of visitors dropped sharply during the regional turmoil in the aftermath of the breakup of Yugoslavia. The sector has rebound briskly as the region has stabilized—inbound tourist arrivals have seen an average annual increase of 18 percent between 2005 and 2012,[2] in comparison to an annual growth of worldwide tourism of 4 percent in the same period.

2. **The sector has proved to be relatively resilient to external shocks in recent years.** The number of tourists visiting Montenegro rose by 2 percent per year on average during 2008–2009 despite the global downturn, compared with a decline in the number of visitors in comparator countries that also depend heavily on tourism.

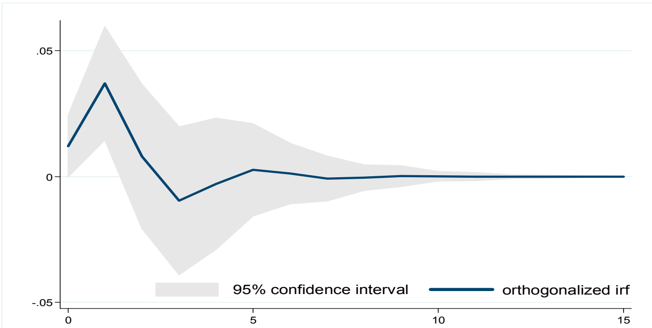
Growth of Inbound Tourist Arrivals 2008-2009
(in percent)



Sources: World Bank and staff calculations

3. **Tourism has become the key driver of growth in Montenegro as many of the unrestructured Yugoslav-era industries have encountered difficulties.** Service exports, which are largely tourism-related, have grown to over 70 percent of total exports in 2012, from 58 percent in 2007. Not surprisingly, G contribution to output and exports, tourism also has a large indirect impact on the economy. It positively affects household income, employment, and activity in tourism-affiliated services.

Impulse Response of Real GDP to Tourist Arrivals
(Sub title - Segoe UI- Size 18)



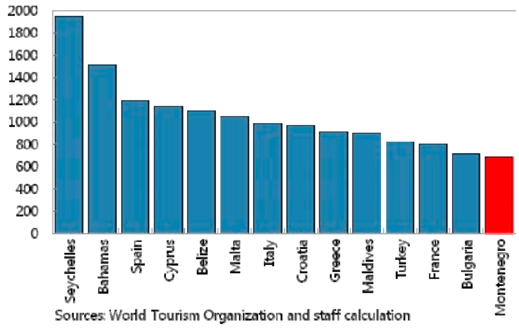
Source: Staff estimate

[1] Prepared by Natasha Che.

[2] Inbound tourist arrival in Montenegro excludes tourists from Serbia, to ensure data are comparable between pre- and post-independence periods.

The tourism multiplier[3] for Montenegro is in the high middle range compared to other tourism intensive countries. Estimates of a structural VAR model, comprising real GDP, inbound tourist arrivals, and exchange rate, show that a 1 percent increase in tourist arrivals in Montenegro is associated with a 1.2 percent increase in GDP.[4] The impact of tourism on GDP is mostly contemporaneous, and tourist arrival shocks do not generate a long-run effect on output.

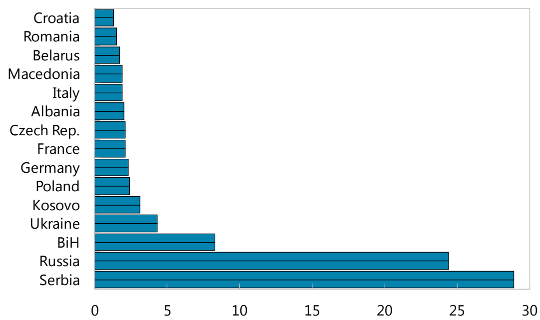
Expenditure per Inbound Visitor
(in US dollars; 2011)



Sources: World Tourism Organization and staff calculation

4. But the sector's growth momentum is waning, because of both external and internal factors. The annual increase in tourist arrivals has been in single digits since 2008, with growth in overnight stays showing a similar trend. Several factors have contributed to the slowdown. The economic downturn in the tourist sending countries has been an important reason, while Montenegro's real estate bust and credit collapse following the financial crisis have discouraged investment in the sector.

