INTERNATIONAL MONETARY FUND

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MONTENEGRO

February 2022

2021 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR MONTENEGRO

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2021 Article IV consultation with Montenegro, the following documents have been released and are included in this package:

- A **Press Release**.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on February 18, 2022, following discussions that ended on November 17, 2021 with the officials of Montenegro on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on February 3, 2022.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for Montenegro.

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

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Washington, D.C.

IMF Executive Board Concludes 2021 Article IV Consultation with Montenegro

FOR IMMEDIATE RELEASE

Washington, DC – February 18, 2022: On February 18, 2022, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Montenegro.[1]

The Montenegrin economy was hit hard by COVID-19, but a strong recovery is underway. The pandemic caused significant human and economic costs, the latter intensified by strong tourism dependence, constrained fiscal space, and labor market rigidities. The Authorities provided support through a variety of measures that helped to contain the economic effects of the pandemic. These included wage subsidies, tax deferrals, financial assistance to the vulnerable, and loan moratoria.

The financial sector appears to have withstood the COVID-19 shock well. Headline banking system metrics indicate resilience. Still, it is possible that there may be some hidden deterioration in asset quality that is masked by forbearance measures. Most of the crisis support measures introduced by the Central Bank in 2020 have been withdrawn over the past months. The Central Bank also successfully completed an independent asset quality review using data as of end-2019, which indicates that the banking sector was generally in a solid position, at the onset of the pandemic.

A growth rebound is expected in 2021 and 2022, of 12 percent and 6 percent respectively, driven primarily by the normalization of tourism. This will support a reversion of the current account to the pre-pandemic average. Over the medium term, growth is currently projected to ease to around 3 percent. Public debt was elevated prior to the pandemic in part due to the Bar-Boljare highway project. The pandemic caused a further increase in public debt levels. The Authorities have passed a landmark reform program, 'Europe Now', beginning in 2022. It aims to arrest outward migration through a series of measures: the near doubling of the net minimum wage; a substantial reduction in the labor tax wedge; and the introduction of a progressive tax code. Absent effective offsetting measures, the reductions in revenue from the removal of healthcare contributions in 'Europe Now' and increases in some long-term spending commitments are currently projected to keep the fiscal deficit and public debt elevated.

Uncertainty surrounding the projections is exceptionally high. On the upside, medium-term growth could be higher than projected, if labor and capital are reallocated to viable firms and sectors promptly, and the reduction in the labor tax wedge attracts significant new investment. On the downside, negative surprises from the pandemic could stymie the recovery of tourism, and the economy. Geopolitical tensions could place sustained upward pressure on energy prices and risk premia. The reforms related to 'Europe Now' are expected to provide a short-term boost to growth. However, their effects on inflation and formal

[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.

employment are uncertain as they depend significantly on the extent to which higher formal wages are absorbed by a commensurate fall in 'grey wages', which are likely to be variable across regions and sectors of the economy.

Executive Board Assessment[2]

Executive Directors agreed with the thrust of the staff appraisal. They commended the authorities' targeted policy response to the pandemic and welcomed the strong economic rebound following the pick-up in tourism. Directors noted, however, that downside risks stemming from a possible pandemic resurgence, persistent inflationary pressures, tightening of global financial conditions, and political uncertainty, warrant vigilance and contingency planning. In that context, Directors encouraged the authorities to safeguard macro-financial stability and fiscal sustainability, while pursuing structural reforms to boost long-term inclusive growth.

Directors agreed with the need for continued targeted pandemic-related spending in the near term. They welcomed the authorities' commitment to a credible and ambitious medium-term fiscal consolidation to preserve fiscal and debt sustainability. Directors called for a combination of revenue and expenditure measures targeting a primary surplus of about 1 percent of GDP over the medium-term to place debt firmly on a downward path. While welcoming the authorities' "Europe Now" program, which aims at tackling labor market challenges and raising labor force participation, Directors noted its associated fiscal costs and risks and underscored the need for fiscal recalibration. In this regard, implementing the initially proposed revenue-raising measures will be important.

Directors concurred that progress on fiscal structural reforms is also needed to support debt reduction efforts. They encouraged the authorities to further enhance the efficiency of revenue administration agencies, adopt a new Public Administration Reform strategy, and enhance public investment management, while exercising caution in the use of PPPs. Directors also cautioned that large capital expenditures should be considered once there is adequate fiscal space.

Directors noted that the financial sector remains well-capitalized and liquid. They encouraged a gradual withdrawal of remaining support measures as the economy recovers and urged the authorities to remain vigilant of emerging risks, including from a possible rise in NPLs. Directors welcomed the positive findings of the independent Asset Quality Review and encouraged the authorities to continue their efforts to implement the FSAP recommendations, highlighting the need to strengthen bank supervision and resolution frameworks and reinforce the AML/CFT framework. This will also help align regulation and supervision with EU frameworks.

