INTERNATIONAL MONETARY FUND

IMF Country Report No. 19/293

MONTENEGRO

September 2019

2019 ARTICLE IV CONSULTATION—PRESS RELEASE, STAFF REPORT, AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR MONTENEGRO

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2019 Article IV consultation with Montenegro, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its September 6, 2019 consideration of the staff report that concluded the Article IV consultation with Montenegro.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on September 6, 2019 following discussions that ended on June 28, 2019, 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 August 8, 2019.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for Montenegro.

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

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FOR IMMEDIATE RELEASE
September 10, 2019

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

IMF Executive Board Concludes 2019 Article IV Consultation with Montenegro

On September 6, 2019 the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Montenegro.[1]

Montenegro has enjoyed strong economic growth in recent years, boosted by the implementation of large investment projects, including the construction of the Bar-Boljare highway. Growth should continue over the medium term, though at a more moderate pace as highway construction ends. Staff projects the economy to expand by 3 percent in 2019 and 2.5 percent in 2020, with the end of highway construction acting as a drag on growth.

While the implementation of large publicly financed infrastructure projects has added economic growth, the accompanying use of fiscal resources has contributed to a large increase in government debt including guarantees, which reached 79 percent of GDP in 2018. Recognizing the need to reduce public debt, the government has continued to implement its 2017 fiscal consolidation strategy. Most of the fiscal measures have been implemented, and the underlying fiscal position has improved. If the fiscal adjustment is maintained, the primary fiscal surplus should exceed 2 percent of GDP beginning in 2021, leading government debt to decline to 61 percent of GDP by 2024.

Despite the recent intervention in two non-systemic domestic banks, the overall banking sector exhibits improving asset quality, strong credit growth, high liquidity, and is well capitalized. However, the sector appears crowded for a small country, which may create earnings challenges for some banks.

The lack of an independent currency and declining fiscal space constrain Montenegro's ability to absorb shocks, which underscores the need for an improvement in economic flexibility to sustain growth over the long run. Low labor productivity and employment levels and a large informal sector limit potential growth.

[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.

Executive Board Assessment[2]

Executive Directors welcomed the strong recent growth performance of the Montenegrin economy, bolstered by large investment projects and buoyant tourism, and took positive note of the significant fiscal adjustment since 2017. Notwithstanding these achievements, Directors stressed the importance of continued fiscal adjustment, further efforts to strengthen banking sector supervision, and fiscal and structural reforms to support inclusive growth over the medium term.

Directors welcomed the authorities' continued implementation of their medium-term adjustment strategy, which has improved the underlying fiscal position over the last two years. Amid high debt levels, Directors concurred that the maintenance of a strong primary fiscal surplus over the medium term is necessary for government debt to decline to safer levels. Directors also called for further efforts to improve the efficiency of public spending, including by carefully managing infrastructure investment, rationalizing government employment and tax expenditures and furthering pension reforms. In this context, Directors encouraged the authorities to move forward with their plans to develop medium-term budgetary and public investment management frameworks. They noted that such initiatives would help create fiscal space over the medium term for greater high-productivity capital spending and targeted social spending and promote fiscal and debt sustainability.

Directors underlined that caution is needed in implementing the next phases of the Bar-Boljare highway project until feasibility, cost-benefit analyses, and financing issues are fully addressed. In this context, Directors underscored the need to consider the trade-offs between undertaking the highway investment vis-à-vis other priority spending needs to meet Montenegro's development goals. In a similar vein, Directors agreed that PPP arrangements should be approached with caution to reduce the risk of assuming significant contingent fiscal liabilities.

Directors welcomed recent measures to strengthen banking supervision, including the establishment of a Supervisory Committee, recent refinements in asset classification rules and ongoing efforts to bolster the capacities and resources in off-site supervision. Notwithstanding these efforts, Directors underscored the importance of furthering risk-based supervision, introducing macroprudential measures when warranted, harmonizing banking laws with the EU Directives, and completing the planned asset quality review by the end of 2020. Directors also encouraged the authorities to strengthen the AML/CFT supervisory framework, including through enhanced monitoring of potential reputational and financial integrity risks posed by the investor citizenship program.

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

Directors noted the importance of structural reforms to boost competitiveness and inclusive growth and improve Montenegro's external position and labor market outcomes over the medium term. While welcoming the authorities' recent efforts to reduce the labor tax wedge and the proposed labor law to selectively reduce some gaps in employment protection between temporary versus open-ended contracts, Directors encouraged the authorities to carefully consider the impact of the planned minimum wage increases.

Montenegro: Selected Economic Indicators, 2015–20

	2015	2016	2017	2018	2019 Proj.	2020 Proj.
Output, prices and labor market (percent change, unless otherwise noted)						
Real GDP (percent change)	3.4	2.9	4.7	4.9	3.0	2.5
Nominal GDP (in millions of euro)	3,655	3,954	4,299	4,619	4,807	5,015
Industrial production	8.2	-2.9	-4.4	22.5	...	...
Tourism (Overnight stays)	5.3	8.4	10.5	8.2	...	...
Unemployment rate (in percent)	17.6	17.7	16.1	15.2	...	...
Consumer prices (average)	1.5	-0.3	2.4	2.6	1.1	1.9
Consumer prices (end of period)	1.4	1.0	1.9	1.7	2.3	1.6
Average net wage (12-month)	0.7	4.0	2.3	0.1	...	...
General government finances (percent of GDP) [1]						
Revenue and grants	40.4	41.3	40.3	41.4	42.0	41.0
Expenditure	46.4	47.5	47.2	47.7	45.7	41.9
Overall fiscal balance	-6.0	-6.2	-6.9	-6.3	-3.6	-0.9
Primary fiscal balance	-3.6	-4.0	-4.5	-4.1	-1.4	1.5
General government gross debt	69.0	66.6	66.3	72.6	81.1	74.8
General gov't gross debt (authorities' definition) [2]	66.3	64.6	64.4	70.8	79.4	73.1
General gov't debt, including loan guarantees	76.4	74.1	73.6	78.8	88.8	82.2
Monetary sector (end-period, percent change)						
Bank credit to private sector	2.4	6.3	8.4	9.1	7.0	7.0
Enterprises	2.0	1.5	6.3	5.2	...	...
Households	2.8	11.0	10.3	12.5	...	...
Private sector deposits	9.0	6.0	15.2	6.0	...	...
Balance of payments (percent of GDP, unless otherwise noted)						
Current account balance	-11.0	-16.2	-16.1	-17.2	-17.1	-14.9
Foreign direct investment	16.9	9.4	11.3	7.1	8.9	8.9
External debt (end of period, stock)	166.2	160.9	159.2	167.5	180.0	178.5
REER (CPI-based; average change, in percent; - indicates depreciation)	0.4	0.6	0.5	2.5	...	...

Sources: Montenegro authorities; and IMF staff estimates and projections

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

2/ The authorities do not include the arrears of local governments in their definition of general government gross debt.

INTERNATIONAL MONETARY FUND

MONTENEGRO

STAFF REPORT FOR THE 2019 ARTICLE IV CONSULTATION

August 8, 2019

KEY ISSUES

Background. The economy has grown strongly since 2015, bolstered by large investments and tourism. While the construction of the first phase of a major highway project has boosted growth, it has also raised government debt. To preserve fiscal sustainability, the authorities embarked on a medium-term adjustment strategy in 2017. The financial sector has been stable and two non-systemic banks were placed into bankruptcy this year.

Outlook and Risks. Growth is expected to moderate toward 3 percent in 2019 and over the medium term as highway construction ends. Government debt is projected to peak in 2019 and decline rapidly thereafter. One crucial risk relates to maintaining healthy primary surpluses and avoiding unsustainable new fiscal costs related to further construction of the highway. Threats to financial stability can only be mitigated by maintained commitment to stronger bank supervision.

Policy Recommendations

- **Fiscal Policy.** A primary fiscal surplus of at least 2 percent of GDP should be maintained over the medium term. Streamlining public employment, reforming the pension system, and eliminating wasteful tax expenditures are key priorities. To safeguard fiscal stability and sustainability, the net benefits of further construction of the highway should first be carefully assessed and then weighed against opportunity costs, whilst remaining mindful of fiscal risks from possible PPP arrangements.

- **Financial Sector.** Efforts to improve banking and Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT) supervision are paramount. The emphasis should be a shift to risk-based tools for supervision in both off-site and on-site functions, and the establishment of a stronger supervisory structure within the central bank. A thorough, independent asset quality review of the banking system should be completed no later than end-2020.

- **Labor Markets.** The main priorities are reduction of the labor tax wedge and implementation of the new labor law that aims to increase labor market flexibility. Future decisions on the minimum wage should consider a broad set of indicators and require careful analyses of the impact of past increases.

Approved By
Jörg Decressin (EUR) and Yan Sun (SPR)

Discussions were held in Podgorica on June 17 - 28, 2019. The team comprised Srikant Seshadri (head), Stephanie Eble, Michelle Hassine, Piotr Kopyrski, William Lindquist, Tonny Lybek (all EUR), A. Antonio Hyman Bouchereau, and Maksym Markevych (both LEG). Mr. Josic (OED) joined most of the meetings. The team met with the authorities (Prime Minister, Central Bank of Montenegro, Ministries of Economy, Finance, Transportation, Labor, and Public Administration), private sector representatives (unions, employers, and banks), the diplomatic community, and international agencies (EC and EBRD). Brett Stewart and Aniko Madaraszova (EUR) provided support from HQ.

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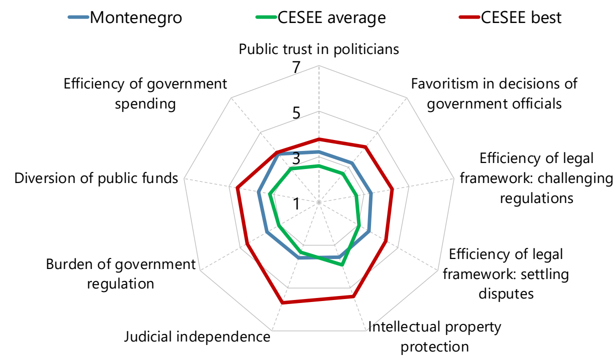
CONTEXT

1. Montenegro is a small, open tourism-dependent economy. Rigid labor markets and weak demographics constrain economic growth. The Bar-Boljare highway project has significantly increased public debt (Box 1), necessitating a fiscal adjustment which began in 2017. With unilateral euroization, there is no independent monetary policy. Foreign-owned banks make up nearly ¾ of the banking sector by assets.

2. Since independence in 2006, Montenegro has made progress in legislative reform and institution building. Yet, weaknesses in financial sector oversight the application of the AML/CFT framework, tax administration, procurement, and the regulatory framework could create vulnerabilities to corruption. Technical capacity in public investment also needs to strengthen. Montenegro is an EU candidate country, with accession envisaged in 2025 at the earliest. Parliamentary elections are due by late 2020.

Selected Sub-Components of Pillar 1. Institutions, 2018

(Index: 1-7, 7=best performer; 9 lowest indicators out of 12 total)



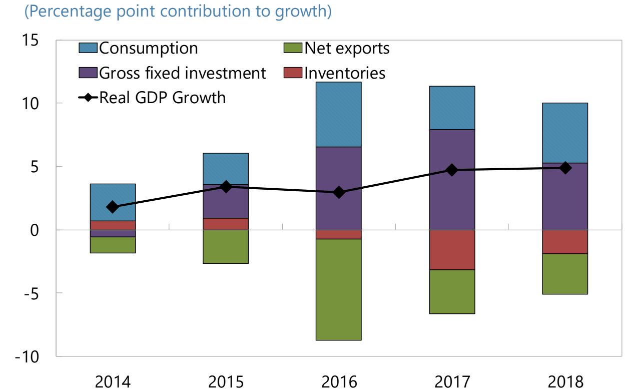
Sources: World Economic Forum, *Global Competitiveness Index*; and IMF Staff calculations.

RECENT DEVELOPMENTS

3. Growth was strong in 2018. The economy expanded 4.9 percent, the fastest since 2008, following growth of 4.7 percent in 2017. Growth continues to be bolstered by public (highway) and private (energy and tourism) investment. Tourism experienced another record year. Private consumption remained strong, despite fiscal adjustment measures. Average inflation increased from 2.4 percent in 2017 to 2.6 percent in 2018, due to a VAT increase and oil prices. The unemployment rate declined from 17 percent in 2017 to 15 percent in 2018. Partially driven by a public sector wage freeze, average wage growth declined to 0.1 percent, down from 2.3 percent in 2017.

Real GDP Growth Decomposition

(Percentage point contribution to growth)



Sources: Monstat; and IMF staff calculations.

Box 1. Bar-Boljare Highway Project

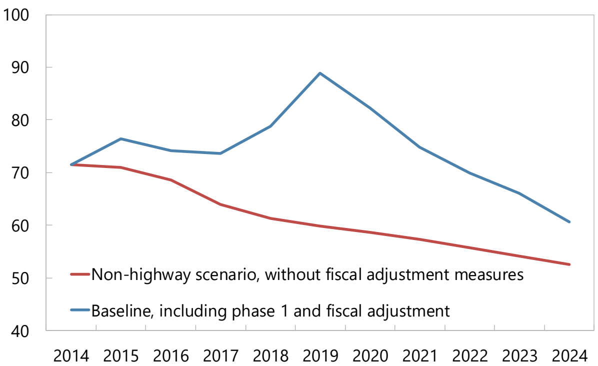
The Bar-Boljare highway aims to connect Montenegro's coast with Serbia. Only the first 41-kilometer phase—also the costliest due to difficult terrain—connecting Podgorica with the less-developed northern municipality Kolašin, at a cost of around €1 billion, is currently under construction. The remaining phases (totaling 136 kilometers) may cost somewhat more than the first phase. Phases 2 (21 kilometers from Mateševo to Andrijevica, with a possible cost around €300 million) and 3 (about 50 additional kilometers) would link the highway to the Serbian border. Phase 4 (about 65 kilometers) would extend the highway from Podgorica to the coast. An eventual corridor to Belgrade requires Serbia to extend a road currently under construction an additional 100 kilometers to the border.

China Road and Bridge Corporation started construction in 2015. Completion was initially expected in 2019 but has been delayed to 2020. Domestic contractors are allocated 30 percent of the work. China Ex-Im Bank is providing a USD-denominated loan for 85 percent of the total cost. The cost of phase 1 was initially set at €809 million (23 percent of 2014 GDP), but overruns may raise the cost by about 7 percent. Because of subsequent USD appreciation, and unhedged currency risk, the cost has increased a further 18 percent. The loan carries a 2 percent interest rate and a 20-year repayment period. Principal payments begin in 2021.

Highway construction has weighed heavily on public finances. Had the first phase not been built, the tough fiscal adjustment strategy adopted in 2017 would not have been necessary to return debt to sustainable levels. Assuming no highway spending and a primary surplus of 1 percent of GDP (consistent with the non-highway primary balance before the 2017 fiscal strategy), government debt including guarantees would likely have declined to 59 percent of GDP by 2020 instead of rising to a projected 82 percent of GDP.

General Government Debt with Guarantees

Percent of GDP

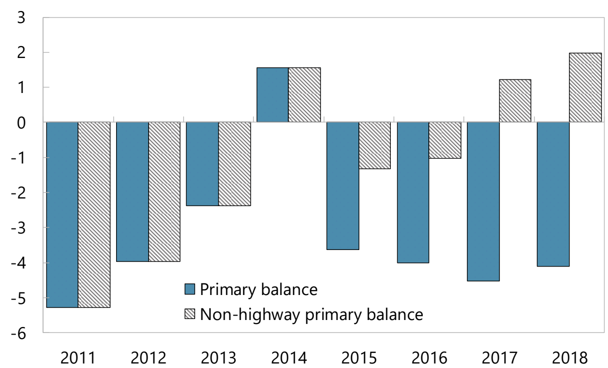


Sources: Ministry of Finance; and IMF staff estimates and projections.

4. Fiscal adjustment continued in 2018, with some setbacks. The authorities continued the 2017 adjustment by increasing the VAT 2 p.p. and continuing a partial public sector wage freeze. However, the July 2018 supplemental budget slowed the pace of tobacco excise increases due to increased smuggling. The supplemental budget also had to accommodate new public sector hiring. The primary fiscal deficit declined from 4.5 percent of GDP in 2017 to 4.1 percent of GDP in 2018. Excluding highway spending, the primary balance improved by 3 p.p. of GDP since 2016, indicating continued progress in the underlying fiscal adjustment. General government debt (including guarantees) reached 79 percent of GDP, up from 74 percent of GDP in 2017.

General Government Primary Fiscal Balance

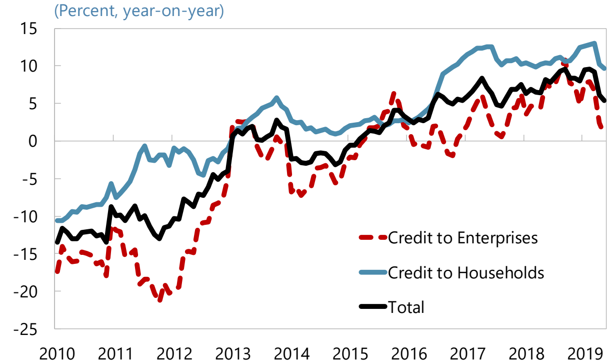
(Percent of GDP)



Sources: Ministry of Finance; and IMF staff calculations.

5. The authorities intervened in two banks in 2018. Longstanding weaknesses in two related non-systemic domestic banks (Atlas and IBM) worsened in late 2018, forcing the Central Bank of Montenegro (CBM) to intervene by installing interim administrations and freezing deposit withdrawals.[1] The CBM placed the smaller of the two banks (IBM, 1 percent of system assets) into bankruptcy within one month and placed Atlas (5 percent of system assets) into bankruptcy in April 2019 following unsuccessful offerings for new private capital. By early June, the Deposit Protection Fund (DPF) had paid out 84 and 73 percent, respectively, of eligible insured deposits.

Bank Lending by Sector 1/
(Percent, year-on-year)



1/ 2019 data distorted by recent Atlas/IBM bankruptcies.
Sources: CBM; and IMF staff calculations.

6. These interventions have not triggered spillovers into the broader banking sector. Despite the freeze on deposit withdrawals from the two intervened banks, system-wide deposits have been stable. Non-performing loans (NPLs) declined from 8 percent at end-2017 to 7.5 percent at end-2018. Private sector credit growth strengthened to 9.1 percent, led by household lending. Following the closure of the intervened banks, NPLs declined further to 5.3 percent in April 2019. The aggregate capital adequacy ratio of 15.3 percent remains above the minimum of 10 percent, while provisioning has improved. Liquid assets remain high at 22 percent of total assets.

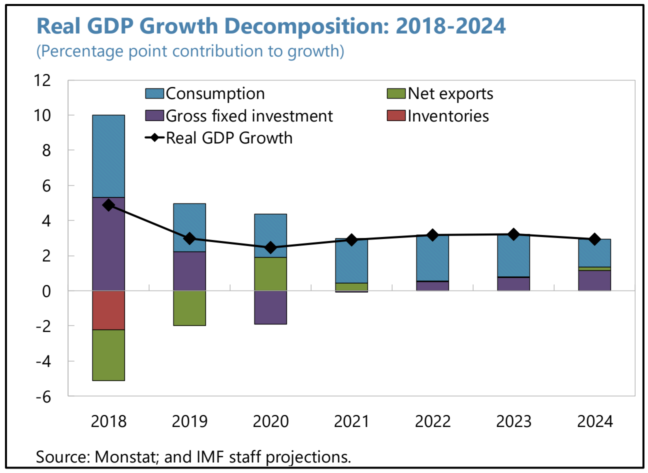
7. External imbalances remain elevated. The current account deficit increased 1 p.p. in 2018 to 17 percent of GDP. While goods and services (especially travel services) exports expanded, imports also increased strongly, driven by oil and investment-related goods (including machinery). Net FDI declined to 7 percent of GDP from 11 percent of GDP in 2017. Driven mainly by the government's issue of a Eurobond, external debt increased 8 p.p. to 167 percent of GDP in 2018.

OUTLOOK AND RISKS

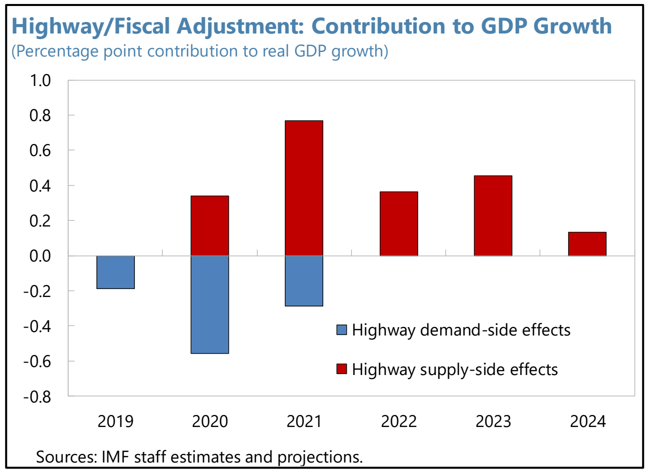
8. Growth is expected to moderate as highway investment peaks. The authorities have not yet defined the model or timing for construction of further phases of the highway. Therefore, baseline projections assume no further construction past phase 1. Growth is projected at 3.0 percent in 2019, driven again by domestic demand. With highway spending likely already having peaked in 2018, public investment will begin to act as an increasing drag on growth over 2019-21 as highway construction ends. Growth is projected to decline towards 2.5 percent in 2020 before increasing to around 3 percent over the medium term. Private investment, driven by tourism and energy sectors, is likely to remain strong over the medium term at around 21 percent of GDP. However, with public investment at a lower level, the contribution of investment to growth will moderate. Household

[1] See Box 1 of the CBM's Financial Stability Report 2018 for additional background information on the Atlas/IBM intervention.

consumption growth—alongside household credit and employment growth—is projected to moderate over the medium term to around 2 percent, compared to an average of 4.5 percent over 2016-18.



9. The medium-term supply-side effects of highway completion are uncertain. With highway spending peaking and the underlying fiscal adjustment nearly complete, the medium-term growth outlook depends partially on how supply-side effects of the completed first highway section balance the contractionary effect of lower public investment. Albeit uncertain, these effects are estimated to be moderate compared to a typical investment project due to the low economic rate of return.[2]



10. External and domestic risks persist.

- *The external environment is the main risk:* The need to refinance Eurobonds maturing in 2020/21 leaves Montenegro (B+/B1 rating) vulnerable to a tightening in global financial conditions. These risks could be largely mitigated with a successful Eurobond issue later this year. The current account deficit is projected to stay elevated, highlighting Montenegro's dependence on FDI and external debt financing. A significant slowdown in growth in Europe could also pose risks for tourism. On the other hand, new investments in tourism facilities, could provide new tourism receipts.

- *Domestic risks relate mainly to sustaining fiscal consolidation.* Parliamentary elections due in 2020 could pose a risk for fiscal discipline. Pressures to move ahead with further phases of the highway, or other large projects, without the necessary fiscal space may prove difficult to resist. Any further banking sector weakness could erode confidence and adversely affect financial stability and fiscal sustainability.

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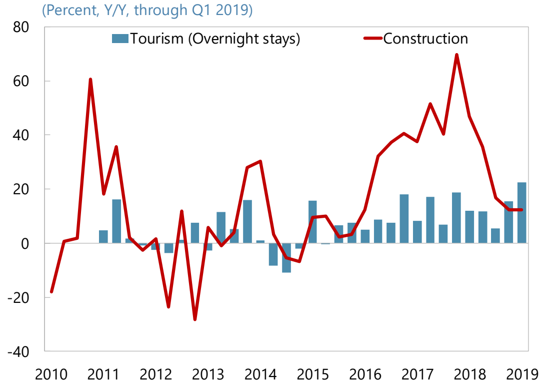
[2] See the 2017 Selected Issues Paper, Chapter 1 "Accounting for the Highway in the Macroeconomic Framework" for a discussion of the impact of the highway on growth.

Figure 1. Montenegro: Real Sector Developments

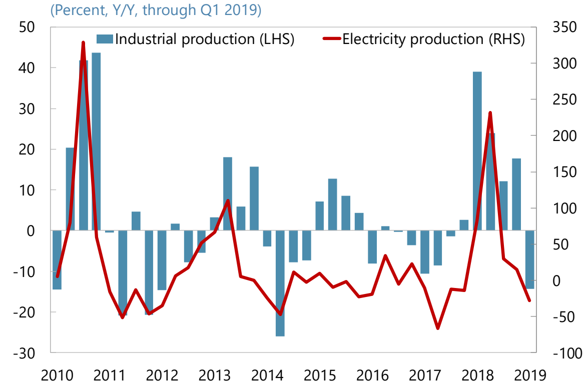
Tourism growth remains strong while construction growth has slowed as highway construction activity peaked....

Indicators of Economic Activity
(Percent, Y/Y, through Q1 2019)



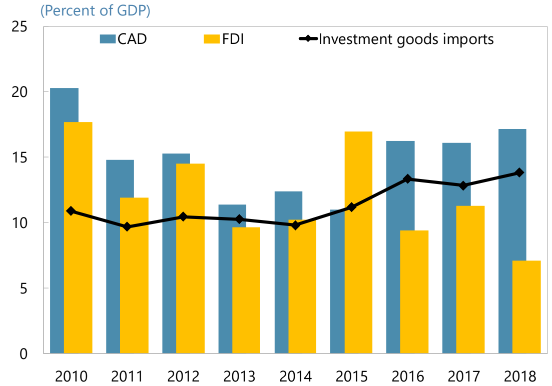
...while a weather-induced recovery in electricity produced drove industrial production growth in 2018.

Industrial Production
(Percent, Y/Y, through Q1 2019)



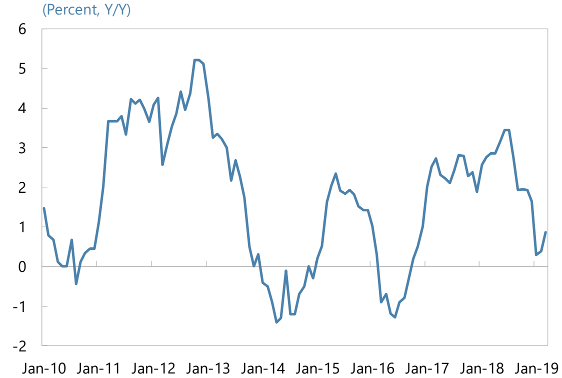
The current account deficit, roughly half financed by FDI, expanded over 2016-18 with increased investment-related imports.

Current Account Deficit and Foreign Direct Investment
(Percent of GDP)



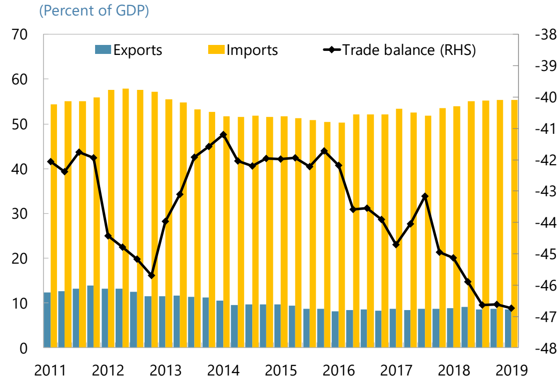
Inflation increased in 2018, driven by oil prices and a VAT increase.

Headline Consumer Price Inflation
(Percent, Y/Y)



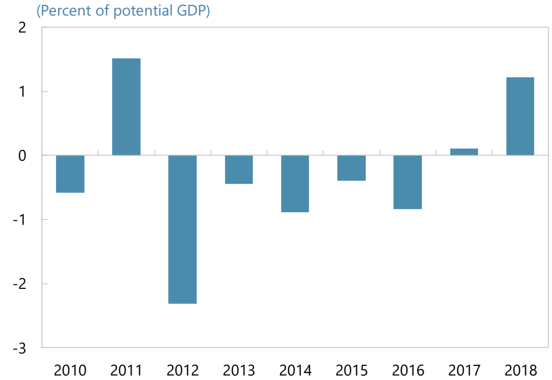
Imports for tourism, investment, and consumption continue to dwarf a small goods export base.

Merchandise Trade
(Percent of GDP)



Strong economic growth has pushed output above estimated potential.

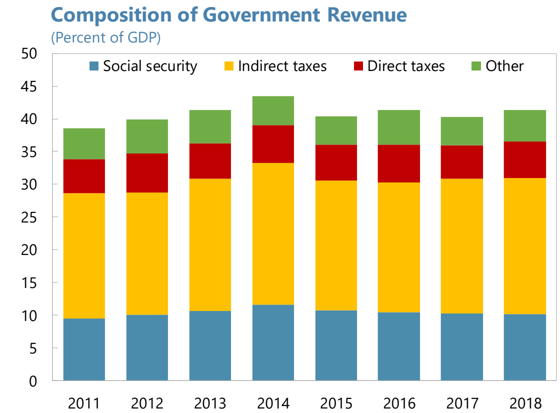
Output Gap
(Percent of potential GDP)



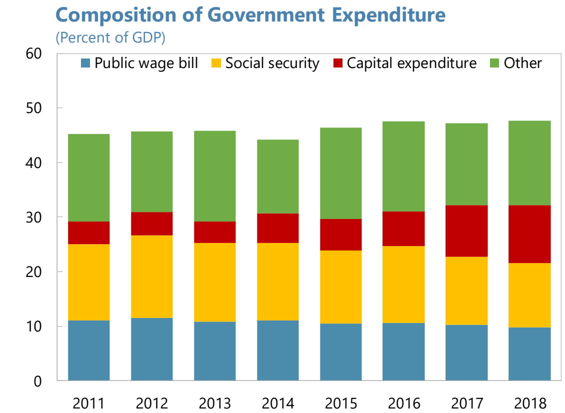
Sources: CBM; Monstat; and IMF staff calculations.