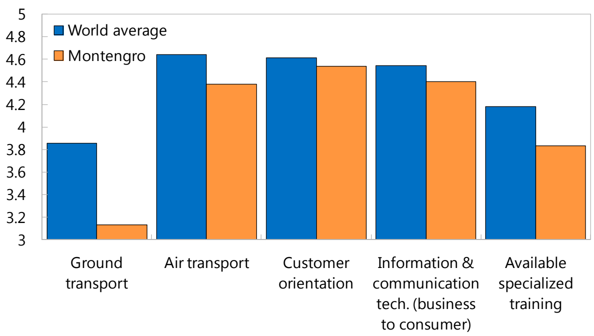
Overnight Stays by Country of Tourist Origin (in percent, 2012



Source: Montenegrin authorities

5. The lack of strategic planning and weak regulation over the past few years has raised sustainability concerns. The sector's expansion in the boom years was dominated by small scale and/or informal operations. Only 20 percent of the country's existing accommodation capacity is in the form of hotel beds, while the rest comprises apartments for rent and other private accommodations, many of which are unregistered. These operations occupy a significant amount of land and other resources, while generating little formal employment and fiscal benefits. The sector's rapid expansion without sufficient

Tourism Competitiveness Scores
(140 countries; higher score is better)



Source: The Travel and Tourism Competitiveness Index 2013

[3] Defined as the change in GDP corresponding to a unit change in inbound tourist arrivals.

[4] The model assumes that tourist arrivals affect GDP contemporaneously and with lags, while the latter only affects the former with lags. For countries with a flexible exchange rate regime, the model assumes that the exchange rate has a contemporaneous effect on tourist arrivals and GDP, while the opposite is not true. In other words, the order of variables in the autoregressive vector is {exchange rate, tourist arrival, GDP).

coordination and planning has also strained local public infrastructure such as transportation and sanitation.

6. **Cross-country analysis reveals that despite the strong overall growth in tourism, Montenegro earns less per visitor than many other tourism-intensive countries.** This is to some extent because Montenegro has traditionally sourced its visitors mostly from the neighboring countries that are in the low-to medium income bracket.[5] But more importantly, the earning ability of the sector is limited by the prevalence of small, unregulated operators that offer low-quality services with minimal value added and without bearing the cost of negative externalities, including to the environment.

7. **Looking forward, tourism can benefit from better regulation, upgrading of quality, and greater diversification.** Targeted investments in related infrastructure and better regulation at both central and municipal levels could carry large benefits. In addition, there is a need for greater diversification in the sector. About 90 percent of Montenegrin tourism is concentrated on the coast, which is in high demand solely during the summer months. To increase the sector's value added, Montenegro should strive to extend its visitor base globally and to higher end visitors, and further explore the tourism potential in its scenic mountainous areas in the north. Diversification to noncoastal tourism and wider visitor base would also serve to reduce the seasonal volatility of the country's tourism income and GDP.

8. **Such an approach would require greater investment in tourism-related physical and social infrastructure, and continuous improvement in the business environment.** A cross-country regression of per-visitor tourist receipts on road and air transport infrastructure reveals a positive relationship between tourism earnings and the extensiveness of transport infrastructure—a major weakness of Montenegro's tourism competitiveness. The tourism ranking data also indicate that to improve competitiveness in the sector, Montenegro would have to invest in the human capital and skills needed in the sector, through for example, more emphasis on vocational training. Given limited fiscal space, Montenegro needs to pursue alternative financing options for tourism-enhancing infrastructure investments. The country may benefit from more extensive exploration of nontraditional financing models, such as public-private partnerships and infrastructure funds. To attract higher quality investment in the tourism sector, Montenegro also needs to continue reducing the costs of doing business, such as the cost of

Infrastructure and Tourism Receipt

	Tourist receipt per visitor					
	(1)			(2)		
	Coef	Std err.		Coef	Std err.	
Road	0.11	0.06	*			
# of flights				0.08	0.04	*
GDP per cap	0.13	0.06	**	0.17	0.04	***
Constant	5.33	0.46	***	5.17	0.39	***
N	109			153		
R-square	0.15			0.12		

