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

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

Economic Outlook and Risks

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

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

Fiscal policy

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

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

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

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

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

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

Public Debt Sustainability

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

Structural policies and business environment

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

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

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

Financial sector policies and addressing financial stability risks

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

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

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

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

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

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

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

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