Statement by Mr. Luc Dresse, Alternate Executive Director for Montenegro and Mr. Liviu Voinea, Senior Advisor to the Executive Director
February 18, 2022.

On behalf of the Montenegrin authorities, we would like to thank Mr. Seshadri and his team for their in-depth report and constructive engagement, including the in-person consultations in Podgorica last November. We would like to offer the following comments.

Recent Economic Developments and Outlook

After taking a severe toll in the first year of the pandemic, primarily due to the negative impact on tourism, Montenegro has been on a strong recovery path since the start of 2021. The staff growth estimate has been revised from 7 percent last October to 12 percent, close to the authorities' baseline scenario.

The Medium-Term Fiscal Strategy, which was adopted by the Parliament last December, is based on a gradually decelerating GDP growth, from 6.4 percent in 2022, to 5.1 percent in 2023, and 4.5 percent in 2024. Staff's projection for 2022 is close to that of the authorities but has a stronger deceleration over the two outer years, with GDP growth at 2.8 percent and 2.5 percent. This difference in the medium-term growth path is the main source of divergence between the authorities' and staff's views on the medium-term fiscal position and debt trajectory.

The authorities share staff's views that fiscal consolidation and prudent debt management are necessary, and they maintain their assessment that the current policies are consistent with the fiscal sustainability goals. While staff foresees a return to higher deficit and debt in the medium-term, the authorities are confident that they will attain a primary surplus by 2024, and that public debt will continue its downward path reaching below 70 percent of GDP by 2024.

They remain cognizant of both upside and downside risks. This applies to growth, the fiscal and debt position, the evolution of the pandemic, the withdrawal of support measures, the recovery of the tourism sector, the adoption of the planned revenue-enhancing measures, the capacity to implement the expenditures' reform, and the progress on structural reforms.

Fiscal policy

A significant fiscal consolidation took place in 2021 due to authorities' actions: the overall deficit shrank from 10.9 percent of GDP in 2020 to an actual deficit of 2 percent of GDP, lower than the 3.6 percent projection. In cyclically adjusted terms, the balance improved by 4 percentage points, from -5.2 percent of GDP in 2020 to -1.2 percent of GDP, while the primary balance turned from a deficit of -8.2 percent of GDP to a surplus of 0.5 percent of GDP.

Against this background, the budget for 2022 departs temporarily from the consolidation path, as a package of fiscal reforms has been adopted, while some revenue-side measures proposed in the same package are yet to be approved. With the Europe Now fiscal package, the net minimum wage has been increased from 250 euro to 450 euro a month; healthcare contributions have been eliminated; a progressive personal income tax has been introduced

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together with a tax-free allowance of 700 euro per month, as well as a progressive corporate tax on profits. This package aims to (i) reduce the gap between the minimum wage and the minimum consumption basket; (ii) entrench a fairer personal income taxation regime; (iii) reduce the size of the informal economy; and (iv) attract investment and support job creation due to a lower labor tax wedge. According to staff calculations, under this package, the overall tax wedge declined substantially.

Nevertheless, the authorities disagree with staff's fiscal projections both on the revenue and expenditure sides in the medium-term, as reflected in Table 7 in the report. The differences stem mainly from (i) the different growth outlook; (ii) the different assumptions regarding the introduction of a series of revenue-enhancing measures; and (iii) the different assessment on the impact and implementation of the Europe Now program.

On the revenue side, recent data has been stronger than expected. Excise duties increased by 3.1 percent in 2021 (7.7 million euro) and continued this trend in January 2022, with excise duties' collection above plan by 2.1 million euro. Social security contributions, where tax collection for January 2022 and (preliminary) for February remained sustained despite the elimination of healthcare contributions, as taxpayers pay overdue contributions, especially for healthcare insurance. Among non-tax revenues, the "digital dividend" already generated higher than planned revenues. Thus, the starting point for revenues collection in 2022 appears underestimated.

Furthermore, the authorities maintain higher VAT projections for 2023 and 2024, considering the projected growth of economic activity as well as the effects of reducing the informal economy through the already implemented electronic fiscalization project, and enhanced enforcement by inspection services.

Looking ahead, for 2023-2024, the authorities plan to resubmit to the Parliament the revenue-enhancing measures which were included in the initial Europe Now program. This pertains amending the Law on Excise Tax to increase the tax on products such as cigarettes, other tobacco products, carbonated beverages, and introducing excise taxes on a new range of products. They also plan to repropose a law to increase the VAT on food preparation and services, bottled drinking water and non-alcoholic non-carbonated beverages in restaurants and facilities providing catering services. Amendments to the Law on Energy are also underway, prescribing a fuel marking obligation to further reduce tax evasion opportunities.

Differences also exist on the expenditure side. The realized expenditures for January 2022 on gross salaries remained broadly unchanged except for the increased salaries for medical personnel. The authorities consider that the implementation of the Europe Now package would lead to a more moderate growth of the wage bill over the period 2023-2026 than foreseen by staff (10 million euro rather than 30 million euro).

The authorities also consider that interest payments may not reach as high as 200 million euro by 2026, which would be more than double the current level, as projected by staff. The difference

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of views stems from the divergent estimates regarding medium-term fiscal deficits and financing needs.

Regarding social security transfers, the additional costs resulting from recently legislated changes in the field of pensions (increase of the minimum pension from October 2021), former beneficiaries of maternity benefits (return of benefits starting from April 2022) and Social and Child Protection (which includes regular harmonization of social benefits) have been included in the 2022 budget. Therefore, the authorities assess lower spending than in staff's projection (703 million euro in 2023, respectively 712 million euro in 2024, compared to staff's 734 million euro in 2023 and 772 million euro in 2024).

