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MONTENEGRO

2012 ARTICLE IV CONSULTATION

May 2012

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 2012 Article IV consultation with Montenegro, the following documents have been released and are included in this package:

- **Staff Report** for the 2012 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on March 6, 2012, 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 April 27, 2012. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- **Informational Annex** prepared bt the IMF.
- **Staff Statement** of May 11, 2012
- **Public Information Notice** (PIN)summarizing the views of the Executive Board as expressed during its May 11, 2012 discussion of the staff report that concluded the ArticleIV consultation.
- **Statement by the Executive Director** for Montenegro.

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STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION

April 27, 2012

KEY ISSUES

Context: Three years after the global crisis, economic output has almost recovered and financial sector conditions are stabilizing. In other ways, though, the crisis and its repercussions are still acute, most visibly in the sizeable and continuing buildup of public debt and a tightening liquidity squeeze in the economy.

Fiscal Policy: Public debt has risen sharply. The immediate priority is a substantial reduction in the fiscal financing requirement. The authorities have adopted ambitious medium-term targets; they must urgently be underpinned with credible and high-quality measures, including staff cuts, and some tax increases. The tight fiscal stance must be carried forward to lower public debt.

Financial Sector: Important progress was made in stabilizing the banking system, but continued progress in financial regulation and supervision is required. Policy actions should focus on liquidity and raising capital buffers of banks. The new resolution framework should be applied if owners fail to meet capital calls, onsite control of NPL identification and disposal be tightened, and legal and administrative obstacles to collateral execution be tackled.

Structural Reform: The country has been at the vanguard of structural reform in the region, though progress has recently slowed, especially on labor markets and previously privatized large enterprises. It is essential to invigorate structural reform with a focus on redressing gaps that are well-identified in relevant surveys; end support to aluminum and steel plants; and increase flexibility in labor contracts.

Approved By
Aasim Husain and Thomas Dorsey

The Article IV discussions were held in Podgoriça, February 23 to March 6, 2012. The staff comprised Mr. Bell (Head), Mr. Gaertner and Ms. Tambunlertchai (all EUR), Mr. Lundback (MCM), and Mr. Zeng (FAD). The mission met with the Prime Minister, the Minister of Finance, the Governor, other economic ministers, regulators, banks, private sector representatives, unions, and parliamentarians.

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CONTEXT: THE BOOM-BUST CYCLE HAS NOT YET RUN ITS COURSE

1. **Three years after the sudden end of Montenegro's boom, some important adjustment has taken place, but the deleveraging challenge remains.** Economic output has now almost regained its pre-crisis level and bank deposits are recovering (Tables 1-3). In other ways, though, the repercussions of the asset bubble and the rapid credit growth that fuelled the boom are still acute, most visibly in the sizeable and continuing buildup of public debt and a tightening liquidity squeeze in the economy. As recommended in the 2011 Article IV consultation, the authorities have progressed with repair of the banking system and initiated fiscal consolidation, but the weak economic outlook and political factors have presented obstacles.

2. **Montenegro's experience reflects the challenges of its demanding policy framework and the economy's high degree of openness**. Without an exchange-rate and monetary-policy tool, fiscal policy was overburdened by the task of preventing overheating during the pre-2008 inflow-driven economic boom. Since then, government dis-saving partly offset the drag on domestic demand due to private sector deleveraging, but at the cost of rapidly accumulating public debt and still high external imbalances. With access to external funding markets more challenging, however, fiscal policy is now constrained.

3. **With elections expected this year, the near-term economic policy reform agenda is light.** Following progress with respect to EU accession—with the European Commission expected to initiate membership negotiations later in the summer—elections are expected to be called in late summer or early fall.

BACKGROUND AND RECENT DEVELOPMENTS: STRONGER HEADWINDS BUT EXHAUSTED POLICY BUFFERS

A. Further Adjustment Still Needed

4. **The bust has so far been less severe than in comparable countries**. (Figure 1) To some extent, this reflects data deficiencies and a later start of the boom compared especially to other fixed exchange rate systems. More importantly, however, the significant use of the public sector balance sheet has offset the impact of private deleveraging since 2008. Conversely, rebalancing has not significantly progressed, evidenced by lagging export

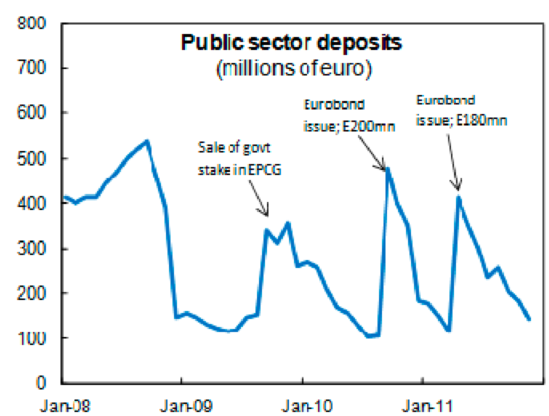
growth, despite an increasingly buoyant tourism sector (Table 4).

5. The recovery is at risk of stalling. High-frequency economic indicators depict a sharp weakening of activity in the fourth quarter of 2011 (Figure 2). Going forward, the policy buffers that have supported growth over the last two years are no longer available, while the international environment continues to be clouded. Staff project growth of only 0.2 percent in 2012 after some 2½ percent in 2011.

- **The 2011 external demand boost is wearing off**. Tourism was the main driver of growth—benefitting from new lodging capacity coming on stream, reductions in cost, and the re-orientation of package tourism away from traditional North-African destinations in the summer of 2011. However, a severe cold spell has cut electricity production in the early part of 2012 and necessitated imports, while additional short-term drag is expected from waning terms of trade and ongoing weakness in the eurozone.

- **Domestic demand is not picking up**. Household demand and investment remain weak and bank credit continues to decline (Figure 3). Three larger foreign-owned banks, in particular, have curtailed new lending given the need to repair their balance sheets, in the context of dwindling support from their parent banks experiencing financial stress elsewhere. The largest domestic bank has only recently resumed lending.

- **Policy buffers are depleting.** The repair of private sector balance sheets was more than offset by the public sector, in the process increasing debt some 15 percent of GDP, selling assets of 11 percent, and issuing guarantees of 8 percent (some 1 percent of which have already been called; Table 5). Faced with external financing challenges, the government is increasingly drawing down its deposits in banks, further aggravating the liquidity squeeze.



B. A Fast Rise in Public Debt as Fiscal Imbalances Have Proved Difficult to Tackle

6. **The end of the boom quickly turned budget surpluses into large deficits, resulting in a rapid rise in public debt**. Deficits averaged 4.8 percent of GDP during 2008-11 and consistently overshot initial targets. Market access and World Bank lending facilitated financing these imbalances and public debt more than doubled in nominal terms.

Montenegro General Government Operations 2008-12

(Percent of GDP)	2008	2009	2010	2011	2012
	Actual			Prel.	Proj.
Revenue	48.4	42.6	41.3	37.9	38.0
taxes	30.0	26.7	24.4	24.2	24.8
social security contributions	9.5	9.0	11.2	9.4	9.6
other	8.9	6.9	5.7	4.3	3.6
Expenditure and net lending 1/	51.5	47.9	46.0	44.2	43.2
current expenditures	22.1	21.1	21.3	20.8	22.2
social security transfers	11.4	13.9	13.6	14.0	14.3
capital expenditures	10.1	8.4	5.3	4.1	3.6
other	8.0	4.5	5.7	5.3	3.1
Overall balance 1/	-3.1	-5.3	-4.7	-6.3	-5.2
Memorendum items					
Public debt (end of period)	31.9	40.7	42.4	46.9	50.2
foreign	15.6	23.5	29.4	32.6	36.2
domestic	16.3	17.2	13.0	14.2	14.0
Stock of public guarantees	-	5.0	11.3	11.7	-
Social security financing gap	-1.8	-4.8	-2.4	-4.5	-4.8

Source: Country authorities and IMF staff estimates.
1/ On accrual basis

- **Revenue collections dropped some 10 percent of GDP** in two broad episodes. Since the crisis, the disappearance of some of the boom-level revenue base (characterized by massive absorption and booming real estate) was compounded by untimely cuts in the personal income tax and social contributions. Subsequent increases of excises and social contributions helped stabilize the revenue share, but 2011 again witnessed a sharp drop in social contributions and nontax revenues.

- **Most of the spending cuts came from capital expenditures**. Tight control efforts on personnel expenditures ran into political difficulties.[1] Expenditures on social security programs actually increased by more than 2½ percent of GDP, driving the social security deficit to 4½ percent of GDP in 2011, a level that now exceeds total capital spending.

- **Expenditure arrears became significant**. Between 2008 and 11, arrears averaged 1¾ percent of GDP. Most reflected unbudgeted current expenses by line ministries, other agencies, and local governments. Measures taken in 2010 aimed at containing arrears, including publication of high frequency fiscal statistics, adoption of a single treasury account, and introduction of a mandatory reporting requirement for line ministries. These steps slowed down arrears accumulation in 2011, though still an estimated 1¼ percent of GDP were accrued.

[1] However, year-by-year comparisons are made very difficult by frequent reclassifications.

- **Contingent claims materialized**. In 2011, a loan guarantee extended to the steel plant in 2010 was called, adding 1 percent of GDP to the deficit. An additional €132 million (4 percent of GDP) in loan guarantees that were extended to the aluminum plant (KAP) are also at risk of being called.
- **Moreover, sizeable below-the-line repayments to non-banks occurred**. They largely reflected ex-Yugoslav legacy restitution and compensation issues and implied additional market debt accumulation of 1¾ percent of GDP per year on average.

C. Rapid Deleveraging and Gradual Repair in the Banking System

7. **Banks have significantly downsized their balance sheets since 2008 in response to the sharp decline in domestic deposits** (Figure 3). While a return of confidence has resulted in a modest recovery of deposits, they remain more than one-fifth off their August 2008 peak.

8. **Moreover, foreign parent-bank support has recently been reduced.** By the later stages of the lending boom, banks had increasingly relied on foreign borrowing to finance credit expansion. This reliance rose further as foreign parents stepped up their support to offset the large deposit outflows in order to avoid an immediate disorderly adjustment to banks' balance sheets. As deposits began to stabilize, however, flows from parents began to reverse and funding from parents declined steadily during 2010 and 2011 as credit lines were repaid. Banks' foreign liabilities fell to 27 percent of total funding at end-February 2012, their lowest level since the end of 2007.

9. **On the asset side, the deleveraging reflects a combination of bad-loan disposal and slow new lending.** Bank lending more than doubled from the end of 2006 through September 2008, with rapid growth to both households and corporates fuelled by real estate speculation. Banks' assets have since declined by 20 percent, with credit to the non-financial private sector contracting by one-third. By early 2012, banks had made considerable progress in re-aligning their lending with their domestic deposit base and the average loan-to-deposits ratio returned to end-2007 levels at 112 percent in February, bringing Montenegro much closer in line with regional peers.

- **A reduction of nonperforming loans (NPLs) was one factor.** Reflecting a sharp reassessment of collection prospects and stepped-up Central Bank monitoring and provisioning requirements, banks aggressively sold bad loans to parents or factoring companies. This contributed to a sharp decline of NPLs from a high of 26 percent of gross loans in June 2011 to 16 percent at end-2011 (Table 6). Provisioning is, however, still lagging. While overall banking system profitability improved in 2011 with most banks recording positive results, the system as a whole continued to be loss making.

- **But bank lending was also curtailed.** The existing debt overhang in the economy continues to limit prospective borrowers, while concerns about asset quality and the significant uncertainty over the economic outlook are constraining banks' appetite for risk.

D. Structural Reform Pushback from Insiders

10. Structural reform progress has somewhat slowed from the immediate post- independence period, when Montenegro championed rapid and comprehensive market liberalization. Recent international business environment and structural reform indicators suggest a slower pace in the past several years.

Global Rankings in Business Environment and Regulatory Framework
(total number of countries surveyed in parentheses)

	2007	2008	2009	2010	2011	2012
Doing business	-	-	-	65 (183)	56 (183)	56 (183)
Global competitiveness	-	82 (131)	65 (134)	62 (133)	49 (139)	60 (142)
Regulatory quality	102 (207)	100 (207)	100 (210)	103 (210)	-	-
Country credit rating	89 (174)	87 (174)	85 (178)	94 (178)	86 (178)	-

Sources: World Bank's Doing Business database, World Economic Forum Global Competitiveness Report, World Bank's Worldwide Governance Indicators, Institutional Investor.

- **Deep-seated problems in the enterprise sector are again coming to the fore**. While the steel and aluminum enterprises were privatized before 2008, they remained a significant drain on public finances in the form of non-paid taxes, direct cash transfers, and loan guarantees. Public support to private enterprises mainly reflects the political clout of their unions, which in the Yugoslav system had broad powers to manage these plants. In 2011, the steel company was declared insolvent and in early 2012, the aluminum company was re-nationalized, in both cases triggering recourse by the previous private owners.

- **Labor markets don't perform well:** The unemployment rate remains at 18 percent, with a low level of participation in the labor force and a growing share of long-term unemployed (Figure 5). Meanwhile, the market for non-resident employment adjusts freely and efficiently. The 2010 reform, which liberalized the use of "fixed-term" contracts that were lower-cost and less regulated than "permanent contracts", triggered significant duality in the labor market, with nearly all hiring since having taken place under fixed terms (see Annex I). Labor law amendments in

2011 have attempted to simplify labor market processes and provide scope for more flexible hiring and firing. At the same time, these amendments have substantially reduced the availability of fixed-term contracts, but by leaving in place many of the protections of permanent contracts, run the risk of depressing new hiring going forward. The government, employers and labor union representatives, however, agreed that these were welcome steps towards better functioning of the labor market while still maintaining appropriate protection for employees.

- **There are also weaknesses in product market regulation:** There is survey evidence that high administrative barriers to business entry impede entrepreneurship and job creation. In the energy sector, price regulation contributed to the poor financial performance of the electricity producer, which has delayed further investments in this area. In the transportation sector, high airport fees may deter low-cost carriers from entering into Montenegro, adversely affecting the tourism industry.

REPORT ON THE DISCUSSIONS

A. Outlook and Risks

11. Staff and authorities agreed that sustainable medium-term growth required attracting large-scale FDI to unleash Montenegro' significant potential. Given the limited amount of financing available domestically, foreign investment offers the benefit of a more rapid transition to higher income levels. The authorities observed that despite the ongoing sharp post-boom slowdown, FDI inflows still amount to more than 10 percent of GDP. They saw this as evidence of continued investor confidence that augured well for a quick pick up in FDI once global and European economic conditions improved. The staff concurred in principle, but noted that some of the recent FDI was in fact backward looking—for example bank recapitalization.

12. Differing views were held regarding competitiveness. Staff and authorities concurred that the application of traditional competitiveness analysis in Montenegro is subject to considerable uncertainty. In addition to the weak statistical base, the very small size of the economy implies that a few lumpy foreign investment projects—that need not be large in absolute terms—could drastically change the outlook, a fact not captured in standard real exchange rate assessments or the computation of current account norms. Even so, staff considered that competitiveness appears somewhat compromised, in particular in view of the poor labor market and export performance, indicators that are subject to less statistical uncertainty (Box 1).

13. All agreed that there was an abundance of risks at the current juncture, with staff viewing them as skewed to the downside. Staff's baseline scenario is based on the current WEO forecast for a modest downturn in the euro area, but projections are very sensitive to prospects for tourism and foreign investment. A more pronounced deterioration in eurozone conditions with attendant spillovers would significantly worsen the growth outlook and prospects for achieving the planned fiscal adjustment. In addition to external risks, which also include parent-bank restructuring and commodity developments, there were large home-grown risks (see Risk Assessment Matrix, Annex II). In particular, if depositor confidence again retreated or if government were faced with another shock that would exhaust stretched deposits, some foreign parents may end support, thus triggering potential outward reputational spillovers despite Montenegro's small size. The authorities considered that their macroframework with 0.5 percent GDP growth in 2012 already included a large part of the risks, and that there was significant upside, especially if conditions in the eurozone improved more than currently projected.

14. The outlook remains challenging. Looking ahead toward the medium term, the authorities expected a return to sustainability, while staff projected sub-par performance even after a resumption of inflows, given the erosion of past policy buffers and the difficult external and domestic environment. Moreover, and despite evidence of wage declines, inflation has remained above trading partner levels—recently reflecting food price increases—thus impeding the needed external adjustment.

15. Accordingly, staff argued for a significant recalibration of policies. Staff considered that the recent experience with public borrowing, which did not result in a lasting improvement in growth prospects or vulnerabilities, underscored the need to change the policy framework. Tighter fiscal policy, accelerated structural reform, and policies facilitating orderly banking sector deleveraging would attract and catalyze stronger inflows. The immediate priority was a substantial reduction in the fiscal financing requirement, while invigorating labor markets. The details are discussed in the following sections.

Box 1. External Competitiveness

The application of traditional competitiveness analysis in Montenegro is subject to considerable uncertainty, given the very small size of the economy and the weak statistical base. Even so, competitiveness appears compromised.

A standard assessment of the real exchange rate using the CGER methodology indicates that Montenegro's exchange rate is overvalued. However, there are large data uncertainties that make the exercise imprecise (errors and omissions amount to some 10 percent of GDP), and only a relatively short time series is available. In addition, there is considerable uncertainty regarding the country's medium-term current account balance; for a small economy such as Montenegro, a surge in service exports or a contraction in imports can substantially narrow the current account gap without any underlying gain in competitiveness.

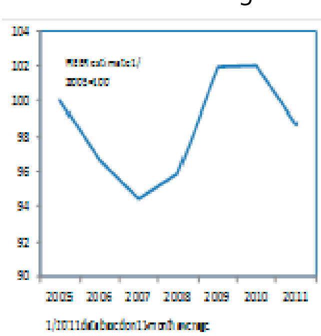
A look at the CPI-based REER estimates shows Montenegro's REER began to depreciate again in 2011. Montenegro's wage data show continued erosion in competitiveness stemming from its high labor costs. Over the past few years, gross wages have risen steadily while producer prices have been flat.

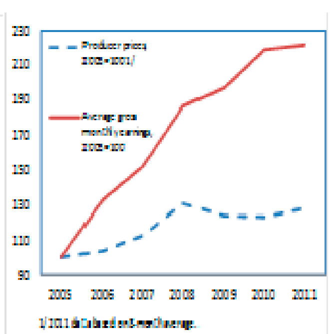
Current Account Balance Gap and Real Exchange Rate Overvaluation
In Macrobalances and External Sustainability Approaches
(in percent of GDP, unless otherwise specified)

	Macroeconomic Balance Approach	External Sustainability Approach
CA Norm 1/	7.0	NA
NFA-stabilizing CA	NA	-5.1
CA Balance	-24.5	-24.5
Gap	**17.5**	**19.4**

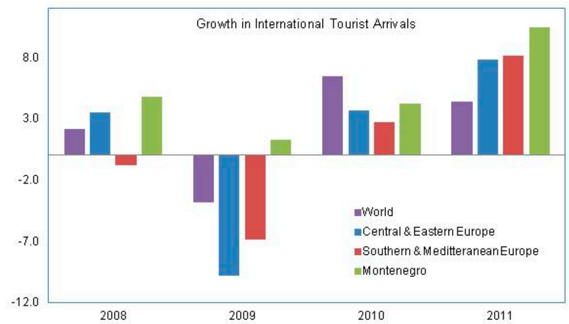
Source: IMF staff estimates
1/ Rahman, Jesmin (2008), "Current Account Developments in New Member States of the European Union: Equilibrium, Excess, and EU-Phoria," IMF Working Paper 08/92.