Figure 2. Montenegro: Fiscal Developments

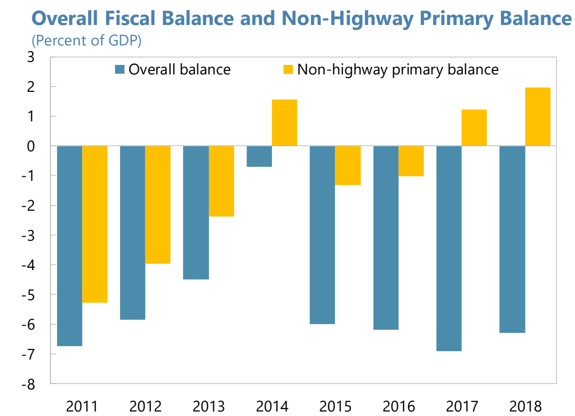
A VAT increase and receipts from a tax debt rescheduling program supported revenues in 2018….



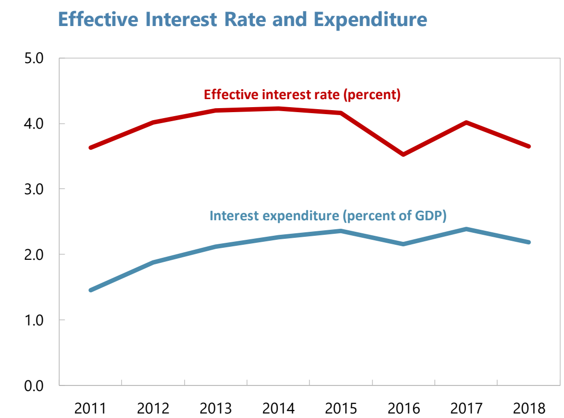
…while a reduction in the wage bill and social security expenditures created space for highway spending.



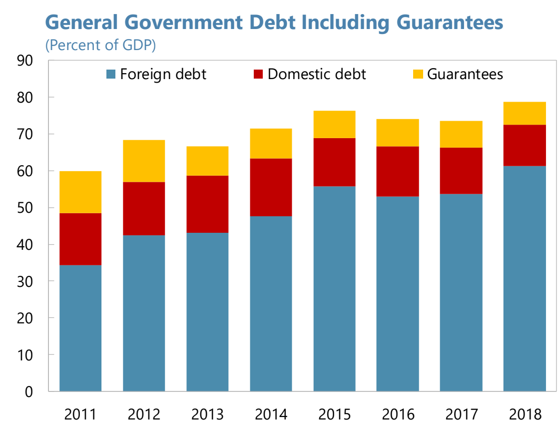
The fiscal deficit remains large, but adjustment measures have improved the non-highway primary balance.



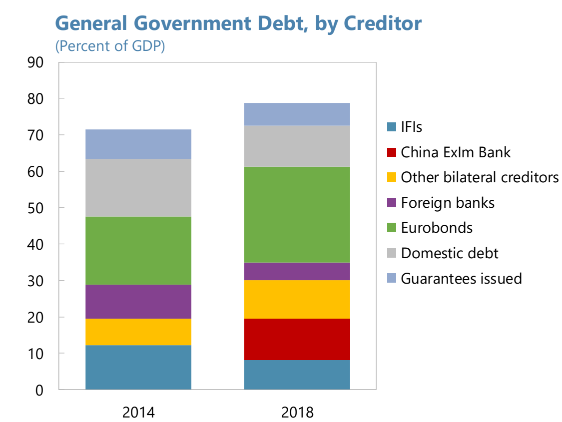
A reduction in the effective interest rate on debt has contained the interest bill, despite rising debt.



Strong nominal GDP growth has contained increases in the debt/GDP ratio since 2016.



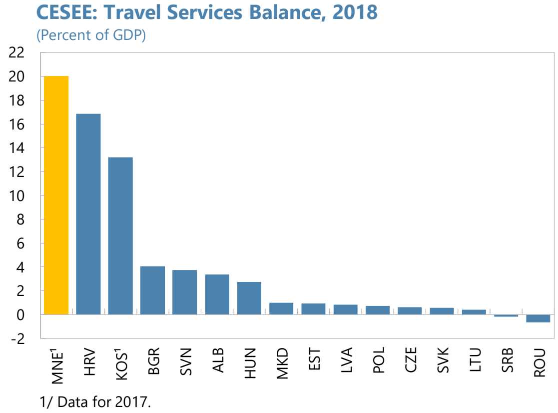
The highway project has made China Ex-Im Bank a sizeable new creditor.



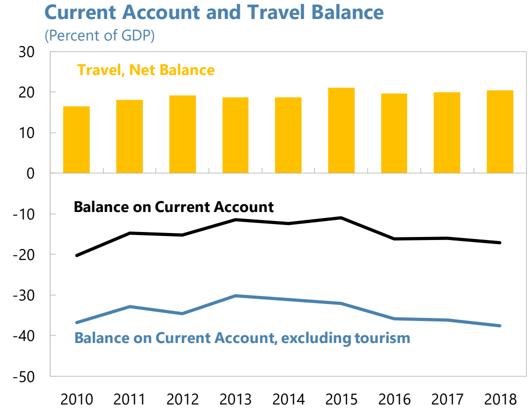
Sources: CBM; Ministry of Finance; and IMF staff calculations.

Figure 3. Montenegro: Tourism Developments

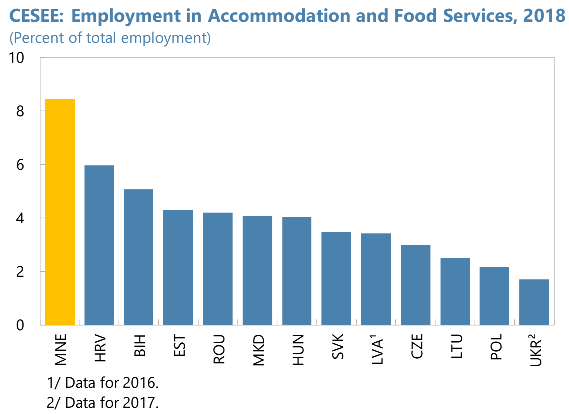
Montenegro's travel service exports are the highest in the region…



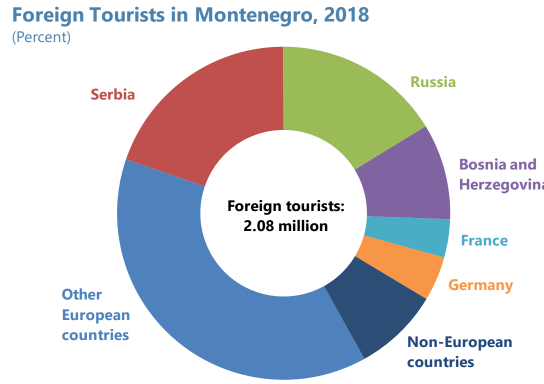
…providing significant support to the current account.



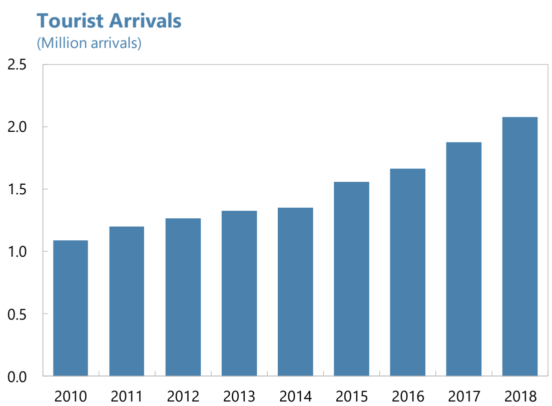
Employment in tourism-related activities is high compared to regional peers.



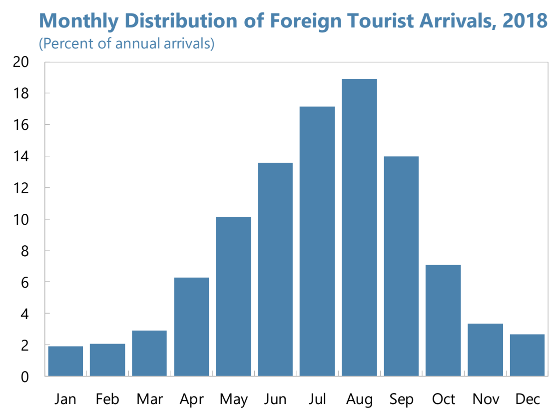
Montenegro draws mostly European tourists, especially from Serbia and Russia.



Tourism arrivals have grown strongly since 2015…



…and remain concentrated in the summer months.



Sources: Monstat; Eurostat; CBM; Haver Analytics; and IMF staff calculations.

Table 1. Montenegro: Staff Assessment of Fiscal Adjustment Factors 1/

Permanent fiscal impact (percent of GDP)

Non-highway budget measures:

Measure	2017	2018	2019	2020	2021	2022	2023	Total
Fuel excise increase 2/	0.67	…	…	…	…	…	…	0.67
VAT increase	…	0.93	…	…	…	…	…	0.93
Cigarette, coal, alcohol, and sugar drinks excises	0.07	0.01	0.05	0.13	0.02	0.02	0.02	0.34
Tax debt rescheduling 3/	0.34	-0.11	-0.04	-0.04	-0.03	-0.05	-0.02	0.05
Contributions from previously employed mothers 4/	0.04	0.07	-0.10	…	…	…	…	0.01
VAT impact of excise increases	0.02	0.00	0.02	0.03	0.00	0.01	0.00	0.08
EPCG dividend 5/	…	0.71	0.00	0.00	-0.24	-0.36	…	0.10
Total revenue measures	1.14	1.61	-0.06	0.11	-0.25	-0.38	0.00	2.18
Public sector wage freeze 6/	0.39	0.48	0.26	-0.04	-0.01	…	…	1.08
Savings from "Mothers' Law" reforms	0.47	0.06	0.20	0.07	0.01	0.04	0.05	0.90
Public sector employment reduction 7/	…	…	…	…	…	…	…	…
Reduction in discretionary spending	0.22	-0.11	0.08	0.06	…	…	…	0.24
Total expenditure measures	1.08	0.43	0.54	0.09	0.01	0.04	0.05	2.23
Total measures	2.22	2.04	0.48	0.20	-0.24	-0.34	0.05	4.41
Additional budgeted spending 8/	-0.22	-1.64	0.43	-0.02	…	…	…	-1.45
Increase in social spending (social assistance)	-0.02	-0.03	-0.10	…	…	…	…	-0.16
Total measures, net of new spending	1.97	0.37	0.81	0.18	-0.24	-0.34	0.05	2.80
Highway budget measures:								
Reduction in highway-related capital spending 9/			1.03	3.00	1.55			5.58
Total projected fiscal adjustment, including highway	**1.97**	**0.37**	**1.83**	**3.18**	**1.31**	**-0.34**	**0.05**	**8.38**

Sources: Montenegrin authorities; and Fund staff estimates and projections.

1/ In this table, a positive (+) sign indicates an improvement in the fiscal balance, while a negative (-) sign represents the opposite. A positive entry followed by "..." indicates a permanent impact in year 1, with no further impact in year 2 relative to a scenario without fiscal adjustment.
2/ Fuels excise was increased as part of the 2017 budget.
3/ The tax debt rescheduling raised a large amount of revenues in 2017, but these revenues are not permanent. Negative signs in later years indicate that the amount raised will be smaller than the previous year.
4/ Social contributions made by government for mothers who received the social benefit and were previously employed. This is offset by equivalent spending by the government to make the contributions.
5/ Dividend payments from state-owned electricity generator.
6/ Includes the savings from partial wage freeze relative to alternative scenario with wage increases.
7/ The authorities intend to reduce staffing levels at central and local government levels. Because the results are still uncertain, staff has not yet included savings in projections.
8/ Includes support for Montenegro Airlines, the health sector, and other spending not envisioned in June 2017 spending projections.
9/ Beginning in 2019, highway expenditures will begin to decline, and spending should stop in 2021, producing an automatic improvement in the fiscal balance.

POLICY DISCUSSIONS

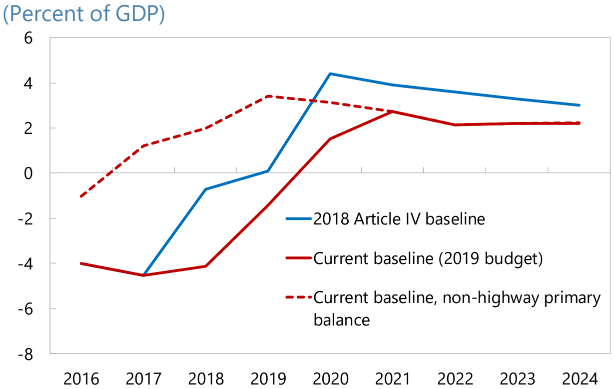
11. Policy discussions focused on three key issues: (i) consolidating the gains from fiscal adjustment, while weighing carefully the costs and benefits of further near-term construction of the Bar-Boljare highway; (ii) strengthening banking and AML/CFT supervision to safeguard financial stability; and (iii) improving labor market outcomes. Governance-related discussions focused on the structure of financial sector oversight, developing stronger AML/CFT supervision tools, and increasing the capabilities of tax administration.

A. Fiscal Policies

Rebuilding Fiscal Space: Preserving Fiscal Adjustment, and the Medium-term Reform Agenda

12. The bulk of the fiscal adjustment strategy has been implemented. The authorities have implemented 4½ percent of GDP in adjustment measures over 2017-19 (Table 1). The 2019 budget contained no further setbacks as did the 2018 supplemental budget. The primary balance is now projected to peak at 2.7 percent of GDP in 2021 (after the conclusion of highway spending), compared to a previous projection of 4½ percent of GDP based on the original 2018 budget.

General Government Primary Fiscal Balance
(Percent of GDP)



Sources: Ministry of Finance; and IMF staff projections.

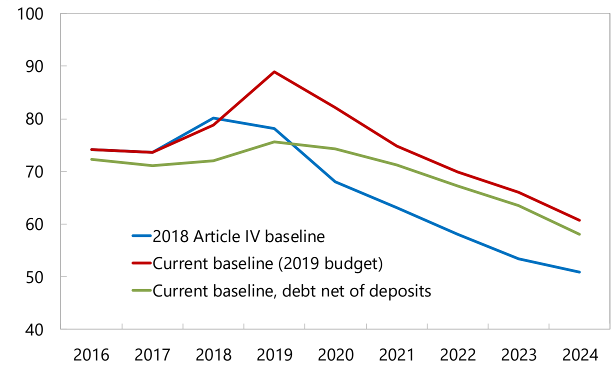
13. Successful debt management operations have reduced, but not eliminated, refinancing risks. In 2018, the authorities pre-financed their 2019 financing needs by issuing a new €500 million Eurobond, which included the exchange of 1/3 of €1 billion in Eurobonds that were maturing in 2019-21. The authorities are exploring €500 million Eurobond issuance in 2019, which if successful would pre-finance the amortizations of the 2020 and 2021 Eurobonds. This would increase general government debt with guarantees to 89 percent of GDP.[3]

14. Staff underscored the need to maintain a primary fiscal surplus of at least 2 percent of GDP over the medium term. Under current policies (without further highway construction past phase 1), the primary surplus is projected around 2 percent of GDP over the medium term. Should planned bond issuance be completed successfully, there would be a significant decline in near-term refinancing risks, and currently projected primary surpluses are adequate to lower the trajectory of public debt and rebuild fiscal space to cope with future shocks. Under current policies, government debt including guarantees is projected to decline strongly beginning in 2020, reaching 61 percent of

[3] With the Eurobond issue, the central government will accumulate sizeable deposits as pre-financing for 2020/21 Eurobond amortizations. Net of deposits, general government debt with guarantees will increase from 72 percent of GDP in 2018 to 76 percent of GDP in 2019.

GDP in 2024. However, in the unlikely event of prolonged external market closure, the achievement of a peak primary surplus of 4½ percent of GDP by 2021, along with additional domestic funds, would be necessary to fully meet financing needs.

General Government Debt with Guarantees
(Percent of GDP)



Sources: Ministry of Finance; and IMF staff projections.

15. Additional desirable reforms would create space for a more growth-friendly budget. The authorities plan to reduce government employment where inefficient and eliminate tax expenditures, especially related to the VAT, as part of EU directive harmonization. Pension reform is also important. These initiatives are not included in the baseline.

- *Government employment (Annex VIII):* The authorities aim to reduce employment at the central and local government levels, respectively, by 5 percent and 10 percent by 2020. The limited progress in 2018 underscores the difficulty of these reforms. The authorities should review active labor market policies to transition redundant employees to the private sector. Current plans to offer zero-interest loans to start businesses are not well targeted.

- *Tax expenditures:* As recommended by FAD TA, the authorities should work to establish a transparent benchmark tax system based on economic grounds to estimate and phase out tax expenditures related to the VAT and other taxes. The authorities intend to move forward in 2019 to eliminate VAT tax exemptions, which they estimate totaled some 0.8 percent of GDP in 2018.

- *Pensions:* Eligibility for early retirements should be tightened and early retirement actuarial penalties increased. Pensions should be valorized by wages and benefits indexed to inflation. Valorization by wages is necessary to maintain socially sustainable replacement rates. Eligible pension ages should be linked to life expectancies.[4]

16. Stronger fiscal institutions are needed to promote better medium-term adherence to fiscal targets.[5] A comprehensive medium-term budget framework is needed, with more binding medium-term expenditure limits and the need to reconcile and justify deviations from these limits. The authorities could consider an overall expenditure limit based on the envelope of the medium-term budget. Any legislation with budgetary consequences should require an assessment by the Ministry of Finance.

[4] See 2017 Selected Issues Paper, "Pension Reform Priorities."

[5] According to Montenegro's Law on Budget and Fiscal Responsibility, the general government fiscal deficit should not exceed 3 percent of GDP, while general government debt should not exceed 60 percent of GDP. If the debt ratio exceeds 60 percent of GDP due to investment projects, the government must propose a reduction program for a period not exceeding five years (which the government proposed in 2017).

17. The continuation of recent tax administration improvements would help generate additional revenues while combating the grey economy. Fiscal Affairs Department (FAD) TA has enabled the development of a multi-year agenda with the tax administration (MTA) to build on prior gains in tax administration. Tax arrears have been reduced, and a strategy with a clear reform direction to overhaul auditing and compliance has been adopted to focus on major tax risks. The government has also granted operational autonomy to the MTA. Yet, the operationalization of these significant reforms will encounter challenges. Legislative changes to the interest and penalty regime are also necessary to induce greater tax compliance.

18. The materialization of additional upside risks would increase scope to rebuild fiscal space. The authorities also hope to raise additional revenues through airport concessions, economic citizenship, and electronic fiscalization. Given the large uncertainties associated with these plans—both in terms of timing and magnitude—they have not been included in the baseline. Progress in these areas could significantly improve the outlook. Given the uncertainties, however, it is important to refrain from spending resources that have not yet materialized.

Authorities' Views

19. The authorities broadly agreed with staff's policy recommendations. The authorities agreed on the importance of maintaining primary surpluses to reduce debt. Compared with staff's primary surplus projection of 2.7 percent of GDP in 2021, the authorities forecast a primary surplus of 4.6 percent of GDP, based on lower projections of spending on the government wage bill, transfers to public institutions, and capital expenditures, and gains to revenues from fiscalization. The authorities plan to complete medium-term refinancing needs with an additional Eurobond this year. They expected that a forthcoming offer of severance packages would help facilitate the planned reduction of public sector employees. They also agreed on the importance of further pension reform but did not plan to re-open the issue in 2019. The authorities plan to implement a medium-term budget beginning in 2021.

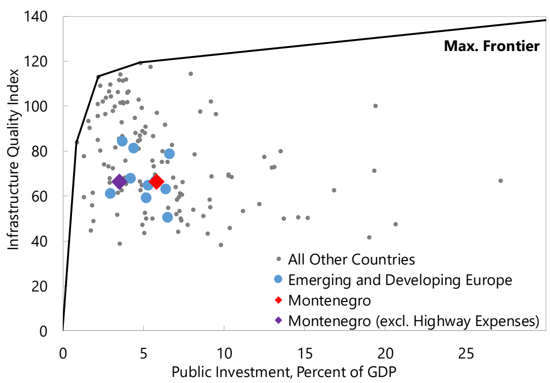
A More Careful and Considered Approach to the Bar-Boljare Highway Project

20. Staff advised the authorities to weigh the benefits of the Bar-Boljare highway project carefully against alternative uses for scarce public resources. With phase 1 of 4 to be completed in 2020, the authorities are weighing options for phase 2. Past feasibility studies completed several years ago estimated a low economic return on the overall highway, based on limited potential for toll revenues relative to the cost. Risks of delayed implementation of the Serbian section raise further questions. In this context, staff pointed to the need for better infrastructure and more public goods (such as waste water treatment) in areas which already experience significant bottlenecks, as well as for more and better targeted education and health spending (Figure 4). Staff urged the authorities to closely consider such opportunity costs before prioritizing one highway project with an uncertain rate of return.

Figure 4. Montenegro: Expenditure Efficiency

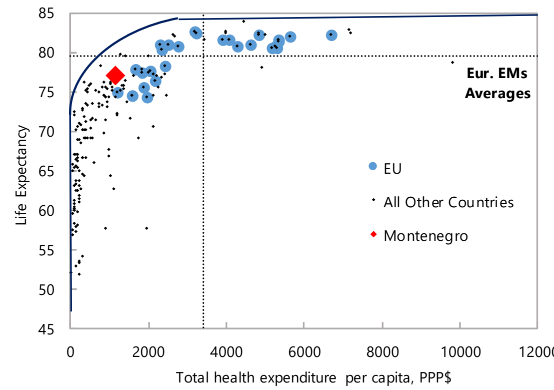
Excluding highway investment, public investment is low relative to peers, with low efficiency….

Infrastructure Quality and Public Investment, 2015



…while health spending is well below EU peers.

Health Spending and Outcome, 2015



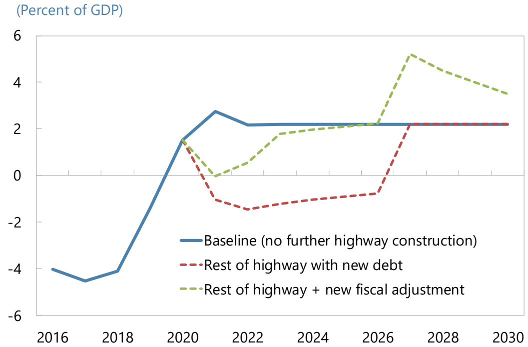
Sources: IMF FAD Expenditure Assessment Tool; World Bank Database; Making Public Investment More Efficient. IMF, 2015; and IMF staff calculations.

21. **A rush to complete the highway is likely to jeopardize fiscal sustainability.** Completion of the phases 2-4 of the highway could cost an additional 25 percent of GDP. Should the authorities move ahead to complete the highway over 2021-26 with new debt financing, general government debt (including guarantees) could remain over 80 percent of GDP for most of the 2020s, versus reaching 50 percent of GDP by 2030 in the baseline. Returning debt to the baseline level in 2030 would require a new round of fiscal adjustment around 3 p.p. of GDP over 2021-23 and the maintenance of primary surpluses averaging nearly 4 percent of GDP over 2026-2030 (Figure 5). Completing and sustaining a new fiscal adjustment of this size would be difficult.

Figure 5. Montenegro: Fiscal Scenarios for Highway Completion

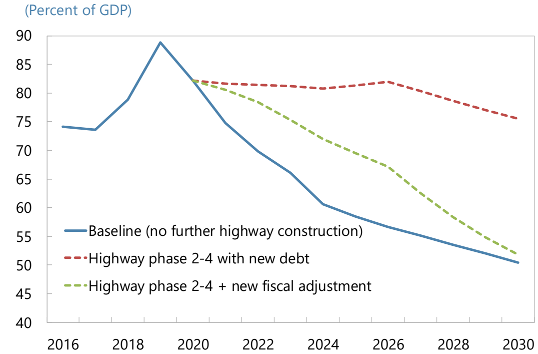
The assumption of new debt to complete the rest of the highway would require further fiscal adjustment…

General Government Primary Fiscal Balance
(Percent of GDP)



…to restore debt sustainability and place debt again on a strongly downward path.

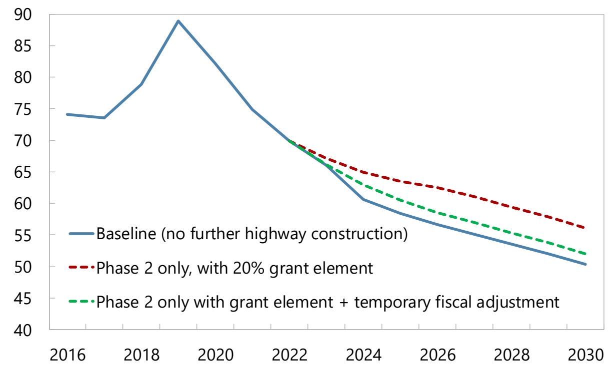
General Government Debt with Guarantees
(Percent of GDP)



Sources: Ministry of Finance; and IMF staff projections.

22. Further highway planning should be paused until a new and credible feasibility study is completed. The authorities have commissioned a feasibility study to be completed in 2020. With results of the study, the authorities should weigh its rate of return against other priority infrastructure projects. Should they decide to proceed, the authorities are advised not to embark on further construction or its financing until at least 2023, when general government debt (by the authorities' definition) is projected to decline below 60 percent of GDP. Phase 2 alone is likely to be less expensive (roughly EUR 300 million, or 5 percent of 2023 GDP) and to deliver a significant share of the envisaged benefits by further connecting the north and tourism areas. Assuming the feasibility of securing grant financing for 20 percent of phase 2 costs, a modest, temporary fiscal adjustment of 1 percent of GDP (returning the primary balance to the current baseline during construction) would be sufficient to nearly return debt to the baseline by 2030.

General Government Debt with Guarantees
(Percent of GDP)



Sources: Ministry of Finance; and IMF staff projections.

23. Continuation of the highway through a PPP structure could also entail significant fiscal costs. The authorities are keen to explore a PPP structure to complete the highway to avoid taking new debt onto the government's balance sheet. Should the feasibility study suggest that the remainder of the project is unlikely to meet a private partner's required rate of return, a private partner would likely require guarantees from the state. The assumption of certain risks by the state – including construction, availability, and demand risks – would according to Eurostat rules require the project to be recognized on the government balance sheet, thus having an equivalent effect to the project being financed by government debt. The need to make minimum revenue guarantee payments from the budget could also impose significant expenditures over a lengthy concession contract.

24. More robust investment management and PPP frameworks are needed. For the Bar-Boljare highway and other projects, it will be critical to establish a strong legislative and institutional framework to analyze projects, identify fiscal risks, and give the Finance Ministry a strong role in safeguarding public finances. The authorities have drafted a new Law on PPPs, strengthened through FAD input.[6] Staff also advised the authorities to consider a Public Investment Management Assessment (PIMA) TA from FAD.

Authorities' Views

25. The authorities emphasized that they would proceed cautiously on further highway construction. Pending the results of the new feasibility study in 2020, the authorities plan to

[6] See Annex VII for an assessment of the strengths and weaknesses of the current PPP management framework.

analyze possible financing models for phase 2, including through a PPP or on-budget public procurement. They stated that they viewed the completion of the first phase as the top priority and that they would not proceed with phase 2 unless questions about feasibility and financing are resolved such that fiscal sustainability is not jeopardized.

B. Financial Sector Policies

26. Initial steps taken by the CBM regarding Atlas/IBM could not prevent their eventual failure. The 2015 FSAP identified three weak domestic banks. In 2017 the CBM placed Atlas and IBM, along with a larger domestic bank (11 percent share) under supervisory action plans. Subsequent examinations of Atlas and IBM in 2018 revealed a high level of NPLs, inadequate provisioning, and significant lending to related parties. These problems were more acute for IBM, and it was placed into bankruptcy within one month of interim administration. Montenegrin prosecutors froze a sizeable portion of Atlas clients' deposits due to concerns about money laundering, previously undetected by nearly annual full scope AML/CFT on-site inspections. The deposit freeze also severely lowered Atlas' liquidity.

27. However, no immediate fiscal and real economy spillovers from these closures have materialized. With large related-lending activity, the closed banks did not play a significant role in credit creation, minimizing real economy spillovers. The deposit insurance fund promptly began to pay insured depositors without recourse to its EBRD credit line. Some local governments, however, have lost uninsured deposits.[7] The central government will not compensate their losses.

28. These events do highlight the need for stronger banking supervision. The CBM's supervisory structure needs enhancement, the process needs to be more risk based, and tools for credit risk supervision require further improvement. The CBM needs to focus on increasing the effectiveness of measures, not only their administrative enactment. The CBM is receiving TA from the Monetary and Capital Markets Department (MCM) to support these efforts.

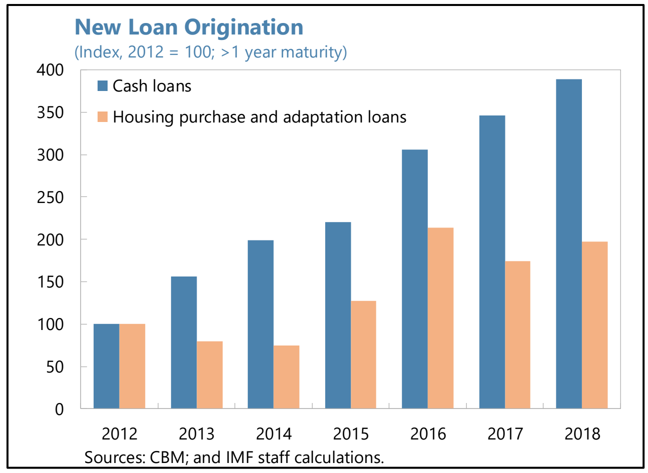
- *Supervisory Committee:* The CBM's supervisory structure will now be strengthened by the establishment of a supervisory committee to better support decisions made by senior management. This staff-level committee with auditable activities aims to bring together all relevant supervisory expertise within the CBM, including on AML issues, and will vet all supervisory decisions, while avoiding the dilution of responsibilities.