Other differences between the authorities' projections and the IMF's forecasts on expenditure items refer to: (i) "other outflows" – the authorities note that these payments relate to existing obligations in signed contracts, and do not tend to increase; (ii) "other transfers" – the authorities note that compared to the 2021 baseline, there are some relatively small one-off compensations for former employees in the metals sector; (iii) "reserves"– the authorities believe that smaller amounts will be needed after the pandemic ends.

Notwithstanding their different assumptions on a series of budget items, the authorities remain committed to fiscal consolidation and a downward debt trajectory.

Financial sector and policies

Although the COVID-19 crisis tested the resilience of the financial sector, key financial sector indicators remained stable. Montenegro's banking system entered the COVID-19 crisis strong, with solid capital and liquidity buffers. Therefore, despite the significant COVID-19 shock on real economy, **the banking system remained liquid (26.4 percent of total assets), well-capitalized (Q3 solvency ratio at 18.5 percent), and adequately profitable (preliminary Q4 ROE at 9.5 percent) at the end of 2021. Key performance indicators (KPIs) of the banking system indicate a strong recovery, with assets, loans, deposits, and capital recording an increase compared to December 2020** (16.2 percent, 6.37 percent, 24.6 percent, and 6.8 percent respectively).

The authorities concur with staff's views that the successful completion of the system-wide Asset Quality Review (AQR) provides an overall comforting picture. Carried out by reputable international assessors, this exercise was the first conducted in line with the ECB methodology by a central bank outside the EU. The AQR results built-up confidence in the financial system, enhanced transparency of asset quality, and assured more robust risk management and better risk-bearing capacities of tested banks. Banks were required to act on the results of the AQR exercise as of 31 October 2021. According to the reports submitted, the capital adequacy ratio decreased slightly, by 0.40 percentage point, given the AQR findings. One bank implemented, in a timely manner, corrective measures for capital conservation. In addition, banks are required to validate and, if necessary, recalibrate their existing impairment and provisioning models by 30 June 2022.

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The authorities are cognizant of the risk that unwinding the temporary crisis support measures could trigger an increase of impaired loans. They will continue to rely on data to ensure a timely unwinding of these measures, while focusing on close supervision of banks and stand ready to react swiftly if needed, primarily via the existing macro-prudential tools. The authorities note that, following the end of the moratoria on targeted corporate loans repayment and loan restructuring, the increase in NPLs was only minor, from 5.47 percent at end-December 2020 to 6.17 percent in December 2021, and the level of loans overdue for more than 90 days stagnated. **Based on the available micro-data, the authorities do not expect a systemic rise of impaired loans.**

The authorities continue with further alignment with the EU Acquis regulation, focusing on further strengthening the domestic regulatory framework and requirements. The Central Bank of Montenegro (CBCG) started with the implementation of the Law on Credit Institutions and the Law on Resolution of Credit Institutions (incorporating the Capital Requirements Directive, the Capital Requirements Regulation and the BRRD) to strengthen the capital requirements of banks and established a framework for new regulatory requirements related to liquidity and capital requirements for institutions of systemic importance.

In addition, corporate governance and transparency standards for credit institutions have significantly improved. The authorities continue to monitor banks' practices and macroprudential indicators, setting the appropriate conditions for the development of macroprudential tools. They completed the amendments to the Law on Resolution of Credit Institutions by harmonizing it fully with the Directive 2019/879/EU to improve the operational execution of the resolution of credit institutions, thereby strengthening the competences of the resolution authorities.

The authorities share staff's view that further strengthening contingency planning is important. As noted by staff, the Law on Deposit Protection Fund (DPF), that became effective in January 2020, is in line with international best practices. It should reach a coverage of 10 percent of guaranteed deposits by 2024. The CBCG established a Resolution Fund. In order to support the Fund's operations, the CBCG adopted internal procedures to guide the drafting of the resolution plans, and began work on resolution plans for individual banks, starting with the systemic banks. The aim is to have credible and fully operational contingency plans for each bank by end-June 2022.

The authorities welcome the findings of the Safeguards' Assessment pointing to strong operational controls at the central bank. The authorities requested and finalized the IMF technical assistance to address the recommendation for several amendments to the Central Bank of Montenegro Law relating to governance structures. The authorities prepared amendments incorporating the recommendations to further strengthen the independence of the central bank and relevant governance structures.

The authorities remain committed to further improving the AML/CFT framework, and to fully aligning it with the EU Acquis and FATF standards. Public consultation on the new Law

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on Prevention of Money Laundering and Terrorist Financing has been completed and the proposal will be sent to the EU Commission for comments. Central bank representatives were involved in drafting the new Law, as well as the important enabling regulations. They also contributed to the preparation of the Strategy for prevention and suppression of terrorism, money laundering and terrorist financing, which was adopted by the Government in December 2021, and to the drafting of a law on restrictive measures. Additionally, the supervision capacity of the Directorate for AML/CFT was strengthened.

Structural reforms

The authorities agree with staff's assessment of structural weaknesses in the labor market and with the key priorities to increase labor force participation while reducing structural unemployment and emigration. They emphasize that the main motivation for the Europe Now program was to reduce the tax wedge and raise the minimum wage, to reduce informality, increase labor participation especially for women and youth, and retain the qualified workforce.

Finally, on the SOEs' governance, the authorities are confident that the consolidated company "Montenegro works" will improve SOEs' performance and will promote the reform agenda.

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