Montenegro's exports as a share of total world trade which began to decrease in 2008 have started to pick up again in 2011. On the other hand, its share of imports peaked in 2008 and has been declining ever since.





The sector that has contributed to increased external competiveness is tourism. The tourism competitiveness ranking has improved substantially owing to a better regulatory framework and infrastructure. Moreover the growth of international tourist arrivals into Montenegro has on average outpaced the growth rates seen at the regional and world levels in the past four years. Given its importance in the Montenegrin economy, it is essential that the tourism sector continues to make gains.



Competitiveness Ranking in the Tourism Sector

	Overall ranking		Regulatory framework		Business environment and infrastructure		Human, cultural, and natural resources	
	2009	2011	2009	2011	2009	2011	2009	2011
Spain	6	8	29	22	8	10	5	6
Cyprus	21	24	25	23	13	14	37	44
Greece	24	29	18	34	27	29	27	29
Italy	28	27	46	45	26	27	22	15
Malta	29	26	11	9	31	22	52	54
Croatia	34	34	43	42	37	36	43	43
Slovenia	35	33	38	29	33	33	61	53
Slovakia	46	54	34	39	54	57	55	52
Bulgaria	50	48	56	54	48	44	46	51
Montenegro	**52**	**36**	**50**	**32**	**66**	**49**	**35**	**36**
Turkey	56	50	63	66	60	55	44	28
Romania	66	63	61	51	64	66	77	66
Serbia	88	82	78	67	80	84	96	94
Albania	90	71	77	53	104	91	66	61

Source: World Economic Forum.
Note: Lower ranking indicates improvement.

B. Fiscal Policy

16. Despite a deterioration of the headline deficit in 2011, some tightening of the fiscal stance occurred. The authorities considered that the evolution of fiscal balances based on the GFSM accounting framework—which puts the overall deficit at a post-independence high of 6.3 percent of GDP because of the inclusion of guarantees at the time they are called—did not correctly reflect their fiscal efforts. Instead, they felt that it was preferable to include called loan guarantees in the fiscal accounts retroactively in the year in which they were extended. However, staff did not see a basis to depart from GFSM accounting.

- **Staff agreed that the payment of called-up loan guarantees in 2011 did not constitute a demand boost that year**, but rather in 2010 when the guarantees were extended and largely used to finance the metal firms' redundancy payments and arrears clearance.

Estmation of Fiscal Stance in 2010 and 11

		2008	2009	2010	2011
A	Overall fiscal deficit	3.1	5.3	4.7	6.3
	Loan guarantees to companies				
B	extended	0.0	2.6	3.5	2.1
C	called	0.0	0.0	0.0	1.0
D	Demand impact (A+B-C)	3.1	7.9	8.2	7.5
E	Stimulus (D(t)-D(t-1))	...	4.8	0.2	-0.7

- **No consensus was reached as to what extent the recently accelerating revenue shortfall reflected automatic stabilizers.** On the one hand, imbalances in the economy—especially still large absorption—inflated the tax base for indirect taxes beyond its structural and sustainable level, such that lower VAT collections may still be a structural rather than cyclical phenomenon. In addition, tax administration problems became apparent in the recently consolidated collection of income taxes and contributions, as the latter dropped far more than the former, despite being levied on largely the same tax base. On the other hand, the liquidity squeeze was arguably affecting taxpayers' ability to pay, though there were no firm data on the evolution of tax arrears.

17. However, the underlying deficit is still large and risks of further slippage are substantial. Staff noted that the underlying deficit remained too high. Moreover, revenue and expenditure trends in the first part of 2012 had resulted in a considerable slippage from the budget plan, while the uncertain situation surrounding KAP posed substantial risks that new contingent claims would materialize.

Box 2. Kombinat Aluminijuma Podgorica (KAP)

Kombinat Aluminijuma Podgorica (KAP) is the aluminum smelter in Montenegro. Up until recently, it has been operated by the Russian company Central European Aluminum Company (CEAC). The company acquired a majority share in KAP in 2005 when the plant was privatized. In 2010, the government retook half of CEAC's stake in exchange for loan guarantees. KAP accounted for 41 percent of the value of goods exported by Montenegro in 2011.

The plant currently suffers from significant operational inefficiencies and is neither competitive nor profitable without large investments in technology upgrades. In recent years, the company has been able to sustain operations only with the support of government-issued loan guarantees and energy subsidies that constitute an increasing drain on public finances. In addition, despite favorable aluminum prices in 2011, KAP has been running large payment arrears on its electricity bills. As the largest energy consumer in the country, the mounting receivables are in turn threatening the viability of the electricity producer. Without these subsidies, staff estimates show that KAP would have made a €21.9 million loss in 2011, or 0.7 percent of GDP. With €132 million of its €350 million debt covered by state guarantees, KAP is currently the biggest and most imminent fiscal risk.

While KAP remains an important contributor to Montenegro's exports, its overall macroeconomic impact has declined considerably over the past decade. The net impact on the balance of payments is mitigated by the imported inputs required (both electricity and alumina). Moreover, KAP has substantially reduced the number of workers in recent years and now accounts for only 0.8 percent of total employment. The direct impact on GDP from closing KAP due to decreased export is estimated at 1.3 percent (a similar estimate of 1.9 percent is obtained using the production approach). The short-term impact of closing down its operations would likely be substantially offset over the medium-term by efficiency gains realized from increased fiscal space, energy surplus, and reduced alumina import.

Estimated Impact of Closing down KAP

BOP (% GDP)	
Export	-5.7
Import	-3.9
Trade deficit	-1.8
Employment (% change)	-0.8
Cost of dismissal (% GDP)	0.1
Nominal GDP (% change)	
Expenditure approach	-1.3
Production approach	-1.9

18. The authorities aim at significant fiscal consolidation, targeting a deficit of 1.2 percent of GDP in 2012 and achieving balance in 2013 and were preparing a budget revision in light of the worsened outlook compared to the one assumed in the original 2012 budget. Staff considered these targets to be quite ambitious and cautioned that they will likely be missed again. Instead, the focus should be on urgent identification and implementation of high-quality structural deficit reducing measures that should reverse the debt dynamics quickly (See Debt Sustainability Analysis, Annex III).

19. Taxation and spending need to be brought closer in line, with the more sizeable adjustment from expenditure cuts. There was consensus that the revenue share remained at a comparatively high level, while expenditure stood at the top end of emerging Europe. Although some laudable progress was made on expenditure commitment controls, some deep-seated problems remain:

- **There was agreement that at some 12 percent of GDP, personnel spending is very large.** The authorities pointed to last year's adoption of their Personnel Policy paper, the resulting 2 percent staff cut, and the recent agreement with public sector unions to contain wage increases in 2012 and beyond. The staff welcomed these steps but cautioned that the complex triggers in the new agreement—tying the initiation of wage negotiations to growth and deficit performance—carried risks and that further staff cuts may be a more lasting solution.

Country / Country Group	General Government Expenses (2010, % of GDP)
Montenegro	45.9
Emerging Europe, flexible exchange rate	39.8
Emerging Europe, fixed exchange rate	39.9
Advanced Europe, non-Euro	45.4
Advanced Europe, Euro	48.7

- **The staff argued for further progress on entitlement spending,** in the first place by advancing pension reform in order to bring down the large pension deficit. Recent reform has already made important headway in reducing longer-term aging costs—but is not scheduled to be fully implemented for some time (2025 for men and 2040 for women). Similarly, the authorities should be ambitious in reforming social protection in order to ensure that benefits target the neediest and no longer serve as impediments to labor market participation.

- **Solutions need to be found to end the fiscal drain from supporting the metals sector.** The authorities intended to henceforth pursue a very strict policy limiting loan guarantees. They also considered that these companies' restructuring—though costly—had left them with a much leaner work force and lower costs, factors that would make them attractive to new owners. Noting the limited investor interest so far, staff was more skeptical and recommended an end to all fiscal and quasi-fiscal support. A second-best option would be raising new revenue to cover these plants' losses through a dedicated new tax; deficit financing of support should be eschewed in any event.

- **Staff also saw some scope to raise tax rates.** With the needed further rebalancing of the economy, the import-related tax base is expected to shrink. In order to protect the revenue share, rate increases are likely necessary. Staff noted that VAT and income tax rates are below levels in the region and the same is true for the tax wedge on labor. Limited rate increases would thus not significantly impede new employment. Moreover, flanking any rate increases by reducing poverty traps—for example by introducing an Earned Income Tax Credit—would provide an important boost for formal employment and tax collection. There is also considerable scope to increase revenue from property taxation by a combination of higher rates, better valuation, and an improved cadastre. On the other hand, care needs to be taken in raising indirect taxes in order not to heighten cost in the tourism sector. The authorities noted their desire to increase excises during the EU accession process but were unconvinced of the case for other tax-policy measures, citing the need to protect Montenegro's reputation as a low tax country.

Country	Marginal Tax Wedge on Labor	Prescott Tax Wedge	Lowest PIT Rate	Employee's SSC	Employer's SSC	Standard VAT Rate
Montenegro	**42.8**	**51.1**	**9**	**24**	**9.8**	**17**
Albania	42.9	52.4	10	11.2	21.7	20
Bosnia & Herzegovina	51.5	58.5	10	31	10.5	17
Croatia	48.7	58.3	12	20	16.7	23
Macedonia, FYR	66	71.2	10	28	28	18
Serbia, Republic of	45.8	54.1	10	17.9	17.9	18
Slovenia	54.2	61.8	16	22.1	16.1	20

Note: Based on various sources of information.
The Prescott tax wage seeks to account for the impact of consumption taxes on the labor-leisure choice. For details see Bell and Tawara (2009), IMF WP/09/92.
i) 2011 Staff Report; ii) Tax comparison table prepared by Ruud De Mooij.

C. Financial Sector

20. The discussions were framed by the uncertainty about a viable post-boom banking business model. There was agreement that the uncertainty called for ongoing focus on protecting macrofinancial stability and liquidity as deleveraging evolves. The need for additional buffers arose from the unilateral use of the euro in Montenegro which essentially rules out significant central bank liquidity injections. Weaker foreign owners and liquidity stretched domestic ones further add to the challenges. There was broad agreement on the following elements:

- **Direct efforts to force more lending are unlikely to work and would probably require resources from the already stretched budget**. While political concerns had arisen from the ongoing lending drought, and some big banks had stopped lending, other banks considered that there was a shortage of profitable lending opportunities. Central Bank and staff agreed that this called for further structural reforms.

- **Intense supervisory presence in banks and aggressive enforcement of regulations across the system:** The risk profile and capital needs of individual banks should be carefully examined, including through the recently upgraded stress testing framework. Bank owners must meet capital shortfalls expeditiously or face sanctions. The Central Bank of Montenegro (CBCG) also plans to soon phase out temporary regulatory relaxations of prudential regulation and in their place adopt a permanent framework, which should be fully in line with international best practice.

- **Continued efforts to improve asset quality:** The recent offloading of troubled assets to factoring companies, other investors, and parent banks needs tight monitoring, e.g., to guard against asset stripping. The CBCG pointed to its recent adoption of relevant regulations and broader work to formulate legislation. Staff stressed that further concerted efforts by the government, CBCG, and other relevant entities to improve the framework and processes related to the execution of collateral are also essential.

- **Raising and monitoring liquidity:** The CBCG has stepped up efforts to monitor liquidity. While the government saw a case for raising the share of reserve requirements that may be held in treasury bills, staff and Central Bank remained unconvinced, stressing that doing so would impart additional risks and distort incentives for credit extension. Instead, staff recommended general reductions in reserve requirements once further gains in confidence and stability are made.

- **Further improving the framework for crisis preparedness and banking resolution:** Considerable progress has been made in recent years, including the passing of a set of financial sector legislation and the creation of the Financial Stability Council (FSC) for cross agency cooperation. Further improvements should include concrete contingency plans. The ongoing work on a national contingency plan, in keeping with a decision by the FSC in its first meeting, and following Fund staff technical assistance, is therefore welcome.

D. Structural Reform

21. There was broad agreement that further ambitious structural reform can achieve the essential rebalancing without sacrificing growth by unleashing Montenegro's large potential, especially in the energy and tourism sectors.

22. Labor market reform deserves priority status. A common factor in recent reform backsliding has been labor related, as difficulties in redressing overstaffing have loomed large in the problems in the metals sector. Staff called for further reform of labor legislation, importantly by making regular contracts more attractive for employers, including by giving greater scope to opt out from collective bargaining arrangements. Staff and authorities also saw scope to use public expenditure reforms—for example of social transfers—as a way to reduce unemployment traps.

23. The business environment needs nurturing and improvement. The authorities are focused on redressing gaps indicated in various business environment surveys, notably deficiencies in the time required to obtain construction permits and complete registration procedures, particularly at the municipal level. Staff noted that the recent public complaints about regulatory shortfalls or legal proceedings by foreign investors in the metals and energy sectors could imply adverse repercussions for Montenegro's reputation as an investment destination and encouraged the authorities to demonstrate their commitment to arm's length and rules-based relation with business, while continuing to streamline investment procedures.

24. Staff also stressed that liquidations and work-outs in the metals sector could be used to improve efficiency and productivity. Liquidations could well arise when public support stops, but would permit whatever parts of the enterprises that remain viable to be sold. Moreover, by now these companies' direct employment effect is small as is their contribution to value added and the balance of payments, if properly measured (Box 2).

25. Continued improvements in economic statistics are also essential. Although there has been significant improvement in the number and timely release of high frequency indicators, inconsistencies across some indicators remain a problem. National accounts data are currently published only annually and with significant lags. External data are subject to frequent revisions, and there is evidence of continued export underreporting. Achieving data accuracy and timeliness will further contribute towards sound policymaking.

STAFF APPRAISAL

26. The Montenegrin economy has recorded valuable progress since the financial crisis. With GDP growth estimated at some 2½ percent in 2011, real output has almost reached its pre-crisis level in 2008. In addition, confidence in the banking system is recovering with deposits continuing to grow, while foreign direct investment remained above one tenth of GDP.

27. However, the recovery is now at risk of stalling. Economic activity indicators have slowed sharply as the boost from tourism has worn off, problems in the metals sector re-emerged, and the international environment turned more challenging. Liquidity is tight and the debt overhang hampers credit growth. After a very rapid buildup of public debt that served to offset the drag from private deleveraging, fiscal policy is now constrained. Accordingly GDP is projected to only record modest growth in 2012.

28. Current policies risk sub-par economic performance. While the economy's small size and high openness impart a large degree of uncertainty on forecasts and projections, medium-term prospects are imperiled by large fiscal and external imbalances, even if the international context turns more auspicious. Ambitious structural reform can unleash Montenegro's large potential, e.g., in the energy and tourism sectors.

29. The steep upward trajectory of public debt needs to be urgently reversed. This requires bringing taxation and spending closer in line in order to redress the large persistent fiscal deficits, which have withstood strong efforts at expenditure control and ambitious consolidation targets.

30. Specific deficit-cutting measures should be identified. Budget targets should be ambitious, yet achievable. The focus should be on urgent identification and implementation high-quality structural deficit reducing measures in order to reverse the debt dynamics quickly.

31. The more sizeable fiscal adjustment needs to come from expenditure cuts. The revenue share remains at a comparatively elevated level, while expenditure stands at the high end of emerging Europe. The very large personnel bill must be brought down and the recent sharp growth in entitlement spending reversed—notably by advancing pension reform. The fiscal drain from the aluminum and steel plants must be arrested by ending all fiscal and quasi-fiscal support.

32. There is scope to raise tax rates and strengthen tax administration. VAT and income tax rates are below levels in the region. The same is true for the tax wedge on labor. Limited rate increases would thus not significantly impede new employment, though care needs to be taken in raising indirect taxes in order not to heighten cost in the tourism sector. Moreover, flanking any rate increases by reducing poverty traps—for example by introducing an Earned Income Tax Credit—would provide an important boost for formal employment and tax collection.

33. Despite welcome stabilization, the banking system still has some way to go. A recovery in deposits together with a sharp slowdown in lending lowered the loan to deposit ratio. Still, the system remains burdened by high non-performing loans—notwithstanding their recent sharp decline—and is lagging in provisioning. Moreover, unilateral use of the euro in Montenegro essentially rules out significant central bank liquidity injections, thus requiring higher prudential buffers than elsewhere.

34. Continued vigilance is necessary to foster stability and create a sustainable foundation for a more broad-based resumption of lending. Supervision and regulatory enforcement need further strengthening, and bank owners must meet capital shortfalls expeditiously or face sanctions. Further efforts to improve asset quality and the framework and processes related to the execution of collateral are also essential. Administrative efforts to boost credit growth or direct lending to certain sectors should be eschewed as should selective relaxations of the reserve requirement.

35. Labor market reform needs to target employment creation. The well-functioning market for non-resident employment should serve as the model to redress poor labor market performance, characterized by high unemployment, low labor force participation, and a growing share of the long-term unemployed. The labor law must reduce hiring and firing costs and provide greater scope to opt out from collective bargaining arrangements. Social protection schemes should be reformed to ensure that benefits target the neediest and no longer serve as impediments to labor market participation.

36. The business environment needs nurturing and improvement. Montenegro has recorded steady progress in various business environment surveys. Still, the time required to obtain construction permits and complete registration procedures, particularly at the municipal level, continues to hamper new investment. Arm's length and rules-based relation with business will also anchor Montenegro's reputation as a safe haven for foreign investment. Continued improvements in economic statistics are also essential.