- *Off-site supervision:* Capacities for off-site supervision need to be strengthened, including by ensuring the availability of well-qualified and appropriately-compensated staff. Continuous off-site supervision and analysis is necessary to better inform and prepare on-site supervision, as well as to help identify systemic risks at an early stage.

[7] The coastal municipality of Tivat lost approximately EUR 2 million in deposits. The Finance Ministry reported that the municipality had secured short-term loans to manage resulting short-term liquidity issues and that the situation was manageable.

29. A thorough asset quality review (AQR) is essential to provide a full diagnostic of banking sector health. This is a key recommendation pending since the 2015 FSAP. The AQR needs to be completed no later than end-2020 to help understand the true value of assets on bank balance sheets, the valuation of collateral (including real estate), and the adequacy of provisioning against potential losses. To ensure the integrity of the process, the AQR needs to be carried out by reputable international assessors.

30. Decisive action is needed to address any residual banking sector vulnerabilities. Informed by the AQR and ongoing supervision, any other weak banks in the system need intense scrutiny with effective action plans and timely enforcement. The CBM is also closely monitoring the rapid growth of uncollateralized consumer lending – often having long maturities and higher interest rates than collateralized loans – and should implement as needed effective macroprudential measures to pre-empt the build-up of systemic risks.



31. The CBM is continuing its efforts to improve the regulatory framework for the financial system. The credit registry has been modernized and now covers a broader range of financial institutions with additional information. The rules for asset classification have also been gradually tightened, including with the implementation of IFRS-9 in January 2018. Effective July 2019, asset classification rules have been tightened by reducing the possibility that adequate collateral could prevent a reduction in asset classification. The CBM adopted in July a decision to remove the remaining reference to "prime" collateral for asset classification, effective in 2020.

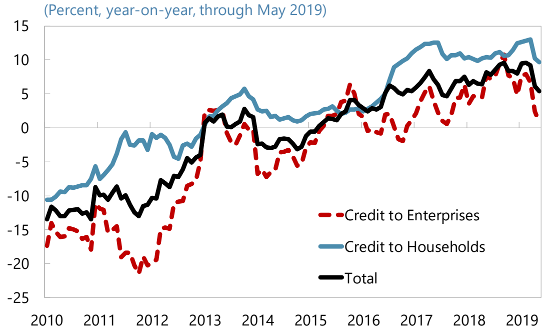
32. The CBM has prepared a comprehensive package of legislation that would harmonize banking laws with EU directives. Legislative approval is expected later this year. The new legislation will increase the minimum capital requirement for new banks from EUR 5 to EUR 7.5 million. Banks will be required to develop clear recovery plans, and the CBM will establish a resolution fund to be financed by banks, with a special resolution unit within the CBM. The deposit protection fund will double the coverage of insured deposits to EUR 100,000, gradually shorten the mandate payout time, and be permitted to use its resources to finance the transfer of insured deposits from unresolvable banks to healthy ones (purchase and assumption).

Figure 6. Montenegro: Credit Developments

Apart from the closure of Atlas/IBM, bank lending to the private sector continues to grow…

Bank Lending by Sector 1/

(Percent, year-on-year, through May 2019)

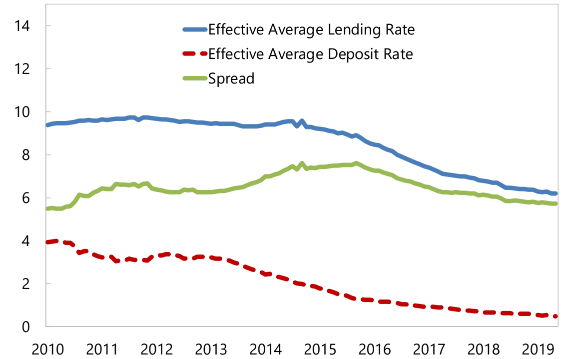


1/ 2019 data distorted by recent Atlas/IBM bankruptcies.

… as lending and deposit rates have further declined.

Effective Bank Lending and Deposit Rates

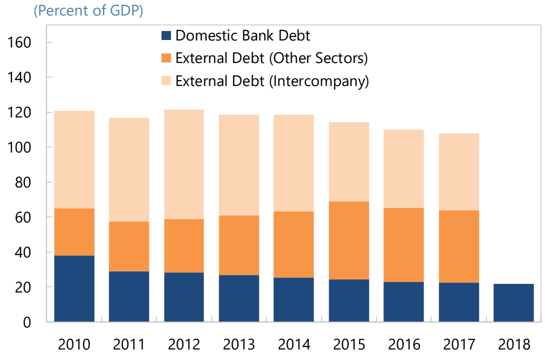
(Percent, through May 2019)



The deleveraging of non-financial corporates…

Corporate Indebtedness

(Percent of GDP)

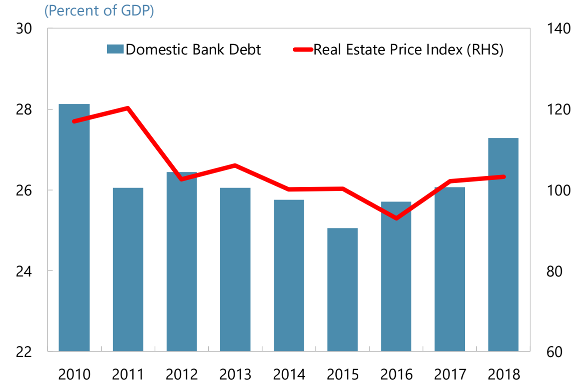


Note: 2018 external debt data are not yet available.

…and especially households has come to an end.

Household Indebtedness

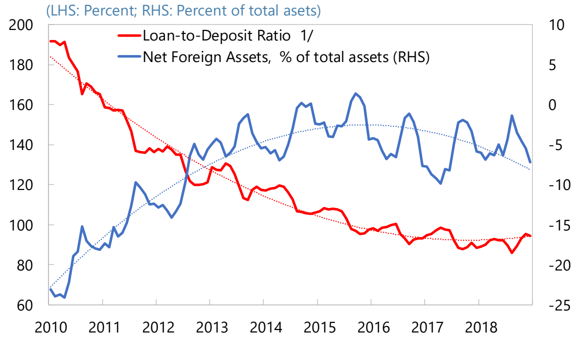
(Percent of GDP)



Net foreign assets of banks have recently declined…

Net Foreign Assets and Loan-to-Deposit Ratio

(LHS: Percent; RHS: Percent of total asets)

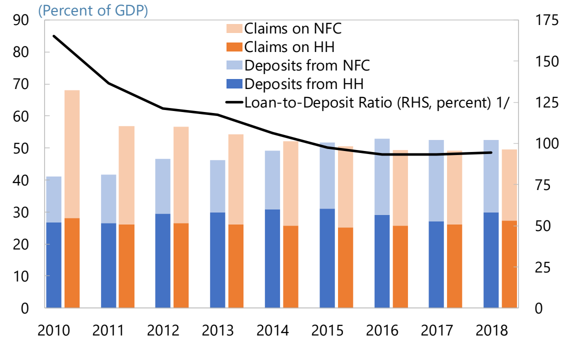


1/ Claims on and deposits of public and private non-financial corporations (NFC) and other domestic sectors, i.e. mainly households (HH).

…mirrored by a small increase in the loan-to-deposit ratio.

Banks' Claims and Deposits on Other Domestic Sectors

(Percent of GDP)



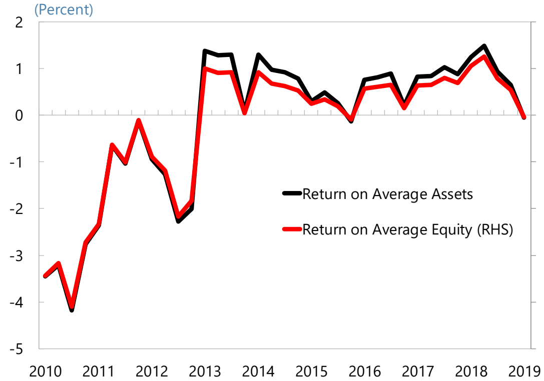
1/ Claims on and deposits of public and private non-financial corporations (NFC) and other domestic sectors, i.e. mainly households (HH).

Sources: CBM; and IMF staff calculations.

Figure 7. Montenegro: Banking Sector Developments

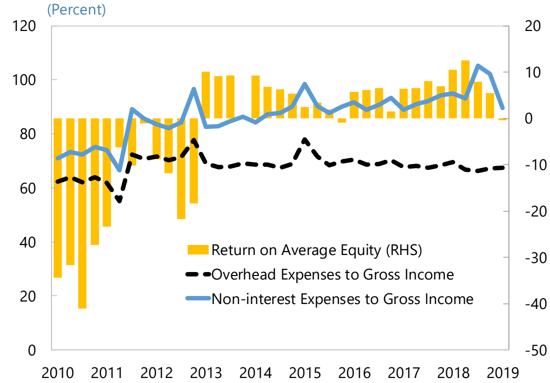
Excluding Atlas' large loss, the banking sector was profitable in 2018....

Bank Sector Net Profits
(Percent)



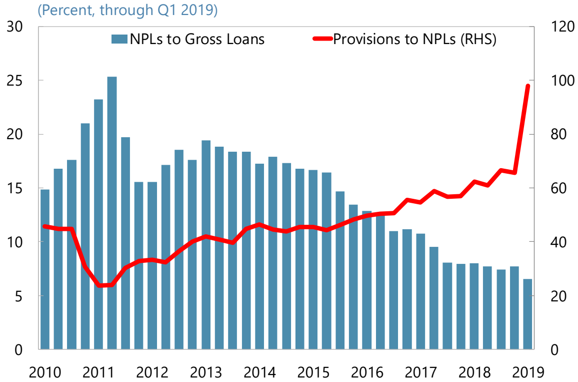
...but there is still room to improve efficiency.

Bank Efficiency and Profitability
(Percent)



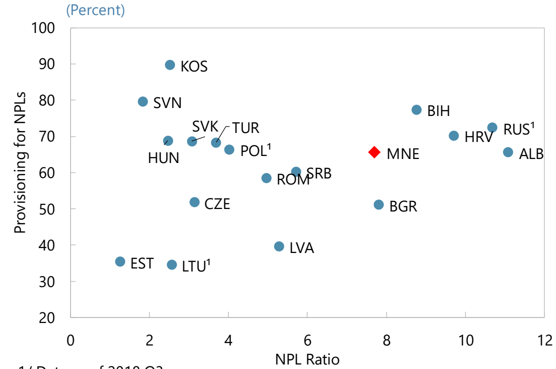
Loan quality and provisioning coverage have improved....

Non-Performing Loans and Provisioning
(Percent, through Q1 2019)



...to levels comparable to regional peers.

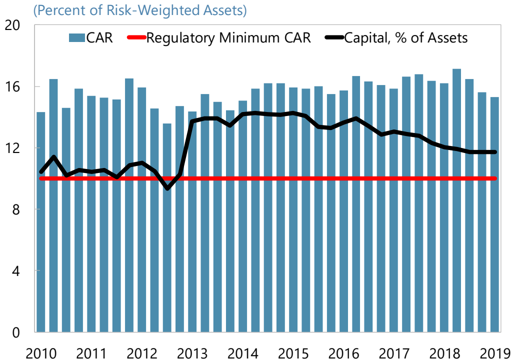
NPLs and Provisioning, 2018Q4
(Percent)



1/ Data as of 2018 Q3.

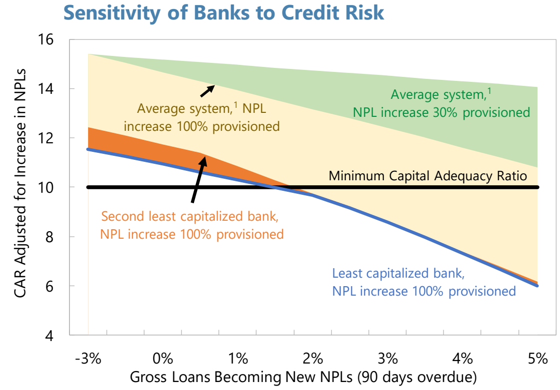
The overall banking system is well capitalized...

Capital Buffers
(Percent of Risk-Weighted Assets)



...with a few banks more vulnerable to credit risk.

Sensitivity of Banks to Credit Risk

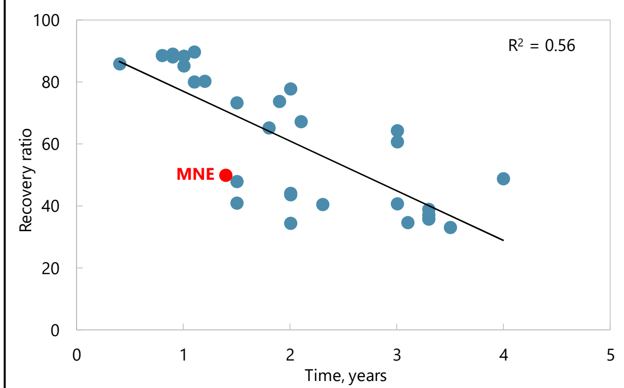


1/ IBM and Atlas Banka excluded from the analysis. Data as of March 2019.

Sources: CBM; IMF FSI database; and IMF staff calculations.

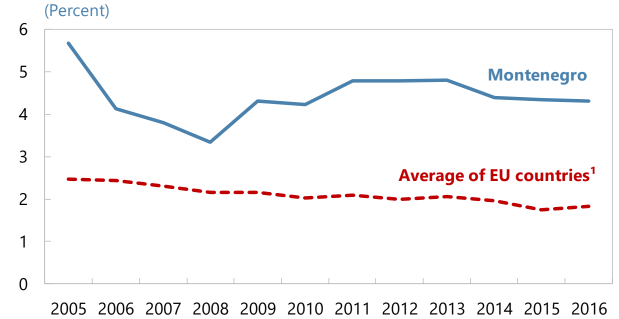
33. NPL ratios are expected to further improve, driven by continued credit growth and improved debt service. Loan restructuring and NPL sales should play a smaller role than in the years following the global financial crisis. The so-called "Podgorica Approach" to facilitate out-of-court restructuring has now expired. There is also room to improve debt recovery ratios, compared to peers.

EU and West. Balkans: Resolving Insolvency, 2018



Source: World Bank, Doing Business 2018.

Net Interest Margins of Banks in Montenegro and EU
(Percent)



Source: Thorsten Beck, Aslı Demirgüç-Kunt and Ross Levine, 2000, "*A New Database on Financial Development and Structure*," World Bank Economic Review 14, 597–605. Database updated July 2018.
Note: Net interest margin defined as the accounting value of bank's net interest revenue as a share of its interest-bearing (total earning) assets.
1/ Simple average of current EU members; missing 2015-2016 Finland observations.

34. Montenegro still has many banks relative to its size. With 13 banks in a small country, high fixed costs and increasing regulatory costs, following the implementation of the envisaged Basel III prudential framework, will trigger additional earnings challenges for small banks. After the completion of the purchase of Société Générale's subsidiary by OTP, the number of banks will fall to 12. The CBM should forcefully apply prudential regulation and grant any new licenses carefully. Empirical evidence suggests that good governance practices – ranging from the rule of law, regulatory quality, government effectiveness, control of corruption, effectiveness of the insolvency framework, and contract enforcement – usually correlates with lower financial intermediation costs.[8]

35. The AML/CFT regime needs to be further strengthened to mitigate financial stability risks. The new AML/CFT law has improved the legal framework, and the CBM has issued detailed guidelines to provide guidance to banks on ML/TF risk analysis, but actions are needed to strengthen AML/CFT supervision by developing risk-based tools and procedures for offsite monitoring and onsite inspections. The fit and proper tests for banks' owners and managers need to be formalized and applied consistently.[9]

36. The investor citizenship program launched this year creates potential financial integrity and reputational risks that should be addressed. The authorities should ensure implementation of comprehensive due diligence measures on applicants, including on their source of wealth and funds, as well as good transparency practices, including publication of the names of the new citizens.

[8] See *Can Good Governance Lower Financial Intermediation Costs?* By Mariusz Jarmuzek and Tonny Lybek, IMF Working Paper WP 18/279.

[9] See Annex IX for a list of recommended actions to strengthen AML/CFT supervision.

Authorities' Views

37. The CBM stressed that the overall banking system has remained stable, highly liquid, and well capitalized. Apart from Atlas/IBM, the overall sector was profitable. They also stressed that they are moving to contain remaining pockets of vulnerability, including through continued efforts to strengthen a third weak bank. The improved credit registry and the tightened asset classification will improve credit risk assessment and reduce information asymmetries. The CBM is studying the increase in uncollateralized cash loans and plans to shortly introduce macroprudential measures.

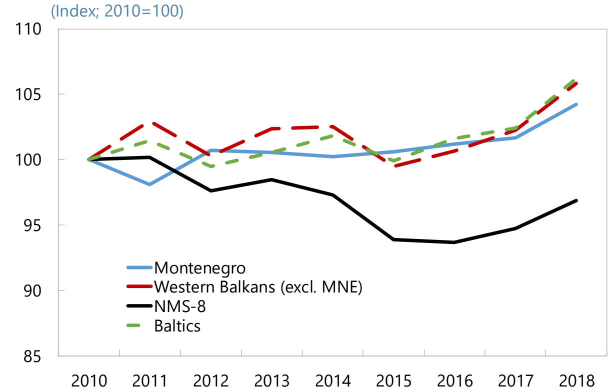
38. The CBM acknowledged the need to further improve bank supervision. In line with staff advice, the CBM has established a supervisory committee to better the support senior management. The offsite unit will be strengthened with additional staff. A separate AML Directorate has already been formed, and additional staff are being hired. The CBM is working to make the supervisory approach more risk-based to better allocate scarce resources. The legislative package transposing pertinent EU banking directives, which is expected to be adopted in late 2019, will bring the CBM's banking supervision and crisis management tools in line with EU practices. The CBM also reiterated its commitment to completing an AQR of the banking system by end-2020 and has begun creating an action plan, defining a timetable, and drafting terms of reference for independent international assessors.

C. External Competitiveness and Labor Markets

39. The external position is assessed to be weaker than fundamentals and desirable policy settings warrant (Annex IV). Since 2010, the REER has appreciated 4 percent, in line with regional peers. The EBA-lite current account model suggests that the REER is overvalued by 12 percent, while the REER regression model estimates the REER to be in line with fundamentals. On balance, staff believes that the REER is overvalued by 10 percent due to persistently large current account deficits, high unit labor costs, stagnant productivity, and weak goods export performance. Gross international reserves appear adequate.

Real Effective Exchange Rate

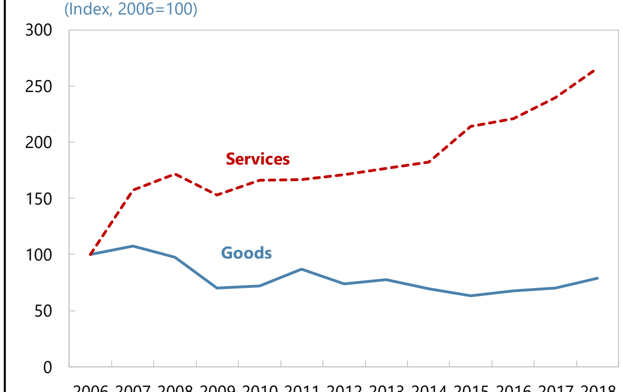
(Index; 2010=100)



Sources: IMF INS database; and IMF Staff calculations.

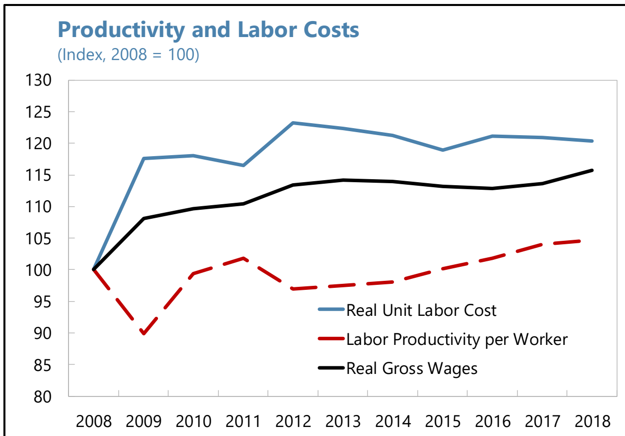
Volumes of Goods and Services Exports

(Index, 2006=100)



Sources: Monstat; and IMF staff calculations.

40. Labor market outcomes remain weak. Despite an improvement in recent years, labor force participation remains low, and the unemployment rate is still high at 15 percent. The informal economy employs an estimated quarter of the labor force, and more than 30 percent of workers are employed on temporary contracts, the highest rate in Europe.

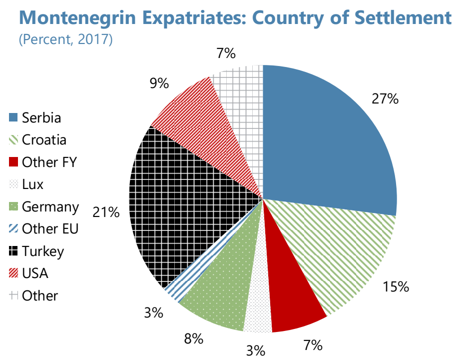


Sources: Monstat; WEO; and IMF Staff calculations.

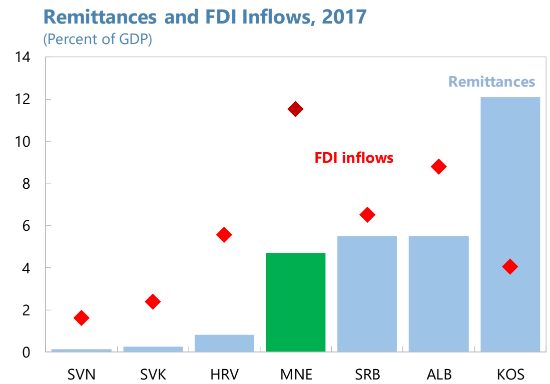
- *Reduction of labor tax wedge:* The tax wedge, at nearly 40 percent, is the second highest in the Western Balkans.[10] A large tax wedge reduces incentives for employment in the formal sector, particularly for low-wage earners. The authorities intend to implement in the second half of 2019 a 2 percentage point reduction in employers' health insurance contributions, which would reduce the cost of employment. Such a reduction will reduce revenues by about 0.5 percent of GDP. The authorities expect that an increase in the minimum wage (see below) will partially offset the revenues losses. The authorities should ensure that lost revenues are fully offset through a reduction in tax expenditures. They could also consider extending the 11 percent upper tax rate on personal income past end-2019, when it is currently set to expire.

Box 2. Remittances in Montenegro

Registered inflows of remittances appear low, given the very high expatriated share of the Montenegrin population. About 38 percent of the population living in Montenegro has resettled abroad, mainly in several neighboring countries, which suggests a high dependency on remittances. However, Montenegro's recorded remittance inflows are smaller than regional peers and remain lower than FDI inflows.



Source: World Bank.



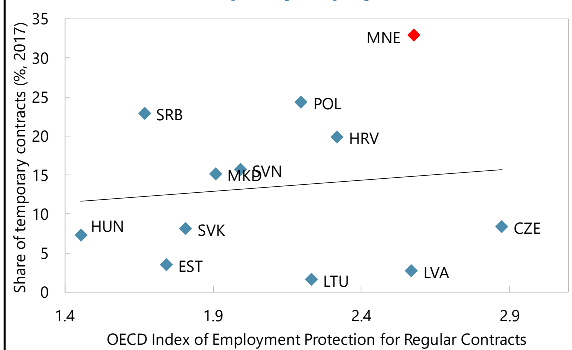
Sources: National Authorities; WIIW FDI Database; and IMF staff calculations.

The actual magnitude of remittances may be much higher and could help explain the large share of the informal economy in Montenegro. Reported remittances are mainly based on bank reports and underestimate actual cash inflows. A steady flow of unreported cash transfers primarily supporting family incomes and new real estate construction could help entrench a high level of informality in the economy.

[10] See 2018 Article IV Selected Issues Paper, "Labor Market Outcomes in Montenegro: Challenges and Policy Options"

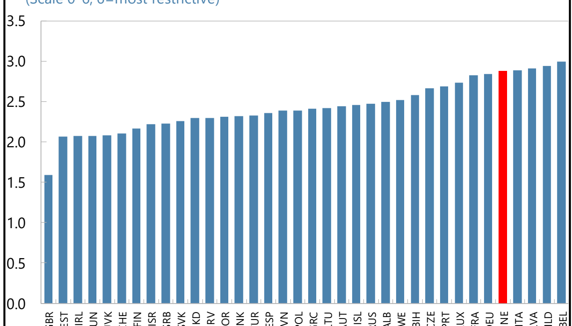
- *Labor Law:* Employees on temporary contracts usually experience lower job security and development opportunities than those on open-ended positions. Montenegro's draft new labor law (expected to be approved in 2019) appropriately aims to ease the most rigid employment protections, including large severance payments under regular contracts. By narrowing the gap between temporary and regular contracts, the draft law aims to make the use of open-ended contracts more attractive. The law will also extend the maximum length of fixed term contracts from 24 to 36 months, with some greater exemptions for seasonal activities. Before the law is finalized, the authorities should also ensure that requirements for organizational charts and classification of positions does not impose an unreasonable administration burden on micro enterprises.

High Protection of Regular Contracts Associated with Greater Temporary Employment



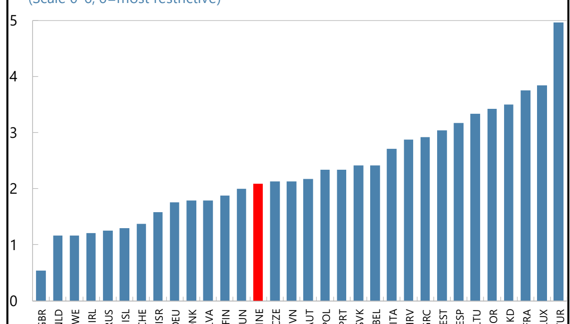
Sources: Eurostat and OECD.

OECD Index of Regular Employment Protection
(Scale 0-6, 6=most restrictive)



Sources: OECD; and IMF Staff calculations.

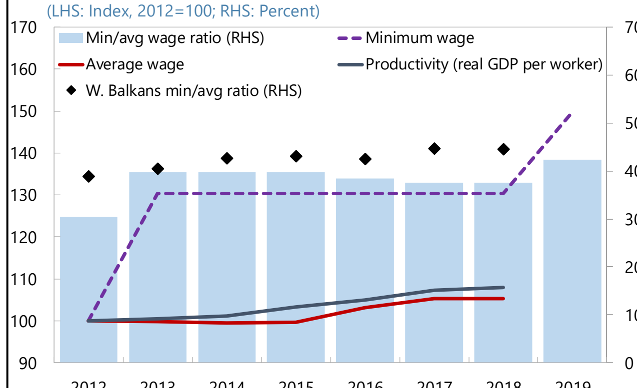
OECD Index of Temporary Employment Protection
(Scale 0-6, 6=most restrictive)



Sources: OECD; and IMF Staff calculations.

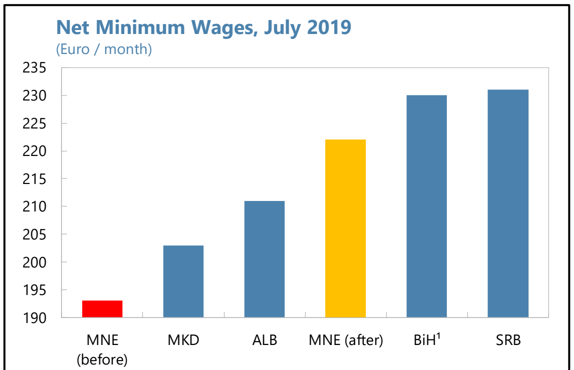
41. The authorities need to balance competing considerations for future decisions on the minimum wage. The government plans to increase the minimum wage 15 percent in the second half of 2019, the first increase since 2013. The net minimum wage will increase from EUR 193 to 222 per month, thus increasing modestly the ratio to the average wage from 38 to 42 percent. This ratio and the absolute level of the minimum wage had been below regional peers but will now shift towards the regional average. The stagnant minimum wage had also not kept pace with increases in the poverty line. Yet, the hike exceeded both accumulated inflation and average wage gains of 6 percent since the last increase in 2013. In discussions with social

Wages and Productivity Growth
(LHS: Index, 2012=100; RHS: Percent)

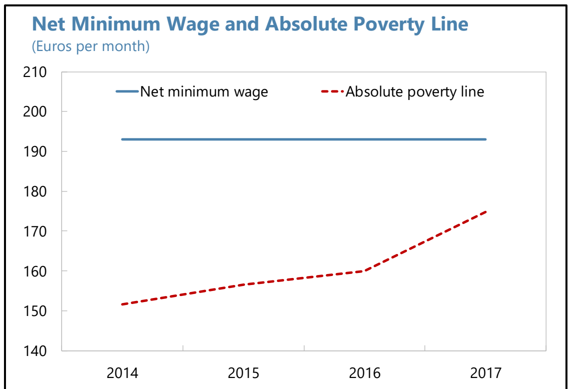


Sources: MONSTAT; Haver Analytics; ILO STAT Database; and IMF staff calculations.

partners, the government emphasized the importance of containing the fiscal impact of the minimum wage. For future discussions, the authorities are advised to assess the impact of prior minimum wage increases and consider a broad set of labor market indicators, including the poverty line, trends in average growth, productivity, and migration.



Sources: Country authorities.
1/ Republika Srpska.



Sources: Monstat.