Note. *: $p < 0.1$; **: $p < 0.05$; ***: $p < 0.01$

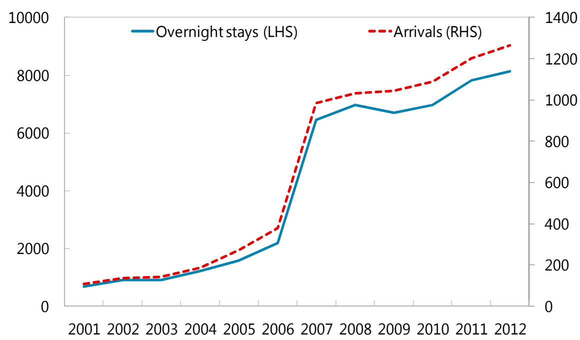
[5] The estimated tourism multiplier becomes very small and statistically insignificant when tourist arrivals from Serbia are included in the estimation, indicating that the earnings coming from Montenegro's largest visitor base may be limited.

obtaining business licenses and construction permits, and the cost of property transactions and resolving contract disputes.

Figure A1. Montenegro: Tourism Development and Growth

The tourism sector has experienced tremendous growth since independence.

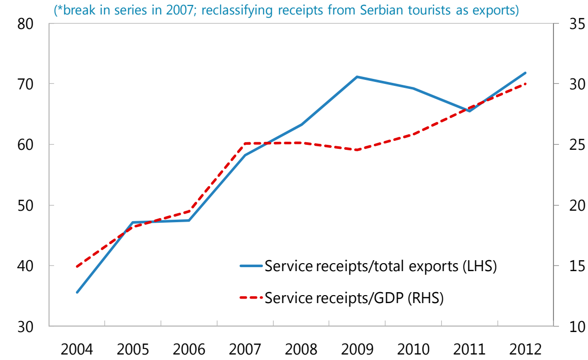
Total Tourism Arrivals and Overnight Stays
(in thousands; 2001-2012)



Source: Montenegro authorities.

Tourism related exports constitute a large and increasing share of total exports.

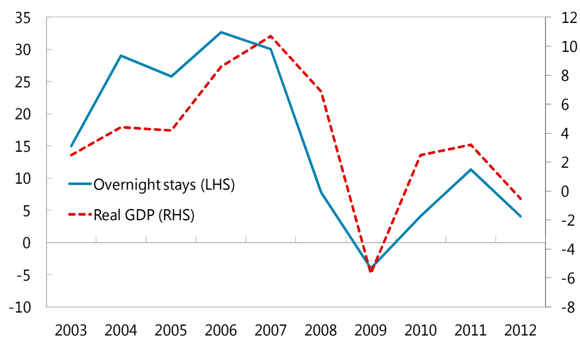
Service Exports
(*break in series in 2007; reclassifying receipts from Serbian tourists as exports)



Sources: Montenegro authorities and staff calculations.

GDP growth has largely tracked growth in tourism.

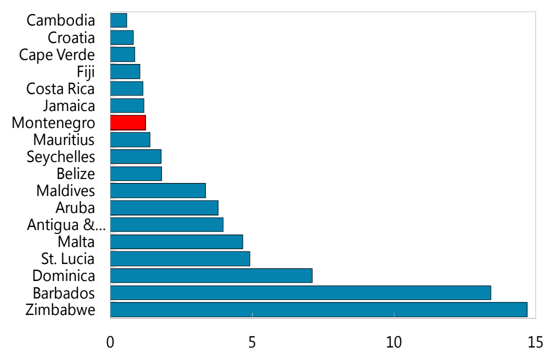
Growth in Tourism and GDP
(2003-2012)



Sources: Montenegro authorities and staff calculations.

And the volatility of the tourism sector is quite low.

Volatility of Inbound Tourist Arrivals
(Coefficient of variation; 2001-2011)



Sources: World Tourism Organization and staff calculation

INTERNATIONAL MONETARY FUND

MONTENEGRO

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

July 3, 2013

Prepared By

European Department
(In Consultation with Other Departments)

CONTENTS

FUND RELATIONS

(As of April 30, 2013)

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

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

SDR Department:	**SDR Million**	**Percent Allocation**
Net cumulative allocation	25.82	100.00
Holdings	26.24	101.60

Outstanding Purchases and Loans: None.

Latest Financial Arrangements: None.