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

Figure 1. Montenegro: Comparative Economic Trends Since Independence (2006-11)

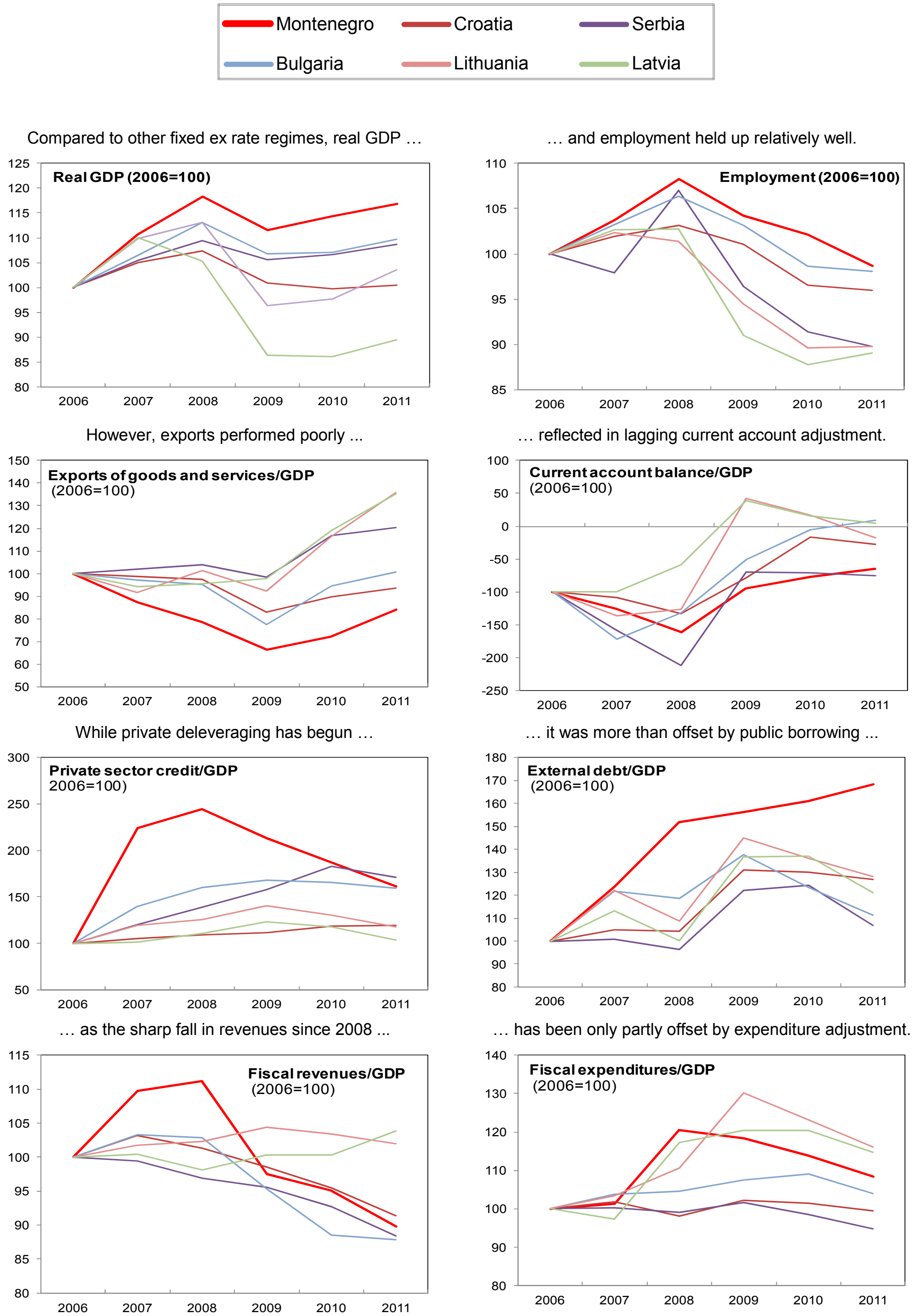


Figure 2. Montenegro: Real Sector Developments in 2011

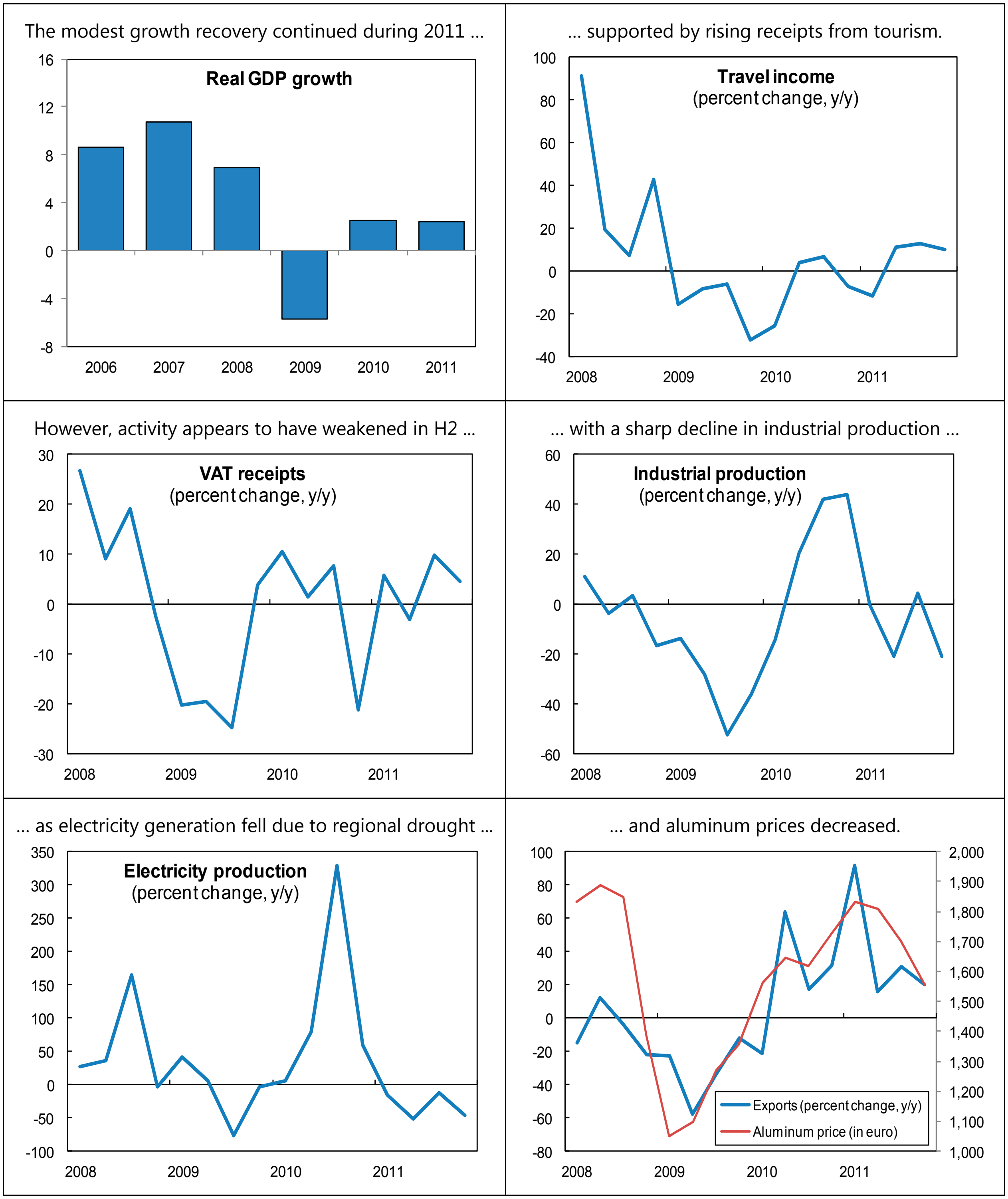


Figure 3. Montenegro: Financial Sector Developments in 2011

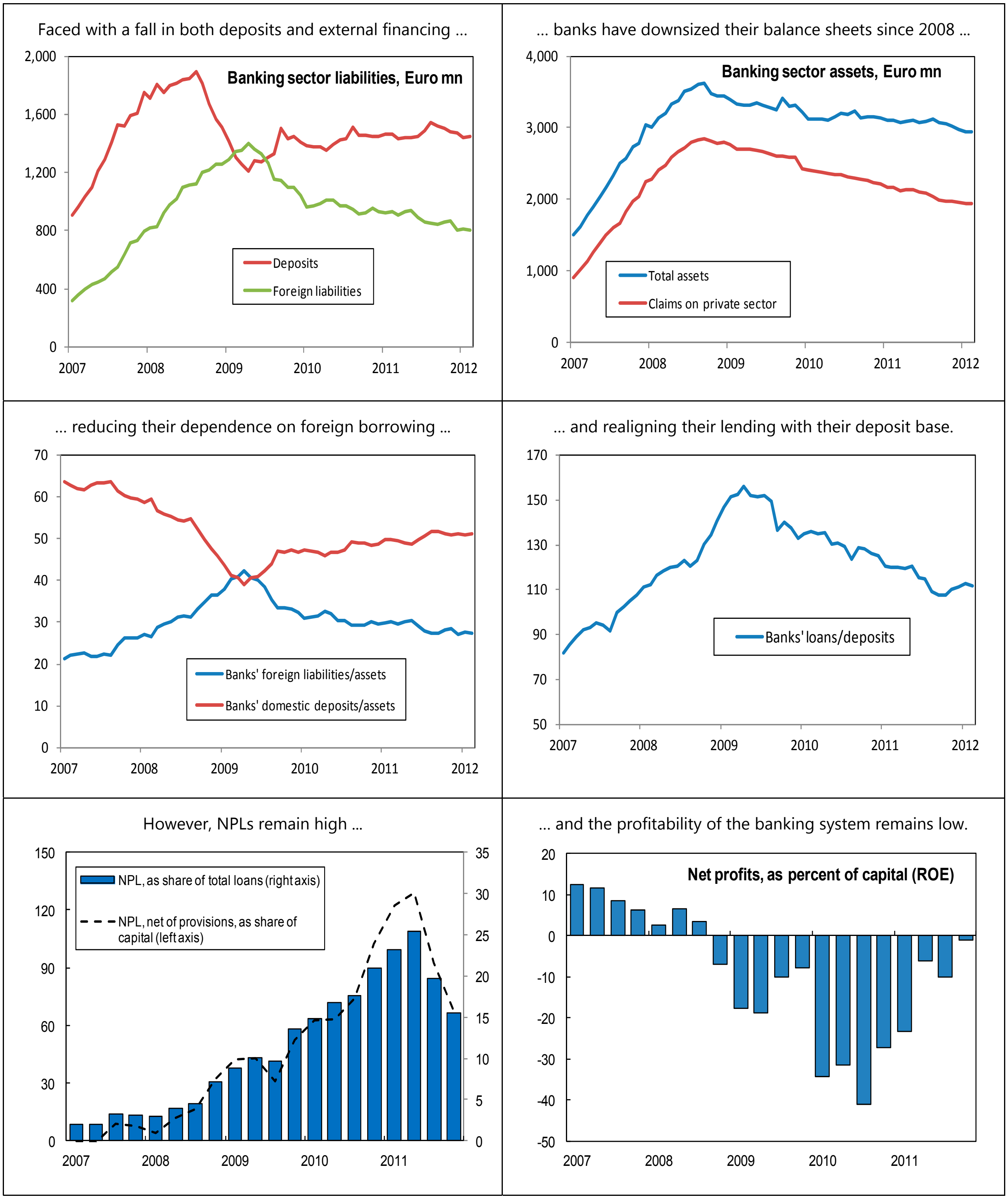


Figure 4. Montenegro: Fiscal Developments in 2011

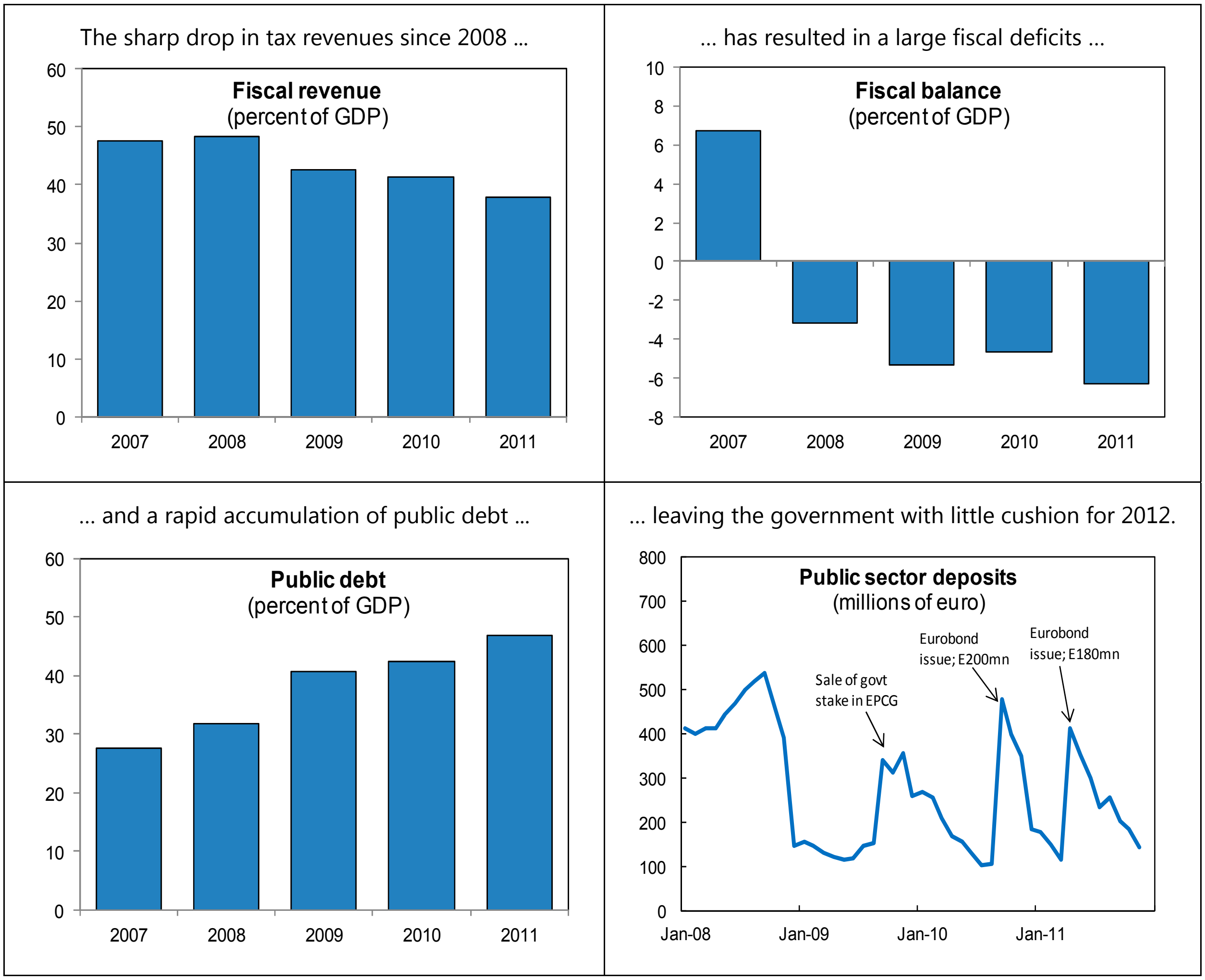
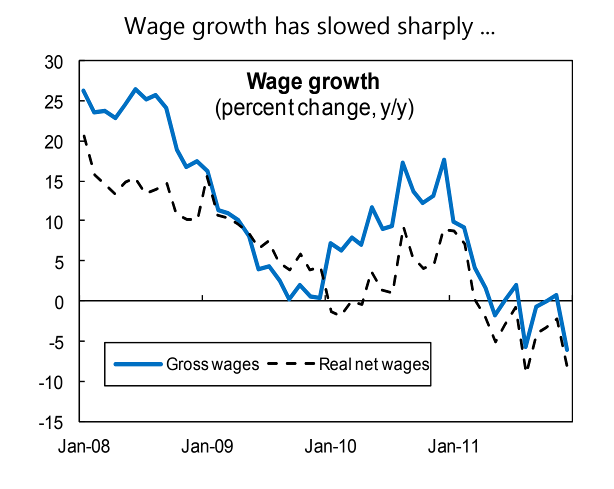


Figure 5. Montenegro: Labor Market Indicators



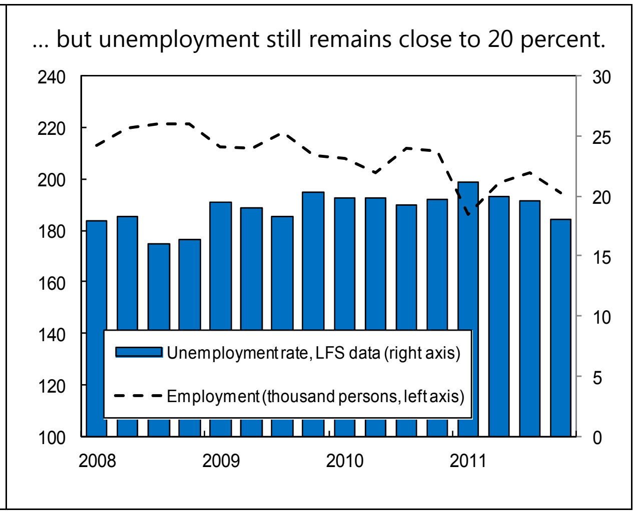


Table 1. Montenegro: Selected Economic Indicators, 2007–16
(Under current policies)

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
					Est.	Projections				
Real economy										
Nominal GDP (millions of €)	2,680	3,086	2,981	3,104	3,260	3,334	3,449	3,601	3,753	3,899
Gross national saving (percent of GDP)	-5.1	-10.0	-3.1	-2.6	-1.2	-0.6	-0.4	0.0	1.1	1.8
Gross investment (percent of GDP)	33.8	40.7	27.1	22.8	19.4	20.3	20.9	21.2	21.7	22.2
					(percent change)					
Real GDP	10.7	6.9	-5.7	2.5	2.5	0.2	1.5	2.0	2.0	2.0
Industrial production	0.1	-2.0	-32.2	17.5	-10.3	…	…	…	…	…
Tourism										
Arrivals	18.8	4.8	1.6	4.6	8.7	…	…	…	…	…
Nights	22.9	6.9	-3.1	5.5	10.2	…	…	…	…	…
Consumer prices (period average)	3.5	9.0	3.6	0.7	3.1	2.0	1.1	1.3	1.3	1.3
Consumer prices (end of period)	6.3	7.2	1.7	0.7	2.8	1.7	1.3	1.3	1.3	1.3
GDP deflator	12.7	7.7	2.4	1.6	2.5	2.1	1.9	2.3	2.2	1.8
Average net wage (12-month) 1/	19.9	23.1	11.3	3.5	1.0	…	…	…	…	…
Money and credit (end of period)										
Bank credit to private sector	180.5	25.0	-15.1	-8.9	-13.0	…	…	…	…	…
Enterprises	199.3	21.3	-18.0	-11.2	-17.6	…	…	…	…	…
Households	153.5	31.2	-10.7	-5.7	-2.6	…	…	…	…	…
Private sector deposits	102.7	-14.2	-4.1	5.9	1.2	…	…	…	…	…
General government finances (accrual) 2/					(as percent of GDP)					
Revenue and grants	47.7	48.4	42.6	41.3	37.9	38.0	38.0	38.1	38.1	38.1
Expenditure	40.9	51.5	47.9	46.0	44.2	43.2	42.3	42.1	42.6	42.8
Overall balance	6.7	-3.1	-5.3	-4.7	-6.3	-5.2	-4.3	-4.1	-4.5	-4.7
Primary balance	7.8	0.5	-4.4	-3.7	-4.6	-3.3	-2.1	-1.6	-1.7	-1.7
Domestic financing (net)	-7.7	2.1	-3.2	-1.4	2.4	0.4	-0.7	-0.5	1.1	1.1
Privatization receipts	4.0	1.2	4.4	0.9	0.5	0.5	0.5	0.5	0.4	0.4
General government gross debt (end of period, stock)	27.5	31.9	40.7	42.4	46.9	50.2	52.1	53.2	54.8	56.7
Balance of payments										
Current account balance	-39.5	-50.6	-29.6	-24.6	-19.4	-19.7	-20.0	-19.9	-19.3	-19.1
Foreign direct investment	21.2	18.9	35.8	17.8	11.9	11.4	12.4	13.3	14.2	15.1
External debt (end of period, stock)	74.1	90.8	93.5	96.4	99.9	107.3	114.5	120.7	126.5	133.3
Of which: Private sector 3/	56.9	75.2	70.0	67.0	67.3	71.1	75.0	78.8	83.2	88.4
REER (CPI-based; annual average change, in percent) (- indicates depreciation)	-2.3	1.6	6.4	0.0	-3.2	…	…	…	…	…
Memorandum:										
Aluminum price (€ per tonne)	1,926	1,752	1,198	1,638	1,725	1,785	1,878	1,965	2,033	2,095

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/ Estimates, as private debt statistics are not officially published.