Authorities' Views

42. The authorities expect labor market reforms to have a positive impact on overall employment and informality. The authorities viewed the minimum wage increase and labor tax wedge as a package of measures negotiated with the social partners. They believe that employers would benefit from the reduction in the overall cost of employment while a minimum wage increase would help workers after a long period of stagnation. The authorities also believe that the minimum wage increase would force greater payment of salaries through formal means, thus raising tax revenues and partially offsetting the revenue loss from the tax wedge reduction. The authorities are of the view that the new labor law would significantly increase the flexibility of labor markets.

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43. Over the last two years, the Montenegrin economy has performed well, and public finances have improved. Growth is expected to moderate in 2019 as highway investment peaks. So long as external conditions remain stable, private investment and tourism should underpin continued growth of around 3 percent over the medium-term. The authorities have implemented most of the measures from their fiscal adjustment strategy begun in 2017. The underlying fiscal position (excluding highway investment) has improved by 3 p.p. of GDP since 2016.

44. High public debt still limits the room for countercyclical fiscal maneuver as well as the ability to invest for future growth. Notwithstanding recent progress, Montenegro lacks a strong track record of sustained fiscal discipline. To set the economy on a more durable path to stability and prosperity, a balance between debt reduction and more efficient public spending is needed. The primary surplus needs to be at least 2 percent of GDP over the medium-term for debt to reach safer levels. At the same time, resources need to be prioritized to where they deliver the highest economic and social returns. Improving technical capacity in public investment assessment and management is thus very important.

45. A more cautious and prudent approach to the Bar-Boljare highway is central to safeguarding fiscal sustainability. The authorities need to carefully evaluate this project against other uses of scarce resources. Financing the rest of the highway with debt would prevent the projected decline in debt over the medium term and likely jeopardize fiscal sustainability. The authorities should move cautiously with future phases of highway construction only after a new and credible feasibility study is completed. Outstanding questions about feasibility and financing must be resolved in a manner that does not jeopardize fiscal sustainability. Extra caution is needed with regard to possible PPP arrangements which could introduce significant contingent fiscal liabilities.

46. Fiscal reforms are needed to create space for a more growth-friendly budget. The authorities should formulate a disciplined medium-term budget framework that brings together short-term debt reduction and medium-term strategic fiscal priorities with more binding expenditure limits. Further expenditure reforms – including to government employment levels, tax expenditures, and pension reforms – would also increase fiscal space over the medium term for high-productivity capital spending and well-targeted social spending.

47. Recent measures to strengthen banking supervision are welcome. Robust action is needed to further improve supervision and address any remaining vulnerabilities. The structure of supervisory oversight is being strengthened. Its efficacy, however, depends on the development and employment of risk-based approaches to financial sector and AML/CFT supervision. An asset quality review should be completed no later than end-2020, with any identified weaknesses promptly addressed. The decisions to further refine the definition of non-performing loans to fully eliminate any role of collateral in asset classification and establish a supervisory committee are welcome. The transposal of EU banking directives into domestic law will also provide the authorities with new supervisory tools. The authorities should forcefully apply prudential regulation – including fit-and-proper requirements – and be judicious in granting any new bank licenses.

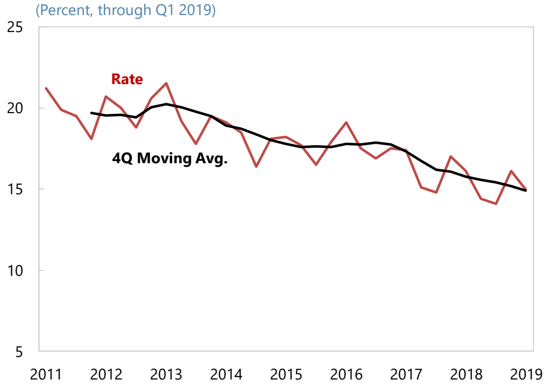
48. The proposed initiatives to improve labor market outcomes are well-motivated. Montenegro faces competitiveness challenges, and its external position is weaker than that consistent with medium-term fundamentals and desirable policy settings. Structural labor market impediments discourage greater labor force participation and the generation of formal sector employment. The authorities appropriately aim to reduce the cost of formal sector employment by reducing the labor tax wedge. It will important to offset the foregone revenues of this reform. The draft labor law also appropriately aims to reduce the gap in employment protection under temporary versus open-ended contracts. In setting the level of the minimum wage, the authorities should assess the impact of prior increases and consider a broad set of labor market indicators.

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

Figure 8. Montenegro: Labor Markets

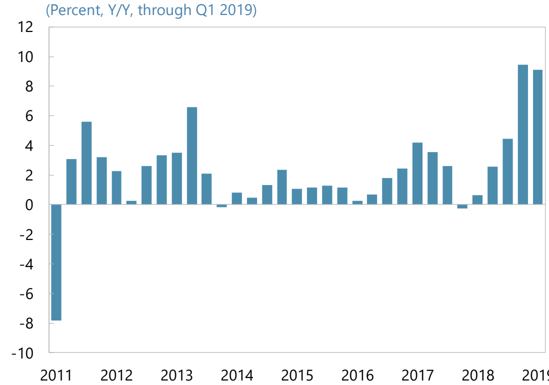
The official unemployment rate has declined moderately in recent years….

Unemployment Rate
(Percent, through Q1 2019)



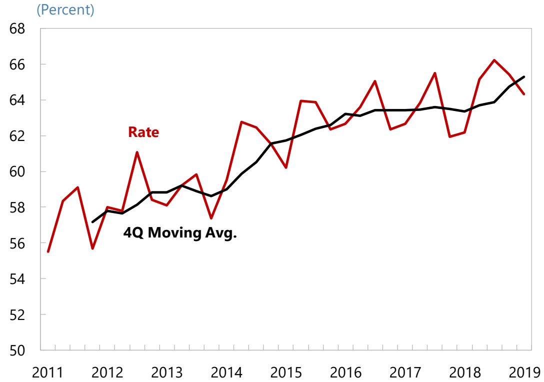
…driven by sustained employment gains….

Employment Growth
(Percent, Y/Y, through Q1 2019)



…notwithstanding an increase in the labor force participation rate.

Labor Force Participation Rate
(Percent)

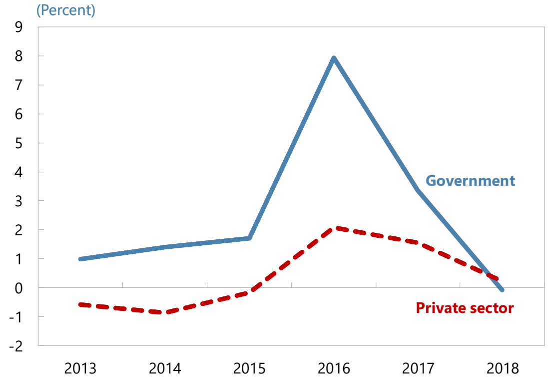


Wage growth has stagnated since the 2016 public sector wage increase….

Gross Wage Growth: All Employment
(Percent, Y/Y, NSA)

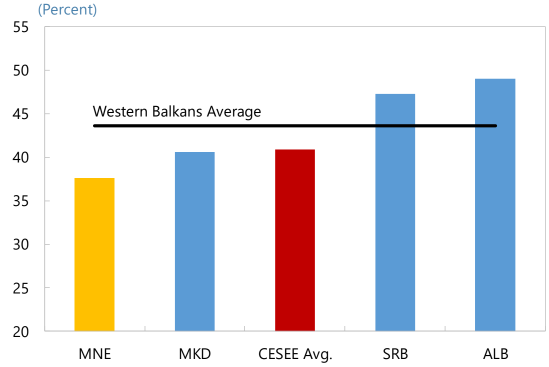
…while public sector wage growth has consistently exceeded that in the private sector.

Public and Private Wage Growth
(Percent)



The current level of the minimum-to-average wage ratio is modestly below regional peers.

Minimum to Average Wage Ratio, 2017 1/
(Percent)

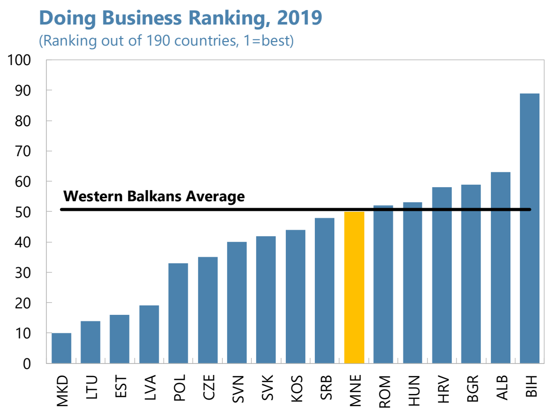


1/ Western Balkans average calculated for MNE, MKD, SRB and ALB.

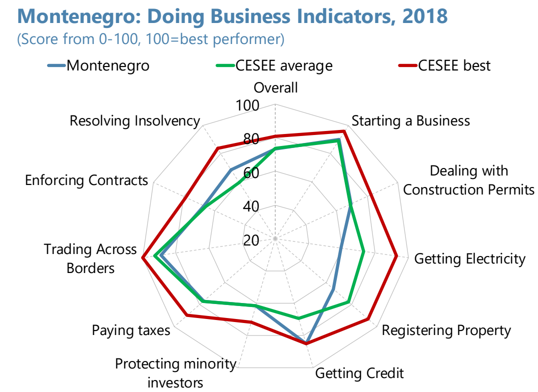
Sources: Monstat; ILOSTAT; and IMF staff calculations.

Figure 9. Montenegro: Business Environment

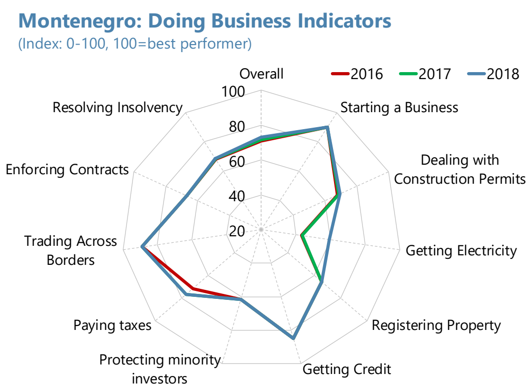
Montenegro's Doing Business ranking is near the Western Balkans average....



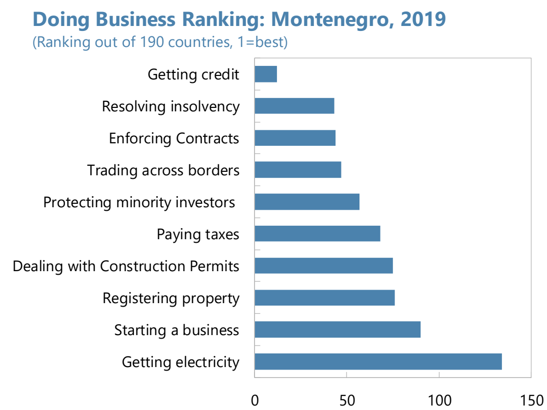
...though it remains behind better performers in CESEE.



Montenegro has shown some improvements since 2016....



...though weaknesses remain, especially in getting electricity.



Sources: World Bank, *Doing Business.*

Table 2. Montenegro: Selected Economic Indicators, 2014-2024

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
					Prelim.			Projections			
Real economy											
Nominal GDP (millions of €)	3,458	3,655	3,954	4,299	4,619	4,807	5,015	5,247	5,511	5,796	6,081
Gross national saving (percent of GDP)	7.8	9.1	9.9	14.1	14.2	14.8	14.2	14.5	15.3	16.2	17.6
Gross investment (percent of GDP)	20.2	20.1	26.1	30.2	31.4	31.8	29.1	27.9	27.4	27.1	27.1
Unemployment rate (percent)	18.0	17.6	17.7	16.1	15.2	...	...	...	...	...	...
Real GDP growth	1.8	3.4	2.9	4.7	4.9	3.0	2.5	2.9	3.2	3.2	2.9
Industrial production growth	-11.4	8.2	-2.9	-4.4	22.5	...	...	...	...	...	...
Tourism											
Arrivals (growth)	-2.6	8.5	10.2	18.2	12.7	...	...	...	...	...	...
Nights (growth)	-9.2	5.3	8.4	10.5	8.2	...	...	...	...	...	...
Consumer price inflation (period average)	-0.7	1.5	-0.3	2.4	2.6	1.1	1.9	1.6	1.7	1.9	1.9
Consumer price inflation (end of period)	-0.3	1.4	1.0	1.9	1.7	2.3	1.6	1.6	1.8	1.9	1.9
GDP deflator (percent change)	1.0	2.2	5.1	3.8	2.4	1.1	1.8	1.7	1.8	1.9	1.9
Average net wage growth	-0.5	0.7	4.0	2.3	0.1	...	...	...	...	...	...
Money and credit (end of period)					(Y-o-y growth)						
Bank credit to private sector	-0.7	2.4	6.3	8.4	9.1	7.0	7.0	6.5	6.0	5.9	5.8
Enterprises	-2.9	2.0	1.5	6.3	5.2	...	...	...	...	...	...
Households	1.6	2.8	11.0	10.3	12.5	...	...	...	...	...	...
Private sector deposits	6.1	9.0	6.0	15.2	6.0	...	...	...	...	...	...
General government finances 1/					(in percent of GDP)						
Revenue and grants	43.5	40.4	41.3	40.3	41.4	42.0	41.0	40.6	40.1	39.9	39.9
Expenditure	44.2	46.4	47.5	47.2	47.7	45.7	41.9	40.0	39.7	39.6	39.5
Overall fiscal balance	-0.7	-6.0	-6.2	-6.9	-6.3	-3.6	-0.9	0.7	0.4	0.4	0.4
Cyclically adjusted overall fiscal balance	-0.3	-5.8	-5.8	-7.0	-6.9	-4.0	-0.9	0.8	0.4	0.4	0.4
Primary balance	1.6	-3.6	-4.0	-4.5	-4.1	-1.4	1.5	2.8	2.2	2.2	2.2
Non-highway primary balance	1.6	-1.3	-1.0	1.2	2.0	3.4	3.1	2.8	2.2	2.2	2.2
General government gross debt	63.4	69.0	66.6	66.3	72.6	81.1	74.8	67.8	63.2	59.8	54.7
General government gross debt (authorities' definition) 2/	59.9	66.3	64.6	64.4	70.8	79.4	73.1	66.2	61.7	58.3	53.3
General government debt, including loan guarantees	71.5	76.4	74.1	73.6	78.8	88.8	82.2	74.8	69.9	66.1	60.7
General government net debt, including guarantees 3/	69.8	74.3	72.5	71.3	72.2	75.8	74.5	71.4	67.5	63.7	58.3
General government net debt, excluding guarantees 4/	61.7	66.9	65.0	64.1	66.0	68.1	67.1	64.3	60.8	57.3	52.3
Balance of payments											
Current account balance	-12.4	-11.0	-16.2	-16.1	-17.2	-17.1	-14.9	-13.5	-12.2	-10.8	-9.5
Foreign direct investment, net	10.2	16.9	9.4	11.3	7.1	8.9	8.9	8.9	8.9	8.9	8.9
External debt (end of period, stock)	161.0	166.2	160.9	159.2	167.5	180.0	178.5	175.6	173.0	170.0	166.1
REER (CPI-based; y-o-y avg . change, in percent) 5/	-0.3	0.4	0.6	0.5	2.5	...	...	...	...	...	...
Memorandum:											
GDP per capita (USD)	6,858	6,389	6,699	8,176	8,443	...	...	...	...	...	...
Nominal GDP Growth (in percent)	2.8	5.7	8.2	8.7	7.4	4.1	4.3	4.6	5.0	5.2	4.9
Real output gap (percent of potential GDP)	-0.9	-0.4	-0.8	0.1	1.2	0.7	-0.1	-0.3	-0.2	0.0	0.1
Gross international reserves in millions of USD 6/	672	679	794	1,003	1,195	1,541	1,274	1,051	1,003	1,017	1,025
In months of imports of goods and services	3.1	3.1	3.3	3.4	3.9	5.0	4.0	3.2	2.9	2.9	2.9

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/ The authorities do not include the arrears of local governments in their definition of general government gross debt.

3/ General government debt, including guarantees, net of central and local government deposits

4/ General government debt, excluding guarantees, net of central and local government deposits

5/ A negative sign indicates depreciation a REER depreciation.

6/ CBM's international reserves have been revised to exclude CBM's holdings of Montenegrin government securities and reclassify SDRs for 2015-17.

Table 3. Montenegro: Savings and Investment Balances, 2014-2024

(Percent of GDP, unless otherwise noted)

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
					Prelim.	Projections					
Gross national savings	7.8	9.1	9.9	14.1	14.2	14.8	14.2	14.5	15.3	16.2	17.6
Non-government	5.1	11.4	11.6	13.7	11.9	11.0	11.4	11.3	12.0	12.9	14.2
Government	2.7	-2.3	-1.8	0.4	2.3	3.8	2.8	3.2	3.3	3.3	3.4
Gross domestic investment	20.2	20.1	26.1	30.2	31.4	31.8	29.1	27.9	27.4	27.1	27.1
Non-government	14.8	14.3	19.7	20.7	20.8	22.4	23.1	23.5	22.9	22.5	22.5
Government	5.5	5.8	6.3	9.5	10.6	9.5	6.0	4.4	4.5	4.5	4.6
Savings - investment balance	-12.4	-11.0	-16.2	-16.1	-17.2	-17.1	-14.9	-13.5	-12.2	-10.8	-9.5
Non-government	-9.7	-2.9	-8.1	-7.0	-8.9	-11.4	-11.7	-12.2	-10.9	-9.6	-8.3
Government	-2.7	-8.1	-8.1	-9.1	-8.3	-5.7	-3.2	-1.3	-1.3	-1.3	-1.2
Current account balance	-12.4	-11.0	-16.2	-16.1	-17.2	-17.1	-14.9	-13.5	-12.2	-10.8	-9.5
Foreign direct investment (net)	10.2	16.9	9.4	11.3	7.1	8.9	8.9	8.9	8.9	8.9	8.9
External debt	161.0	166.2	160.9	159.2	167.5	180.0	178.5	175.6	173.0	170.0	166.1
Consumption	99.6	98.4	96.4	93.2	92.8	92.5	92.6	92.2	91.3	90.3	88.8
Non-government	80.2	79.2	76.8	74.8	74.0	74.3	74.8	74.4	73.5	72.6	71.2
Government	19.4	19.2	19.6	18.4	18.7	18.1	17.8	17.8	17.8	17.7	17.7

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

Table 4. Montenegro: Contribution to Real Gross Domestic Product, 2014-2024

(Contribution to real GDP growth)

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
					Prelim.	Projections					
Gross domestic product	1.8	3.4	2.9	4.7	4.9	3.0	2.5	2.9	3.2	3.2	2.9
Consumption	2.9	2.5	5.1	3.4	4.7	2.7	2.5	2.6	2.6	2.4	1.6
Government	0.3	0.4	0.2	-0.3	0.5	-0.1	0.1	0.6	0.6	0.5	0.5
Private	2.6	2.1	4.9	3.7	4.2	2.8	2.4	2.0	2.0	1.9	1.1
Investment	0.1	3.5	5.9	4.8	3.1	2.2	-1.9	-0.1	0.5	0.7	1.1
Gross fixed capital formation	-0.6	2.6	6.6	7.9	5.3	2.2	-1.9	-0.1	0.5	0.7	1.1
Government	1.8	0.6	1.1	4.2	1.9	-1.0	-3.8	-1.7	0.3	0.2	0.2
Private	-2.4	2.0	5.4	3.7	3.4	3.2	1.9	1.6	0.2	0.6	0.9
Changes in inventories	0.7	0.9	-0.7	-3.1	-2.2	0.0	0.0	0.0	0.0	0.0	0.0
Net Exports	-1.3	-2.6	-8.0	-3.5	-2.9	-2.0	1.9	0.4	0.0	0.1	0.2
Exports	-0.5	3.9	2.0	3.3	5.3	2.6	1.6	1.7	1.8	1.8	1.8
Goods	-1.5	-1.3	0.9	0.4	1.4	0.1	0.3	0.5	0.5	0.5	0.5
Services	0.9	5.3	1.1	2.9	3.9	2.5	1.3	1.2	1.4	1.3	1.3
Imports	-0.7	-6.6	-10.0	-6.8	-8.2	-4.6	0.3	-1.3	-1.8	-1.8	-1.6
Goods	-0.8	-3.7	-8.0	-5.6	-5.6	-3.9	0.5	-0.9	-1.4	-1.3	-1.2
Services	0.1	-2.9	-2.0	-1.2	-2.6	-0.6	-0.2	-0.3	-0.4	-0.4	-0.4

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

Table 5. Montenegro: Consolidated General Government Fiscal Operations, 2014-2024 1/
(Millions of euro, GFSM 2014)

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
						Projections					
1. Revenue	**1,497**	**1,469**	**1,630**	**1,725**	**1,901**	**2,009**	**2,044**	**2,120**	**2,195**	**2,301**	**2,414**
Taxes	950	926	1,013	1,104	1,220	1,281	1,338	1,404	1,468	1,538	1,614
Personal income tax	137	136	160	146	163	167	170	180	187	193	203
Corporate income tax	45	42	45	49	68	68	71	74	73	77	80
Property taxes	15	15	13	15	18	19	20	21	22	23	24
Value added tax	498	457	501	549	617	652	682	714	749	784	823
Excises	156	170	183	225	221	234	250	263	277	293	308
Taxes on international trade	22	23	24	25	27	28	29	31	32	34	35
Local government taxes	71	76	77	86	96	101	105	110	115	121	127
Other taxes	6	7	9	9	9	12	12	12	12	12	13
Social security contributions	401	392	414	441	467	472	470	485	510	536	563
Nontax revenues	137	138	186	149	184	207	206	200	188	197	207
Grants	9	14	17	30	29	49	30	30	30	30	30
2. Expense	**1,350**	**1,479**	**1,624**	**1,614**	**1,706**	**1,732**	**1,794**	**1,859**	**1,932**	**2,023**	**2,114**
Gross salaries and other personal income	395	403	434	452	467	471	490	513	539	568	596
Use of goods and services	140	188	187	173	188	186	190	204	220	231	243
Interest payments	78	86	85	103	101	107	122	110	99	105	108
Subsidies to enterprises	19	20	28	29	32	33	35	36	38	40	42
Other current outflows	37	45	51	54	61	55	57	59	62	65	68
Social security transfers	492	488	556	539	545	557	574	596	618	641	668
Other transfers	154	230	263	243	285	286	296	309	323	339	354
Repayment of guarantees	18	0	0	0	0	9	0	0	0	0	0
Reserves	16	19	21	22	27	28	30	31	32	34	36
3. Gross operating balance (= 1 - 2)	**147**	**-10**	**6**	**111**	**195**	**276**	**251**	**261**	**263**	**278**	**300**
4. Net acquisition of nonfinancial assets	**181**	**205**	**247**	**401**	**480**	**444**	**290**	**220**	**236**	**249**	**266**
Capital revenue	-7	-8	-4	-7	-11	-12	-12	-13	-13	-14	-15
Capital expenditure	189	213	251	408	491	456	302	233	250	263	281
5. Net lending (+) / borrowing (-) (= 3 - 4)	**-34**	**-215**	**-241**	**-290**	**-285**	**-168**	**-39**	**41**	**26**	**29**	**34**
6. Net acquisition of financial assets	**13**	**22**	**-22**	**47**	**307**	**357**	**-245**	**-196**	**-41**	**14**	**9**
Domestic	13	22	-22	47	307	357	-245	-196	-41	14	9
Currency and deposits	35	27	-14	49	248	322	-241	-202	-47	8	3
Loans	-10	4	4	7	6	6	6	6	6	7	7
Equity and investment fund shares	-12	-10	-11	-9	53	29	-11	0	0	0	-1
7. Net incurrence of liabilities	**117**	**178**	**199**	**296**	**613**	**525**	**-206**	**-236**	**-67**	**-16**	**-25**
Domestic	19	-43	76	36	71	107	-36	55	58	-35	98
Foreign	98	221	123	260	543	418	-169	-291	-126	19	-123
8. Discrepancy (= 5 - 6 + 7) 2/	**69**	**-59**	**-19**	**-41**	**22**	**0**	**0**	**0**	**0**	**0**	**0**
Memorandum items:											
Primary balance	44	-129	-155	-188	-184	-61	83	151	125	134	142
Nonhighway primary balance	44	-44	-37	59	97	170	164	151	125	134	142
Current balance	138	-23	-11	81	166	227	221	231	233	248	270
Nominal general government debt	2,191	2,520	2,633	2,850	3,352	3,900	3,750	3,556	3,484	3,463	3,323
Nominal gen. gov. debt, with guarantees	2,473	2,791	2,931	3,163	3,640	4,271	4,121	3,927	3,855	3,834	3,694
Nominal GDP	3,458	3,655	3,954	4,299	4,619	4,807	5,015	5,247	5,511	5,796	6,081

Sources: Ministry of Finance; and Fund staff estimates and projections.

1/ Includes central government budget and local governments.

2/ Historical discrepancy refers to differences between reported financing and that derived from monetary and debt data.

Table 6. Montenegro: Consolidated General Government Fiscal Operations, 2014-2024 1/

(Percent of GDP, GFSM 2014)

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
					Prelim.			Projections			
1. Revenue	**43.3**	**40.2**	**41.2**	**40.1**	**41.1**	**41.8**	**40.8**	**40.4**	**39.8**	**39.7**	**39.7**
Taxes	27.5	25.3	25.6	25.7	26.4	26.6	26.7	26.8	26.6	26.5	26.5
Personal income tax	4.0	3.7	4.0	3.4	3.5	3.5	3.4	3.4	3.4	3.3	3.3
Corporate income tax	1.3	1.2	1.1	1.1	1.5	1.4	1.4	1.4	1.3	1.3	1.3
Property taxes	0.4	0.4	0.3	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Value added tax	14.4	12.5	12.7	12.8	13.4	13.6	13.6	13.6	13.6	13.5	13.5
Excises	4.5	4.7	4.6	5.2	4.8	4.9	5.0	5.0	5.0	5.1	5.1
Taxes on international trade	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6
Local government taxes	2.1	2.1	2.0	2.0	2.1	2.1	2.1	2.1	2.1	2.1	2.1
Other taxes	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Social security contributions	11.6	10.7	10.5	10.3	10.1	9.8	9.4	9.2	9.2	9.3	9.3
Nontax revenues	4.0	3.8	4.7	3.5	4.0	4.3	4.1	3.8	3.4	3.4	3.4
Grants	0.3	0.4	0.4	0.7	0.6	1.0	0.6	0.6	0.5	0.5	0.5
2. Expense	**39.0**	**40.5**	**41.1**	**37.5**	**36.9**	**36.0**	**35.8**	**35.4**	**35.1**	**34.9**	**34.8**
Gross salaries and other personal income	11.4	11.0	11.0	10.5	10.1	9.8	9.8	9.8	9.8	9.8	9.8
Use of goods and services	4.1	5.1	4.7	4.0	4.1	3.9	3.8	3.9	4.0	4.0	4.0
Interest payments	2.3	2.4	2.2	2.4	2.2	2.2	2.4	2.1	1.8	1.8	1.8
Subsidies to enterprises	0.5	0.6	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Other current outflows	1.1	1.2	1.3	1.2	1.3	1.1	1.1	1.1	1.1	1.1	1.1
Social security transfers	14.2	13.3	14.1	12.5	11.8	11.6	11.4	11.4	11.2	11.1	11.0
Other transfers	4.4	6.3	6.6	5.7	6.2	6.0	5.9	5.9	5.9	5.8	5.8
Repayment of guarantees	0.5	0.0	0.0	0.0	0.0	0.2	0.0	0.0	0.0	0.0	0.0
Reserves	0.5	0.5	0.5	0.5	0.6	0.6	0.6	0.6	0.6	0.6	0.6
3. Gross operating balance (= 1 - 2)	**4.3**	**-0.3**	**0.2**	**2.6**	**4.2**	**5.7**	**5.0**	**5.0**	**4.8**	**4.8**	**4.9**
4. Net acquisition of nonfinancial assets	**5.2**	**5.6**	**6.2**	**9.3**	**10.4**	**9.2**	**5.8**	**4.2**	**4.3**	**4.3**	**4.4**
Capital revenue	-0.2	-0.2	-0.1	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2
Capital expenditure	5.5	5.8	6.3	9.5	10.6	9.5	6.0	4.4	4.5	4.5	4.6
5. Net lending (+) / borrowing (-) (= 3 - 4)	**-1.0**	**-5.9**	**-6.1**	**-6.7**	**-6.2**	**-3.5**	**-0.8**	**0.8**	**0.5**	**0.5**	**0.6**
6. Net acquisition of financial assets	**0.4**	**0.6**	**-0.6**	**1.1**	**6.6**	**7.4**	**-4.9**	**-3.7**	**-0.7**	**0.2**	**0.1**
Domestic	0.4	0.6	-0.6	1.1	6.6	7.4	-4.9	-3.7	-0.7	0.2	0.1
Currency and deposits	1.0	0.8	-0.4	1.1	5.4	6.7	-4.8	-3.9	-0.9	0.1	0.1
Loans	-0.3	0.1	0.1	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Equity and investment fund shares	-0.3	-0.3	-0.3	-0.2	1.1	0.6	-0.2	0.0	0.0	0.0	0.0
7. Net incurrence of liabilities	**3.4**	**4.9**	**5.0**	**6.9**	**13.3**	**10.9**	**-4.1**	**-4.5**	**-1.2**	**-0.3**	**-0.4**
Domestic	0.6	-1.2	1.9	0.8	1.5	2.2	-0.7	1.0	1.1	-0.6	1.6
Foreign	2.8	6.0	3.1	6.0	11.7	8.7	-3.4	-5.5	-2.3	0.3	-2.0
8. Discrepancy (= 5 - 6 + 7) 2/	**2.0**	**-1.6**	**-0.5**	**-1.0**	**0.5**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Memorandum items:											
Primary balance	1.3	-3.5	-3.9	-4.4	-4.0	-1.3	1.7	2.9	2.3	2.3	2.3
Nonhighway primary balance	1.3	-1.2	-0.9	1.4	2.1	3.5	3.3	2.9	2.3	2.3	2.3
Current balance	4.0	-0.6	-0.3	1.9	3.6	4.7	4.4	4.4	4.2	4.3	4.4

Sources: Ministry of Finance; and Fund staff estimates and projections.