Projected Obligations to Fund (In millions of SDR):

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

Implementation of HIPC Initiative: Not Applicable.

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

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

Exchange Arrangement: Montenegro does not issue its own currency, has been using the euro as legal tender since 2002, and 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.

Last Article IV Consultation: Concluded on April 27, 2012 (IMF Country Report No. 12/122).

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

Technical Assistance in the Past 12 Months:

Department	Timing	Purpose
STA	Apr. 2013	National Accounts
FAD	Apr, 2013	Tax Administration – Arrears Management
FAD	Apr, 2013	Tax Administration - IT
LEG	Mar. 2013	Corporate Debt Restructuring and NPLs
FAD	Feb, 2013	Tax Administration – Audit
FAD	Feb, 2013	Tax Administration – Taxpayer Services
STA	Jan. 2013	External Sector Statistics
MCM	Dec. 2012	Hedging International Bonds
FAD	Oct. 2012	Tax Administration – Compliance LTO
MCM	Oct.2012	Bank Resolution
MCM	July-Aug. 2012	Banking Supervision and Resolution Framework
FAD	Aug.-Sep. 2012	Public Financial Management

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

Resident Representative: None.

WORLD BANK GROUP RELATIONS

Montenegro joined the World Bank Group (WBG) as an independent country in January 2007. The Bank had implemented a discrete program of lending and analytical work for Montenegro for most of the period since the State Union of Serbia and Montenegro had joined the WBG in 2001, with three projects still being active at the onset of Montenegro's first Country Partnership Strategy (CPS) for the fiscal years 2007–10. Within this framework, the Board approved two IDA credits (US$19 million)—just prior to graduation—and five IBRD loans (US$54 million) to provide selective support to three key country priorities: (i) enhancing sustainable macroeconomic growth; (ii) building institutions and strengthening the rule of law; and (iii) improving the standard of living for citizens. The committed portfolio has grown from US$34 million in 2007 to US$70.3 million by May 2013. About 52 percent of these commitments remain to be disbursed. Investment operations are focused principally on supporting sustainable development and human development.

Montenegro: World Bank Project Portfolio, May 2013

Active Project Portfolio	Board Date	Original Commitment (US$ millions)	Disbursement Ratio (percent)
SEE Energy Community (APL3)	Jul. 2007	9.0	50.6
Energy Efficiency	Dec. 2008	9.4	66.6
Land Administration (LAMP)	Dec. 2008	16.2	26.8
Agriculture and Institutional Development (MIDAS)	Apr. 2009	15.7	34.3
Agriculture and Institutional Development (GEF)	Apr. 2010	4.0	5.0
Higher Education and Research	Jan. 2011	16.0	16.9

In January 2011, the Board approved the US$ 216-million CPS for FY2011–14. This CPS supports the government's overarching objective of full integration with the EU within a medium-term horizon. The strategy—reflecting Montenegro's status as an upper middle income client with well-defined development priorities—aims at (i) strengthening institutions and competitiveness in line with EU accession requirements; and (ii) improving environmental management including reducing the costs of environmental problems. The government has requested the Bank to focus its support in areas where it had previously been engaged and/or gained applicable regional or global experience. The centerpiece of the Bank's engagement in 2011 and 2012 was the financial-sector development policy loan (FSDPL) of US$80 million and a Policy-Based Guarantee (PBG) of US$80 million, both disbursed in 2012, which supported the government's program to strengthen the banking sector, bringing regulations into line with EU norms, and to encourage resumption of credit growth. The Bank's engagement in 2013 is focused on a US$50 million development policy loan that provides budget support to strengthen fiscal consolidation and policies geared towards sustained growth. New investment lending was approved for a Higher Education/R&D project in amount of US$16 million, while an additional new investment lending for the Industrial Waste

Management and Clean-Up Project is being prepared. In the area of analytical work, the Country Economic Memorandum (CEM), disseminated in May 2013, provided analytical support to the authorities' National Development Plan, which aims to implement Montenegro's growth and sustainability agenda in the process of convergence with the EU.

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 FSDPL and PBG in 2011 and 2012 and continued under the Public Expenditure Development Policy Loan (PEDPL). 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 resolution of nonperforming loans; (iii) public sector institutions and fiduciary review, and (iv) agricultural assessment; and (v) statistical capacity building and poverty monitoring. The Fund and Bank staff have sought each other's input in internal review processes.