Table 2. Montenegro: Macroeconomic Framework, 2007–16

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

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
					Est.	Projections				
Real GDP (percent change)	10.7	6.9	-5.7	2.5	2.5	0.2	1.5	2.0	2.0	2.0
Consumer prices (percent change, end-period)	6.3	7.2	1.7	0.7	2.8	1.7	1.3	1.3	1.3	1.3
Gross domestic savings	-8.5	-13.8	-6.2	-5.6	-5.6	-4.3	-3.6	-2.8	-1.4	-0.3
Non-government	-22.2	-20.5	-9.1	-5.7	-3.3	-2.5	-2.7	-2.3	-0.5	0.8
Government	13.7	6.6	3.0	0.1	-2.3	-1.8	-0.9	-0.5	-1.0	-1.2
Gross domestic investment	33.8	40.7	27.1	22.8	19.4	20.3	20.9	21.2	21.7	22.2
Non-government	26.8	30.6	18.7	17.5	15.3	16.8	17.3	17.5	18.0	18.5
Government	7.0	10.1	8.4	5.3	4.1	3.6	3.6	3.7	3.7	3.7
Net factor receipts and transfers from abroad	3.4	3.9	3.0	3.0	4.4	3.7	3.2	2.9	2.5	2.2
Non-government	4.0	3.9	3.4	3.2	5.5	5.1	4.9	4.9	4.9	4.7
Government	-0.6	-0.1	-0.3	-0.2	-1.1	-1.4	-1.7	-2.0	-2.4	-2.6
Gross national savings	-5.1	-10.0	-3.1	-2.6	-1.2	-0.6	-0.4	0.0	1.1	1.8
Non-government	-18.2	-16.6	-5.8	-2.6	2.1	2.5	2.2	2.5	4.4	5.5
Government	13.1	6.6	2.6	0.0	-3.4	-3.2	-2.5	-2.5	-3.3	-3.7
Non-government national savings minus investment	-45.0	-47.2	-24.5	-20.0	-13.1	-14.2	-15.1	-15.0	-13.6	-13.0
Savings - investment balance	-38.9	-50.7	-30.3	-25.4	-20.6	-20.9	-21.2	-21.2	-20.6	-20.4
Non-government	-45.0	-47.2	-24.5	-20.0	-13.1	-14.2	-15.1	-15.0	-13.6	-13.0
Government	6.1	-3.5	-5.8	-5.4	-7.5	-6.7	-6.1	-6.2	-7.0	-7.4
General government finances										
Revenues and grants	47.7	48.4	42.6	41.3	37.9	38.0	38.0	38.1	38.1	38.1
Expenditures	40.9	51.5	47.9	46.0	44.2	43.2	42.3	42.1	42.6	42.8
Current	33.9	41.5	39.5	40.7	40.0	39.6	38.7	38.4	38.9	39.1
Capital	7.0	10.1	8.4	5.3	4.1	3.6	3.6	3.7	3.7	3.7
Overall balance	6.7	-3.1	-5.3	-4.7	-6.3	-5.2	-4.3	-4.1	-4.5	-4.7
Public debt (gross)	27.5	31.9	40.7	42.4	46.9	50.2	52.1	53.2	54.8	56.7
Current account balance	-39.5	-50.6	-29.6	-24.6	-19.4	-19.7	-20.0	-19.9	-19.3	-19.1
Foreign direct investment (net)	21.2	18.9	35.8	17.8	11.9	11.4	12.4	13.3	14.2	15.1
External debt	74.1	90.8	93.5	96.4	99.9	107.3	114.5	120.7	126.5	133.3
Memorandum items:										
Net export of goods and services	-42.3	-54.5	-33.3	-28.4	-25.0	-24.6	-24.5	-24.1	-23.1	-22.5
Nominal GDP (millions of €)	2,680	3,086	2,981	3,104	3,260	3,334	3,449	3,601	3,753	3,899

Sources: Statistical Office of Montenegro, Ministry of Finance; and IMF staff estimates and projections.

Table 3. Montenegro: Summary of Accounts of the Financial System, 2007–2012

(Millions of euros)

	2007	2008	2009	2010	2011	2012 Proj.
			I. Central Bank			
Net foreign assets	468	313	369	386	273	218
Assets	468	313	397	416	303	249
Liabilities	0	0	28	30	31	31
Net domestic assets	-417	-250	-310	-321	-191	-136
Net credit to the nonfinancial public sector	-98	-11	-96	-71	-18	-8
Of which: general government	-98	-11	-96	-71	-18	-8
Net credit to the banking system	-343	-263	-239	-277	-207	-169
Required reserves	-259	-217	-134	-134	-129	-136
Giro account	-83	-46	-104	-142	-77	-32
Claims on depository institutions	0	-1	-1	-1	-1	-1
Other assets net	24	24	26	27	35	41
Deposits included in broad money	6	12	13	19	22	22
Equity	44	51	46	47	61	61
			II. Banking System			
Net foreign assets	-457	-1,007	-712	-532	-348	-256
Assets	342	250	328	399	456	520
Liabilities	799	1,257	1,040	932	804	776
Net domestic assets	2,315	2,738	2,446	2,327	2,085	2,060
Net assets held in the central bank	342	262	238	276	206	168
Net credit to nonfinancial public sector	-220	-265	-115	-69	37	40
Of which: general government	-195	-238	-92	-70	64	40
Credit to the private sector	2,151	2,696	2,276	2,076	1,808	1,787
Other domestic assets	41	46	47	44	34	65
Liabilities	1,858	1,731	1,734	1,795	1,737	1,804
Private sector deposits	1,548	1,328	1,273	1,349	1,365	1,438
Other items, net	310	403	461	446	372	366
o/w capital	237	279	332	311	318	318
			III. Consolidated System			
Net foreign assets	11	-694	-342	-146	-75	-38
Net domestic assets	1,897	2,489	2,136	2,007	1,894	1,924
Net credit to the nonfinancial public sector	-318	-276	-212	-140	18	32
Of which: general government	-293	-249	-189	-140	46	32
Credit to the private sector	2,151	2,696	2,276	2,076	1,808	1,787
Other net domestic assets	64	69	72	71	67	106
Liabilities	1,864	1,743	1,747	1,814	1,758	1,825
Equity capital of the central bank	44	51	46	47	61	61
			IV. Ratios			
Reserves ratio	22.1	19.7	18.7	20.5	15.1	11.7
Effective required reserves ratio	16.7	16.3	10.6	9.9	9.5	9.5
Credit to private sector / GDP	80.3	87.4	76.4	66.9	55.5	53.6
Banks' capital / credit to private sector	11.0	10.4	14.6	15.0	17.6	17.8
CBCG reserves / bank deposits	30.2	23.6	31.2	30.9	22.2	17.3
Banks' foreign liabilities / lending	37.1	46.6	45.7	44.9	44.4	40.0

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

Table 4. Montenegro: Balance of payments, 2007-16
(Under current policies)

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
					Est.	Projections				
	(Millions of euros)									
Current account balance	-1,059	-1,561	-881	-764	-634	-657	-689	-717	-726	-745
Trade balance	-1,544	-2,025	-1,322	-1,267	-1,306	-1,322	-1,367	-1,426	-1,494	-1,561
Exports	483	450	296	357	477	493	516	540	566	593
Imports	-2,028	-2,476	-1,618	-1,624	-1,783	-1,815	-1,883	-1,966	-2,060	-2,154
Services account	395	346	350	410	530	542	566	605	674	732
Receipts	673	751	680	747	847	853	889	941	1,025	1,098
Expenditures	-278	-405	-331	-337	-317	-311	-322	-337	-352	-366
Income account	31	46	5	-22	26	4	-11	-25	-39	-54
Compensation of employees, net	75	137	150	150	168	172	178	185	193	201
Investment income, net	-43	-91	-144	-172	-142	-167	-189	-210	-232	-255
Current transfers, net	59	73	85	114	116	119	123	128	134	139
Government, net	2	9	5	16	5	5	5	5	5	6
Other sectors, net	57	64	80	98	112	114	118	123	128	133
Capital and financial account	1,204	1,170	613	388	166	138	183	186	174	234
Foreign direct investment, net	568	582	1,066	552	389	381	429	480	534	590
Portfolio investment, net	5	-16	-42	-12	-16	-24	-25	-26	-27	-28
Other investments, net	633	604	-414	-152	-203	-219	-220	-268	-332	-328
General government	-61	-7	141	209	133	40	34	-5	-47	-24
Commercial banks	416	551	-303	-176	-206	-91	-89	-93	-97	-101
Other sectors	278	61	-252	-185	-130	-167	-165	-170	-189	-203
Errors and omissions	5	235	353	393	353	361	374	390	407	423
Unidentified financing	0	0	0	0	0	103	122	153	161	152
Change in official reserves (- denotes increase)	-151	155	-85	-17	114	55	11	-11	-17	-63
Memorandum items	(percent of GDP)									
Current account balance	-39.5	-50.6	-29.6	-24.6	-19.4	-19.7	-20.0	-19.9	-19.3	-19.1
Trade balance	-57.6	-65.6	-44.3	-40.8	-40.1	-39.6	-39.6	-39.6	-39.8	-40.0
Exports	18.0	14.6	9.9	11.5	14.6	14.8	15.0	15.0	15.1	15.2
Imports	-75.7	-80.2	-54.3	-52.3	-54.7	-54.4	-54.6	-54.6	-54.9	-55.2
Services account	14.7	11.2	11.7	13.2	16.3	16.2	16.4	16.8	18.0	18.8
Receipts	25.1	24.3	22.8	24.1	26.0	25.6	25.8	26.1	27.3	28.2
Payments	-10.4	-13.1	-11.1	-10.8	-9.7	-9.3	-9.3	-9.3	-9.4	-9.4
Income account	1.2	1.5	0.2	-0.7	0.8	0.1	-0.3	-0.7	-1.0	-1.4
Current transfers, net	2.2	2.4	2.9	3.7	3.6	3.6	3.6	3.6	3.6	3.6
Foreign direct investment, net	21.2	18.9	35.8	17.8	11.9	11.4	12.4	13.3	14.2	15.1
Portfolio investment, net	0.2	-0.5	-1.4	-0.4	-0.5	-0.7	-0.7	-0.7	-0.7	-0.7
Other investment, net	23.6	19.6	-13.9	-4.9	-6.2	-6.6	-6.4	-7.4	-8.9	-8.4
Errors and omissions	0.2	7.6	11.9	12.7	10.8	10.8	10.8	10.8	10.8	10.8
Gross external debt 1/	74.1	90.8	93.5	96.4	99.9	107.3	114.5	120.7	126.5	133.3

Sources: Central Bank of Montenegro; and IMF staff estimates.
1/ This includes only estimates of private external debt as private debt statistics are not officially published.

Table 5a . Montenegro: Consolidated General Government Fiscal Operations, 2009-2016 1/
(Millions of Euro)

	2009	2010	2011	2011	2012	2013	2014	2015	2016
	Act.	Act.	Prel. (cash)	Prel.	Proj.	Proj.	Proj.	Proj.	Proj.
Total revenues and grants	1271.1	1283.1	1235.6	1235.6	1266.7	1311.4	1370.3	1429.5	1486.3
Total revenues	1259.5	1277.2	1227.8	1227.8	1264.7	1309.3	1368.2	1427.3	1483.9
Current revenues	1250.8	1268.4	1227.8	1227.8	1264.7	1309.3	1368.2	1427.3	1483.9
Taxes	795.7	757.2	789.4	789.4	826.5	856.0	895.0	934.0	971.5
Personal income tax	121.4	115.1	112.4	112.4	121.4	125.6	131.1	136.6	141.9
Corporate income tax	54.7	20.3	35.9	35.9	34.2	35.4	37.0	38.5	40.0
Taxes on turnover of real estate right	19.8	16.5	15.7	15.7	12.9	13.3	13.9	14.5	15.0
Value added tax	370.8	364.2	390.2	390.2	402.6	417.4	437.0	456.8	475.7
Excises	128.7	134.3	141.7	141.7	161.8	167.4	174.8	182.2	189.2
Taxes on international trade	49.1	50.8	45.1	45.1	52.9	54.7	57.1	59.5	61.9
Local government taxes	42.3	44.6	44.2	44.2	37.6	38.8	40.6	42.3	43.9
Other taxes	8.9	11.6	4.1	4.1	3.3	3.4	3.5	3.7	3.8
Social security contributions	268.9	347.6	307.3	307.3	318.7	329.7	344.2	358.8	372.7
Nontax revenues	186.2	163.6	131.1	131.1	119.4	123.5	129.0	134.4	139.7
Duties	29.0	26.3	21.9	21.9	25.0	25.9	27.0	28.1	29.2
Fees	105.6	102.0	72.4	72.4	51.4	53.2	55.5	57.9	60.1
Other revenues	51.6	35.3	36.9	36.9	43.0	44.5	46.5	48.4	50.3
Capital revenues	8.7	8.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Grants	11.6	5.9	7.8	7.8	2.0	2.1	2.2	2.3	2.3
Total expenditures and net lending	1428.8	1428.3	1399.4	1439.4	1440.9	1460.8	1517.8	1599.3	1670.4
Total expenditures	1465.3	1428.2	1399.2	1439.2	1441.9	1461.8	1518.6	1600.2	1671.2
Current expenditures	629.4	661.4	655.0	677.5	741.1	725.0	749.0	798.9	839.7
Gross salaries	331.1	354.3	362.6	362.6	371.7	371.8	372.1	387.8	402.9
Other personal income	27.7	24.6	20.1	20.1	15.7	15.8	16.0	16.7	17.3
Goods and services	176.1	194.9	148.0	169.6	203.8	210.8	220.1	229.4	238.3
Interest payments	25.4	31.4	52.7	52.7	63.0	77.9	90.9	107.1	119.5
Rent	8.8	8.6	7.8	7.8	8.2	8.2	8.2	8.6	8.9
Subsidies to enterprises 2/	51.0	39.8	46.4	46.4	68.4	30.0	31.0	38.3	41.3
Other outflow s 2/	9.3	7.9	17.6	18.4	10.3	10.5	10.6	11.1	11.5
Social security transfers	413.1	423.6	455.5	455.5	477.9	508.5	530.6	553.0	574.5
Other transfers	157.1	161.6	113.2	130.7	69.6	71.4	73.1	76.2	79.1
Capital expenditures	251.2	165.8	135.0	135.0	119.8	124.5	133.5	139.1	144.5
Capital transfers	0.0	0.0	26.3	26.3	22.0	22.0	22.0	22.0	22.0
Reserves	14.5	15.8	14.1	14.1	11.5	10.4	10.5	10.9	11.3
Net lending	-36.5	0.1	0.2	0.2	-1.0	-1.0	-0.8	-0.8	-0.8
Overall Balance	-157.7	-145.2	-163.8	-203.8	-174.2	-149.4	-147.5	-169.8	-184.1
Financing	157.7	145.2	163.8	203.8	174.2	149.4	147.5	169.8	184.1
Domestic financing	-95.3	-42.5	36.7	76.7	13.2	-24.4	-18.0	40.0	41.8
Use of gov. deposits	-65.3	66.9	92.8	92.8	10.6	8.6	8.6	15.0	15.0
Net borrow ings from other domestic sources	-30.0	-109.4	-56.1	-16.1	2.5	-33.0	-26.6	25.0	26.8
New borrow ing (disbursement)	125.7	42.1	49.1	49.1	56.0	6.0	5.0	10.0	10.0
Repayment of principal (amortization)	-76.7	-62.1	-37.3	-37.3	-27.5	-29.4	-26.9	-30.0	-30.0
Net repayment of previous liabilities	-79.0	-89.4	-67.8	-27.8	-26.0	-9.6	-4.7	45.0	46.8
Net repayment of liabilities other than budget arrears	-62.9	-61.7	-26.8	-26.8	...	...	...	...	...
Accumulation of new budget arrears	29.1	61.8	0.0	40.0	...	...	...	...	...
Repayment of prior arrears	-45.2	-89.5	-41.0	-41.0	...	...	...	...	...
Foreign financing	123.2	160.3	126.9	126.9	39.7	33.9	-5.3	-46.6	-24.3
Borrow ing	148.6	205.7	189.4	189.4	111.1	104.2	78.5	200.0	200.0
Repayment	-25.4	-45.3	-62.5	-62.5	-71.4	-70.3	-83.8	-246.6	-224.3
Privatization receipts	129.8	27.4	14.9	14.9	18.0	18.0	18.0	15.0	15.0
Unidentified	0.0	0.0	-14.7	-14.7	103.4	121.9	152.8	161.4	151.6
Memorandum items:									
Primary balance	-132.2	-113.8	-111.1	-151.1	-111.2	-71.5	-56.6	-62.7	-64.6
Overall balance excluding loan guarantee payments	-157.7	-145.2	-137.5	-177.5	-152.2	…	…	…	…
Stock of net public debt	965.2	1151.0	1444.5	1444.5	1600.7	1732.1	1861.6	2016.4	2185.5
Discrepancy (=net debt stock change - debt financing) 3/	118.5	68.0	159.3	119.3	0.0	0.0	0.0	0.0	0.0
Stock of public guarantees	149.9	351.5	380.8	380.8	...	...	...	...	...

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.

3/ Part of the discrepancy is due to new issuance of restitution bonds and court rulings, both leading to increase of government liabilities.