1/ Includes central government budget and local governments.

2/ Historical discrepancy refers to differences between reported financing and that derived from monetary and debt data.

Table 7. Montenegro: Consolidated General Government Fiscal Operations, 2014-2024 1/

(Millions of euro)

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
						Projections					
Total revenues and grants	**1,505**	**1,477**	**1,635**	**1,732**	**1,912**	**2,021**	**2,057**	**2,133**	**2,208**	**2,315**	**2,429**
Total revenues	1,495	1,464	1,617	1,701	1,882	1,971	2,027	2,103	2,178	2,285	2,399
Current revenues	1,488	1,456	1,613	1,695	1,871	1,960	2,014	2,090	2,165	2,271	2,384
Taxes	950	926	1,013	1,104	1,220	1,281	1,338	1,404	1,468	1,538	1,614
Personal income tax	137	136	160	146	163	167	170	180	187	193	203
Corporate income tax	45	42	45	49	68	68	71	74	73	77	80
Taxes on turnover of real estate	15	15	13	15	18	19	20	21	22	23	24
Value added tax	498	457	501	549	617	652	682	714	749	784	823
Excises	156	170	183	225	221	234	250	263	277	293	308
Taxes on international trade	22	23	24	25	27	28	29	31	32	34	35
Local government taxes	71	76	77	86	96	101	105	110	115	121	127
Other taxes	6	7	9	9	9	12	12	12	12	12	13
Social security contributions	401	392	414	441	467	472	470	485	510	536	563
Nontax revenues	137	138	186	149	184	207	206	200	188	197	207
Duties	21	21	19	20	23	24	25	26	27	29	30
Fees	71	76	120	80	76	90	93	98	103	108	113
Other revenues	45	41	47	49	86	94	88	77	58	61	64
Capital revenues	7	8	4	7	11	12	12	13	13	14	15
Grants	9	14	17	30	29	49	30	30	30	30	30
Total expenditures and net lending	**1,529**	**1,696**	**1,879**	**2,029**	**2,203**	**2,195**	**2,102**	**2,098**	**2,188**	**2,292**	**2,402**
Total expenditures	1,539	1,692	1,875	2,022	2,197	2,188	2,096	2,092	2,182	2,286	2,395
Current expenditures	1,350	1,479	1,624	1,614	1,706	1,732	1,794	1,859	1,932	2,023	2,114
Gross salaries	381	383	419	438	450	453	472	494	519	547	574
Other personal income	14	20	15	14	17	17	18	19	20	21	22
Goods and services	115	163	161	146	161	158	162	169	177	185	194
Current maintenance	25	25	26	26	26	27	29	36	44	46	48
Interest payments	78	86	85	103	101	107	122	110	99	105	108
Rent	9	9	10	10	11	12	12	13	14	14	15
Subsidies to enterprises	19	20	28	29	32	33	35	36	38	40	42
Other outflows 2/	28	37	41	44	50	43	45	46	48	51	53
Social security transfers	492	488	556	539	545	557	574	596	618	641	668
Other transfers	154	230	263	243	285	286	296	309	323	339	354
Repayment of guarantees	18	0	0	0	0	9	0	0	0	0	0
Reserves	16	19	21	22	27	28	30	31	32	34	36
Capital expenditures	189	213	251	408	491	456	302	233	250	263	281
Non-highway capital expenditures	189	128	132	161	210	224	221	233	250	263	281
Highway capital expenditures	0	85	119	247	281	231	81	0	0	0	0
Net lending	-10	4	4	7	6	6	6	6	6	7	7
Overall Balance	**-24**	**-219**	**-244**	**-297**	**-291**	**-174**	**-46**	**34**	**20**	**23**	**27**
Financing	**93**	**160**	**225**	**256**	**313**	**174**	**46**	**-34**	**-20**	**-23**	**-27**
Domestic financing	-16	-71	91	-13	-177	-215	204	257	105	-43	95
Central bank financing (- deposit increase)	-13	-5	10	-25	-207	-315	245	203	48	-6	0
Net borrowing from other sources	-3	-66	81	12	30	101	-41	54	57	-36	95
Commercial bank financing	-15	112	133	35	36	57	-35	30	33	-62	68
Change in deposits (- increase)	-22	-22	4	-24	-40	-7	-5	-1	-1	-1	-3
Bank loans, net	-37	-16	18	67	26	-29	-30	0	4	2	41
Bank purchases of securities, net	44	150	111	-7	50	93	0	30	30	-63	30
Non-bank financing, net	12	-177	-52	-23	-5	44	-6	25	25	26	27
Foreign financing	98	221	123	260	543	418	-169	-291	-126	19	-123
Disbursements	210	661	325	353	913	770	321	150	119	244	134
Amortization	-113	-322	-310	-136	-464	-334	-430	-394	-245	-225	-257
Change in foreign accounts receivable 3/	0	-118	107	42	93	-18	-60	-48	0	0	0
Privatization receipts	12	10	11	9	-53	-29	11	0	0	0	1
Unidentified	0	0	0	0	0	0	0	0	0	0	0
Discrepancy 4/	-69	59	19	41	-22	0	0	0	0	0	0
Memorandum items:											
Primary balance	54	-133	-159	-195	-190	-67	76	144	119	128	136
Nonhighway primary balance	54	-48	-40	52	91	164	158	144	119	128	136
Nonhighway overall balance	-24	-134	-126	-50	-10	57	36	34	20	23	27
Current balance	138	-23	-11	81	166	227	221	231	233	248	270

Sources: Ministry of Finance; and Fund staff estimates and projections.

1/ Includes central government budget and local governments.

2/ According to GFSM 1986, payments of loan guarantees or related to court rulings are recorded as government expenses.

3/ To reflect pre-payments made for construction of Bar-Boljare highway that exceed the pace of actual capital expenditure.

4/ Historical discrepancy is the difference between reported financing and that derived from monetary and debt data.

Table 8. Montenegro: Consolidated General Government Fiscal Operations, 2014-2024 1/

(Percent of GDP)

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
					Prelim.	Projections					
Total revenues and grants	**43.5**	**40.4**	**41.3**	**40.3**	**41.4**	**42.0**	**41.0**	**40.6**	**40.1**	**39.9**	**39.9**
Total revenues	43.2	40.0	40.9	39.6	40.8	41.0	40.4	40.1	39.5	39.4	39.4
Current revenues	43.0	39.8	40.8	39.4	40.5	40.8	40.2	39.8	39.3	39.2	39.2
Taxes	27.5	25.3	25.6	25.7	26.4	26.6	26.7	26.8	26.6	26.5	26.5
Personal income tax	4.0	3.7	4.0	3.4	3.5	3.5	3.4	3.4	3.4	3.3	3.3
Corporate income tax	1.3	1.2	1.1	1.1	1.5	1.4	1.4	1.4	1.3	1.3	1.3
Taxes on turnover of real estate	0.4	0.4	0.3	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Value added tax	14.4	12.5	12.7	12.8	13.4	13.6	13.6	13.6	13.6	13.5	13.5
Excises	4.5	4.7	4.6	5.2	4.8	4.9	5.0	5.0	5.0	5.1	5.1
Taxes on international trade	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6
Local government taxes	2.1	2.1	2.0	2.0	2.1	2.1	2.1	2.1	2.1	2.1	2.1
Other taxes	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Social security contributions	11.6	10.7	10.5	10.3	10.1	9.8	9.4	9.2	9.2	9.3	9.3
Nontax revenues	4.0	3.8	4.7	3.5	4.0	4.3	4.1	3.8	3.4	3.4	3.4
Duties	0.6	0.6	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Fees	2.1	2.1	3.0	1.9	1.6	1.9	1.9	1.9	1.9	1.9	1.9
Other revenues	1.3	1.1	1.2	1.1	1.9	2.0	1.8	1.5	1.0	1.0	1.0
Capital revenues	0.2	0.2	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Grants	0.3	0.4	0.4	0.7	0.6	1.0	0.6	0.6	0.5	0.5	0.5
Total expenditures and net lending	**44.2**	**46.4**	**47.5**	**47.2**	**47.7**	**45.7**	**41.9**	**40.0**	**39.7**	**39.6**	**39.5**
Total expenditures	44.5	46.3	47.4	47.0	47.6	45.5	41.8	39.9	39.6	39.4	39.4
Current expenditures	39.0	40.5	41.1	37.5	36.9	36.0	35.8	35.4	35.1	34.9	34.8
Gross salaries	11.0	10.5	10.6	10.2	9.8	9.4	9.4	9.4	9.4	9.4	9.4
Other personal income	0.4	0.5	0.4	0.3	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Goods and services	3.3	4.5	4.1	3.4	3.5	3.3	3.2	3.2	3.2	3.2	3.2
Current maintenance	0.7	0.7	0.7	0.6	0.6	0.6	0.6	0.7	0.8	0.8	0.8
Interest payments	2.3	2.4	2.2	2.4	2.2	2.2	2.4	2.1	1.8	1.8	1.8
Rent	0.2	0.2	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Subsidies to enterprises	0.5	0.6	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Other outflows 2/	0.8	1.0	1.0	1.0	1.1	0.9	0.9	0.9	0.9	0.9	0.9
Social security transfers	14.2	13.3	14.1	12.5	11.8	11.6	11.4	11.4	11.2	11.1	11.0
Other transfers	4.4	6.3	6.6	5.7	6.2	6.0	5.9	5.9	5.9	5.8	5.8
Repayment of guarantees	0.5	0.0	0.0	0.0	0.0	0.2	0.0	0.0	0.0	0.0	0.0
Reserves	0.5	0.5	0.5	0.5	0.6	0.6	0.6	0.6	0.6	0.6	0.6
Capital expenditures	5.5	5.8	6.3	9.5	10.6	9.5	6.0	4.4	4.5	4.5	4.6
Non-highway capital expenditures	5.5	3.5	3.3	3.7	4.5	4.7	4.4	4.4	4.5	4.5	4.6
Highway capital expenditures	0.0	2.3	3.0	5.7	6.1	4.8	1.6	0.0	0.0	0.0	0.0
Net lending	-0.3	0.1	0.1	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Overall Balance	**-0.7**	**-6.0**	**-6.2**	**-6.9**	**-6.3**	**-3.6**	**-0.9**	**0.7**	**0.4**	**0.4**	**0.4**
Financing	**2.7**	**4.4**	**5.7**	**6.0**	**6.8**	**3.6**	**0.9**	**-0.7**	**-0.4**	**-0.4**	**-0.4**
Domestic financing	-0.5	-1.9	2.3	-0.3	-3.8	-4.5	4.1	4.9	1.9	-0.7	1.6
Central bank financing (- deposit increase)	-0.4	-0.1	0.3	-0.6	-4.5	-6.6	4.9	3.9	0.9	-0.1	0.0
Net borrowing from other sources	-0.1	-1.8	2.0	0.3	0.7	2.1	-0.8	1.0	1.0	-0.6	1.6
Commercial bank financing	-0.4	3.1	3.4	0.8	0.8	1.2	-0.7	0.6	0.6	-1.1	1.1
Change in deposits (- increase)	-0.6	-0.6	0.1	-0.6	-0.9	-0.1	-0.1	0.0	0.0	0.0	0.0
Bank loans, net	-1.1	-0.4	0.5	1.6	0.6	-0.6	-0.6	0.0	0.1	0.0	0.7
Bank purchases of securities, net	1.3	4.1	2.8	-0.2	1.1	1.9	0.0	0.6	0.5	-1.1	0.5
Non-bank financing, net	0.4	-4.8	-1.3	-0.5	-0.1	0.9	-0.1	0.5	0.4	0.4	0.4
Foreign financing	2.8	6.0	3.1	6.0	11.7	8.7	-3.4	-5.5	-2.3	0.3	-2.0
Disbursements	6.1	18.1	8.2	8.2	19.8	16.0	6.4	2.9	2.2	4.2	2.2
Amortization	-3.3	-8.8	-7.8	-3.2	-10.0	-6.9	-8.6	-7.5	-4.4	-3.9	-4.2
Change in foreign accounts receivable 3/		-3.2	2.7	1.0	2.0	-0.4					
Privatization receipts	0.3	0.3	0.3	0.2	-1.1	-0.6	0.2	0.0	0.0	0.0	0.0
Unidentified	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Discrepancy 4/	-2.0	1.6	0.5	1.0	-0.5	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:											
Primary balance	1.6	-3.6	-4.0	-4.5	-4.1	-1.4	1.5	2.8	2.2	2.2	2.2
Nonhighway primary balance	1.6	-1.3	-1.0	1.2	2.0	3.4	3.1	2.8	2.2	2.2	2.2
Nonhighway overall balance	-0.7	-3.7	-3.2	-1.2	-0.2	1.2	0.7	0.7	0.4	0.4	0.4
Current balance	4.0	-0.6	-0.3	1.9	3.6	4.7	4.4	4.4	4.2	4.3	4.4
General government debt (gross)	63.4	69.0	66.6	66.3	72.6	81.1	74.8	67.8	63.2	59.8	54.7
Gen. govt debt, including guarantees	71.5	76.4	74.1	73.6	78.8	88.8	82.2	74.8	69.9	66.1	60.7

Sources: Ministry of Finance; and Fund staff estimates and projections.

1/ Includes central government and local governments.

2/ According to GFSM 1986, payments of loan guarantees or related to court rulings are recorded as government expenses.

3/ To reflect pre-payments made for construction of Bar-Boljare highway that exceed the pace of actual capital expenditure.

4/ Historical discrepancy is the difference between reported financing and that derived from monetary and debt data.

Table 9. Montenegro: Summary of Accounts of the Financial System, 2014-2019

(Millions of euro, unless otherwise noted)

	2014	2015	2016	2017	2018	2019 Proj.
			I. Central Bank			
Net foreign assets	514	591	720	816	1018	1334
Assets 1/	545	624	753	847	1050	1365
Liabilities	31	33	33	31	32	32
Net domestic assets	-408	-475	-590	-673	-840	-1172
Net credit to the nonfinancial public sector	-25	19	30	2	-205	-520
Of which: general government	-25	19	30	2	-205	-520
Net credit to the banking system	-416	-525	-654	-708	-669	-683
Required reserves	-171	-196	-226	-234	-252	-266
Giro account	-245	-329	-427	-474	-416	-416
Claims on depository institutions	0	0	-1	-1	0	-1
Other assets net	33	31	34	34	33	30
Deposits included in broad money	46	55	65	78	109	90
Equity	60	61	64	66	69	71
			II. Banking System			
Net foreign assets	-74	-152	-290	-246	-316	-406
Assets	613	592	527	616	650	648
Liabilities	687	744	818	861	966	1,053
Net domestic assets	2,173	2,362	2,623	2,858	3,137	3,359
Net assets held in the central bank	415	524	653	708	668	683
Net credit to nonfinancial public sector	-56	-24	-5	17	138	195
Of which: general government	79	161	275	316	350	407
Credit to the private sector	1,765	1,808	1,922	2,083	2,273	2,432
Other domestic assets	49	54	53	50	58	50
Liabilities	2,099	2,211	2,333	2,612	2,821	2,906
Private sector deposits	1,570	1,711	1,812	2,086	2,211	2,290
Other items, net	529	500	520	526	610	617
o/w capital	441	465	496	529	536	572
			III. Consolidated System			
Net foreign assets 1/	440	439	430	571	702	928
Net domestic assets	1,765	1,888	2,033	2,185	2,296	2,187
Net credit to the nonfinancial public sector	-81	-4	25	19	-67	-325
Of which: general government	54	180	305	318	146	-113
Credit to the private sector	1,765	1,808	1,922	2,083	2,273	2,432
Other net domestic assets	81	84	86	83	90	80
Liabilities	2,145	2,266	2,398	2,690	2,930	2,996
Equity capital of the central bank	60	61	64	66	69	71
			IV. Ratios			
Net assets held in CBCG/Deposits	26.4	30.6	36.0	33.9	30.2	29.2
Effective required reserves ratio	10.9	11.4	12.5	11.2	11.4	11.4
Credit to private sector / GDP	51.0	49.5	48.6	48.5	49.2	50.6
Banks' capital / credit to private sector	25.0	25.7	25.8	25.4	23.6	23.5
CBCG reserves / bank deposits 1/	34.7	36.5	41.5	40.6	47.5	58.4
Banks' foreign liabilities / credit to private sector	38.9	41.1	42.5	41.3	42.5	43.3
Memo item:						
Broad money	1,838.2	2,046.4	2,240.5	2,546.8	2,612.8	2,765.1
BM growth	9.0	11.3	9.5	13.7	2.6	5.8

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

1/ CBM's foreign assets have been revised to exclude CBM's holdings of Montenegrin government securities and reclassify SDR holdings for 2015-17.

Table 10. Montenegro: Balance of Payments, 2014-2024

(Millions of euro, unless otherwise noted; BPM6)

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
						Projections					
					(Millions of euros)						
Current account balance	**-429**	**-402**	**-642**	**-691**	**-793**	**-820**	**-749**	**-706**	**-670**	**-629**	**-577**
Trade balance	-1,376	-1,464	-1,658	-1,860	-2,049	-2,202	-2,186	-2,217	-2,264	-2,309	-2,351
Exports	357	330	351	382	436	437	457	485	515	548	580
Imports	1,734	1,794	2,008	2,243	2,485	2,639	2,644	2,702	2,779	2,858	2,932
Services account	690	789	769	852	937	1,032	1,098	1,159	1,229	1,303	1,383
Receipts	1,031	1,214	1,255	1,382	1,563	1,689	1,772	1,859	1,958	2,063	2,174
Expenditures	340	425	486	531	627	658	675	700	729	760	790
Primary Income	46	80	35	88	55	55	55	56	56	56	56
Compensation of employees, net	194	214	224	234	216	225	235	246	258	272	285
Investment income, net	-148	-134	-190	-146	-162	-170	-180	-190	-202	-216	-229
Secondary Income	211	193	212	228	265	294	285	296	308	322	335
Government, net	24	4	24	21	33	53	33	33	32	31	30
Other sectors, net	187	189	188	208	232	241	252	263	276	291	305
Capital account	**0**	**0**	**1**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**
Financial account	**-375**	**-375**	**-690**	**-774**	**-905**	**-1,136**	**-504**	**-504**	**-622**	**-635**	**-578**
Foreign direct investment, net	-354	-619	-372	-484	-328	-426	-447	-468	-491	-517	-542
Abroad, net	21	11	-167	10	87	96	100	105	110	116	121
In Montenegro, net	375	630	205	494	415	522	547	573	601	632	664
Portfolio investment, net	-84	-116	4	-26	-135	-323	330	237	10	10	11
Assets, net	67	-14	54	-10	6	8	8	9	9	10	10
Liabilities, net	151	103	50	16	141	331	-321	-228	0	0	0
of which:											
General government	149	221	89	0	137	331	-321	-227	0	0	0
Eurobond	267	313	120	0	129	331	-321	-227	0	0	0
Disbursements (increase in liabilities)	280	500	300	0	491	500	0	0	0	0	0
Amortization (reduction in liabilities)	-13	-187	-180	0	-362	-169	-321	-227	0	0	0
Derivatives, net	0	0	0	0	0	0	0	0	0	0	0
Other investment, net	64	361	-323	-263	-442	-387	-386	-273	-140	-128	-46
General government, Net	34	-104	24	-256	-422	-87	-152	63	126	-19	123
of which:											
Amortization (reduction in net liabilities)	-125	-509	-490	-136	-826	-503	-752	-621	-245	-225	-257
Disbursements	210	161	25	353	422	270	321	150	119	244	134
Highway-related trade credits 1/	0	-118	107	42	93	-18	-60	-48	0	0	0
Commercial banks	62	-35	-152	55	-33	-86	-96	-107	-117	-126	-136
Other sectors	-33	500	-195	-62	13	-214	-139	-229	-149	17	-33
Errors and omissions	173	105	80	15	95	0	0	0	0	0	0
Change in official reserves (+ denotes increase) 2/	118	78	129	97	202	315	-245	-203	-48	6	0
Memorandum items						(Percent of GDP)					
Current account balance	-12.4	-11.0	-16.2	-16.1	-17.2	-17.1	-14.9	-13.5	-12.2	-10.8	-9.5
Trade balance	-39.8	-40.1	-41.9	-43.3	-44.4	-45.8	-43.6	-42.3	-41.1	-39.8	-38.7
Exports	10.3	9.0	8.9	8.9	9.4	9.1	9.1	9.2	9.3	9.5	9.5
Imports	50.1	49.1	50.8	52.2	53.8	54.9	52.7	51.5	50.4	49.3	48.2
Services account	20.0	21.6	19.4	19.8	20.3	21.5	21.9	22.1	22.3	22.5	22.7
Receipts	29.8	33.2	31.7	32.2	33.8	35.1	35.3	35.4	35.5	35.6	35.7
Payments	9.8	11.6	12.3	12.3	13.6	13.7	13.5	13.3	13.2	13.1	13.0
Income account	1.3	2.2	0.9	2.1	1.2	1.2	1.1	1.1	1.0	1.0	0.9
Current transfers, net	6.1	5.3	5.4	5.3	5.7	6.1	5.7	5.6	5.6	5.6	5.5
Foreign direct investment, net	-10.2	-16.9	-9.4	-11.3	-7.1	-8.9	-8.9	-8.9	-8.9	-8.9	-8.9
Portfolio investment, net	-2.4	-3.2	0.1	-0.6	-2.9	-6.7	6.6	4.5	0.2	0.2	0.2
Other investment, net	1.8	9.9	-8.2	-6.1	-9.6	-8.1	-7.7	-5.2	-2.5	-2.2	-0.8
General government	1.0	-2.9	0.6	-6.0	-9.1	-1.8	-3.0	1.2	2.3	-0.3	2.0
Other sectors	-1.0	13.7	-4.9	-1.4	0.3	-4.5	-2.8	-4.4	-2.7	0.3	-0.5
Errors and omissions	5.0	2.9	2.0	0.3	2.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross external debt	161.0	166.2	160.9	159.2	167.5	180.0	178.5	175.6	173.0	170.0	166.1
of which: Government	47.6	55.8	53.0	53.6	61.3	68.1	63.0	55.5	50.5	48.2	43.9
Real goods import growth	1.4	6.6	12.8	8.4	8.1	5.5	-0.7	1.3	1.9	1.9	1.7
Real goods export growth	-10.2	-8.9	6.7	3.7	11.9	0.6	2.7	4.0	4.0	4.2	3.7
Real service export growth	3.2	17.6	3.1	8.5	11.1	6.7	3.3	3.2	3.5	3.4	3.4

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

1/ The line reflects increase in GG liabilities, which captures pre-payments made for the construction of the Bar-Boljare highway that exceed the pace of actual capital expenditure.

2/ CBM's international reserves have been revised to exclude CBM's holdings of Montenegrin government securities and reclassify SDRs for 2015-17.

Table 11. Montenegro: Financial Soundness Indicators of the Banking Sector, 2012-2019

	2012 Dec	2013 Dec	2014 Dec	2015 Dec	2016 Dec	2017 Dec	2018 Dec	2019 Mar
Capital adequacy								
Regulatory capital as percent of risk-weighted assets	14.7	14.4	16.2	15.5	16.1	16.4	15.6	15.3
Capital as percent of assets	10.3	13.4	14.2	13.3	12.9	12.3	11.6	11.8
Asset composition and quality								
Non-performing loans (NPL), in percent of gross loans	17.6	18.4	16.8	13.4	11.1	8.0	7.5	6.5
Provisions, in percent of NPL	40.2	47.4	48.8	52.2	60.7	62.6	75.8	82.6
Earnings and profitability								
Gross profits, in percent of average assets (ROAA)	-2.0	0.1	0.8	-0.1	0.3	0.9	0.7	0.0
Gross profits, in percent of average equity capital (ROAE)	-18.0	0.9	5.7	-0.5	1.9	7.4	5.6	-0.2
Net interest margin 1/	5.0	4.2	4.5	4.5	4.3	4.0	4.0	1.0
Non-interest income, in percent of gross income	26.9	31.8	27.7	29.6	27.4	31.2	26.3	20.4
Liquidity								
Liquid assets, in percent of total assets	24.0	20.0	22.2	24.8	24.5	25.3	22.6	21.8
Liquid assets, in percent of short-term liabilities	40.1	32.2	35.7	40.1	34.8	35.6	29.7	28.1
Loans, in percent of deposits	94.0	114.0	101.7	90.3	83.7	82.4	84.7	88.2
Sensitivity to market risk								
Off-balance sheet operations, in percent of assets	370.2	313.3	301.5	274.0	202.6	189.3	211.5	215.0
Original maturity of assets (in percent of total)								
Less than 3 months	32.1	38.7	43.2	42.8	39.9	38.9	35.6	34.4
Original maturity of liabilities (in percent of total)								
Less than 3 months	31.3	40.4	38.9	33.1	55.0	58.9	73.3	74.9

Source: Central Bank of Montenegro.

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

Annex I. Risk Assessment Matrix[1]

(Scale – High, medium, or low)

Source of Risks	Relative Likelihood	Impact if Realized	Policy Response
1. **Weaker-than-expected global growth**	**Medium/High** The global growth slowdown could be synchronized as weakening outlooks in the U.S., Europe, and China feed off each other and impact on earnings, asset prices, and credit performance.	**High** A protracted slowdown in the EU and neighboring countries could adversely impact the appetite for external and public financing (especially FDI flows and tourism infrastructure developments). A significant slowdown of consumption in the EU could impact tourism flows, a significant source of Montenegro's service exports.	• Let automatic fiscal stabilizers work. • Accelerate structural reforms to increase competitiveness and reduce structural bottlenecks that impede credit to the private sector.
2. **Sharp tightening of global financial conditions**	**Low/Medium** This causes higher debt service and refinancing risks; stress on leveraged firms, households, and vulnerable sovereigns; capital account pressures; and a broad-based downturn. The tightening could be a result of market expectations of a tighter U.S. monetary policy triggered by strong wage growth and higher-than-expected inflation or a sustained rise in the risk premium in reaction to concerns about debt levels in some euro area countries; a disorderly Brexit; or idiosyncratic policy missteps in large emerging markets.	**Medium** Montenegro is highly reliant on external financing. External financial needs are covered in 2019, but the sovereign will need to rollover maturing Eurobonds in 2020 or 2021. Gross external financing needs average 40 percent of GDP over 2019-2021.	• Let automatic fiscal stabilizers work. • Continue to implement the medium-term fiscal consolidation plan that puts debt on a strongly downward trajectory. Intensify adjustment if tighter conditions are permanent. • Continue implementing the medium-term debt strategy with an emphasis on developing the domestic bond market.
3. **Intensification of security risks in parts of Africa, Asia, Europe, Latin America, and/or the Middle East cause**	**High** Intensification of conflicts in the Middle East and Africa could lead to sharp rises in migrant flows into Europe. Failure to implement and improve the common policy to deal with asylum seekers and other migrants to the EU could deepen political divisions. Border control	**Medium** Given important tourism and real estate links, such restrictive developments could undermine FDI inflows and thus weaken growth prospects, depress real estate prices, and further limit Montenegro's capacity	• Let automatic fiscal stabilizers work. • Speed up structural reforms to improve the business environment and competitiveness. • Intensify reforms to improve the labor

[1] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability of 30 percent or more). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.

Source of Risks	Relative Likelihood	Impact if Realized	Policy Response
regional socio-economic and political disruptions, with potential global spillovers.	could restrict movement of goods, services, and labor in the single market. Limited integration of asylum seekers could raise unemployment, exert pressure on national budgets, and put social cohesion at risk.	to absorb shocks. However, as a competitor for tourism, Montenegro could benefit from instability in rival destinations. Montenegro is not a transit country for refugees and thus the direct impact should be muted.	markets with a focus on job creation. • Accelerate policies to resolve concerns about pockets of banking sector weakness and encourage a revitalization of bank lending.
4. **Insufficient fiscal discipline**	**High** The authorities do not have a strong track record of prolonged fiscal consolidation. Political pressures to construct further phases of the highway could override concerns about debt sustainability or fiscal risks from a PPP. It will be politically difficult to maintain the primary surpluses needed to keep public debt on a strong downward path. The ruling coalition has a small majority in parliament.	**High** Given high public debt, a loss of fiscal discipline could lead to future financing difficulties and potentially result in debt sustainability problems.	• Improve medium-term budgeting and public financial management practices. Consider implementation of an overall expenditure limit based on envelope of medium-term budget. Improve public communication regarding the need for fiscal adjustment. Suspend further highway construction.
5. **Delays and withdrawals from capital investment projects**	**Medium** Ongoing geopolitical tensions, weak administrative procedures on land development, and concerns regarding fiscal sustainability could threaten capital investments in tourism and industry.	**Medium** Construction and activity associated with large-scale investment projects (both tourism and infrastructure based) are key drivers of growth.	• Sustain the medium-term fiscal consolidation effort to safeguard fiscal sustainability and implement structural reforms to improve the business environment and strengthen anti-corruption and AML/CFT frameworks.
6. **Lingering concerns about pockets of weakness in banking sector**	**Medium** Following the bankruptcy of two small/medium domestic banks, concerns may linger regarding the health of some other (particularly domestic) banks in the system.	**Medium** A perception of other weak banks in the system could raise concerns about banking sector stability, leading to possible deposit outflows and disintermediation.	• Carry out asset quality review and require shareholders to increase capital levels to address any shortfalls revealed. Strengthen AML/CFT legal and supervisory framework.