Directors noted the importance of structural reforms to enhance competitiveness, improve the business environment and governance, and boost growth. They welcomed measures to address labor market weaknesses and reduce informality in the context of 'Europe Now'. Directors also called for comprehensive reforms to enhance the oversight and transparency of SOEs and encouraged establishing solid institutional and legal frameworks for "Montenegro Works".

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

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

Selected Economic Indicators 2017-2022						
	2017	2018	2019	2020	2021	2022
				Est.	**Proj.**	
Output						
Real GDP growth (%)	4.7	5.1	4.1	-15.3	12.0	6.0
Employment						
Unemployment (%)	17.0	15.2	15.1	17.9	--	--
Prices						
Inflation (avg, %)	2.4	2.6	0.4	-0.2	2.4	4.1
General government finances						
Revenue (% GDP)	40.3	41.0	42.2	43.4	43.0	38.8
Expenditure (% GDP)	47.1	47.2	44.0	54.4	45.0	44.9
Overall fiscal balance (% GDP)	-6.8	-6.2	-1.8	-10.9	-2.0	-6.1
Primary fiscal balance (% GDP)	-4.4	-4.0	0.4	-8.2	0.5	-4.2
General government debt (% GDP)	66.2	71.9	78.8	107.3	88.2	79.4
Gen. govt. debt including guarantees (% GDP)	73.5	78.1	83.7	112.6	92.2	83.0
Money and credit						
Credit to the private sector (% change)	8.4	11.0	5.0	3.4	5.4	8.1
Non-performing loans (% of total loans)	7.3	6.7	4.7	5.5	--	--
Balance of payments						
Current account (% GDP)	-16.1	-17.0	-14.3	-26.0	-15.7	-15.0
Foreign direct investment (% GDP)	11.3	6.9	6.2	11.2	7.9	7.5
Reserves (months of imports)	3.4	4.0	5.1	8.2	5.5	3.7
Exchange rate						
REER (% change)	0.5	2.7	-1.5	-0.6	--	--

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

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MONTENEGRO

STAFF REPORT FOR THE 2021 ARTICLE IV CONSULTATION

February 3, 2022

KEY ISSUES

Background. COVID-19 hit the economy hard, but a strong recovery is underway. Public debt, already elevated before the pandemic, has increased further. The government has embarked on a reform program 'Europe Now', which aims to arrest outward migration through a sharp minimum wage increase, labor tax wedge reduction, and the introduction of a progressive tax code. The financial sector appears to have withstood the COVID-19 shock well.

Outlook and Risks. The strong growth momentum is expected to continue in 2022, but output is expected to stay below its pre-pandemic trend over the medium term. Permanent reductions in revenue and increases in some long-term spending commitments are projected to keep the fiscal deficit and public debt elevated. On the upside, the reduction of the labor tax wedge could encourage investment and boost growth, if accompanied by broader reforms to the business climate. As the pandemic support measures are withdrawn, non-performing loans are expected to increase but remain manageable.

Policy Priorities and Recommendations.

- **Fiscal policy.** Offsetting measures to close the fiscal gaps created by 'Europe Now' are essential. The Authorities are advised to target and maintain a primary fiscal surplus of about 1 percent of GDP over the medium term, so that debt may be put on a firm downward trajectory. Large capital expenditures should only be considered when there is adequate fiscal space.
- **Financial Sector.** The gradual and data-dependent unwinding of crisis response measures should continue. Using the Asset Quality Review findings, efforts to strengthen financial sector supervision and contingency planning should be further pursued. Further improving the AML/CFT framework is key.
- **Structural Reforms.** Key priorities are increasing labor force participation while reducing structural unemployment and informality. Risks to formal employment and competitiveness stemming from the minimum wage increase should be carefully managed. On SOE sector reform, 'Montenegro Works' would require robust institutional and legal frameworks, and deep professional expertise.

Approved By
Jörg Decressin (EUR) and Natalia Tamirisa (SPR)

Discussions were held virtually from October 25 – November 5, and in Podgorica from November 10 – 17, 2021. The team comprised S. Seshadri (Head), S. Eble (Regional Resident Representative for the Western Balkans), G. Minasyan, Y. Mooi, A. Pienkowski (all EUR), V. Tang (FAD), and C. Acosta (LEG). Mr. Voinea (OED) joined most of the meetings. The team met with the authorities (Central Bank of Montenegro, Ministries of Finance and Social Welfare, Economic Development, Capital Investments, and Public Administration, Digital Society and Media), private sector representatives (unions, employers, and banks), the diplomatic community, and international agencies. H. Baldev and Z. Zhu (all EUR), and A. Madaraszova (HRD) provided support from Headquarters.

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ANNEXES