Montenegro: JMAP Bank and Fund Planned Activities in Macro-critical Structural Reform Areas, January—December 2013

Title	Products	Provisional Timing of Missions	Expected Delivery Date
1. Fund work program	Article IV staff report	May 2013	July 2013
	Technical assistance on revisions to the budget law, debt management and fiscal reporting	April 2012	June 2012
	Technical assistance on pension system reform	Note to be drafted from HQ	Summer 2013
2. Bank work program	Public Expenditure Development Policy Loan	May 2013	September 2013
	Technical assistance on NPL resolution	Spring–Summer 2013	July 2013
	Country Economic Memorandum	January–July 2012	May 2013
3. Joint work program	None	None	

Prepared by World Bank staff. Questions may be addressed to Abebe Adugna, lead economist, Western Balkans (aadugna@worldbank.org; 202-473-4419).

STATISTICAL ISSUES

MONTENEGRO—STATISTICAL ISSUES APPENDIX As of May 2013
I. Assessment of Data Adequacy for Surveillance
General: Data provision has some shortcomings, but is broadly adequate for surveillance. Most affected areas are: national accounts, labor market indicators, and external sector statistics.
National Accounts: The Statistical Office of Montenegro (MONSTAT) compiles annual production and expenditure GDP in current and previous year's prices, and quarterly GDP by production at aggregated level (mostly NACE section level). Accuracy of the data sources needs to be improved. Work has started on measuring informal activities 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. MONSTAT has started compiling experimental quarterly GDP estimates by expenditure approach at current and at previous year's prices. Data collection for quarterly GDP by production approach has started too. MONSTAT plans to publish time series of quarterly GDP estimates by production and by expenditure approach in late 2014.
Price Statistics: MONSTAT compiles and disseminates monthly consumer and producer price indices, which broadly follow international standards. However, in both indices, the "carry-forward" technique for treatment of seasonal goods and missing items are used, potentially resulting in a downward bias. The EU harmonized consumer price index was compiled and released starting in 2011. The export price index has been published since 2009, and the industrial import price index since 2011. There is a need to develop a construction price 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 larger informal sector impedes the accurate assessment of unemployment rate. Frequent methodological revisions also impair time series analyses.
Government Finance Statistics: Fiscal data are compiled by the Ministry of Finance (MOF) based on a new GFS institutional classification, and since early 2006, include 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 (SOE), but a satisfactory compilation of the public sector fiscal balance requires significant further effort. Data on enterprises owned by municipalities are rarely available. Data on the stock of local government arrears need to be significantly strengthened and disseminated. Data on stocks of financial assets and liabilities are incomplete. The latest GFS TA mission in March 2013 recommended updating the table on the institutional structure of the public sector to facilitate consistency among producers of official statistics. It was also recommended to establish a migration plan to phase in the GFSM 2001 framework and to start publishing quarterly budgetary central government data in the *IFS*.

Monetary and Financial Statistics: Monetary and financial statistics are compiled by the Central Bank of Montenegro (CBM), broadly following the institutional coverage, classification, and evaluation methodology set forth in the Monetary and Financial Statistics Manual (2000). Dissemination practices meet the recommendations of the General Data Dissemination System (GDDS) with respect to the periodicity and timeliness for financial sector data. However, Montenegro reports monetary data to STA based on old reporting forms rather than in the Standardized Report Forms (SRFs). Montenegro also does not report FSIs to STA. 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 commercial banks. At the beginning of 2013, the Central Bank of Montenegro adopted new financial reporting requirements for banks in line with IAS 39; as a result, monetary data for 2013 is not comparable with data from previous years.
External sector statistics: Balance of payments (BOP) statistics are compiled by the CBM following international reporting standards. The 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 import data from MONSTAT from CIF to FOB basis. The biggest challenge to the BOP statistics is the coverage of transactions through the informal economy. As with many euroized economies, difficulty in estimating currency held by nonfinancial sectors continue to be an issue in the balance of payment statistics, as the large and recurrent positive error and omissions show. Although the errors and omissions have diminished recently due to (i) the upward revision of export of tourism (services) and (ii) the downward revision of euro bank notes (currency and deposits) cumulated in the economy, they are still large and with a positive bias. The CBM has made progress in improving the recording of transactions via the ITRS by refining the transactions coding system and increasing interaction with the commercial banks. However, the ITRS remains inadequate for recording a broad range of balance of payments transactions such as reinvested earnings and trade credits as well as the informal payments that do not flow through the banking system. Therefore, the CBM still needs to undertake a small number of direct surveys of enterprises and a border survey among travelers to supplement the data received through the ITRS, and prepare comprehensive documentation on compilation methods and data sources. Due to capacity constraints and the difficulty to differentiate between domestic and foreign financial positions in an open economy that does not have its own currency, Montenegro has yet to disseminate data on International Investment Position (IIP) and external debt statistics. The latest BOP TA mission in January 2013 concluded with the following action benchmarks: (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 plans for improvement was in 2012.	No data ROSC available.