Annex II. Public Debt Sustainability Analysis

Debt is sustainable under the baseline, if the authorities avoid a fiscal relaxation following the completion of the first phase of the highway and avoid fiscal costs related to further highway construction. However, debt sustainability and financing risks remain significant. General government debt (including guarantees) increased from 36 percent of GDP in 2006 to 79 percent of GDP in 2018. In the baseline, debt is projected to peak at 89 percent of GDP in 2020, though net debt (adjusted for government deposits) would peak in 2019, as the authorities pre-finance future Eurobond amortizations. Gross debt would decline to 62 percent of GDP in 2024, based on the completion of a fiscal adjustment began in 2017 and the maintenance of primary surpluses over the medium term. The projected debt trajectory is highly susceptible to shocks, especially a negative economic growth shock, but declines under all standard scenarios. Gross financing needs remain high, though the 2018 liability management operation reduced financing needs over 2019-21 by extending Eurobond maturities. Under the baseline scenario, debt begins a strong downward trend in 2021, but the authorities would still have to manage finances carefully to maintain market access.

Baseline and Realism of Projections

- **Background.** Public debt is reported on a gross basis and includes only general government debt and government-issued guarantees, which comprised 6.2 percent of GDP in 2018.[1] A key driver of the increase in public debt since 2014 has been an external loan to fund construction of the first section of the Bar-Boljare highway. Denominated in U.S. dollars, this loan is projected to increase the foreign currency share of public debt to 21 percent by 2020 from 4 percent in 2014.

- **Macroeconomic assumptions.** Growth is expected to slow to 3.0 percent in 2019, below growth observed in 2017-18, as the pace of highway construction has peaked, and government consumption slows in line with fiscal adjustment. Growth is projected to slow further in 2020-21 to an average of 2.7 percent as highway investment spending ends. Growth would then increase to average 3.1 percent over 2022-24 as the modest supply-side effects of the highway begin.

- **Fiscal scenario.** The baseline projections assume implementation of fiscal measures in 2019 to complete the underlying non-highway fiscal adjustment strategy, improving the non-highway primary balance to 3.4 percent of GDP. After the completion of highway spending in 2020, a large (2.7 percent of GDP) primary surplus emerges in 2021. The maintenance of a primary surplus of 2 percent of GDP over the medium term critically depends on the avoidance of new budgetary spending on the next phase of highway construction.

- **Eurobond amortizations.** The authorities completed in 2018 two financing operations to partially pre-finance coming Eurobond amortizations. Leveraging a World Bank Policy-Based

[1] Existing government guarantees are mostly directed to infrastructure and SMEs, often in conjunction with the EBRD. Since peaking at 11.6 percent of GDP in 2012, guarantees fell to 6.2 percent of GDP in 2018, as the authorities have been more cautious in issuing guarantees. The authorities plan to issue 1.5 percent of GDP in guarantees in 2019. Data on public enterprises are not available.

Guarantee (PBG), they borrowed €250 million from a syndicate of international banks, with a 2.95 percent interest rate and 12-year maturity. They also issued a seven-year €500 million Eurobond, of which €362 million was used to buy back part of the €1.1 billion in Eurobonds set to mature in 2019-21. The Eurobond carries a coupon rate of 3.375 percent. These two operations increased government deposits at the central bank in 2018 by €200 million, which were used to amortize the remainder (€169 million) of the 2019 Eurobond. The baseline assumes that the authorities can fully meet medium-term financing needs largely based on two assumed operations in 2019-2020. First, the baseline includes the issuance of a new €500 million Eurobond in 2019 that would allow the authorities to pre-finance the amortization of the remainder of the 2020 Eurobond (€321 million) and the 2021 Eurobond (€228 million). Second, the baseline assumes a second World Bank PBG, raising €155 million in 2020.

- **Heatmap and debt profile vulnerabilities.** Risks from the debt level are deemed high as debt exceeds the 70 percent of GDP benchmark in 2014. Debt only falls below this level in 2022 in the baseline and expands in some shock scenarios. Proactive debt management has reduced gross financing needs below the 15 percent of GDP threshold in the baseline scenario, but this level is still exceeded in some shocks. Public debt held by non-residents (Eurobonds and the China Ex-Im Bank loan) also constitutes a vulnerability. Shocks to economic growth have the largest impact on the debt profile.

- **Realism of baseline assumptions.** The median forecast errors for real GDP growth (actual minus projection) in 2009-2017 suggests on average an optimistic bias in staff's past projections, possibly due to the impact of the Great Recession. The median forecast error for the primary balance suggests that staff projections have been somewhat pessimistic on average over this period. While the three-year adjustment in the cyclically-adjusted primary balance is very large (in the 4th percentile of observations for advanced and emerging economies over 1990 to 2011), most of the adjustment comes from the reduction in highway spending, which will occur automatically after the completion of the first phase in 2020.

- **Domestic debt markets.** Further development of the domestic government debt market could help mitigate future financing risks. The stock of government securities is small and consists primarily of T-bills, which are mostly held by domestic banks. The authorities have received MCM TA on developing the local debt market. A domestic debt issuance in early 2019 successfully placed new domestic debt securities with banks and non-bank creditors, including retail customers. A more regular offering of domestic bonds has been integrated into the baseline, increasing the share of domestic debt as a share of total debt from 16 percent in 2018 to 20 percent in 2024.

Alternative Scenarios

Alternative scenarios show worse outcomes, reflecting historically weak fiscal outcomes and the still-incomplete fiscal adjustment. Under the historical scenario, in which projections are based on the average level of the primary balance over the last ten years, a primary deficit of 3.6 percent of GDP over 2020-24 would lead debt to increase to 94 percent of GDP by 2024. If the primary balance were to stay at the projected 2019 level of -1.4 percent of GDP (before the completion of the fiscal adjustment), debt would remain nearly stable around 80 percent of GDP, instead of declining to 62 percent of GDP in the baseline scenario.

Shocks and Stress Tests

Debt and gross financing needs would still decline over time under all standard stress tests. Stress tests indicate that growth shocks would have a substantial effect on the debt path. Fiscal shocks, including a decision to fund the remaining phases of the highway with debt, would also have a major impact on fiscal sustainability.

Montenegro-Specific Stress Tests

- **Highway Phases 2-4.** In this scenario, the authorities decide to proceed with the debt-financed construction of the remainder of the Bar-Boljare highway, which staff assumes would cost €1.2 billion, equally spent over 2022-24. Assuming a low spending multiplier of 0.2 during the construction phase because at least 70 percent of the inputs are imported and modest supply effects upon completion, economic growth would increase ¾ percentage point on average over 2022-24 relative to the baseline. In this scenario, the primary balance declines in line with highway spending, and the public debt ratio increases to 81 percent of GDP by 2024 (compared to 62 percent of GDP in the baseline). Gross financing needs would peak at 16 percent of GDP in 2023, 9 percentage points higher than in the baseline. This scenario demonstrates that a decision to take on new debt to complete the remainder of the highway could jeopardize fiscal stability and sustainability.

Standard Stress Tests

- **Growth shock.** Under this scenario, real output growth rates are lowered during 2020 and 2021 by one standard deviation (3.4 percentage points), also lowering inflation and raising interest rates. The public debt ratio remains at 87 percent of GDP in 2020 before falling to 73 percent of GDP in 2024, while the gross financing needs ratio in 2021 increases 5 percentage points of GDP relative to the baseline.

- **Interest rate shock.** This scenario examines the implications of an increase in interest rates on new debt by 249 basis points (the difference between the maximum past effective interest rate and the average interest rate in the projection period) in 2020–24. Debt increases by 1 percentage point in 2024 in this scenario relative to the baseline, while financing needs increase by 1 percentage point of GDP in 2024.

- **Combined macro shock.** This scenario comprises a recession in 2020 and 2021, a 249 basis-point increase in interest rates, a real exchange rate shock, and a sharp rise in expenditures in 2020-21. It pushes the debt-to-GDP ratio up to 90 percent of GDP in 2020 and substantially increases gross financing needs.

- **Financial contingent liability shock.** Expenditures increase in 2020 equivalent to 10 percent of the size of the banking sector, combined with a shock to GDP and interest rates. The shock results in a sharp increase in the debt ratio to 93 percent of GDP in 2020. Meanwhile, gross financing needs would peak at 22 percent of GDP in 2020 and stay well above the baseline over the medium term.

- **Primary balance shock.** This scenario assumes an expenditure shock and a rise in interest rates leading to a 1.5 p.p. deterioration in the primary balance over 2020-21. The combined shocks lead to deterioration in the debt ratio by about 2 percent of GDP by 2024, while the impact on gross financing needs peaks at 2 percentage points of GDP in 2020.

- **Real exchange rate shock.** The scenario assumes a 13 percent depreciation of the real exchange rate in 2020. The debt ratio would fall marginally from the baseline, because the impact from a larger GDP deflator on total debt outweighs the increase in the relatively modest foreign currency debt. This depends critically on the assumption of an exchange rate pass-through to inflation of 25 percent.

Figure 1. Montenegro: Public Sector Debt Sustainability Analysis (DSA) – Baseline Scenario

(in percent of GDP unless otherwise indicated)

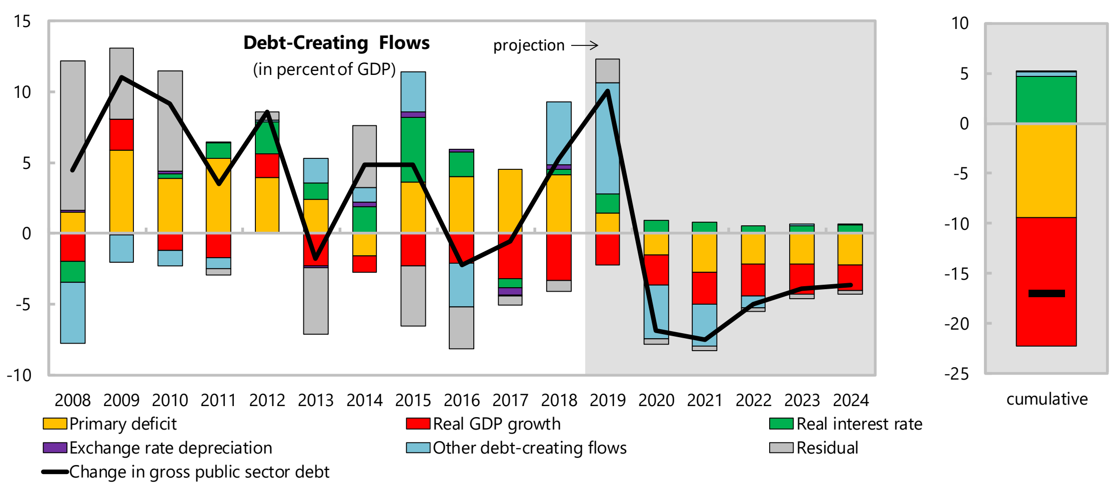
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2008-2016 [2/]	2017	2018	2019	2020	2021	2022	2023	2024
Nominal gross public debt	61.9	73.6	78.8	88.8	81.9	74.4	69.4	65.5	61.8
Of which: guarantees	7.9	7.3	6.2	7.7	7.4	7.1	6.7	6.4	6.1
Public gross financing needs	10.5	15.0	19.8	13.8	14.0	9.1	6.4	6.6	5.7
Real GDP growth (in percent)	1.8	4.7	4.9	3.0	2.5	2.9	3.2	3.2	2.9
Inflation (GDP deflator, in percent)	2.6	3.8	2.4	1.0	1.8	1.7	1.9	1.9	2.0
Nominal GDP growth (in percent)	4.5	8.7	7.4	4.1	4.3	4.7	5.1	5.2	4.9
Effective interest rate (in percent) [4/]	3.3	3.9	3.5	2.9	2.9	2.7	2.6	2.8	3.0

As of July 16, 2019		
Sovereign Spreads		
EMBIG (bp) 3/		307
5Y CDS (bp)		n.a.
Ratings	Foreign	Local
Moody's	B1	B1
S&Ps	B+	B+
Fitch	n.a.	n.a.

Contribution to Changes in Public Debt

	Actual			Projections							
	2008-2016	2017	2018	2019	2020	2021	2022	2023	2024	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	4.7	-0.5	5.2	10.0	-6.9	-7.5	-5.0	-3.9	-3.7	-17.0	
Identified debt-creating flows	3.0	0.1	6.0	8.4	-6.5	-7.2	-4.7	-3.7	-3.4	-17.1	
Primary deficit	3.2	4.5	4.1	1.4	-1.5	-2.7	-2.2	-2.2	-2.2	-9.4	-1.2
Primary (noninterest) rev. and grants	42.2	40.3	41.4	42.0	41.0	40.6	40.1	39.9	39.9	243.6	
Primary (noninterest) expenditure	45.5	44.8	45.5	43.4	39.5	37.9	37.9	37.7	37.7	234.2	
Automatic debt dynamics [5/]	0.4	-4.4	-2.6	-0.9	-1.2	-1.5	-1.7	-1.6	-1.2	-8.1	
Interest rate/growth differential [6/]	0.3	-3.8	-3.0	-0.9	-1.2	-1.5	-1.7	-1.6	-1.2	-8.1	
Of which: real interest rate	1.3	-0.6	0.4	1.4	0.9	0.8	0.5	0.5	0.6	4.7	
Of which: real GDP growth	-1.0	-3.2	-3.4	-2.3	-2.1	-2.3	-2.2	-2.1	-1.8	-12.8	
Exchange rate depreciation [7/]	0.1	-0.6	0.3	…	…	…	…	…	…	…	
Other identified debt-creating flows	-0.6	-0.1	4.5	7.9	-3.8	-2.9	-0.9	0.1	0.0	0.4	
Privatization and deposits (negative)	-1.3	0.9	6.5	7.3	-5.0	-3.9	-0.9	0.1	0.0	-2.3	
Contingent liabilities	0.6	0.0	0.0	0.2	0.0	0.0	0.0	0.0	0.0	0.2	
Use of foreign account receivable	0.1	-1.0	-2.0	0.4	1.2	0.9	0.0	0.0	0.0	-3.2	
Residual, including asset changes [8/]	1.7	-0.6	-0.7	1.7	-0.4	-0.3	-0.3	-0.3	-0.3	0.1	



Source: IMF staff.

1/ Public sector is defined as general government and includes public guarantees, defined as Public enterprises.

2/ Based on available data.

3/ Long-term bond spread over German bonds.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as $[(r - \pi(1+g) - g + ae(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the numerator in footnote 5 as r - π (1+g) and the real growth contribution as -g.

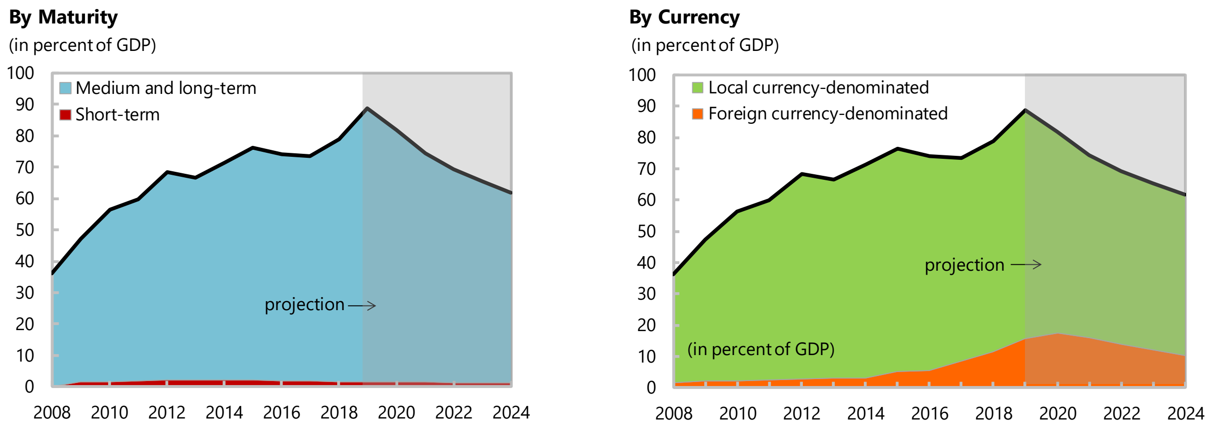
7/ The exchange rate contribution is derived from the numerator in footnote 5 as ae(1+r).

8/ Includes changes in the stock of guarantees, asset changes, and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

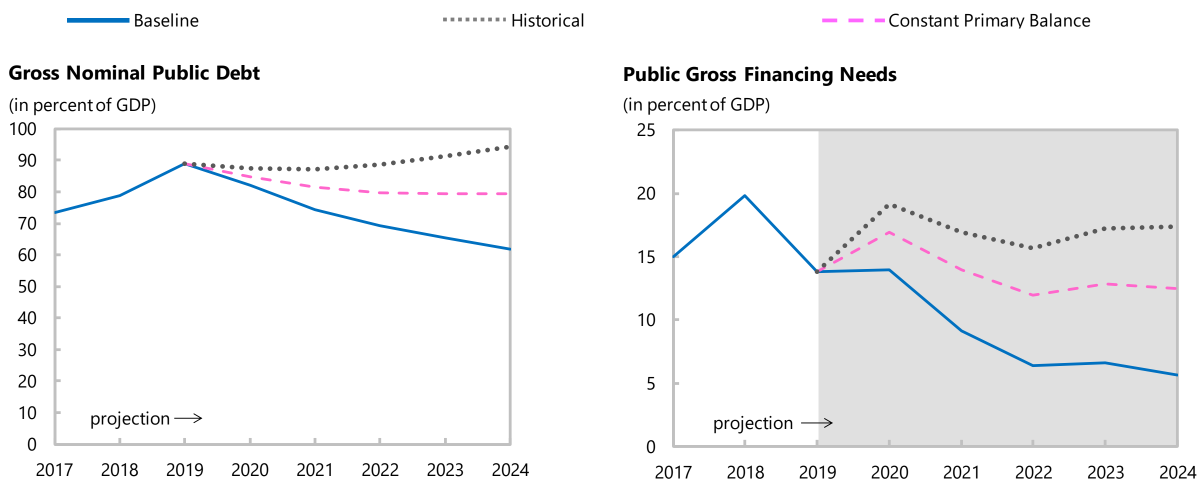
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure 2. Montenegro: Public DSA – Composition of Public Debt and Alternative Scenarios

Composition of Public Debt



Alternative Scenarios



Underlying Assumptions
(in percent)

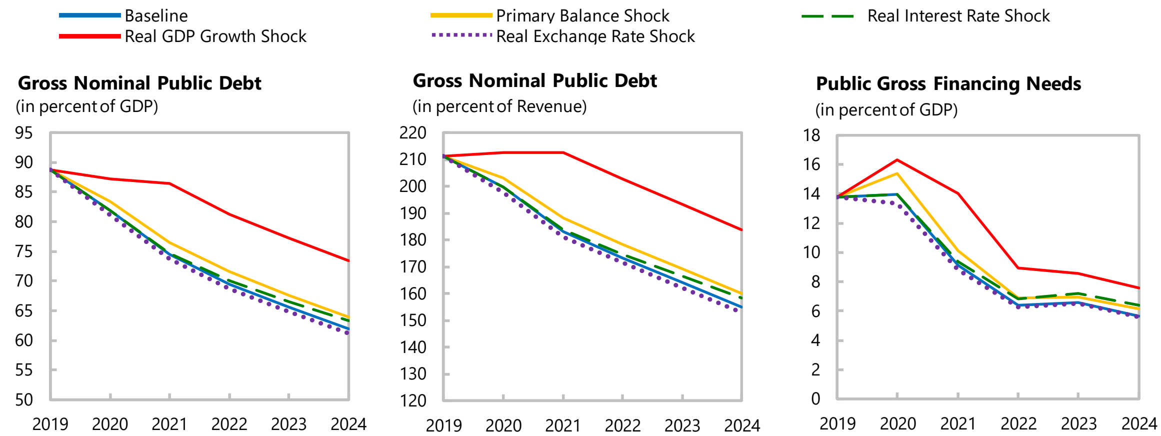
Baseline Scenario	2019	2020	2021	2022	2023	2024
Real GDP growth	3.0	2.5	2.9	3.2	3.2	2.9
Inflation	1.0	1.8	1.7	1.9	1.9	2.0
Primary Balance	-1.4	1.5	2.7	2.2	2.2	2.2
Effective interest rate	2.9	2.9	2.7	2.6	2.8	3.0
Constant Primary Balance Scenario						
Real GDP growth	3.0	2.5	2.9	3.2	3.2	2.9
Inflation	1.0	1.8	1.7	1.9	1.9	2.0
Primary Balance	-1.4	-1.4	-1.4	-1.4	-1.4	-1.4
Effective interest rate	2.9	2.9	2.7	2.7	2.9	3.2

Historical Scenario	2019	2020	2021	2022	2023	2024
Real GDP growth	3.0	1.9	1.9	1.9	1.9	1.9
Inflation	1.0	1.8	1.7	1.9	1.9	2.0
Primary Balance	-1.4	-3.6	-3.6	-3.6	-3.6	-3.6
Effective interest rate	2.9	2.9	2.7	2.8	3.1	3.4

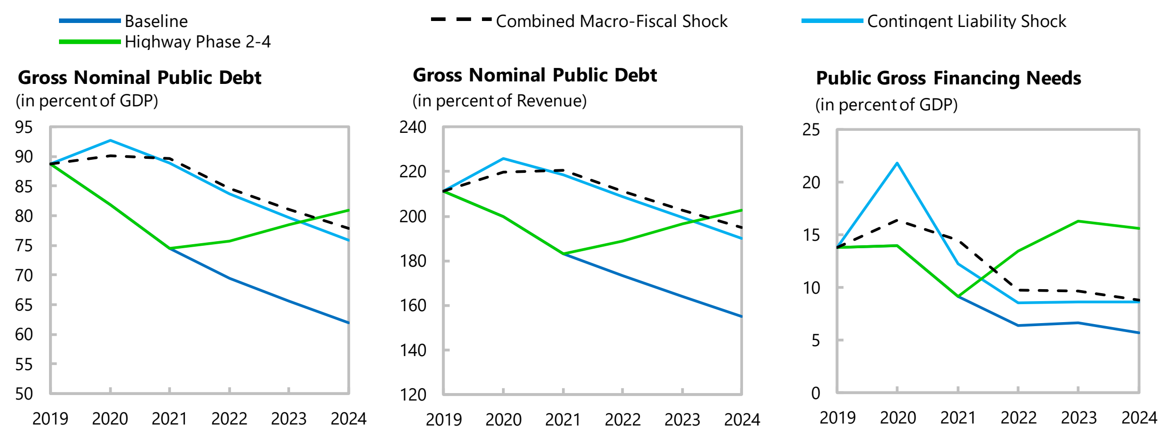
Source: IMF staff.

Figure 3. Montenegro: Public DSA – Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions

(in percent)

	2019	2020	2021	2022	2023	2024
Primary Balance Shock						
Real GDP growth	3.0	2.5	2.9	3.2	3.2	2.9
Inflation	1.1	1.8	1.7	1.8	1.9	1.9
Primary balance	-1.4	0.1	2.1	2.2	2.2	2.2
Effective interest rate	2.9	2.9	2.8	2.7	2.9	3.1
Real Interest Rate Shock						
Real GDP growth	3.0	2.5	2.9	3.2	3.2	2.9
Inflation	1.1	1.8	1.7	1.8	1.9	1.9
Primary balance	-1.4	1.5	2.8	2.2	2.2	2.2
Effective interest rate	2.9	2.9	3.1	3.1	3.5	3.9
Combined Shock						
Real GDP growth	3.0	-1.0	-0.5	3.2	3.2	2.9
Inflation	1.1	0.9	0.8	1.8	1.9	1.9
Primary balance	-1.4	-0.2	-0.6	2.2	2.2	2.2
Effective interest rate	2.9	3.0	3.1	3.3	3.6	4.1

	2019	2020	2021	2022	2023	2024
Real GDP Growth Shock						
Real GDP growth	3.0	-1.0	-0.5	3.2	3.2	2.9
Inflation	1.1	0.9	0.8	1.8	1.9	1.9
Primary balance	-1.4	-0.2	-0.6	2.2	2.2	2.2
Effective interest rate	2.9	2.9	2.8	2.8	3.0	3.2
Real Exchange Rate Shock						
Real GDP growth	3.0	2.5	2.9	3.2	3.2	2.9
Inflation	1.1	6.2	1.7	1.8	1.9	1.9
Primary balance	-1.4	1.5	2.8	2.2	2.2	2.2
Effective interest rate	2.9	3.0	2.7	2.6	2.8	3.0
Contingent Liability Shock						
Real GDP growth	3.0	-1.0	-0.5	3.2	3.2	2.9
Inflation	1.1	0.9	0.8	1.8	1.9	1.9
Primary balance	-1.4	-5.5	2.8	2.2	2.2	2.2
Effective interest rate	2.9	3.1	3.0	2.9	3.1	3.3

Source: IMF staff.

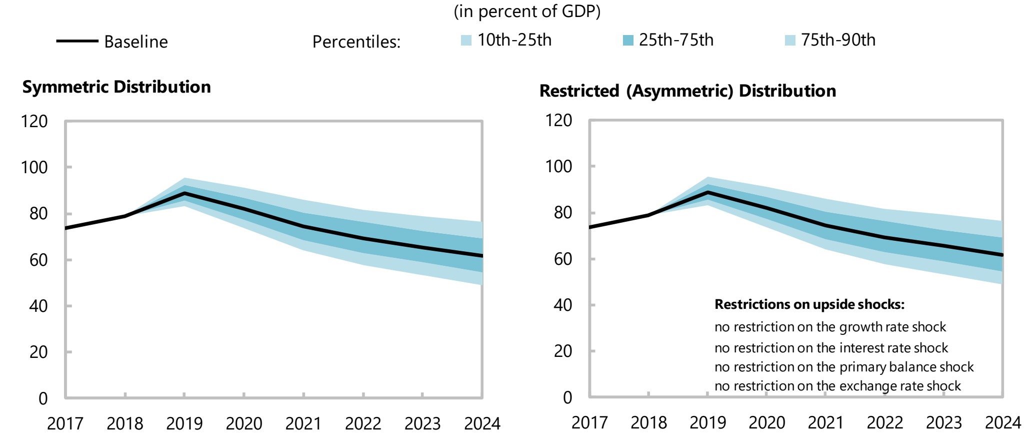
Figure 4. Montenegro: Public DSA Risk Assessment

Heat Map

Debt level 1/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs 2/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile 3/	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

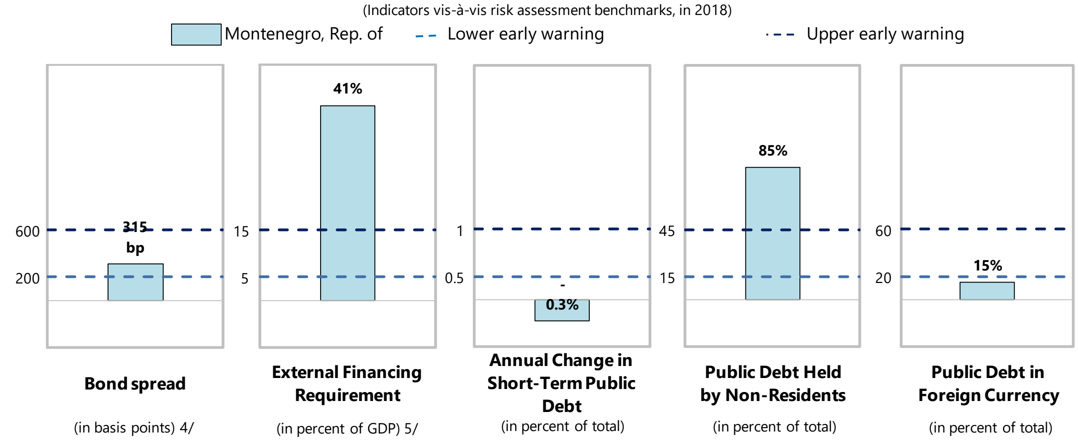
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2018)



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 70% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 15% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.
Lower and upper risk-assessment benchmarks are:

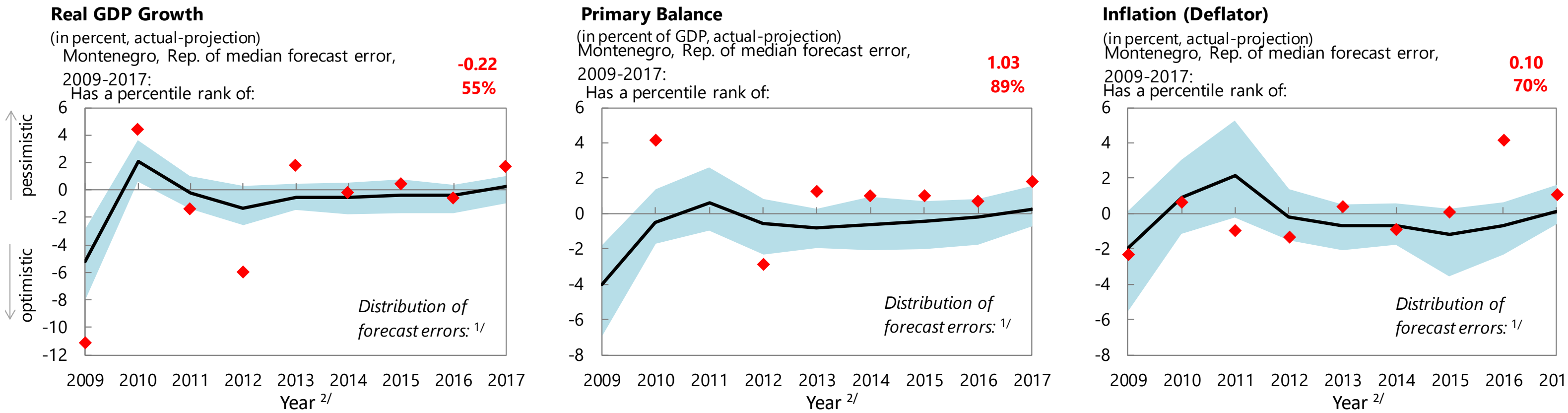
200 and 600 basis points for bond spreads; 5 and 15 percent of GDP for external financing requirement; 0.5 and 1 percent for change in the share of short-term debt; 15 and 45 percent for the public debt held by non-residents; and 20 and 60 percent for the share of foreign-currency denominated debt.