Table 5b. Montenegro: Consolidated General Government Fiscal Operations, 2009-2016 1/
(In percent of GDP)

	2009 Act.	2010 Act.	2011 Prel. (cash)	2011 Prel.	2012 Proj.	2013 Proj.	2014 Proj.	2015 Proj.	2016 Proj.
Total revenues and grants	42.6	41.3	37.9	37.9	38.0	38.0	38.1	38.1	38.1
Total revenues	42.3	41.1	37.7	37.7	37.9	38.0	38.0	38.0	38.1
Current revenues	42.0	40.9	37.7	37.7	37.9	38.0	38.0	38.0	38.1
Taxes	26.7	24.4	24.2	24.2	24.8	24.8	24.9	24.9	24.9
Personal income tax	4.1	3.7	3.4	3.4	3.6	3.6	3.6	3.6	3.6
Corporate income tax	1.8	0.7	1.1	1.1	1.0	1.0	1.0	1.0	1.0
Taxes on turnover of real estate right	0.7	0.5	0.5	0.5	0.4	0.4	0.4	0.4	0.4
Value added tax	12.4	11.7	12.0	12.0	12.1	12.1	12.1	12.2	12.2
Excises	4.3	4.3	4.3	4.3	4.9	4.9	4.9	4.9	4.9
Taxes on international trade	1.6	1.6	1.4	1.4	1.6	1.6	1.6	1.6	1.6
Local government taxes	1.4	1.4	1.4	1.4	1.1	1.1	1.1	1.1	1.1
Other taxes	0.3	0.4	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Social security contributions	9.0	11.2	9.4	9.4	9.6	9.6	9.6	9.6	9.6
Nontax revenues	6.2	5.3	4.0	4.0	3.6	3.6	3.6	3.6	3.6
Duties	1.0	0.8	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Fees	3.5	3.3	2.2	2.2	1.5	1.5	1.5	1.5	1.5
Other revenues	1.7	1.1	1.1	1.1	1.3	1.3	1.3	1.3	1.3
Capital revenues	0.3	0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Grants	0.4	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.1
Total expenditures and net lending	47.9	46.0	42.9	44.2	43.2	42.3	42.1	42.6	42.8
Total expenditures	49.2	46.0	42.9	44.2	43.2	42.4	42.2	42.6	42.9
Current expenditures	21.1	21.3	20.1	20.8	22.2	21.0	20.8	21.3	21.5
Gross salaries	11.1	11.4	11.1	11.1	11.1	10.8	10.3	10.3	10.3
Other personal income	0.9	0.8	0.6	0.6	0.5	0.5	0.4	0.4	0.4
Goods and services	5.9	6.3	4.5	5.2	6.1	6.1	6.1	6.1	6.1
Interest payments	0.9	1.0	1.6	1.6	1.9	2.3	2.5	2.9	3.1
Rent	0.3	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Subsidies to enterprises 2/	1.7	1.3	1.4	1.4	2.1	0.9	0.9	1.0	1.1
Other outflows 2/	0.3	0.3	0.5	0.6	0.3	0.3	0.3	0.3	0.3
Social security transfers	13.9	13.6	14.0	14.0	14.3	14.7	14.7	14.7	14.7
Other transfers	5.3	5.2	3.5	4.0	2.1	2.1	2.0	2.0	2.0
Capital expenditures	8.4	5.3	4.1	4.1	3.6	3.6	3.7	3.7	3.7
Capital transfers	0.0	0.0	0.8	0.8	0.7	0.6	0.6	0.6	0.6
Reserves	0.5	0.5	0.4	0.4	0.3	0.3	0.3	0.3	0.3
Net lending	-1.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Overall Balance	-5.3	-4.7	-5.0	-6.3	-5.2	-4.3	-4.1	-4.5	-4.7
Financing	5.3	4.7	5.0	6.3	5.2	4.3	4.1	4.5	4.7
Domestic financing	-3.2	-1.4	1.1	2.4	0.4	-0.7	-0.5	1.1	1.1
Use of gov. deposits	-2.2	2.2	2.8	2.8	0.3	0.2	0.2	0.4	0.4
Net borrowings from other domestic sources	-1.0	-3.5	-1.7	-0.5	0.1	-1.0	-0.7	0.7	0.7
New borrowing (disbursement)	4.2	1.4	1.5	1.5	1.7	0.2	0.1	0.3	0.3
Repayment of principal (amortization)	-2.6	-2.0	-1.1	-1.1	-0.8	-0.9	-0.7	-0.8	-0.8
Net repayment of previous liabilities	-2.6	-2.9	-2.1	-0.9	-0.8	-0.3	-0.1	1.2	1.2
Net repayment of liabilities other than budget arrears	-2.1	-2.0	-0.8	-0.8	...	...	...	...	...
Accumulation of new budget arrears	1.0	2.0	0.0	1.2	...	...	...	...	...
Repayment of prior arrears	-1.5	-2.9	-1.3	-1.3	...	...	...	...	...
Foreign financing	4.1	5.2	3.9	3.9	1.2	1.0	-0.1	-1.2	-0.6
Borrowing	5.0	6.6	5.8	5.8	3.3	3.0	2.2	5.3	5.1
Repayment	-0.9	-1.5	-1.9	-1.9	-2.1	-2.0	-2.3	-6.6	-5.8
Privatization receipts	4.4	0.9	0.5	0.5	0.5	0.5	0.5	0.4	0.4
Unidentified	0.0	0.0	-0.5	-0.5	3.1	3.5	4.2	4.3	3.9
Memorandum items:									
Primary balance	-4.4	-3.7	-3.4	-4.6	-3.3	-2.1	-1.6	-1.7	-1.7
Overall balance excluding loan guarantee payments	-5.3	-4.7	-4.2	-5.4	-4.6	…	…	…	…
Stock of net public debt	32.4	37.1	44.3	44.3	48.0	50.2	51.7	53.7	56.0
Discrepancy (=net debt stock change - debt financing) 3	4.0	2.2	4.9	3.7	0.0	0.0	0.0	0.0	0.0
Stock of public guarantees	5.0	11.3	11.7	11.7	...	...	...	...	...

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.

3/ Part of the discrepancy is due to new issuance of restitution bonds and court rulings, both leading to increase of government liabilities.

Table 5c . Montenegro: Consolidated General Government Fiscal Operations, 2009-2016 1/
(Millions of Euro, GFSM2001)

	2009 Act.	2010 Act.	2011 Prel.	2012 Proj.	2013 Proj.	2014 Proj.	2015 Proj.	2016 Proj.
1. Revenue	**1262.4**	**1274.3**	**1235.6**	**1266.7**	**1311.4**	**1370.3**	**1429.5**	**1486.3**
Taxes	795.7	757.2	789.4	826.5	856.0	895.0	934.0	971.5
Personal income tax	*121.4*	*115.1*	*112.4*	*121.4*	*125.6*	*131.1*	*136.6*	*141.9*
Corporate income tax	*54.7*	*20.3*	*35.9*	*34.2*	*35.4*	*37.0*	*38.5*	*40.0*
Taxes on turnover of real estate right	*19.8*	*16.5*	*15.7*	*12.9*	*13.3*	*13.9*	*14.5*	*15.0*
Value added tax	*370.8*	*364.2*	*390.2*	*402.6*	*417.4*	*437.0*	*456.8*	*475.7*
Excises	*128.7*	*134.3*	*141.7*	*161.8*	*167.4*	*174.8*	*182.2*	*189.2*
Taxes on international trade	*49.1*	*50.8*	*45.1*	*52.9*	*54.7*	*57.1*	*59.5*	*61.9*
Local government taxes	*42.3*	*44.6*	*44.2*	*37.6*	*38.8*	*40.6*	*42.3*	*43.9*
Other taxes	*8.9*	*11.6*	*4.1*	*3.3*	*3.4*	*3.5*	*3.7*	*3.8*
Social security contributions	268.9	347.6	307.3	318.7	329.7	344.2	358.8	372.7
Nontax revenues	186.2	163.6	131.1	119.4	123.5	129.0	134.4	139.7
Grants	11.6	5.9	7.8	2.0	2.1	2.2	2.3	2.3
2. Expense	**1214.1**	**1262.5**	**1304.1**	**1322.0**	**1337.3**	**1385.1**	**1461.0**	**1526.7**
Gross salaries and other personal income	358.8	378.8	382.7	387.4	387.6	388.1	404.5	420.2
Use of goods and services	176.1	194.9	169.6	203.8	210.8	220.1	229.4	238.3
Interest payments	25.4	31.4	52.7	63.0	77.9	90.9	107.1	119.5
Subsidies to enterprises	51.0	39.8	46.4	68.4	30.0	31.0	38.3	41.3
Other current outflows	18.1	16.5	26.2	18.5	18.7	18.9	19.7	20.4
Social security transfers	413.1	423.6	455.5	477.9	508.5	530.6	553.0	574.5
Other transfers	157.1	161.6	130.7	69.6	71.4	73.1	76.2	79.1
Capital transfers	0.0	0.0	26.3	22.0	22.0	22.0	22.0	22.0
Reserves	14.5	15.8	14.1	11.5	10.4	10.5	10.9	11.3
3. Gross operating balance (= 1 - 2)	**48.3**	**11.8**	**-68.6**	**-55.4**	**-25.9**	**-14.8**	**-31.5**	**-40.4**
4. Net acquisition of nonfinancial assets	**242.5**	**157.0**	**135.0**	**119.8**	**124.5**	**133.5**	**139.1**	**144.5**
Capital revenue	-8.7	-8.8	0.0	0.0	0.0	0.0	0.0	0.0
Capital expenditure	251.2	165.8	135.0	119.8	124.5	133.5	139.1	144.5
5. Net lending (+) / borrowing (-) (= 3 - 4)	**-194.2**	**-145.1**	**-203.6**	**-175.2**	**-150.4**	**-148.2**	**-170.7**	**-184.9**
6. Net acquisition of financial assets	**-101.0**	**-94.2**	**-107.5**	**-29.6**	**-27.6**	**-27.4**	**-30.8**	**-30.8**
Domestic	-101.0	-94.2	-107.5	-29.6	-27.6	-27.4	-30.8	-30.8
Currency and deposits	*65.3*	*-66.9*	*-92.8*	*-10.6*	*-8.6*	*-8.6*	*-15.0*	*-15.0*
Loans	*-36.5*	*0.1*	*0.2*	*-1.0*	*-1.0*	*-0.8*	*-0.8*	*-0.8*
Equity and investment fund shares	*-129.8*	*-27.4*	*-14.9*	*-18.0*	*-18.0*	*-18.0*	*-15.0*	*-15.0*
7. Net incurrence of liabilities	**93.3**	**50.9**	**110.8**	**42.3**	**0.9**	**-31.9**	**-21.6**	**2.5**
Domestic	-30.0	-109.4	-16.1	2.5	-33.0	-26.6	25.0	26.8
Foreign	123.2	160.3	126.9	39.7	33.9	-5.3	-46.6	-24.3
8. Discrepancy (= 5 - 6 + 7)	**0.0**	**0.0**	**14.7**	**-103.4**	**-121.9**	**-152.8**	**-161.4**	**-151.6**
Memorandum items:								
Primary balance	-168.8	-113.7	-150.9	-112.2	-72.5	-57.4	-63.6	-65.5
Stock of net public debt	965	1151	1444	1601	1732	1862	2016	2186
Stock of public guarantees	150	352	381	…	…	…	…	…
Nominal GDP	2981	3104	3260	3334	3449	3601	3753	3899

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

Table 5d . Montenegro: Consolidated General Government Fiscal Operations, 2009-2016 1/
(In percent of GDP, GFSM2001)

	2009 Act.	2010 Act.	2011 Prel.	2012 Proj.	2013 Proj.	2014 Proj.	2015 Proj.	2016 Proj.
1. Revenue	**42.3**	**41.1**	**37.9**	**38.0**	**38.0**	**38.1**	**38.1**	**38.1**
Taxes	26.7	24.4	24.2	24.8	24.8	24.9	24.9	24.9
Personal income tax	*4.1*	*3.7*	*3.4*	*3.6*	*3.6*	*3.6*	*3.6*	*3.6*
Corporate income tax	*1.8*	*0.7*	*1.1*	*1.0*	*1.0*	*1.0*	*1.0*	*1.0*
Taxes on turnover of real estate right	*0.7*	*0.5*	*0.5*	*0.4*	*0.4*	*0.4*	*0.4*	*0.4*
Value added tax	*12.4*	*11.7*	*12.0*	*12.1*	*12.1*	*12.1*	*12.2*	*12.2*
Excises	*4.3*	*4.3*	*4.3*	*4.9*	*4.9*	*4.9*	*4.9*	*4.9*
Taxes on international trade	*1.6*	*1.6*	*1.4*	*1.6*	*1.6*	*1.6*	*1.6*	*1.6*
Local government taxes	*1.4*	*1.4*	*1.4*	*1.1*	*1.1*	*1.1*	*1.1*	*1.1*
Other taxes	*0.3*	*0.4*	*0.1*	*0.1*	*0.1*	*0.1*	*0.1*	*0.1*
Social security contributions	9.0	11.2	9.4	9.6	9.6	9.6	9.6	9.6
Nontax revenues	6.2	5.3	4.0	3.6	3.6	3.6	3.6	3.6
Grants	0.4	0.2	0.2	0.1	0.1	0.1	0.1	0.1
2. Expense	**40.7**	**40.7**	**40.0**	**39.6**	**38.8**	**38.5**	**38.9**	**39.2**
Gross salaries and other personal income	12.0	12.2	11.7	11.6	11.2	10.8	10.8	10.8
Use of goods and services	5.9	6.3	5.2	6.1	6.1	6.1	6.1	6.1
Interest payments	0.9	1.0	1.6	1.9	2.3	2.5	2.9	3.1
Subsidies to enterprises	1.7	1.3	1.4	2.1	0.9	0.9	1.0	1.1
Other current outflows	0.6	0.5	0.8	0.6	0.5	0.5	0.5	0.5
Social security transfers	13.9	13.6	14.0	14.3	14.7	14.7	14.7	14.7
Other transfers	5.3	5.2	4.0	2.1	2.1	2.0	2.0	2.0
Capital transfers	0.0	0.0	0.8	0.7	0.6	0.6	0.6	0.6
Reserves	0.5	0.5	0.4	0.3	0.3	0.3	0.3	0.3
3. Gross operating balance (= 1 - 2)	**1.6**	**0.4**	**-2.1**	**-1.7**	**-0.8**	**-0.4**	**-0.8**	**-1.0**
4. Net acquisition of nonfinancial assets	**8.1**	**5.1**	**4.1**	**3.6**	**3.6**	**3.7**	**3.7**	**3.7**
Capital revenue	-0.3	-0.3	0.0	0.0	0.0	0.0	0.0	0.0
Capital expenditure	8.4	5.3	4.1	3.6	3.6	3.7	3.7	3.7
5. Net lending (+) / borrowing (-) (= 3 - 4)	**-6.5**	**-4.7**	**-6.2**	**-5.3**	**-4.4**	**-4.1**	**-4.5**	**-4.7**
6. Net acquisition of financial assets	**-3.4**	**-3.0**	**-3.3**	**-0.9**	**-0.8**	**-0.8**	**-0.8**	**-0.8**
Domestic	-3.4	-3.0	-3.3	-0.9	-0.8	-0.8	-0.8	-0.8
Currency and deposits	*2.2*	*-2.2*	*-2.8*	*-0.3*	*-0.2*	*-0.2*	*-0.4*	*-0.4*
Loans	*-1.2*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*
Equity and investment fund shares	*-4.4*	*-0.9*	*-0.5*	*-0.5*	*-0.5*	*-0.5*	*-0.4*	*-0.4*
7. Net incurrence of liabilities	**3.1**	**1.6**	**3.4**	**1.3**	**0.0**	**-0.9**	**-0.6**	**0.1**
Domestic	-1.0	-3.5	-0.5	0.1	-1.0	-0.7	0.7	0.7
Foreign	4.1	5.2	3.9	1.2	1.0	-0.1	-1.2	-0.6
8. Discrepancy (= 5 - 6 + 7)	**0.0**	**0.0**	**0.5**	**-3.1**	**-3.5**	**-4.2**	**-4.3**	**-3.9**
Memorandum items:								
Primary balance	-5.7	-3.7	-4.6	-3.4	-2.1	-1.6	-1.7	-1.7
Stock of net public debt	32	37	44	48	50	52	54	56
Stock of public guarantees	5.0	11.3	11.7	…	…	…	…	…