Table of Common Indicators Required for Surveillance

(As of end-May 2013)

	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]	Apr-2013	29-May-2013	M	M	M
Reserve/Base Money	Apr-2013	29-May-2013	M	M	M
Central Bank Balance Sheet	Apr-2013	29-May-2013	M	M	M
Consolidated Balance Sheet of the Banking System	Apr-2013	29-May-2013	M	M	M
Interest Rates[2]	May-2013	29-May-2013	M	M	M
Consumer Price Index	Apr-2013	17-May-2013	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Apr-2013	31-May-2013	Q	Q	Q
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	Apr-2013	31-May-2013	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Apr-2013	31-May-2013	Q	Q	Q
External Current Account Balance	Q1-2013	28-May-2013	Q	Q	Q
Exports and Imports of Goods and Services	Q1-2013	28-May-2013	Q	Q	Q
GDP/GNP	Q4-2012	28-Mar-2013	A	A	A
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).

Press Release No.13/315
FOR IMMEDIATE RELEASE
August 28, 2013

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

IMF Executive Board Concludes 2013 Article IV Consultation with Montenegro

On July 22, 2013, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Montenegro and considered and endorsed the staff appraisal without a meeting on a lapse-of-time basis.[2]

Montenegro's recovery from the collapse of the lending boom in 2008 has been slowed by the debt overhang that remains in the private sector. Output contracted in 2012 because of unusually severe winter weather early in the year, as well as a sharp decline in aluminum production as the financial position of the troubled aluminum company (KAP) continued to worsen. Activity picked up in early 2013 as more favorable weather conditions resulted in a sharp increase in hydro-based electricity production, but the metals sector has remained a drag on activity.

Public debt has risen sharply in recent years as large structural fiscal deficits at the end of the credit boom have proved difficult to unwind. The authorities undertook sizable fiscal adjustment in 2012, but the level of debt continued to rise, reaching 52 percent by end year. The authorities have taken several significant measures to underpin their ambitious 2013 budget, which targets a further structural adjustment of 1¾ percentage points, including a freeze in pensions and an increase in the standard VAT rate.

The banking system adjustment is at an advanced stage after a massive downsizing following the collapse of the credit bubble, but banks continue to struggle with a large stock of nonperforming loans (NPLs). Banks have aggressively sold off NPLs to factoring companies, but the latter have

[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. The Executive Board takes decisions under its lapse of time procedure when it is agreed by the Board that a proposal can be considered without convening formal discussions.

[2] The Executive Board takes decisions under its lapse-of-time procedure when the Board agrees that a proposal can be considered without convening formal discussions.

moved slowly with resolution or restructuring of these problem assets, leaving private balance sheets still impaired. This has contributed to a negative feedback loop whereby sluggish private sector demand is contributing to weak economic activity and a further deterioration of asset quality. As a result, new bank lending remains limited, despite a steady recovery in deposits.

KAP has been downsized but fiscal costs and risks remain. The company has continued to require significant fiscal support, in direct subsidies as well as accumulated electricity bill arrears, and the government had to guarantee its loans in 2009. The authorities have recently launched bankruptcy proceedings in the local commercial court.