4/ Long-term bond spread over German bonds, an average over the last 3 months, 17-Apr-19 through 16-Jul-19.

5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

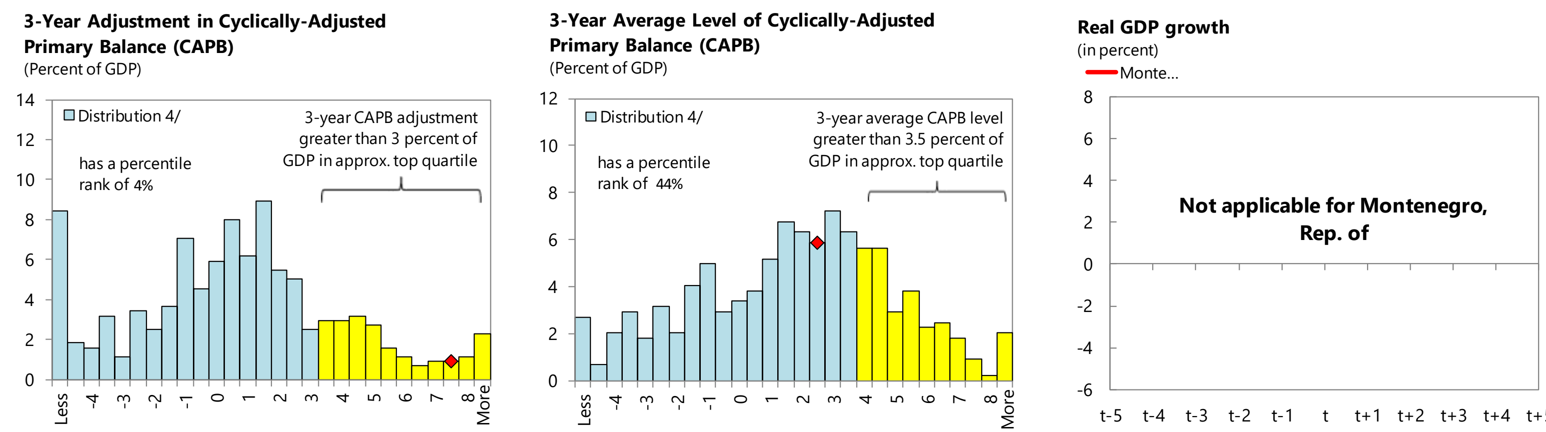
Figure 5. Montenegro: Public DSA – Realism of Baseline Assumptions

Forecast Track Record, versus all countries



Assessing the Realism of Projected Fiscal Adjustment

Boom-Bust Analysis 3/



Source : IMF Staff.

1/ Plotted distribution includes all countries, percentile rank refers to all countries.

2/ Projections made in the spring WEO vintage of the preceding year.

3/ Not applicable for Montenegro, Rep. of, as it meets neither the positive output gap criterion nor the private credit growth criterion.

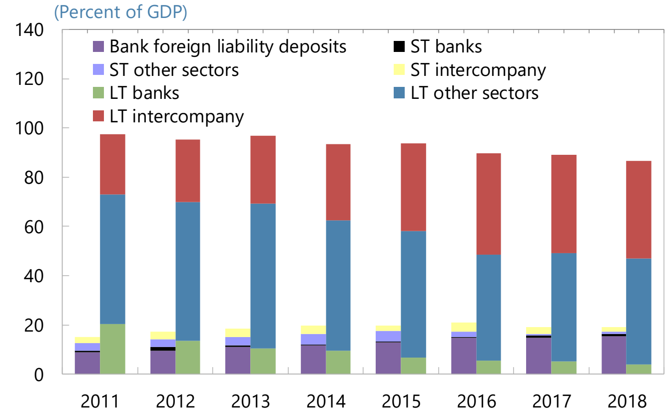
4/ Data cover annual observations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Annex III. External Debt Sustainability Analysis

External debt has increased by about 38 percentage points of GDP since 2007 to an estimated 168 percent of GDP in 2018. This increase was driven partly by the sharp increase in the general government external debt ratio, which tripled over this period and comprises 37 percent of Montenegro's external debt. The current account deficit also continues to weigh adversely on external debt dynamics. Under the baseline, external debt is projected to increase to 180 percent of GDP in 2019 before slowly declining to 166 percent of GDP in 2024. The debt trajectory is highly sensitive to a range of shocks, particularly to a growth or a non-interest current account shock (i.e. tourism receipts). A depreciation of the euro would also raise external debt. Montenegro's heavy dependence on external financing reinforces the importance of fiscal and structural reforms to safeguard market access.

1. **At 168 percent of GDP at end-2018, external debt is high and projected to further increase to 180 percent of GDP in 2019 and slowly decline thereafter.** More than one-third of external debt is general government debt, which has increased by 31 percentage points of GDP since 2010. About half of external debt comes from the non-bank private sector, which is nearly evenly distributed between long-term intercompany debt and long-term loans contracted by private and public non-financial corporations. The share of private sector short-term debt (including non-resident bank deposits) is relatively small at 12 percent of external debt. Construction of the Bar-Boljare highway has played a key role in the increase in government external debt.

Private External Debt
(Percent of GDP)



Sources: CBM and IMF staff estimates.
Notes: Majority of private external debt outstanding at year-end is financial loans.

Shocks and Stress Tests

2. **Standardized stress tests indicate that external debt is particularly sensitive to a variety of shocks**. Current account shocks—possibly due to a decline in revenue from tourism, higher interest rates, and some overruns on highway construction costs—and a combined deterioration in the macroeconomic environment would also impact external sustainability, with significant implications for gross financing needs. In addition, external debt would be sensitive to a depreciation of the euro.

Standard stress tests

- **Growth shock.** Under this scenario, baseline real GDP growth is permanently reduced by a one-half standard deviation calculated over the recent 10-year period ending in 2018. This corresponds to an average growth rate during 2020–24 of 1.2 percent, compared with baseline average growth of 2.9 percent. Under this scenario, the external debt ratio increases by 10 percentage points (compared to the baseline) to 176 percent of GDP in 2024.

- **Interest rate shock.** This scenario examines the implications of an increase in nominal external interest rates on new debt (relative to the baseline) by a one-half standard deviation during 2020–24. Stable average external interest rates historically imply only a modest average increase in interest rates of 20 basis points in this scenario and, consequently, only a small increase in external debt by 1 percentage point to 167 percent of GDP by 2024.

- **Non-interest current account shock.** This scenario permanently increases the non-interest current account by one-half standard deviation in 2020–24. Given historically-variable current account deficits, this amounts to an increase of 2.5 percentage points. In the absence of offsetting non-debt-creating flows, external debt increases by about 10 percentage points to 177 percent of GDP by 2024.

- **Combined macro shock.** This scenario comprises a permanent ¼ standard deviation shock applied to the real interest rate, the growth rate, and the current account deficit during 2020–24. The combined shock pushes the external debt ratio up by about 10 percentage points to 176 percent of GDP by 2024.

- **Real exchange rate shock.** The scenario assumes a one-time 30 percent devaluation in the real exchange rate in 2020 applied to the estimated stock of external debt in foreign currency (not in euros). For the public sector, this is mainly related to the construction of the highway, which represents 20 percent of public external debt. For the private sector, in the absence of data on currency breakdown, we have assumed that 100 percent is non-euro external debt, which results in an upper-bound estimate of the impact. Given the large stock of external debt, the shock increases the external debt-to-GDP ratio by 19 percentage points of GDP by 2024. Gross financing needs are correspondingly higher, by 10 percentage points of GDP, on average, over 2020-24 relative to the baseline.

Table 1. Montenegro: External Debt Sustainability Framework, 2014-2024

(In percent of GDP, unless otherwise indicated)

	Actual							Projections							
	2014	2015	2016	2017	2018	10-Year Historical Average	10-Year Standard Deviation	2019	2020	2021	2022	2023	2024	For debt stabilization	Debt-stabilizing non-interest current account 6/
Baseline: External debt	149.4	162.9	160.9	159.2	167.5			**180.0**	**178.5**	**175.6**	**173.0**	**170.0**	**166.1**		**-18.2**
Change in external debt	-12.0	13.6	-2.0	-1.8	8.3			12.5	-1.5	-2.9	-2.6	-3.0	-3.9	0.0	
Identified external debt-creating flows (4+8+9)	2.2	-7.7	-1.6	-5.5	1.1			4.4	3.1	1.0	-0.7	-1.9	-2.7	0.0	
Current account deficit, excluding interest payments	15.6	14.0	19.7	17.6	20.6			19.7	17.6	16.2	14.9	13.7	12.4	18.2	
Deficit in balance of goods and services	-100.1	-103.0	-108.8	-100.7	-114.8			-112.7	-110.2	-109.2	-108.2	-107.1	-106.1		
Exports	40.1	42.3	42.6	39.2	44.9			44.2	44.3	44.5	44.8	44.9	45.1		
Imports	-60.0	-60.7	-66.2	-61.5	-69.9			-68.5	-65.9	-64.6	-63.5	-62.2	-61.0		
Net non-debt creating capital inflows (negative)	-5.8	-11.2	-6.4	-7.7	-5.8			-7.5	-7.5	-7.5	-7.5	-7.5	-7.5	-7.5	
Automatic debt dynamics 1/	-7.6	-10.6	-14.9	-15.4	-13.7			-7.8	-7.0	-7.7	-8.1	-8.1	-7.6	-10.7	
Contribution from nominal interest rate	-3.2	-3.1	-2.5	-2.4	-2.5			-2.8	-2.7	-2.8	-2.8	-2.9	-2.9	-2.8	
Contribution from real GDP growth	-2.8	-5.7	-4.5	-6.8	-6.9			-5.0	-4.3	-4.9	-5.3	-5.2	-4.7	-4.6	
Contribution from price and exchange rate changes 2/	-1.7	-1.8	-7.9	-6.1	-4.2			...	...	...	...	...	...	-3.2	
Residual, incl. change in gross foreign assets (2-3) 3/	-14.2	21.3	-0.4	3.7	7.2			8.1	-4.6	-3.8	-2.0	-1.1	-1.2	0.0	
External debt-to-exports ratio (in percent)	372.1	385.5	377.7	406.4	372.8			407.1	402.8	394.3	386.5	378.6	367.9		
Gross external financing need (in billions of US dollars) 4/	1.2	1.3	1.6	1.5	1.9			2.1	2.3	2.3	2.2	2.2	2.3		
in percent of GDP	26.8	32.8	38.8	30.4	36.0			41.0	41.1	39.2	35.3	34.0	33.6		
Scenario with key variables at their historical averages 5/								**180.0**	**180.2**	**181.6**	**185.0**	**189.5**	**194.1**		**-17.6**
Key Macroeconomic Assumptions Underlying Baseline															
Real GDP growth (in percent)	1.8	3.4	2.9	4.7	4.9	1.9	3.4	3.0	2.5	2.9	3.2	3.2	2.9	2.9	
GDP deflator in US dollars (change in percent)	1.1	-14.6	4.8	6.0	7.2	0.2	7.2	-3.5	2.3	2.4	2.5	2.5	2.7	2.7	
Nominal external interest rate (in percent)	-2.0	-1.8	-1.7	-1.7	-1.8	-2.1	0.4	-1.7	-1.6	-1.6	-1.7	-1.8	-1.8	-1.8	
Growth of exports (US dollar terms, in percent)	-0.1	-7.1	3.7	12.2	18.5	3.6	13.8	1.6	5.4	5.9	6.2	6.2	6.3		
Growth of imports (US dollar terms, in percent)	0.5	-10.6	12.1	13.5	17.4	-12.9	54.0	1.2	1.1	3.3	3.8	3.8	3.7		
Current account balance, excluding interest payments	-15.6	-14.0	-19.7	-17.6	-20.6	-19.4	4.9	-19.7	-17.6	-16.2	-14.9	-13.7	-12.4		
Net non-debt creating capital inflows	5.8	11.2	6.4	7.7	5.8	11.1	7.6	7.5	7.5	7.5	7.5	7.5	7.5		

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).

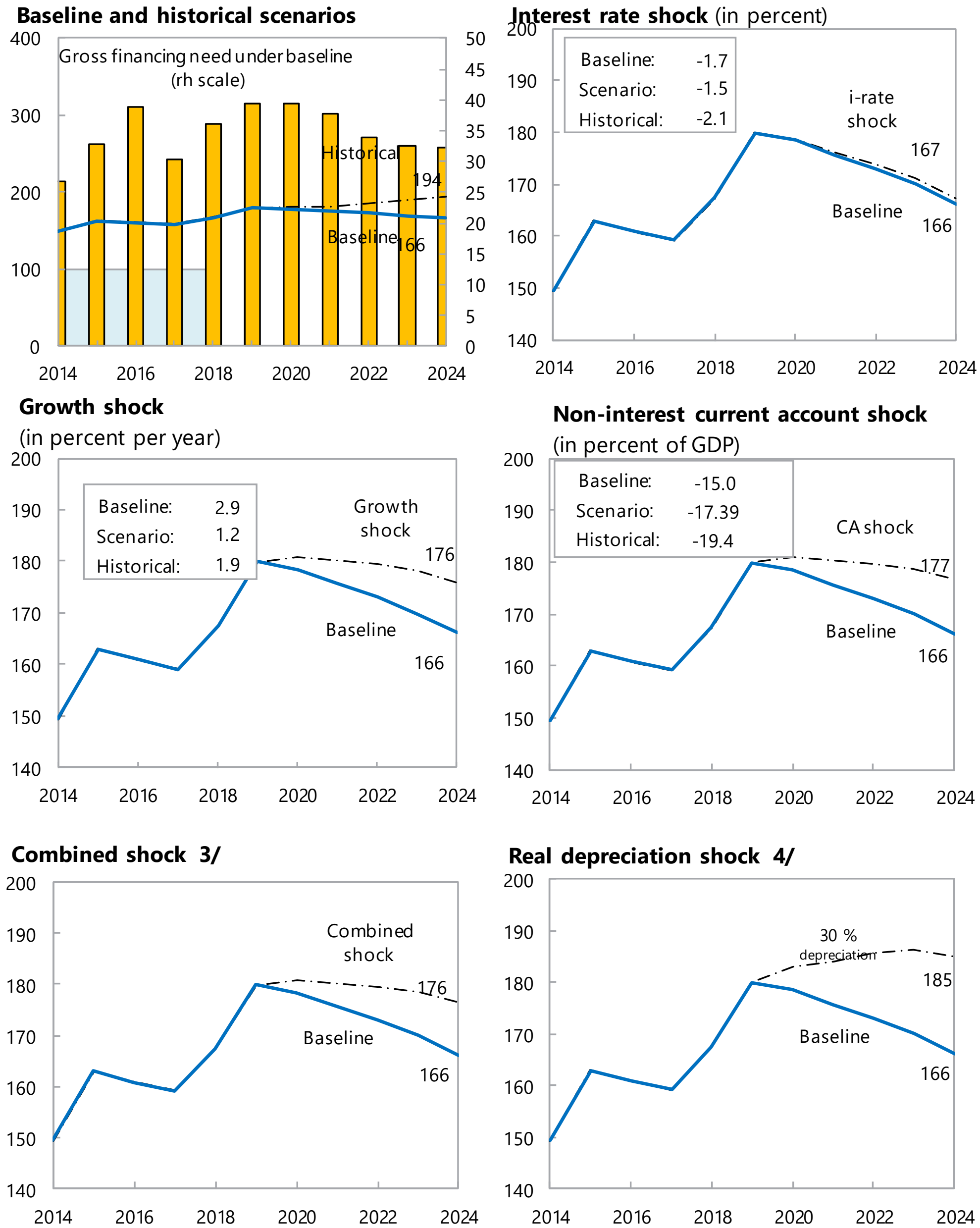
3/ For projection, line includes the impact of price and exchange rate changes.

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

5/ The key variables include real GDP growth; nominal interest rate; 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)

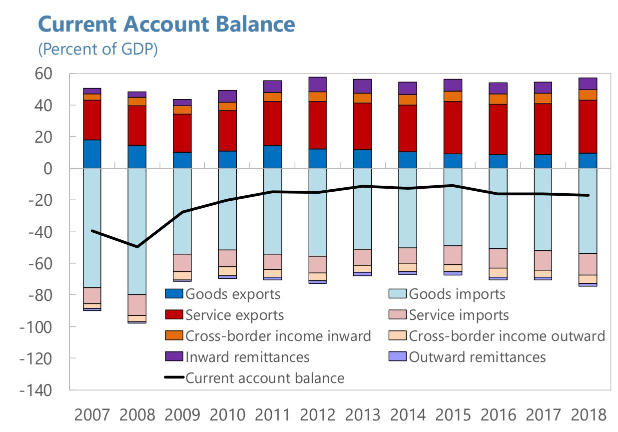


Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. 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 2020.

Annex IV. External Sector Assessment

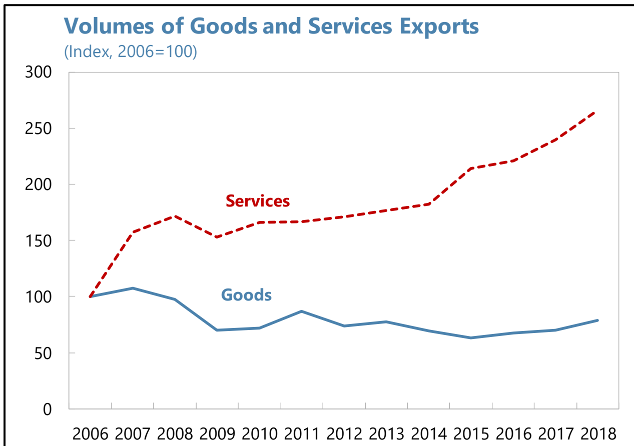
Staff assesses that Montenegro's external position in 2018 was weaker than implied by fundamentals and desirable policies. A real exchange rate depreciation driven by wage restraint and productivity improvements based on structural reforms to strengthen competitiveness would help reduce imbalances over the medium term.

1. The current account has been in persistent deficit since Montenegro's independence. After peaking at nearly 50 percent of GDP in 2008, the current account deficit has persisted at a level between 10 to 20 percent of GDP since 2010. In 2018, the current account deficit reached 17 percent of GDP, above its five-year average of 15 percent of GDP, boosted by imports for large-scale infrastructure projects and robust domestic demand. Trade in goods remained at a high deficit in 2018 at 44 percent of GDP. This deficit was partly offset by a continued, growing surplus in services trade (20 percent of GDP in 2018), primarily driven by the tourism sector. Primary and secondary incomes provided a surplus of 7 percent of GDP in 2018, reflecting in part growing remittances from expatriated workers (see Box 3 on remittances).

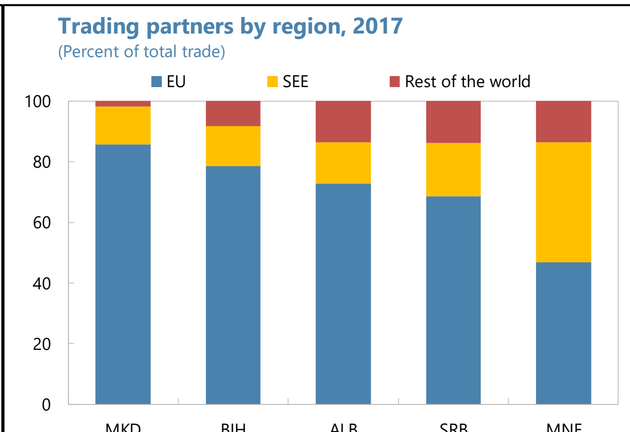


Sources: CBM; and IMF staff estimates.

2. Montenegro's goods export performance has been weak, and its goods trade with the EU remains lower than regional peers. Montenegro's goods exports volume is estimated to have declined by 27 percent since 2007, principally due to a reduction in aluminum exports after the closure of KAP (aluminum smelter). Montenegro's share in world goods exports has fallen since 2007, while its regional peers have seen expanding market shares. Compared to regional peers, Montenegro's goods exports are more concentrated in non-EU Southeastern Europe rather than the



Sources: Monstat; and IMF staff calculations.



Source: UN Comtrade database; and IMF Staff calculations.

EU. Services exports have increased steadily, more than doubling since 2007, driven by strong increases in tourism (see Figure 3 on tourism).

Current Account

3. The current account model of the EBA-lite framework suggests that the current account deficit is larger than that suggested by medium-term fundamentals and desirable policies. The model estimated an unadjusted current account gap of -7.4 percent of GDP for 2018, with a current account norm of -10.3 percent of GDP, implying a current account gap of 7.4 percent of GDP and a REER overvaluation of nearly 20 percent.[1] If the highway project (which mostly explains the increase in the current account deficit since 2016) is treated as a one-off factor, the cyclically-adjusted current account deficit is estimated at 14.1 percent of GDP, implying an adjusted current account gap of 4.4 percent of GDP and a REER overvaluation of nearly 12 percent.

EBA-Lite Current Account Approach Results, 2018
(Percent of GDP)

	Standard Version	*With Adjustment*
Actual CA	-17.2	-17.2
Cyclically adjusted CA	-17.1	-14.1
CA norm	-10.3	-10.3
CA gap	-7.4	-4.4
o/w policy gap	-0.2	-0.2
Elasticity	-0.38	-0.38
REER gap (percent)	19.6	11.7

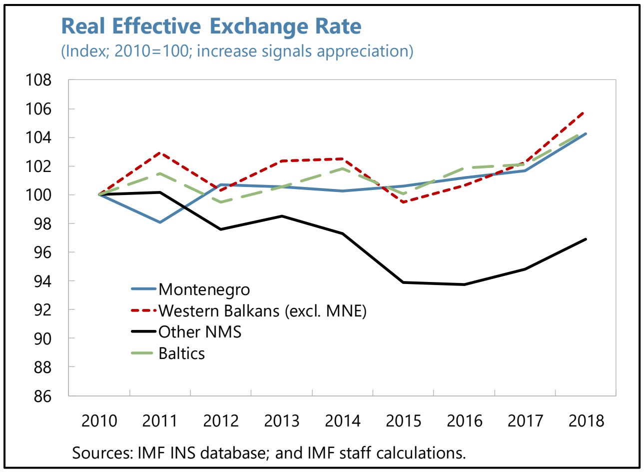
Source: IMF staff estimates

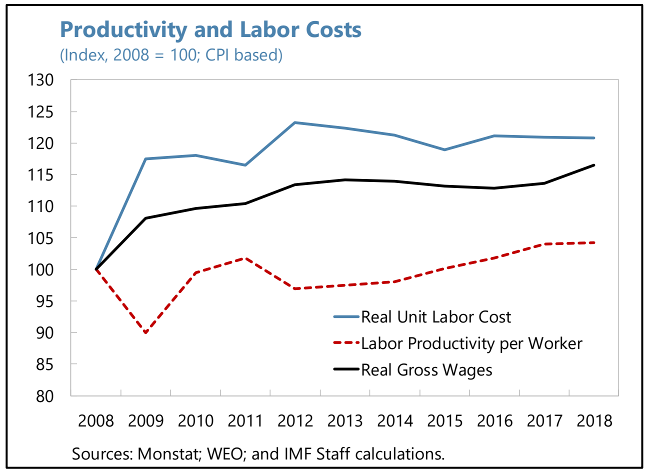
Exchange Rate Indicators

4. The real effective exchange rate (REER) has appreciated modestly since 2010, and the EBA-lite REER model estimates the REER to be in line with fundamentals. Since 2010, the REER has appreciated 4 percent. This is similar to the appreciation experienced by the other Western Balkans countries, but in contrast to the new EU member states (excluding Baltics), which saw a depreciation of the REER. In 2018, the REER registered an appreciation of 2.5 percent, driven by a positive inflation differential. From a medium-term perspective (2009-18), unit labor costs have been relatively stable since 2009, while labor productivity growth has also stagnated. While the EBA-lite REER regression model estimates the REER to be in line with fundamentals in 2018, data limitations make an accurate estimation of the REER norm difficult for Montenegro.[2]

[1] Staff has revised the data on the percentage of overseas population as a share of the national population, filling in missing data on Montenegrins living in Turkey. As a result, the share of the overseas population increases from 22 to 42 percent, resulting in an increase in the fitted current account deficit from 7.5 to 10.3 percent of GDP in 2018. Data on the capital control index were also not available for Montenegro, so Serbia was used as a proxy.

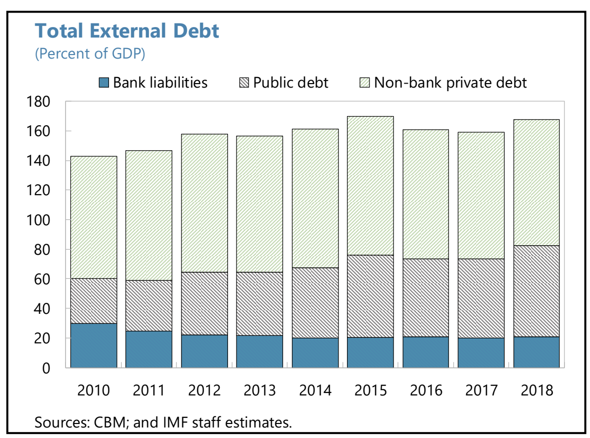
[2] As in the current account approach, staff has revised the data on the percentage of overseas population as a share of the national population. The REER regression model also did not estimate a country fixed effect for Montenegro, so staff has taken the averages of the fixed effects of Serbia, Albania, and Croatia as a proxy. The level of the country fixed effect can make a significant difference to the calculation of the REER norm and is significantly different from the level used last year, using the former EBA lite methodology.





5. **Considering current account and exchange rate indicators, staff assesses the external position of Montenegro to be weaker than fundamentals and desirable policy settings.** While the current account approach (adjusted) estimates a current account gap of -4.4 percent of GDP, the REER model estimates the REER to be in line with fundamentals. Both approaches suffer from shortcomings, including a short data series and missing data. On balance, staff assesses the external position to be weaker (rather than substantially weaker) than fundamentals and desirable policy settings due to these uncertainties and the results of the REER approach. The REER has also only appreciated modestly since 2010. A real depreciation through wage restraint and productivity improvements from structural reforms to strengthen competitiveness would help reduce economic imbalances over the medium term. The large current account deficit also reflects large fiscal deficits. The current account deficit is projected to decline over the medium term once highway construction concludes and the fiscal deficit improves. Nevertheless, the continued construction of large energy and tourism projects could continue to put pressure on the current account deficit in coming years.

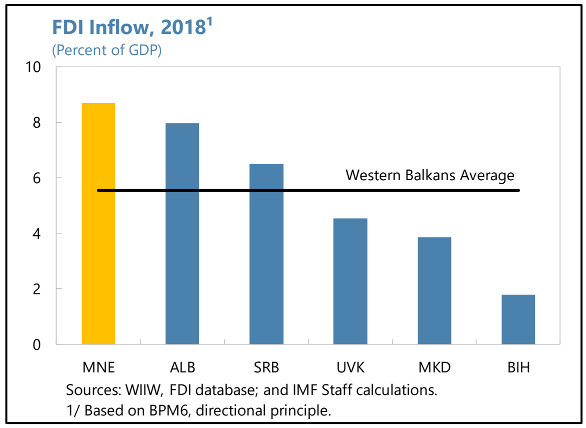
Foreign Asset and Liability Position



6. **The authorities are in the early stages of publishing information in the international investment position (IIP).** The authorities are implementing the recommendations of a 2017 technical assistance mission by the Statistics Department to construct annual and quarterly IIP data and have released data for 2016 and 2017. The data show a net IIP of -189 percent of GDP in 2017, driven by the high level of foreign FDI in Montenegro. At end-2018, gross external debt reached an estimated 168 percent of GDP and is expected to peak around 180 percent of GDP in 2019. About a third of external debt is government debt, which has increased by 32 percentage points of GDP since 2010 due to Eurobond issuances and borrowing from China Ex-Im Bank to finance highway construction.

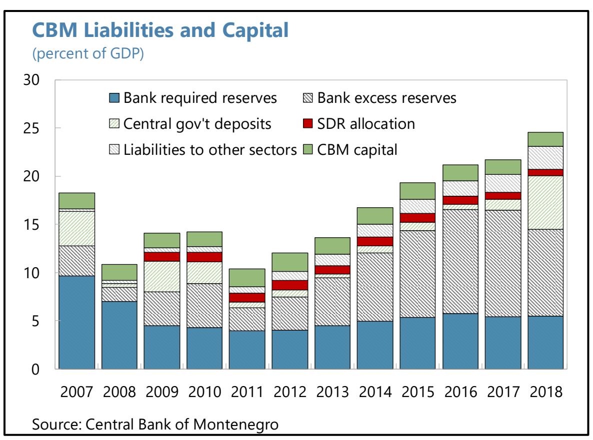
Capital and Financial Account Flows

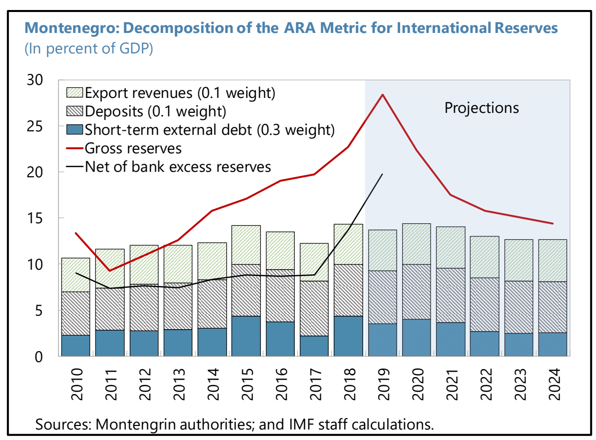
7. FDI inflows finance most of the current account deficit. Annual net FDI has averaged 12 percent of GDP since 2010, compared to an average current account deficit of 15 percent of GDP during this period. Gross FDI inflows of nearly 9 percent of GDP in Montenegro in 2018 were high compared to regional peers. Large government Eurobond issuances have increased net portfolio investment liabilities as government financing needs have grown, and other investment flows also increased in 2015-18 as the government received large external loans from China Ex-Im Bank for highway construction and secured several syndicated bank loans from international banks. After significant deleveraging of banks' external liabilities over 2009-12, banks' external liabilities have declined more slowly since 2013.