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, 2007–11

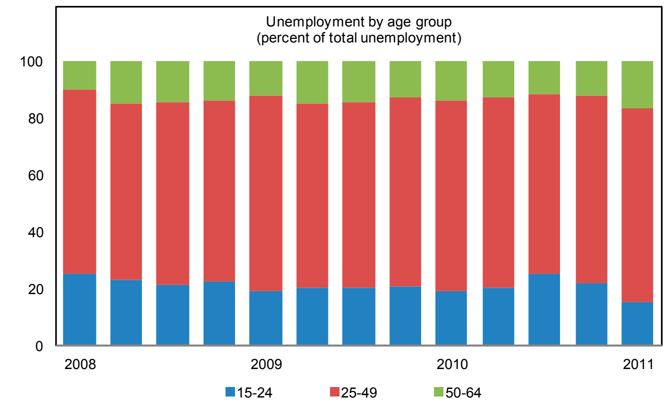
	2007	2008	2009	2010				2011			
	Dec	Dec	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec
Capital adequacy											
Regulatory capital as percent of risk-weighted assets	17.1	15.0	15.7	14.3	16.5	14.6	15.9	15.4	15.3	15.1	16.5
Capital as percent of assets	8.0	8.4	11.0	10.4	11.4	10.2	10.6	10.4	10.6	10.1	10.9
Asset composition and quality											
Distribution of bank credit by borrower											
Central government, local government, government agencies	1.4	1.0	1.3	2.2	2.6	2.0	2.1	2.5	2.6	3.4	4.9
Funds	0.6	0.4	1.2	1.1	0.4	0.5	0.1	0.1	0.1	0.1	0.5
State-owned companies	1.0	1.0	1.9	1.9	2.0	2.5	2.7	3.4	3.4	2.8	2.8
Private companies, entrepreneurs	60.6	59.2	56.4	56.1	56.8	55.9	54.8	52.9	50.7	49.3	47.7
Banks	0.2	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial Institutions	0.9	0.8	0.3	0.5	0.3	0.3	0.4	0.4	0.4	0.4	0.5
Citizens	34.5	35.8	36.6	34.7	36.1	36.4	37.1	38.0	39.7	41.0	40.5
Credit cards	0.9	1.3	1.7	1.8	1.8	1.8	2.2	2.1	2.1	2.1	2.1
Other	0.0	0.4	0.6	1.8	0.0	0.6	0.6	0.7	1.0	0.9	0.9
Distribution of bank credit by sectoral economic activity											
Agriculture, hunting, fishing	1.0	0.6	0.3	0.5	0.3	0.4	0.4	0.7	0.9	1.1	1.2
Mining and energy	1.0	1.6	2.2	2.3	2.2	2.4	2.5	2.4	2.4	1.8	1.8
Civil engineering	9.0	7.2	7.8	7.8	8.2	8.8	8.1	7.9	7.3	7.6	6.7
Trade	26.1	22.6	22.8	21.3	21.9	22.7	22.9	21.5	21.7	20.7	20.7
Services, tourism	8.6	7.7	7.5	9.4	7.9	7.8	7.4	6.8	6.4	6.0	6.1
Transport, warehousing, communications	3.6	3.1	2.6	2.5	3.0	3.0	3.0	3.4	3.3	2.8	3.1
Finance	2.8	2.5	2.4	2.5	1.8	2.0	1.7	1.8	1.5	2.1	2.7
Real estate trading	3.6	4.2	4.4	3.8	3.6	2.9	3.0	2.8	2.1	2.2	2.3
Administration, other public services	2.9	2.0	2.6	2.4	2.6	2.9	3.1	3.4	3.3	2.8	4.3
Consumer loans	35.1	36.4	38.3	38.2	37.9	38.2	39.3	40.1	41.8	43.1	42.6
Other	6.3	12.1	9.1	9.3	10.7	8.8	9.0	9.3	9.3	9.7	8.4
Asset quality											
Non-performing loans (NPL), in percent of gross loans	3.2	7.2	13.5	14.9	16.8	17.6	21.0	23.2	25.3	19.7	15.5
Provisions, in percent of NPL	73.6	55.6	46.3	45.7	44.9	44.9	30.7	23.8	24.0	30.4	32.8
Provisions, in percent of total loans	2.3	4.0	6.3	6.8	7.5	7.9	6.4	5.5	6.1	6.0	5.1
NPL net of provisions, in percent of capital	7.9	32.0	52.5	62.5	63.4	74.0	102.8	122.3	129.1	92.4	66.9
Earnings and profitability											
Gross profits, in percent of average assets (ROAA)	0.8	-0.6	-0.6	-3.4	-3.2	-4.2	-2.7	-2.3	-0.7	-1.0	-0.1
Gross profits, in percent of average equity capital (ROAE)	10.5	-6.6	-6.9	-34.4	-31.6	-40.9	-27.0	-23.4	-6.4	-10.0	-0.6
Net profits, in percent of average assets (ROAA)	0.7	-0.6	-0.7	-3.5	-3.2	-4.2	-2.8	-2.4	-0.6	-1.0	-0.1
Net profits, in percent of average capital (ROAE)	6.2	-6.9	-7.8	-34.4	-31.6	-41.1	-27.3	-23.4	-6.3	-10.1	-1.1
Net interest margin 1/	3.0	3.8	4.9	1.1	2.4	3.7	4.9	1.2	2.3	3.5	4.8
Gross income, in percent of average assets	7.0	5.1	5.3	5.2	5.3	5.6	5.4	4.8	5.0	4.8	5.2
Net interest income, in percent of gross income	55.4	67.7	74.2	69.5	71.9	71.9	71.6	75.7	71.8	74.3	70.5
Non-interest income, in percent of gross income	44.6	32.3	25.8	30.5	28.1	28.1	28.4	24.3	28.2	25.7	29.5
Net fee income, in percent of net interest income	57.1	43.3	27.2	28.6	29.4	30.3	30.3	26.3	31.1	26.7	28.6
Trading income, in percent of gross income	12.9	3.0	5.7	10.6	7.0	6.3	6.7	4.4	5.8	5.8	9.4
Aggregate overhead expenses, in percent of gross income	57.3	61.4	62.3	62.3	64.0	62.0	64.0	61.9	55.0	72.4	70.7
Liquidity											
Liquid assets, in percent of total assets	18.1	11.2	15.3	13.5	16.6	17.1	19.1	19.4	19.9	23.0	19.9
Liquid assets, in percent of short-term liabilities	32.0	20.9	25.8	22.8	28.3	28.9	32.9	33.5	33.9	39.2	32.8
Deposits, in percent of assets	70.3	60.1	60.3	60.6	60.6	61.3	60.8	61.4	63.6	65.0	64.7
Loans, in percent of deposits	107.4	140.5	131.4	133.3	129.1	126.9	122.9	117.3	111.3	104.2	107.6
Sensitivity to market risk											
Original maturity of assets (in percent of total)											
Less than 3 months	31.1	24.7	30.4	28.9	31.1	31.3	34.4	33.6	31.6	24.9	21.5
3 months to 1 year	20.4	23.6	20.5	22.8	19.5	20.1	17.2	18.5	16.7	23.1	28.2
1 to 5 years	34.0	35.0	33.9	34.0	34.7	33.8	33.6	33.1	35.6	36.8	35.4
Over 5 years	14.6	16.8	15.3	14.3	14.7	14.8	14.8	14.8	16.1	15.2	14.9
Original maturity of liabilities (in percent of total)											
Less than 3 months	35.0	32.2	34.7	39.7	37.0	38.7	38.5	38.6	39.5	24.7	21.9
3 months to 1 year	27.3	27.2	32.4	27.3	30.2	27.7	27.1	26.8	26.8	40.9	47.1
1 to 5 years	28.7	31.7	23.5	22.9	23.9	24.5	24.4	26.3	24.5	25.5	23.4
Over 5 years	9.1	8.8	9.4	10.0	9.0	9.1	10.0	8.3	9.3	8.9	7.7

Source: Central Bank of Montenegro.

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

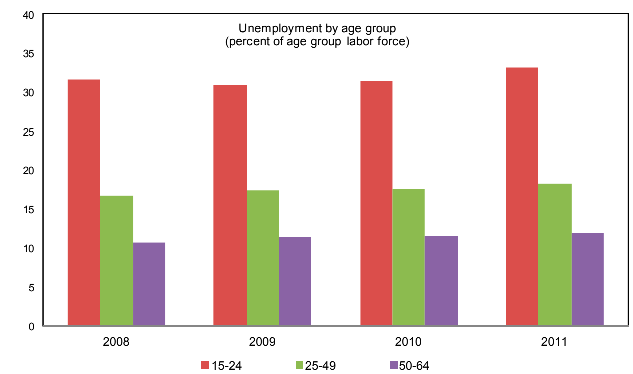
Annex I. Employment Gap in Montenegro's Labor Market

The Montenegrin labor market continues to struggle with high unemployment rates, long unemployment spells, and falling labor force participation. For an economy dependent on labor-intensive primary industries and service exports, these problems are an important structural challenge for the medium- to long-term growth prospects. Since 2008, the quarterly unemployment rate in Montenegro has ranged between 16 and 21 percent. Such rates are among the highest and most persistent relative to comparators in the region and central Europe.

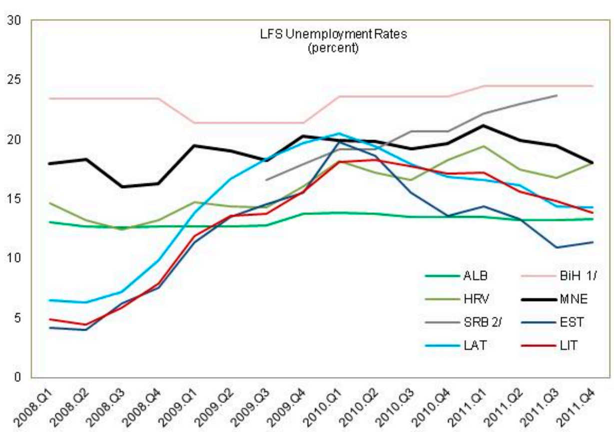


Source: Monstat's Labor Force Survey

The unemployment problem in Montenegro is most severe among the younger generations. Those between ages 25 and 49 comprise the largest segment of the unemployed while the jobless rate is highest among those in the 15-24 age group.

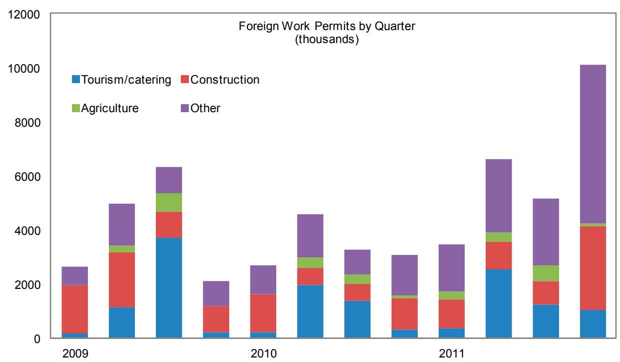


Source: Monstat's Labor Force Survey



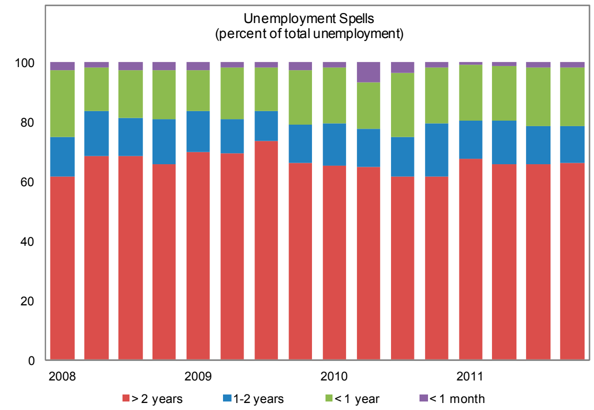
1/ Annual data
2/ Latest data from November 2011

The high unemployment rate among the economically active young points to a gap between the skills supplied and demanded in the labor market. To an extent, this gap is driven by the mismatch in skills produced in the education system and those needed in the growing sectors. At the same time, the lack of unemployment deterrents and the existing structure of social safety nets may provide the jobless with an incentive to choose unemployment over certain types of jobs. Therefore, more and more foreign workers are hired into the economy each year to fill the labor need despite the availability of workers in the domestic labor market. In 2011, recorded foreign workers accounted for as much as 10.5 percent of the labor force.



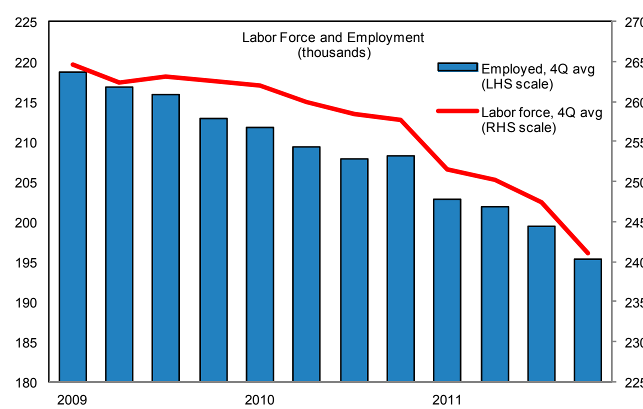
Source: Employment Agency of Montenegro

The jobless typically face long unemployment spells, during which previously acquired skills depreciate and job search becomes increasingly more difficult. Labor force survey statistics show that on average over 60 percent of the unemployed in Montenegro are without a job for more than two years. Since over 80 percent of the unemployed are below 50 years in age, it is the younger generations that make up the bulk of the chronically unemployed in the country. Such a structure of unemployment means that enhancing re-employment should be the immediate priority in order to prevent those with the highest productive potential from becoming discouraged with job search and leaving the labor force altogether.

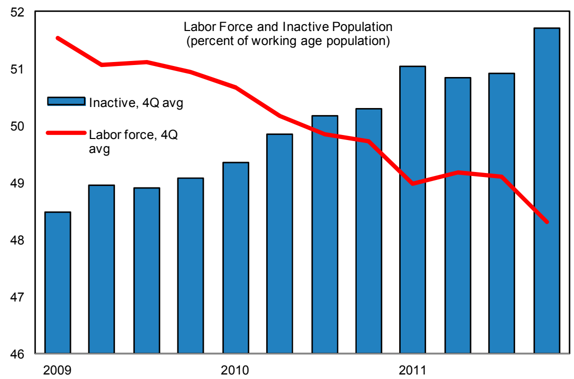


Source: Monstat's Labor Force Survey

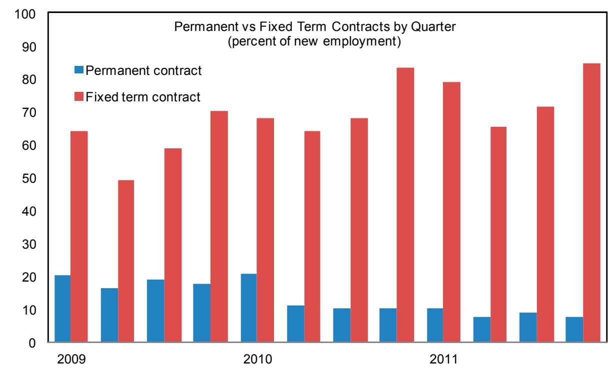
Already there is evidence that job seekers are becoming discouraged and withdrawing themselves from the search process. The recent decline in the unemployment rate in Montenegro has been driven by a shrinking labor force rather than a higher rate of job creation. Over the past two years, the average labor force and the number of employed persons have fallen by 8 percent, whereas the inactive population has gone up by 3 percent.



Source: Monstat's Labor Force Survey



Source: Monstat's Labor Force Survey



Source: Employment Agency of Montenegro

Job creation with a focus on the domestic labor market should be the near-term imperative going forward. Recent amendments to the labor law have made progress by simplifying the dismissal and redundancy processes. On the other hand, however, the amendments have restricted hiring flexibility by regulating the availability and the duration of fixed-term employment contracts. Such a restriction detracts from the increased flexibility of the dismissal process and could be detrimental to job creation as the majority of new jobs over the last 3 years were generated through fixed-term contracts.

Along with job creation, congruent measures to reabsorb the long-term unemployed and eliminate disincentives to work should also be considered. Reducing unemployment benefits and adopting the Earned Income Tax Credit policy, for example, would encourage greater job search efforts while offering training in areas where there is a skill shortage would improve the employability of the long-term unemployed.

Annex II. Montenegro Risk Assessment Matrix

Nature/Source of Main Threats	Overall Level of Concern	
	Likelihood of Severe Realization of Threat in the Next 1–3 Years (high, medium or low)	Expected Impact if Threat is Realized (high, medium or low)
1. Spillovers from an intensified eurozone crisis result in a further worsening in economic activity.	**Medium** • The eurozone sovereign debt crisis and its impact on economic activity across the region remains a key risk.	**High** • A sharp deterioration in eurozone conditions could have a significant adverse impact on tourism and foreign direct investment, which are key drivers of the domestic economy. Tourism receipts alone accounted for close to one-fifth of GDP in 2012.
2. Loss of confidence in the banking system triggers a resumption of deposit outflows.	**Medium** • Although it has stabilized since 2009, the banking system remains relatively fragile: non-performing loans remain high, provisioning is lagging, and the sector as a whole continued to record losses in 2011. • The unilateral use of the euro in Montenegro essentially rules out significant central bank liquidity injections, and there is limited scope for further fiscal support or capital injections from parent banks given financial pressures in their home markets.	**High** • A sudden outflow of deposits would accelerate the process of bank deleveraging and add to growing liquidity pressures within the economy. • A worsening of the already stressed liquidity conditions would increase tax arrears and create a potential fiscal financing gap. • A further contraction in bank lending would also be a potential significant drag on domestic demand.
3. Additional contingent liabilities materialize.	**High** • In addition to the loan to KAP that the government has already assumed, additional loan guarantees for KAP amounting to 3.2 percent were also extended during 2009–10 and are at risk of being called. • Political pressures in the lead up to autumn elections could put pressure on the government to provide further support to struggling enterprises. • In the event that the government opts to keep KAP operating, it could face potentially large operating losses. There also remains the possibility of significant environmental contingencies and clean-up costs.	**High** • Additional expenditures associated with contingent liabilities would further stretch the already ambitious budget target for 2012 and exacerbate financing pressures.
4. Montenegro loses access to capital markets.	**Medium** • Montenegro's credibility with international investors has become increasingly constrained in light of the sharp increase in public debt. The 2016 Eurobond is currently trading at a spread of roughly 800 basis points.	**High** • Large fiscal deficits have eroded deposit buffers. • The small domestic capital market increases reliance international capital markets for budget financing.