Executive Board Assessment

Last year's output contraction was heavily influenced by adverse weather conditions, and a modest rebound is likely this year. Declining output in the struggling aluminum sector will continue to be a drag on activity. Montenegro has significant potential in energy and tourism, but this will require improvements in the business climate to facilitate greater inflows of foreign investment into these sectors, including by strengthening anti-corruption efforts.

A sustained, multi-year fiscal consolidation effort is needed to reduce the public debt burden to an appropriately low level in the medium term. Financing constraints and the risk of a loss of market access, as highlighted by the recent surge in global risk aversion, will continue to be a concern till financing needs dissipate. Aiming to return public debt to its 2008 level (as a share of GDP) in 10 years is appropriate, but it would require sustained fiscal effort in future years.

The authorities' recent fiscal measures are welcome as they would stem the pace of debt accumulation in 2013, but these will need to be extended into 2014 and beyond to put public debt on a declining path. The growing financing gap in the pension fund has cramped the fiscal space, and serious front-loaded reforms are needed in this area to allow savings for 2014 and beyond, including, to meet fiscal contingencies. Efforts to improve the targeting of social spending are welcome, and should be expanded.

Limited progress on NPL resolution has left private sector balance sheets burdened with very high debt, risking a prolonged period of sub-par growth. It is essential to remove structural distortions that hinder the cleanup of private sector balance sheets, including lengthy and ad hoc judicial processes that delay collateral execution. Efforts should also focus on improving the accuracy of appraisals, strengthening the land registry, and advancing auditing standards.

Moving KAP toward liquidation appears to be the least cost option, one that would also improve resource allocation. Prospects for a durable long-term solution that allows the company to operate profitably while paying market prices for electricity appear limited, and it seems inevitable that continuing KAP in its current structure would require further fiscal support—at a time when the authorities are forced to take difficult decisions to raise taxes and curb spending. While liquidation could entail some near term fiscal costs, it would remove the specter of continual subsidies from the budget and release scarce resources that can be employed more productively, including electricity for exports.

Montenegro: Selected Economic Indicators

	2008	2009	2010	2011	2012	2013 Proj.
Output, prices and labor market (percent change, unless otherwise noted)						
Real GDP (percent change)	6.9	-5.7	2.5	3.2	-0.5	1.5
Nominal GDP (in millions of euro)	3,086	2,981	3,104	3,234	3,276	3,411
Industrial production	-2.0	-32.2	17.5	-10.3	-7.1	--
Tourism (Overnight stays)	6.9	-3.1	5.5	10.2	4.3	--
Unemployment rate (in percent) 1/	16.8	19.1	19.7	19.7	19.6	--
Consumer prices (average)	9.0	3.6	0.7	3.1	3.6	3.4
Consumer prices (end of period)	7.2	1.7	0.7	2.8	5.1	3.3
General government finances (percent of GDP) 2/						
Revenue and grants	48.4	42.5	41.3	38.5	38.4	38.9
Expenditure	51.6	47.8	45.9	43.8	42.7	41.2
Fiscal balance	-3.2	-5.4	-4.6	-5.2	-4.3	-2.3
Primary fiscal balance	-2.4	-4.5	-3.6	-3.8	-2.5	-0.1
General government gross debt	29.0	38.2	40.9	46.0	51.9	55.3
Monetary sector (end-period, percent change)						
Bank credit to private sector	25.0	-15.1	-8.9	-13.0	-3.1	0.2
Enterprises	21.3	-18.0	-11.2	-20.3	-4.9	--
Households	31.2	-10.7	-5.7	-3.2	-1.1	--
Private sector deposits	-14.2	-4.1	5.9	1.2	7.2	--
Balance of payments (percent of GDP, unless otherwise noted)						
Current account balance	-49.8	-27.9	-22.9	-17.7	-17.9	-16.9
Exports of goods and services	39.7	34.5	37.3	42.8	42.4	42.4
Imports of goods and services	-93.4	-65.4	-63.2	-64.9	-66.1	-64.7
Foreign direct investment	18.9	35.8	17.8	12.0	14.1	14.6
External debt 3/	90.8	93.5	96.4	101.4	108.4	113.3
REER (CPI-based; average change, in percent; + indicates appreciation)	-3.1	5.2	2.8	-3.2	-0.9	--

Sources: Montenegro authorities; and IMF staff estimates and projections

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