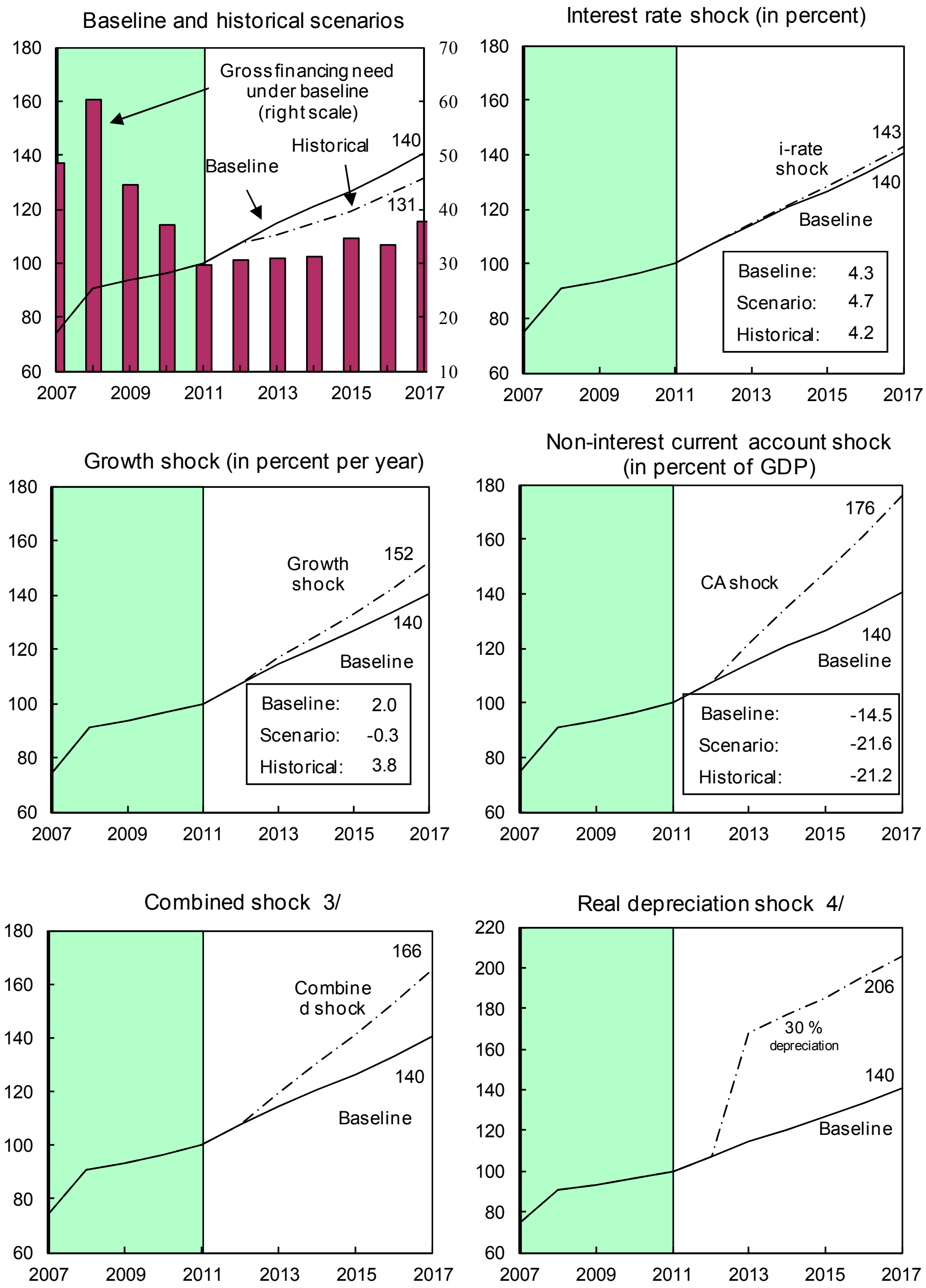
Annex III. Debt Sustainability Analysis

Table 1. Montenegro: External Debt Sustainability Framework, 2007-2017
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Debt-stabilizing non-interest current account 6/
Baseline: External debt	74.1	90.8	93.5	96.4	99.9	**107.3**	**114.5**	**120.7**	**126.5**	**133.3**	**140.4**	**-15.4**
Change in external debt	26.6	16.7	2.7	2.9	3.5	7.4	7.2	6.2	5.8	6.8	7.1	
Identified external debt-creating flows (4+8+9)	8.9	22.0	-3.0	3.1	2.9	8.1	5.9	4.4	2.8	1.5	0.3	
Current account deficit, excluding interest payments	37.3	47.7	26.7	21.3	15.7	15.6	15.6	15.3	14.4	13.9	13.5	
Deficit in balance of goods and services	42.9	54.4	32.6	27.6	23.8	23.4	23.2	22.8	21.9	21.3	20.8	
Exports	43.1	38.9	32.8	35.6	40.6	40.4	40.7	41.1	42.4	43.4	44.0	
Imports	86.0	93.4	65.4	63.2	64.4	63.8	63.9	63.9	64.2	64.6	64.9	
Net non-debt creating capital inflows (negative)	-21.2	-18.9	-35.8	-17.8	-11.9	-11.4	-12.4	-13.3	-14.2	-15.1	-15.8	
Automatic debt dynamics 1/	-7.3	-6.9	6.1	-0.4	-0.8	4.0	2.8	2.4	2.6	2.7	2.6	
Contribution from nominal interest rate	2.1	2.9	2.9	3.3	3.8	4.2	4.4	4.7	4.9	5.2	5.4	
Contribution from real GDP growth	-4.1	-4.4	5.4	-2.2	-2.2	-0.2	-1.6	-2.2	-2.3	-2.5	-2.9	
Contribution from price and exchange rate changes 2/	-5.3	-5.3	-2.2	-1.5	-2.4	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	17.7	-5.3	5.7	-0.3	0.6	-0.7	1.3	1.9	3.0	5.3	6.8	
External debt-to-exports ratio (in percent)	171.8	233.2	285.3	271.0	246.0	265.7	281.2	293.5	298.4	307.4	318.8	
Gross external financing need (in billions of Euros) 4/	1.3	1.9	1.3	1.1	1.0	1.0	1.1	1.1	1.3	1.3	1.5	
in percent of GDP	48.6	60.3	44.6	37.0	29.7	30.7	31.0	31.1	34.6	33.5	37.6	
Scenario with key variables at their historical averages 5/						**107.3**	**110.6**	**114.7**	**119.4**	**125.1**	**131.4**	**-22.1**
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (in percent)	10.7	6.9	-5.7	2.5	2.4	0.2	1.5	2.0	2.0	2.0	2.2	
GDP deflator in Euros (change in percent)	12.7	7.7	2.4	1.6	2.5	2.1	1.9	2.3	2.2	1.8	1.7	
Nominal external interest rate (in percent)	5.6	4.5	3.1	3.7	4.1	4.3	4.2	4.3	4.3	4.3	4.3	
Growth of exports (Euro terms, in percent)	31.4	3.9	-18.7	13.0	19.9	1.7	4.3	5.5	7.4	6.3	5.6	
Growth of imports (Euro terms, in percent)	37.2	24.9	-32.3	0.6	7.1	1.3	3.7	4.4	4.7	4.5	4.3	
Current account balance, excluding interest payments	-37.3	-47.7	-26.7	-21.3	-15.7	-15.6	-15.6	-15.3	-14.4	-13.9	-13.5	
Net non-debt creating capital inflows	21.2	18.9	35.8	17.8	11.9	11.4	12.4	13.3	14.2	15.1	15.8	

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in Euro terms, g = real GDP growth rate, ε = nominal appreciation (increase in euro value of domestic currency), and α = share of domestic-currency denominated debt in total external debt.
2/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\varepsilon > 0$) and rising inflation (based on GD
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; dollar 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, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Figure 1. 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 2010.

Table 2. Montenegro: Public Sector Debt Sustainability Framework, 2007-2017
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	**Debt-stabilizing primary balance 9/**
Baseline: Public sector debt 1/	27.5	31.9	40.7	42.4	46.9	**50.2**	**52.1**	**53.2**	**54.8**	**56.7**	**58.6**	**1.0**
o/w foreign-currency denominated	14.3	12.4	12.3	11.8	10.8	10.1	9.2	8.2	7.3	6.5	5.6	
Change in public sector debt	-5.1	4.4	8.8	1.7	4.5	3.3	1.9	1.2	1.6	1.9	1.9	
Identified debt-creating flows (4+7+12)	-13.2	-0.5	6.4	3.1	4.2	4.2	2.7	1.9	2.4	2.7	2.6	
Primary deficit	-7.8	2.4	4.4	3.7	4.6	3.3	2.1	1.6	1.7	1.7	1.6	
Revenue and grants	47.7	48.4	42.6	41.3	37.9	38.0	38.0	38.1	38.1	38.1	38.1	
Primary (noninterest) expenditure	39.9	50.8	47.1	45.0	42.5	41.3	40.1	39.6	39.8	39.8	39.8	
Automatic debt dynamics 2/	-5.4	-2.8	2.0	-0.6	-0.4	0.8	0.6	0.3	0.7	1.0	1.0	
Contribution from interest rate/growth differential 3/	-5.4	-2.8	2.0	-0.6	-0.4	0.8	0.6	0.3	0.7	1.0	1.0	
Of which contribution from real interest rate	-2.6	-1.2	0.1	0.4	0.6	0.9	1.3	1.3	1.7	2.1	2.2	
Of which contribution from real GDP growth	-2.8	-1.6	1.9	-1.0	-1.0	-0.1	-0.7	-1.0	-1.0	-1.1	-1.2	
Contribution from exchange rate depreciation 4/	0.0	0.0	0.0	0.0	0.0	...	...	...	...	...	...	
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	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/	8.1	4.9	2.4	-1.4	0.2	-0.9	-0.8	-0.7	-0.8	-0.8	-0.7	
Public sector debt-to-revenue ratio 1/	57.7	65.8	95.4	102.6	123.6	132.1	137.0	139.9	143.9	148.8	153.6	
Gross financing need 6/	-6.7	3.1	8.7	8.1	9.3	8.2	7.2	7.2	11.9	11.2	15.7	
in billions of Euros	-0.2	0.1	0.3	0.3	0.3	0.3	0.2	0.3	0.4	0.4	0.6	
Scenario with key variables at their historical averages 7/						**50.2**	**47.0**	**44.0**	**41.2**	**38.6**	**36.2**	**-2.3**
Scenario with no policy change (constant primary balance) in 2012-2017						**50.2**	**53.3**	**56.3**	**59.5**	**63.2**	**66.9**	**1.2**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	10.7	6.9	-5.7	2.5	2.4	0.2	1.5	2.0	2.0	2.0	2.2	
Average nominal interest rate on public debt (in percent) 8/	4.0	3.2	2.6	2.6	4.0	4.1	4.7	5.1	5.6	5.8	5.8	
Average real interest rate (nominal rate minus change in GDP deflator, in p	-8.7	-4.5	0.1	1.0	1.5	2.0	2.8	2.7	3.4	4.0	4.1	
Nominal appreciation (increase in Euro value of local currency, in percent)	0.0	0.0	0.0	0.0	0.0	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	12.7	7.7	2.4	1.6	2.5	2.1	1.9	2.3	2.2	1.8	1.7	
Growth of real primary spending (deflated by GDP deflator, in percent)	12.2	36.1	-12.6	-2.0	-3.2	-2.7	-1.5	0.8	2.4	2.1	2.3	
Primary deficit	-7.8	2.4	4.4	3.7	4.6	3.3	2.1	1.6	1.7	1.7	1.6	

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 $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = 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 $\alpha\varepsilon(1+r)$.

5/ For projections, this line includes exchange rate changes.

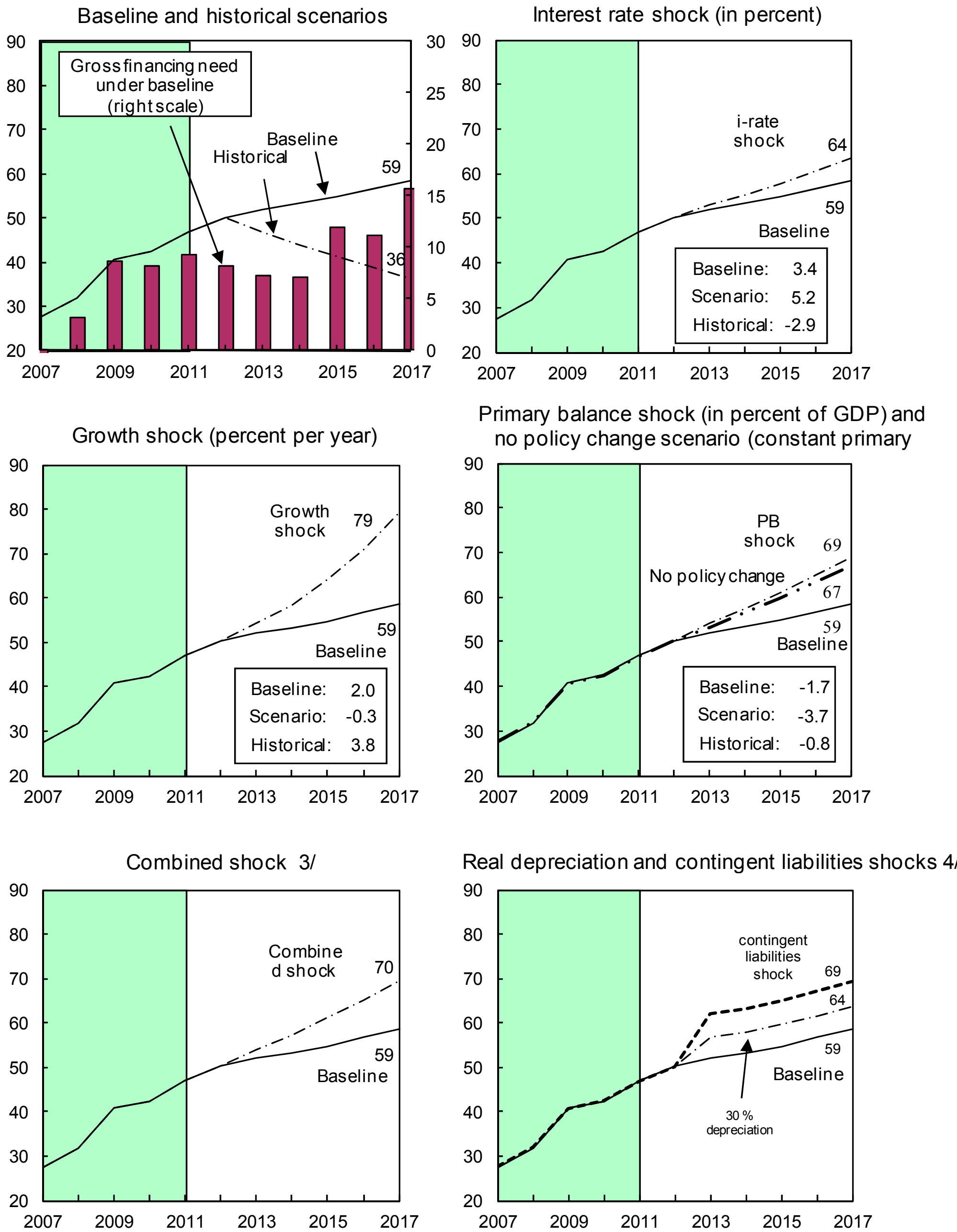
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

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 2. 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 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 primary balance.
4/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2010, with real depreciation defined as nominal depreciation (measured by percentage fall in euro value of local currency) minus domestic inflation (based on GDP deflator).

INTERNATIONAL MONETARY FUND

MONTENEGRO

STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

April 27, 2012

Prepared By

European Department
(In consultation with other departments and the World Bank)

CONTENTS

FUND RELATIONS

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 in fund	6.60	24.00

SDR Department

	SDR Million	Percent Allocation
Net cumulative allocation	25.82	100.00
Holdings	26.19	101.41

Outstanding Purchases and Loans
None

Latest Financial Arrangements
None

Exchange Rate Arrangements
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.

Article IV Consultation
Montenegro is on a 12-month cycle.

FSAP Participation and ROSCs
A Financial Sector Assessment Program, initiated in July 2006 jointly with the World Bank, was concluded during the 2007 Article IV consultation.

Technical Assistance

FAD	April 2006	Assessment of state-owned enterprises under the World Bank Public Expenditure Review
STA	June 2006	Monetary and financial statistics
FAD	January 2007	Peripatetic advisor on debt management
FAD	March 2007	Fiscal risk assessment of Private Public Partnership
FAD	April 2007	Tax administration
STA	April 2007	Real sector statistics
MCM	October 2007	Emergency liquidity management
MCM	March 2008	Enforcement of securities regulation
MCM	January 2009	Crisis preparedness and management
LEG/MCM	February 2009	Exchange system
STA	August 2009–July 2010	Resident advisor for real sector statistics
LEG	April 2010	Bank resolution framework
FAD	June 2010	Debt management
STA	December 2010	Real sector statistics
FAD	February 2011	Tax policy
FAD	March 2011	Tax administration
FAD	March 2011	Medium-term budget framework
STA	August 2011	JSA national accounts
STA	October 2011	Balance of payment statistics
STA	October 2011	GDDS: Metadata development
FAD	October 2011	Public financial management
FAD	November 2011	Tax administration

Resident Representative

None.

RELATIONS WITH THE WORLD BANK GROUP

Montenegro has joined 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$97 million in 2012 (including the new IBRD loan approved within the new CPS for FY 2011–2014). About 66 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, February 29, 2012

Project Name	Board Date	Original Commitment (US$ millions)	Disbursement Ratio (percent)
Active project portfolio			
Environment (solid waste management)	Nov. 2003	12.5	26
Health system improvement	Jun. 2004	14.2	33.4
SEE energy community (APL3)	Jul. 2007	9.0	20.3
Energy efficiency	Dec. 2008	9.4	11.4
Land administration	Dec. 2008	16.2	12.7
Agriculture and institutional development	Apr. 2009	15.7	3.4
Agriculture and institutional development (GEF)	Apr. 2010	4.0	1.5
Higher education and research	Jan. 2011	16.0	0

Source: World Bank.

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 was the financial-sector development policy loan (FSDPL) of US$80 million, which was disbursed in early 2012. Currently, the Bank is preparing a Policy Based Guarantee (PBG) of US$80 million, which supports the government's program to strengthen the banking sector, bring regulations into line with EU norms, and encourage resumption of credit growth. The third pillar of the Bank's engagement in 2012 will be a US$50 million development policy loan, which will provide budget support to strengthen public expenditure efficiency 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 a small investment is planned to facilitate Montenegrin participation in a Regional Catastrophe Risk Insurance Facility, and an additional new investment lending for the Industrial Waste Management and Clean-Up Project. In the area of analytical work, the main ongoing task is the preparation of the Country Economic Memorandum (CEM) report with the view to provide analytical support to the authorities' thinking and policy deliberations about how best to implement its accelerated growth agenda in Montenegro's process of accession to the EU and a vision of a prosperous economy.

Cooperation with the IMF has been good, particularly the areas of macroeconomic and financial sector policies. Bank and Fund teams have coordinated closely during the preparation of the FSDPL and PBG in 2011 and 2012. 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 2012

Title	Products	Provisional Timing of Missions	Expected Delivery Date
1. Fund work program	Article IV staff report	February 2012	April 2012
	Technical assistance on Contingency Planning and Crises Preparedness for the Central Bank of Montenegro	Fall 2012	December 2012
2. Bank work program	Policy Based Guarantee	May 2012	June 2012
	Technical assistance on the NPL resolution	Spring-Summer 2012	July 2012
	Country Economic Program	January-July 2012	Fall 2012
3. Joint work program	None	None	

Source: Prepared by the World Bank staff; questions may be addressed to Mr. Zeljko Bogetic, lead economist and country sector coordinator (CSC), Western Balkans, (zbogetic@worldbank.org; 202-473-2143).

STATISTICAL ISSUES

(As of end-March 2012)

A. Assessment of Data Adequacy for Surveillance
General: Data provision has some shortcomings that significantly affect surveillance. The main problems are in national accounts and balance of payments. Montenegro began participation in the GDDS in December 2011.
National Accounts: The Statistical Office of Montenegro (MONSTAT) compiles real sector data. MONSTAT has started to adopt the *1993 System of National Accounts* as a framework for compiling national accounts estimates. The scope of the accounts is currently limited to the annual production and expenditure account in current and previous year's prices. Accuracy of the data sources needs to be improved and breaks in the time series eliminated by revising historical data. Business statistics are still following the material system product concepts, collecting data mainly on quantities produced. The quality of investment and merchandise trade data is unsatisfactory. MONSTAT switched from general to specific trade statistics in an effort to better capture imports; however, there are indications that exports remain under-recorded, resulting in an underestimation of GDP. National accounts data are also undermined by the lack of sound techniques to account for unreported activities. Some work has been done on measuring informal activity in construction, retail trade, hotels and restaurants, but a more comprehensive approach needs to be developed. Statistical techniques for deriving volume measures of GDP are constrained by the lack of suitable price and volume indices. Some progress has been made in the compilation of quarterly national accounts. Following STA missions to Podgorica in December 2010 and August 2011 to assist MONSTAT in the compilation of NA and QNA, data needs are being addressed. The latest STA mission concluded there is still a critical need to: (i) improve data quality, volume measures price indices by economic activity, as well as data exhaustiveness for annual GDP; (ii) compile quarterly GDP components at current and previous year's prices. The QNA statistics for the first quarter of 2012 are scheduled to be published in July 2012.
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, new goods, and missing items are used, resulting in a downward bias. There are inconsistencies between monthly and annual price indices. The EU harmonized consumer price indices, as well as export and import price indices were compiled and released starting in 2011. The export price index has been published since 2009, and the industrial import price index since 2011.

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 the labor and wage indicators is relatively good, but information on foreign employment remains limited. 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.
Monetary 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. 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.
Balance of payments: Balance of payments 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 export and import data from MONSTAT from CIF to FOB basis. The difference in the external data from the CBM and from MONSTAT reflects this adjustment. However, there are indications that exports continue to be underestimated. This is an issue that MONSTAT is currently investigating. Weaknesses remain, due primarily to the paucity of source data and the shortage of staff to undertake the data collection and compilation processes. As with many euroized economies, difficulty in estimating currency and deposits and large errors and omissions continue to be an issue in the balance of payment statistics. 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. Further, the ITRS records transactions on a cash basis, whereas balance of payments transactions should be recorded on an accruals basis. The CBM still needs to

undertake a small number of direct surveys of enterprises to supplement the data received through the ITRS, and prepare comprehensive documentation on compilation methods and data sources. The CBM has received TA on International Investment Position (IIP) statistics, but does not yet disseminate these data.	
B. Data Standards and Quality	
Montenegro began participating in the GDDS in December 2011.	No data ROSC is available.
C. Reporting to STA	
A page for Montenegro in *International Financial Statistics* (IFS) was introduced in the March 2007 issue. Montenegro does not report government finance statistics for publication in the *Government Finance Statistics Yearbook* or *IFS*. Montenegro does not report data for the IMF's Coordinated Portfolio Investment Survey and the Coordinated Direct Investment Survey, respectively. The CBM does not yet report monetary data in the format of Standardized Report Forms (SRFs). To avoid duplication of effort, the CBM will need to decide whether to adopt the European Central Bank's framework for collecting, compiling and reporting monetary data or the STA-developed SRFs, either of which will provide monetary data that accord with international standards.	

Montenegro: Table of Common Indicators Required for Surveillance
(As of end-March 2012)

	Date of Latest Observation	Date Received	Frequency of Data	Frequency of Reporting	Frequency of Publication
International reserve assets and reserve liabilities of the monetary authorities[1]	Jan. 2012	Feb. 2012	M	M	M
Reserve/base money	Jan. 2012	Feb. 2012	M	M	M
Central bank balance sheet	Jan. 2012	Feb. 2012	M	M	M
Consolidated balance sheet of the banking system	Jan. 2012	Feb. 2012	M	M	M
Interest rates[2]	Jan. 2012	Feb. 2012	M	M	M
Consumer price index	Dec. 2011	Jan. 2012	M	M	M
Revenue, expenditure, balance and composition of financing[3] – general government[4]	Dec. 2011	Feb. 2012	Q	Q	Q
Revenue, expenditure, balance and composition of financing[3]– central government	Dec. 2011	Feb. 2012	M	M	M
Stocks of central government and central government-guaranteed debt[5]	Dec. 2011	Feb. 2012	Q	Q	Q
External current account balance	Dec. 2011	Feb. 2012	Q	Q	Q
Exports and imports of goods	Dec. 2011	Feb. 2012	Q	Q	Q
GDP/GNP	2010	Nov. 2011	A	I	A
Gross external debt	Dec. 2011	Feb. 2012	Q	Q	Q
International Investment Position[6]	…	…	NA	NA	NA

Source: IMF Staff.

[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 non-bank financing.

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

[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), Semi-annually (SA), Annually (A), Irregular (I); or Not Available (NA).

Statement by the IMF Staff Representative on Montenegro
May 11, 2012

This statement provides information that has become available since issuance of the Staff Report. The information does not alter the thrust of the staff appraisal.

1. **The first quarter fiscal outturn was weaker than expected,** largely on the back of considerable revenue underperformance (a decline of 12 percent year-on-year), while wages and entitlement spending came in lower than budgeted. These factors pushed the first quarter Central Government deficit to 1.6 percent of GDP, in excess to the original full-year general government deficit target of 1.2 percent.

2. **The cabinet adopted a revised 2012 budget** that increases excise duties on heating oil and gas; introduces a new tax on SIM cards, cable TV, electricity meters and smoking zones; and reduces allowances and salaries for public officials and capital spending. The authorities estimate the combined 2012 fiscal savings from these measures at 0.7 percent of GDP and are seeking parliamentary approval.

3. **The government has finalized a commercial bank loan.** The five-year loan for €150mn provides €100mn in new financing, with €50mn refinancing a previous loan due in 2015, and thereby lowers near-term fiscal financing risks.

4. A potential buyer for the insolvent steel mill has emerged while discussions on the future of the aluminium plant (KAP) remain ongoing. A successful bid was placed at the third steel plant auction in May. Regarding KAP, following the parliamentary decision in March to cancel the privatization contract, negotiations with the owner over the resolution of their stake in KAP continue. Parallel negotiations are taking place with lenders over a possible rescheduling of two guaranteed loans to KAP (totaling €110 million) that are at risk of being called.

Public Information Notice (PIN) No. 12/51
FOR IMMEDIATE RELEASE
May 16, 2012

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

IMF Executive Board Concludes 2012 Article IV Consultation with Montenegro

On May 11, 2012, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Montenegro.[1]

Background

Three years after the sudden end of Montenegro's boom, there has been considerable progress toward recovery. Strong growth in tourism supported real GDP growth of 2½ percent in 2011, bringing output nearly back to its pre-crisis level in 2008. The recovery is at risk of stalling, however, with the projected downturn in the euro area likely to weigh on growth in 2012. The debt overhang continues to linger, moreover, with domestic liquidity shortages a growing constraint. High-frequency economic indicators depict a weakening of activity in late 2011 and early 2012.

In addition, the policy buffers that have supported growth in recent years have been largely depleted. Public debt has risen sharply since 2007, increasing from 28 to 47 percent of GDP at the end of 2011, as fiscal surpluses quickly turned into large deficits following the collapse of the boom.

[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. 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.

Fiscal imbalances have proved difficult to rein in, reflecting a large fall in revenue after the collapse of the boom, rising pension expenditures, and costs stemming from public support for struggling enterprises. However, and notwithstanding an increase in the headline deficit, there was some progress toward fiscal consolidation in 2011. Although the headline deficit rose to 6.3 percent of GDP, this partly reflected payment of called loan guarantees that had been extended in 2009-10 but did not have an impact on demand in 2011. Adjusting for these payments, the fiscal stance tightened by 0.7 percent of GDP. The authorities aim for further consolidation this year and over the medium term, and are in the process of identifying needed measures to achieve this adjustment.

After three years of rapid bank deleveraging, there are indications that conditions are stabilizing. The gradual return of deposits to the banking system continued in 2011, and banks took steps to off-load problem loans and re-align their lending with their domestic deposit base. However, the system remains burdened by high non-performing loans—notwithstanding their recent sharp decline—and is lagging in provisioning. New bank lending remains limited, reflecting the existing debt overhang and the significant uncertainty over the economic outlook.

Executive Board Assessment

Executive Directors commended the authorities' efforts to stabilize the economy, and welcomed the progress made since the financial crisis. With the recovery now at risk of stalling, Directors called for intensified efforts to address large fiscal and external imbalances, further enhance financial sector stability, and improve competitiveness.

Directors recognized the sizable public expenditure adjustment over the past few years, but underscored the need for further high-quality deficit reducing measures to put public debt on a declining trajectory. While fiscal consolidation will need to rely on both revenue and expenditure measures, the more sizable adjustment should come from further spending cuts. Directors saw the 2012 supplementary budget, adopted by the cabinet, as a step in the right direction. Going forward, Directors recommended further reducing personnel and entitlement spending. They underscored the importance of ending fiscal and quasi-fiscal support to the metals sector and assessing its viability. Directors stressed that revenue measures should focus on improving tax administration, but saw some scope to raise tax rates that are below regional levels. Some Directors cautioned that tax rate increases should be considered only after tax administration is strengthened, given their potential impact on competitiveness.

Directors commended the authorities' efforts to stabilize the financial sector, and to improve the framework for crisis preparedness and banking resolution. Given remaining vulnerabilities, they stressed the need to further strengthen supervision and regulation, including the macroprudential framework. They underlined the need to enforce capital requirements and improve asset quality, while monitoring liquidity closely and maintaining high prudential buffers.

Directors welcomed progress in advancing structural reforms, and called on the authorities to accelerate efforts to enhance competitiveness and attract foreign investment. In particular, they underscored the need to further improve the business environment and increase labor market flexibility. Directors also saw merit in reforms to ensure that social protection schemes target the neediest and do not impede labor market participation.

Directors called for continued efforts to address shortcomings in economic statistics which hamper policy design and evaluation.

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Montenegro: Selected Economic Indicators, 2008-12

	2008	2009	2010	2011 Est.	2012 Proj.
Real economy (percent change, unless otherwise noted)					
Nominal GDP (millions of €)	3,086	2,981	3,104	3,260	3,334
Gross national saving (percent of GDP)	-10.0	-3.1	-2.6	-1.2	-0.6
Gross investment (percent of GDP)	40.7	27.1	22.8	19.4	20.3
Real GDP	6.9	-5.7	2.5	2.5	0.2
Industrial production	-2.0	-32.2	17.5	-10.3	...
Tourist arrivals	4.8	1.6	4.6	8.7	...
Consumer prices (average)	9.0	3.6	0.7	3.1	2.0
Consumer prices (end of period)	7.2	1.7	0.7	2.8	1.7
Money and credit (end of period, percent change)					
Bank credit to private sector	25.0	-15.1	-8.9	-13.0	...
Enterprises	21.3	-18.0	-11.2	-17.6	...
Households	31.2	-10.7	-5.7	-2.6	...
Private sector deposits	-14.2	-4.1	5.9	1.2	...
General government finances (accrual; percent of GDP) [1]					
Revenue and grants	48.4	42.6	41.3	37.9	38.0
Expenditure	51.5	47.9	46.0	44.2	43.2
Overall balance	-3.1	-5.3	-4.7	-6.3	-5.2
Primary balance	0.5	-4.4	-3.7	-4.6	-3.3
Privatization receipts	1.2	4.4	0.9	0.5	0.5
General government gross debt (end of period)	31.9	40.7	42.4	46.9	50.2
Balance of payments (percent of GDP)					
Current account balance	-50.6	-29.6	-24.6	-19.4	-19.7
Foreign direct investment	18.9	35.8	17.8	11.9	11.4
External debt (end of period, stock) [2]	90.8	93.5	96.4	99.9	107.3
REER (CPI-based; average percent change, + indicates appreciation)	1.6	6.4	0.0	-3.2	…

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

[1] Includes extra-budgetary funds and local governments, but not public enterprises.

[2] Estimate, as private debt statistics are not officially published.

Statement by Menno Snel, Executive Director for Montenegro and Ana Martinis, Advisor to the Executive Director
May 11, 2012

The authorities of Montenegro would like to thank staff for the open and constructive dialogue during the mission. The authorities broadly agree with staff's analysis and share staff's views regarding the economic challenges ahead. The importance of the staff papers is hard to overestimate, especially for a small country like Montenegro, for which Fund publications represent the most complete source of information and reference for international financial markets. Bearing this in mind, and fully devoted to transparency, the authorities continue the practice of consenting to the publication of the staff report.

Macroeconomic developments

Montenegro's economic activity recovered after a major contraction in 2009, boosted by continued foreign investment inflows and buoyant tourism revenues. Thus, real GDP grew by 2.5 percent annually in 2010 and 2011. Price stability has been maintained, despite moderate acceleration of inflation in 2011 driven by food and fuel prices and increases in excises on alcohol and tobacco. The current account deficit has adjusted considerably since the wake of the crisis (from above 50 percent in 2008 to 19.4 percent in 2011), but, nevertheless, external imbalances remain high.

As of late 2011 the external conditions deteriorated, leading to a slowdown in exports and consequently, weakening of growth. In addition, the first quarter of 2012 was particularly challenging due to several other exogenous shocks - the extremely difficult weather conditions, that paralyzed trade and transport for almost two weeks in February, and unplanned budget costs related to the repayment of a state-guaranteed loan for the aluminum company KAP. Hence, for this year the authorities expect growth to slow down to 0.5 percent, while inflation is expected to remain well contained (around 2 percent on average).

Fiscal policy

The authorities are fully aware that in a euroized system with no leeway for monetary policy, fiscal policy is the main effective instrument for policy adjustment. Against such backdrop, throughout the past three years the authorities have pursued strong fiscal consolidation. Fiscal expenditures have been cut by more than 8 percentage points of GDP in the period 2008-2012, achieving one of the largest expenditure adjustments among the peer countries. Last year alone the expenditures were down by 1.8 percent of GDP including a guarantee payment of 1 percent of GDP, bringing adjustment to 2.8 percent in only one year. While the cuts were mostly related to non-essential capital spending, the authorities also implemented new rules for strict control of public wages and initiated downsizing of the public sector work force, centralized monitoring of all current expenditures, reduced the number of spending units and adopted a new financing scheme for local governments. According to the authorities' data, arrears were reduced in 2011 by 0.3 percent of GDP.

Also in line with previous Fund advice, the authorities recently signed an agreement with the public sector unions which introduces opt-out clauses from collective agreements and allows for public wage decrease if one of the two predefined criteria is satisfied: (i) real GDP growth below 2 percent or (ii) budget balance below zero. These triggers represent for the Government favorable economic criteria provisions for the wage adjustments and could easily result in public sector wage cuts already for this year.

Despite the sizeable headline fiscal adjustment, the country's overall fiscal position has been hit hard by the materialization of contingent liabilities, in particular the state-guaranteed loans for the metal industry. In 2011 the government repaid a guarantee amounting to 1 percent of GDP for a steel company which declared bankruptcy, while in April 2012 a guarantee for the aluminum company KAP was called and fully repaid in the amount of 0.7 percent of GDP. Against this backdrop, and due to revenue shortfalls, the major consolidation efforts have not been reflected in the overall balances. However, the Government has recently (end-April) sold the bankrupt steel mill to a Turkish steel company, which will bring additional 0.3 percent of GDP of revenues in 2012 and thus help reduce the fiscal burden of the guarantee payments.

Public debt reached 45.3 percent of GDP as of end-February 2012 and, although it has not reached the 60-percent threshold, the authorities are mindful of the high debt sustainability risks due to their unique policy framework. Given the currently unfavorable financing conditions on international markets, this year the authorities plan to rely predominantly on bilateral and multilateral borrowing, including through World Bank assistance. After the approval of the Development Policy Loan (DPL) early this year, Montenegro is in the final stage of negotiations for a Policy-Based Guarantee (PBG), which, if successfully completed, would help the country in acquiring financing under substantially more favorable terms.

Supplementary budget for 2012

In order to address the revenue shortfall in the first quarter (amounting to 0.7 percent of GDP compared to last year) and to provide fiscal space for financing the guarantee payment, in April the Government introduced a supplementary budget with total fiscal adjustment of 1.2 percent of GDP. The new budget is expected to be adopted by the Parliament by end-May and includes specific deficit-cutting measures on both the revenue and the expenditure sides:

- Revenue-boosting measures (with expected effect of 0.7 percent of GDP) include: introduction of tax on mobile SIM cards, cable television and electricity meters, a fee for "smoking zones", increase in excises on fuel oil for heating, tax on undistributed profits, measures against the unofficial economy, improvements in tax collection etc. However, the authorities aim at keeping the basic tax rates unchanged in order to maintain the country's comparative advantage of low basic taxation.

- On the expenditure side, cuts amount to 0.5 percent of GDP and include savings on official automobiles, telephone services, travel allowances, office material costs, a 7-percent wage cut for high-ranking public officials and embassy employees and further cuts in capital spending.

Financial sector

The banking sector had been severely hit by the boom-bust episode, including through deposit withdrawals, credit crunch, deteriorating quality of credit portfolios and eroding profitability. Hence, given the limited scope for the use of conventional monetary policy instruments, the central bank focused its policy actions on improving the regulatory and supervisory framework.

Thanks to decisive actions by the authorities, during 2011 the situation in the banking sector improved significantly. Tightened regulation pressed foreign owners to recapitalize their banks and to ensure appropriate liquidity in the system. The capital adequacy ratio rose to 16.5 percent of risk-weighted assets as of end-2011. Non-performing loans fell by 10 percentage points from their peak reached in mid-2011 until the end of the same year, as major banks, pushed by the increased provisioning requirements, cleaned their balance sheets by selling their bad credit portfolio to parent banks or to factoring companies financed by parent banks. Confidence in the banking system has been restored and deposits started recovering. Nevertheless, credit activity still remains subdued, affected by the high financing costs and lack of credit demand from creditworthy clients.

Going forward, the authorities are fully aware of the potential spillover risks from the euro area crisis and the deleveraging processes in Europe and will thus continue improving the macroprudential framework. The central bank recently established a Council for bank liquidity, adopted regulation on large exposures and implemented stress testing in coordination with the ECB. Furthermore, contingency plans have been recently adopted by each and every regulatory institution at the internal level, and the National Contingency Plan, developed in cooperation with the Fund's technical assistance, has been adopted by the Financial Stability Council. Finally, five new laws covering the financial sector will be adopted in 2012 (i.e. an insurance law and a compulsory insurance law, a law on capital markets, a law on payment services, and a law on financial collaterals).

Structural reforms

In addition to fiscal consolidation and improvements in public finances, significant progress has been made in tackling medium-term challenges through implementation of an ambitious and comprehensive structural reform agenda:

1. A labor market reform, adopted in 2010 and additionally amended in 2011, liberalized the use of fixed term contracts, lowered the minimum obligatory level of severance payments and introduced restrictions in unemployment protection, including cuts in the unemployment benefits and maternity and sick leave benefits, with the aim to address low labor force participation rates.
2. The pension system reform, implemented as of January 2011, increased the retirement age to 67 (from 65 for men and 60 for women), removed incentives for early retirement and reduced the frequency of pension benefit index calculation from biannually to once a year.

3. This year the authorities have initiated social protection system reform, which will, *inter alia*, include cuts in the government compensation for maternity leave and sick leave and introduce private health insurance premium for obtaining full medical coverage.
4. Having in mind the importance of foreign investment for this small open economy, the authorities are particularly dedicated to the business environment reform. Their efforts resulted in continued progress in various business climate and economic freedom indicators, according to which Montenegro stands out as the second best performer in the region (after Macedonia). Nevertheless, the authorities agree with staff that the business environment needs continued nourishing. In that respect, the Council for the Elimination of Business Barriers was established for monitoring business environment progress across the ministries, one-stop shops for business registration were opened and electronic registration will be introduced by end-June.

EU and WTO accession

International organizations and the European Union all note the significant and sustained progress on structural reforms, especially in the financial sector, trade, and social sectors. In particular, the forthcoming start of negotiations for EU membership, tentatively scheduled for June 2012, represents a confirmation of the authorities' efforts in achieving the objective of adhering to the EU principles. Going forward, the EU accession process will undoubtedly bring additional stimulus for continued reforms in legislative, judicial and economic areas and provide incentives for foreign investments. Also, in May 2012 Montenegro became a member of WTO, reflecting the government's commitment and tangible efforts toward open trade and regional trade collaboration within CEFTA.

Final remarks

The Montenegrin authorities are mindful of the key domestic and external risks presented in the staff paper, including sizeable external imbalances and fast-growing public debt, and will continue to use the available policy mix of fiscal and structural reforms to reduce vulnerabilities, as well as to improve competitiveness and enhance the long-term growth potential of Montenegro. Given the huge untapped potential in the tourism and energy sectors, the authorities firmly believe that Montenegro is set to return to a comparably higher growth trajectory.