International Reserve Adequacy

8. Montenegro's gross international reserves are estimated to be adequate. Montenegro has adopted the euro as its currency, which provides a strong monetary anchor but does not entail access to the Eurosystem. The central bank's reserves are primarily a function of banks' required and excess reserves and central government deposits at the CBM. Reserves stood at 23 percent of GDP at end-2018, above standard rules of thumb (months of import cover, short-term external debt, and bank deposits). Montenegro's reserves are estimated at 159 percent of the standard IMF metric for reserve adequacy and projected to further exceed the ARA metric in 2019 as the government further increases its CBM deposits following the anticipated issue of an additional Eurobond.[3]





[3] See 2018 Selected Issues Paper "Reserve Adequacy" for details on the application of the reserve adequacy methodology to Montenegro.

Annex V. Implementation of Past IMF Recommendations

In the 2018 Article IV consultation, Directors stressed the importance of continued fiscal adjustment to reduce debt and meet financing needs, sustained efforts to strengthen the financial sector, and fiscal and structural reforms to support higher and more inclusive growth.

Key recommendations	Implemented Policies
Fiscal Policies	
Continue to implement fiscal consolidation strategy, aiming to deliver a primary fiscal surplus of 4½ percent of GDP by 2020.	The authorities continued implementation of the fiscal consolidation strategy, with two setbacks in the 2018 supplemental budget. First, the authorities assessed that large increases in tobacco excises had incentivizing smuggling, undermining excise revenues. The authorities revised the excise tax schedule and lowered excise revenue projections. Second, additional allocations to the government wage bill were necessary to account for new hiring in 2017. With these modifications, staff assesses that the primary fiscal surplus will peak around 2.7 percent of GDP in 2021. The 2019 budget contained no further deviations from the fiscal consolidation strategy.
Strengthen fiscal institutions, including fiscal rules and budgetary processes.	Starting in 2019, the budget has been presented on a three-year basis, but it remains only indicative for years 2-3, with no requirement to explain the difference between indicative levels and actual levels in subsequent budgets. The authorities plan to adopt a detailed medium-term budget in 2021.
Reform public sector employment, the pension system, and local government finances. Review the cost of tax expenditures.	The authorities adopted in 2018 an ambitious public administration optimization plan that aims to reduce by 2020 the levels of central and local government employment by 5 and 10 percent, respectively. Progress was limited in 2018. Pension reform was attempted in 2018 but ultimately put on hold after it became clear that the changes being negotiated with unions would not move in a reform direction. The law on local government finances was amended in 2018 to shift the allocation of central government transfers relatively more towards more underdeveloped municipalities. The law also includes new requirements for reporting to the Ministry of Finance and penalties for municipalities in breach of the law. The authorities have begun a comprehensive review of tax expenditures – with FAD technical assistance – and plan to eliminate many VAT tax expenditures in 2019.

Key recommendations	Implemented Policies
Financial Sector Policies	
Implement policy recommendations from the FSAP to address financial sector vulnerabilities, including an independent asset quality review (AQR) for banks and measures to enhance emergency liquidity assistance (ELA).	The authorities have been considering options to strengthen ELA capacity. The central bank has initiated planning for an AQR to be carried out and completed in 2020.
Supervisory action plans (SAPs) for problem banks should be implemented forcefully, with intervention if necessary.	The CBM intervened in 2018 to impose interim administration on two banks, later placing them into bankruptcy. The CBM has continued to implement a supervision action plan with a third bank and carried out an on-site supervision.
Adopt a definition of non-performing loans that does not exclude impaired assets that are deemed to have adequate collateral.	In 2018, the CBM Council adopted a "Decision on Minimum Standards for Credit Risk Management in Banks" which reduces the possibility that banks can classify assets as performing solely on the basis of adequate collateral. This decision comes into effect in July 2019. A subsequent decision adopted in July 2019 will eliminate references to "prime" collateral, beginning in 2020.
The authorities should consider measures to promote consolidation of the banking system such as an increase in the minimum amount of capital. The authorities should be judicious in granting any new bank licenses.	The draft Law on Credit Institutions would increase the minimum capital requirement for a new bank from EUR 5 million to EUR 7.5 million. The authorities have not issued any new bank licenses.
Structural Policies	
Implement a unified strategy to address structural labor market impediments, including by reducing the labor tax wedge and reforming the withdrawal of social benefits.	The authorities plan to reduce the employers' contribution for health insurance by 2 p.p. in H2 2019.
Adopt amendments to the labor law that balance the need for worker protection with an increase in labor market flexibility.	The draft labor law (to be adopted in 2019) aims to reduce large severance payments required for firing a worker with a regular contract. The law will also extend the maximum length of fixed term contracts from 24 to 36 months.
Review the involvement of the state in the economy to ensure that it is limited to areas of market failures.	The authorities are considering restructuring options to bolster the viability of Montenegro Airlines, a state-owned enterprise that has been a drain on the state budget.
Strengthen the framework for PPPs to minimize the risk of large liabilities being transferred to the public sector.	The authorities have drafted a new Law on PPPs which they expect to adopt in 2019.

Annex VI. Implementation of 2015 FSAP Recommendations

Recommendations	Timing[1]	Progress
Prepare and implement time-bound supervisory action plans for vulnerable banks (CBM).	I	**Done.** Supervisory action plans for vulnerable banks were adopted, and the banks were under intensified supervision by the CBM. On-site examinations of the three vulnerable banks took place, of which two were put under interim administration in December 2018 and entered bankruptcy in 2019. The third bank has agreed to increase its subordinated debt, but it will remain subject to intensified supervision by the CBM.
Conduct an Asset Quality Review (AQR) for all banks to determine adequacy of provisions (CBM).	I	**Not Done**. It has been postponed to 2020, first to prepare for the introduction of IFRS 9 in 2018, and then to allow time to deal with three weak banks. The CBM has requested assistance from peer countries to prepare the manual and tender documents for reputable international assessors. The CBM has underscored its commitment to do an AQR for the whole banking system based on end-2019 data by end-2020.
Introduce a macroprudential mandate taking into account the institutional setup and establish pertinent policies and a toolkit consistent with EU/ESRB framework (MOF/CBM/FSC).	MT	**Partially done.** A framework for macroprudential policy has been prepared and was adopted in June 2018, clarifying that the macroprudential mandate is with the CBM. The envisaged legislative package expected to be adopted in 2019 and to become effective in late 2020 will broaden the scope of macroprudential tools.
Introduce effective consolidated supervision (CBM). Improve the regulatory and supervisory framework for liquidity and credit risks (CBM).	NT, I	**Not Done**. The authorities have been preparing for these recommendations under a twinning project. The CBM plans to implement these recommendations after the envisaged legislative banking package has been adopted in late 2019 and the accompanying regulations by mid-2020.

[1] "I-Immediate" is within one year; "NT-near-term" is 1–3 years; "MT-medium-term" is 3–5 years.

Recommendations	Timing[1]	Progress
Tighten prudential norms for identification, classification, and reclassification of nonperforming assets (CBM).	NT	**Done.** The decision on minimum standards for banks credit risk management was amended to accommodate the introduction of IFRS 9 in January 2018, accompanied by a new decision on chart of accounts for banks and the decision on reporting to the CBM. Beginning in July 2019, the reference to "adequate" collateral has been removed as a criterion for asset classification. The remaining reference to "prime" collateral has been deleted in a new July 2019 decision, effective January 2020.
Adopt risk-based supervision (ISA).	I	**Not done.** Development of a risk assessment framework is an on-going process. Further steps in risk-based supervision will be taken after the adoption of a new Insurance Law. (For banks, a risk matrix has been developed for the yearly off-site examination applicable as of 2016. The matrix is currently under revision.)
Incrementally implement Solvency II (ISA).	NT	**Not done.** Further and more comprehensive implementation of Solvency II will be achieved after adopting a new Insurance Law. An ongoing twinning project will facilitate the implementation of Solvency II by the Montenegrin Insurance Supervision Agency.
Strengthen the CBM's oversight function over FMI (CBM).	NT	**Done.** At the end of October 2015, the CBM adopted a Decision establishing the "Framework for Payment System Oversight." (Preparation of an instant retail payment system is proceeding.)
Implement risk mitigation measures to minimize liquidity risks in the RTGS system and to eliminate the possibility of partial unwinding in the DNS system (CBM).	I	**In progress.** The CBM emergency liquidity facility was adopted in 2017. However, the linkage between the real-time gross settlement system and the central securities depository still needs to be refined to allow pledging of additional eligible securities toward the end of opening hours.
Finalize national risk assessment and ensuing action plan and ensure that high	NT	**Done.** The national risk assessment has been adopted in 2015. In July 2017, the government adopted the 12th report on the implementation

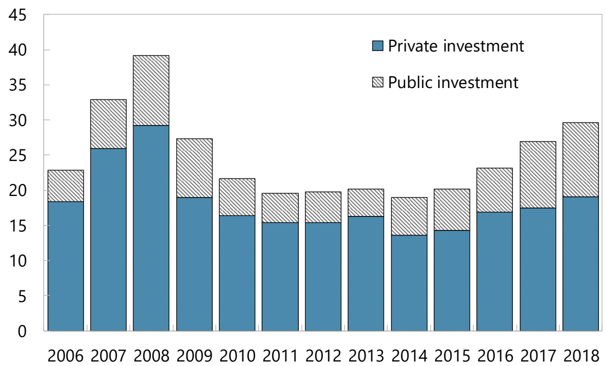
Recommendations	Timing[1]	Progress
money laundering/terrorist financing risks are adequately mitigated (CBM).		of the Strategy for the Prevention and Suppression of Terrorism, Money Laundering and Terrorism Financing 2015-2018 and measures from the Action Plan 2017-2018. In November 2017, the CBM prepared a report on implementation of measures from the Action Plan for the period Jan-Nov 2017, which was submitted to the Administration for the Prevention of Money Laundering and Terrorist Financing. A new 2018 risk assessment is currently being prepared. In April 2019, the CBM issued new AML/CFT guidelines for banks.
Strengthen the voluntary debt-restructuring framework (MOF).	I	**Done.** The recommendation was implemented as part of the "Podgorica Approach" and based on the: (i) *Law on Voluntary Financial Restructuring of Debts towards Financial Institutions*, effective May 2015 - May 2017; and the *Decision on Amendments to the Decision on Minimum Standards for Credit Risk Management in Banks*, effective from January 2014. The Law was extended twice (OGM 037/17 of 14 June 2017 and OGM 043/18 of 3 July 2018), while the CBM adopted the Decision on Amendments to the Decision on Minimum Standards for Credit Risk Management in Banks (OGM 44/17) in 2017. The Law expired in Q2 2019.
Amend the personal bankruptcy regime to clarify creditors' rights regarding existing and future loans secured by mortgages (MOF).	I	**Done.** Personal bankruptcy regime has been amended.
Set strict and objective criteria for determining the systemic importance of banks to determine eligibility for capital support (CBM/MOF).	NT	**Not done, but in progress.** In parallel with the expected adoption of the banking legislative package in the autumn of 2019, the CBM is preparing a new regulatory framework, including guidelines for determining the systemic importance of banks, expected to be adopted by mid-2020. The guidelines are part of a twinning project.

Recommendations	Timing[1]	Progress
Strengthen resolution-funding options (MOF).	NT	**Not done, but in progress.** The envisaged new laws on credit institutions, resolution of credit institutions, and on the Deposit Protection Fund (DPF) will transpose pertinent EU Directives and I strengthen the resolution tools of the CBM. For instance, the DPF will be able to support "purchase and assumption."
Organize a dedicated resolution unit within the CBM, and initiate bank-specific resolution planning, prioritizing the weakest CAMEL-rated banks (CBM).	I	**Not done, but in progress.** Following the expected adoption of the legal package transposing pertinent EU banking directives in the autumn of 2019, the CBM will establish a resolution fund as well as a special resolution unit that will be independent from the supervision department.
Implement risk-based contributions and shorten the pay-out term for DPF (DPF/MOF).	NT	**Not done, but in progress.** The pay-out of the two recently closed banks went smoothly. The envisaged Deposit Protection Law is expected to be adopted in the autumn of 2019. It will gradually shorten the pay-out term and risk-based contributions are expected to be introduced. (The current Law also permits risk-based premiums. Consideration should be given to conduct the AQR before introducing risk-based premiums.)
Streamline ELA policies and strengthen safeguards to protect the CBM's financial autonomy (CBM/MOF).	NT	**Done.** The CBM's financial autonomy was strengthened by amending the Law on the Central Bank of Montenegro. In 2017, the CBM adopted a decision on detailed conditions for granting short-term liquidity loans and established a Credit Risk Management Committee as an advisory body.
Strengthen the FSC's focus on its crisis preparedness and management mandate complementing its financial stability mandate (FSC).	I	**Done.** The contingency plan has been updated. The Deposit Protection Fund Director regularly attends FSC meetings. In 2017, the CBM has adopted a decision on detailed conditions for granting liquidity loans to banks. Contingency plans, however, should be regularly tested.

Annex VII. Public-Private Partnerships Framework Assessment

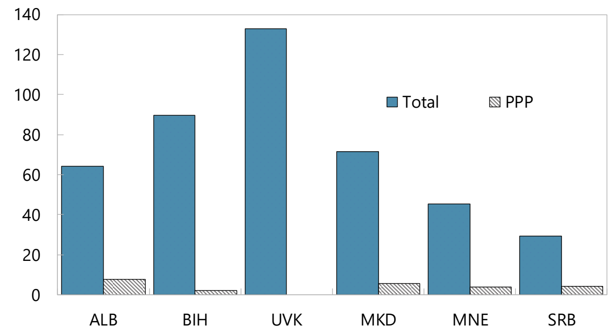
1. Public and private investment have been key drivers of Montenegro's economic growth. Private investment increased to 19 percent of GDP in 2018, while public investment similarly reached nearly 11 percent of GDP in 2018. Growth in the private capital stock has been driven primarily by investments in tourism facilities, and energy production/transmission. On the public side, the construction of the first phase of the Bar-Bojlare highway has greatly increased public investment. Still, the total capital stock in Montenegro remains below the average of neighbors.

Montenegro: Public and Private Investment
(Percent of GDP)



Sources: Monstat; Ministry of Finance; and IMF staff calculations.

Total and PPP Capital Stock, 2015 1/
(Percent of GDP)



Sources: *Public Infrastructure in the Western Balkans* IMF Departmental Paper, using IMF Fiscal Affairs Department database; and IMF staff calculations.
1/ 2015 is last observation in FAD database.

2. Investment through public-private partnerships (PPPs) is limited. At less than 4 percent of GDP in 2015, the PPP capital stock remained in line with the average for emerging Europe but below the average of emerging market economies worldwide (6 percent of GDP). The experience with PPP projects in the Western Balkans has been limited in part due to the small size of national markets, inadequate legal and institutional frameworks, and perceived regional political risks.

3. Montenegro seeks to increase the use of PPPs in future investments. With general government debt (including guarantees) reaching nearly 80 percent of GDP in 2018, financing the remainder of the highway with debt could jeopardize fiscal sustainability. The authorities are considering the feasibility of constructing further phases through a PPP structure. The authorities also plan to auction airport concessions.

4. PPPs can deliver benefits but also bring fiscal risks. If properly managed, PPPs can raise private capital and channel expertise to raise the efficiency of investments. However, PPPs also pose risks for fiscal management, especially if used primarily to bypass traditional budgetary constraints. While the use of a private partner reduces the upfront use of public funds to start a project, the net cost to the government is the same in theory, with the cost paid over time either as foregone user fees or payments to the private partner. Governments often bear residual risks in such contracts, including by providing revenue guarantees.

5. It is critical to build a proper legal framework and institutions to promote good projects and manage fiscal risks from PPPs. The authorities expect to adopt a new Law on PPPs in 2019. The main strengths and weaknesses of the draft law and PPP-related institutions (compared with best practices identified by the Fiscal Affairs Department) are:

- *The draft PPP law clearly defines PPPs and broadly applies to nearly all PPPs.* It is important to avoid fragmentation of the regulatory framework. Montenegro's draft law has broad coverage, with the exception of natural resources concessions, which will be covered by a separate law.

- *However, PPPs are not integrated with the budget and overall investment strategy.* The PPP process will be held outside the budget cycle, resulting in two project pipelines. This process risks creating a bias towards PPPs, accepting lower value for money, and failing to internalize their fiscal risks.

- *Positively, the Minister of Finance will be able to veto PPP projects due to their potential fiscal impact.* PPPs should pass through a gateway process that empowers the Minister of Finance to stop any projects that are fiscally unaffordable. According to the draft PPP law, a proposed PPP (including one implemented by a municipality) would have to obtain the positive opinion of the Ministry of Finance.

- *The process to review PPPs and estimate value for money should be improved.* The Montenegrin Investment Agency will check compliance with financial objectives, but as the promoter and evaluator of PPPs, the agency may have a conflict of interest, even if separate parts of the agency will handle these functions. The Ministry of Finance currently lacks the technical capacity to analyze the value of PPP projects.

- *Mechanisms for PPP bidding and unsolicited proposals are generally well developed.* The draft Law on Public Procurement, written with the EU legal framework in mind, should ensure competitive bidding processes for PPPs. The draft law requires that unsolicited proposals be awarded under equal conditions to other PPPs. The authorities should also require outside verification of the feasibility analysis for unsolicited proposals.

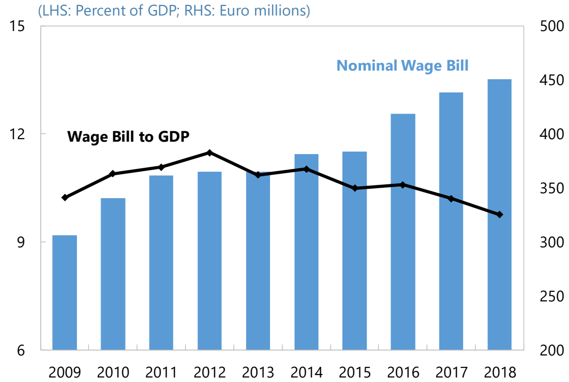
- *The framework to analyze and manage fiscal risks needs to be improved.* The authorities do not plan to implement a ceiling on the stock of PPPs or PPP-related payments. Such ceilings can help contain fiscal costs and provide incentives for project prioritization (including at the municipal level). Similarly, the Ministry of Finance does not currently possess the resources to properly analyze fiscal risks coming from PPPs.

- *The authorities should implement procedures to provide transparent accounting and reporting of PPPs.* Accounting for PPPs in line with international standards contributes to fiscal transparency and provides the government with vital information to help understand the potential fiscal costs of PPPs. Transparent accounting also helps reduce the incentive to use PPPs to "hide" public investment by pushing them off balance sheet to escape fiscal constraints.

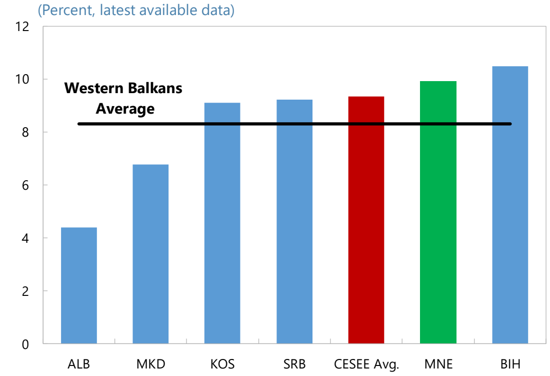
Annex VIII. Montenegro's Government Wage Bill

1. Montenegro's government wage bill remains high. The general government wage bill peaked at 11.5 percent of GDP in 2012 and declined to 9.8 percent in 2018, driven more by strong nominal GDP growth than spending restraint. In the Western Balkans, Montenegro has the highest wage bill as a percent of GDP – excepting Bosnia and Herzegovina, which has a complex government structure.

General Government Wage Bill
(LHS: Percent of GDP; RHS: Euro millions)



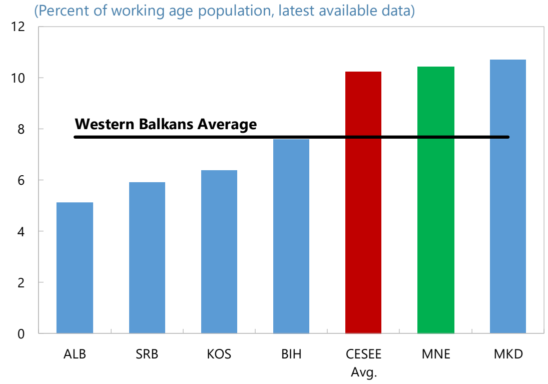
General Government Wage Bill to GDP
(Percent, latest available data)



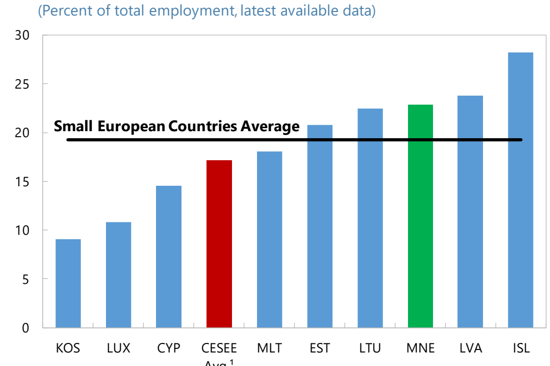
Sources: Ministry of Finance; IMF FAD Expenditure Assessment Tool; and IMF staff calculations.

2. Government employment appears high, even considering Montenegro's small size. In 2017, government employment accounted for 10 percent of the working age population in Montenegro, above the Western Balkan average of 8 percent. Montenegro's small population (approximately 622,000) is an obstacle to achieving economies of scale. Still, among a sample of other small European countries, Montenegro's ratio stands out, only exceeded by Iceland and Latvia.

Western Balkans: Government Employment
(Percent of working age population, latest available data)



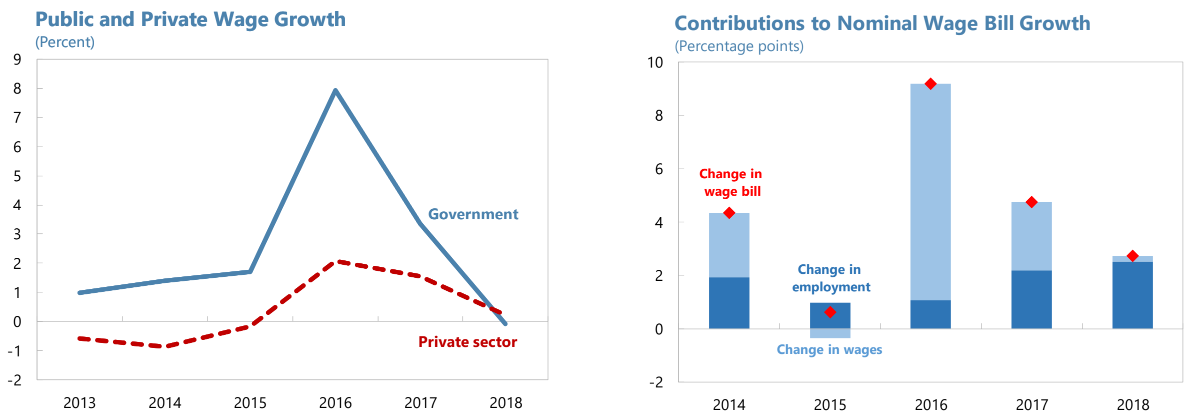
Small European Economies: Government Employment
(Percent of total employment, latest available data)



1/ Excluding Hungary.

Sources: World Bank Database; IMF FAD Expenditure Assessment Tool; and IMF staff calculations.

3. Government wage growth has exceeded that in the private sector in recent years. In 2016, government employees were granted a wage increase averaging 8 percent. In 2016 and 2017, the carryover impact of the wage increase was largely responsible for increases in the nominal wage bill.



Sources: Monstat; Ministry of Finance; and IMF staff calculations.

4. Government wages have been partially frozen since 2016. Across-the-board wage increases were not granted in 2017-19. The authorities also reduced the salaries of senior officials by 8 percent in the 2017 budget, followed by a further reduction of 6 percent later in the year. Average government wage growth declined to approximately zero in 2018.

5. The authorities adopted an ambitious public administration optimization plan in 2018. Besides reducing the level of employment, the authorities aim to improve HR management, enhance efficiency, and deepen coordination with municipal governments. Relative to 2017 levels, the authorities aim to reduce by 2020 central government employment by 5 percent and local government employment by 10 percent. These targets would be achieved through a combination of strict limits to new hiring, termination of existing fixed-term contracts, and consensual termination of employment.

Table 1. Montenegro: Progress on Public Sector Optimization, 2018

	2017 Baseline	2018 Target	2018 Outcome	Net Reduction	Planned Reduction	Change (%)	Planned Reduction (%)
Local Government	12,174	11,565	11,699	475	609	-3.9	-5.0
Central Government	39,312	38,133	40,400	-1,088	1,179	2.8	-3.0
Total	51,486	49,698	52,099	-613	1,788	1.2	-3.5

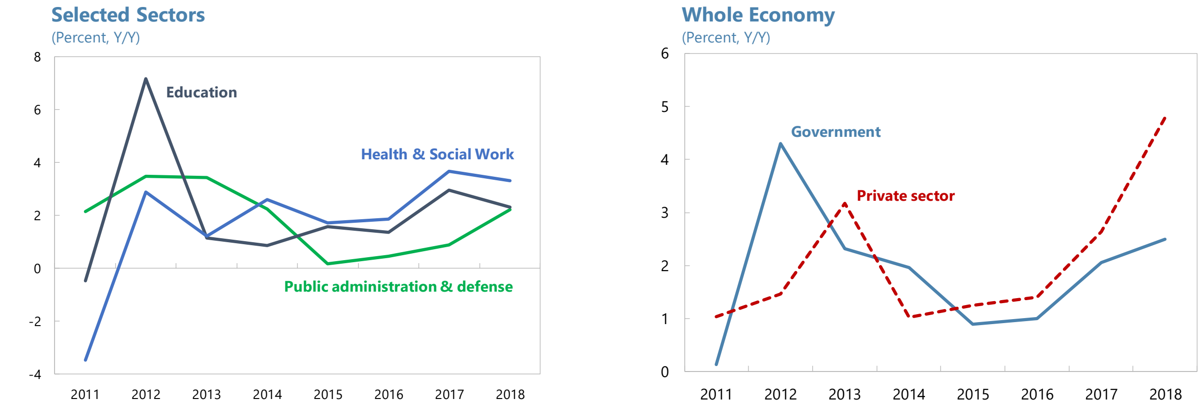
Source: Ministry of Public Administration

6. Initial progress on employment reductions in 2018 was disappointing. The authorities aimed to decrease general government employment by 3.5 percent in 2018, but employment increased a further 1.2 percent. Although local governments reduced employment by 3.9 percent in 2018, the central government grew by 2.8 percent, led by new hiring in health and education.

Figure 1. Employment Growth Comparisons

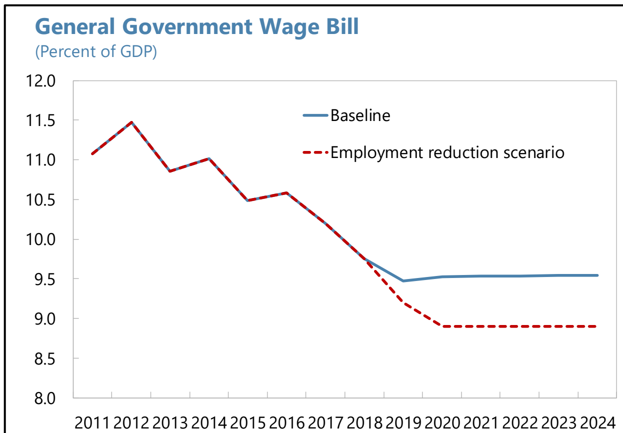
Health and education have led the increase in government employment in recent years...

...which fell significantly below private sector employment growth only in 2018.



Sources: Ministry of Finance; MONSTAT; and IMF staff calculations.

7. If implemented, employment reductions would reduce the government wage bill to 8.9 percent of GDP in 2020, versus staff's current projection of 9.5 percent of GDP. The current projection (baseline) more conservatively assumes that government employment will not change over the projection period and that the partial wage freeze will continue through 2019, after which nominal wage growth will resume.



Sources: Ministry of Finance; and IMF staff calculations.

8. A successful employment optimization would be supported by better monitoring tools, improved transparency, and effective implementation at the local level. So far, optimization efforts have been focused on downsizing, while other key elements outlined in the plan (HR planning, increasing efficiency and productivity) are lagging. Cross-country experience suggests that wage bill reductions achieved during periods of fiscal adjustment are rarely maintained over the long term. Therefore, the authorities are advised to focus on:

- *Functional analysis:* Functional reviews are instrumental to successful wage bill optimization and should be treated with high priority, but the process has not been completed, hindering the identification of redundancies.

- *Severance packages:* To ensure that the severance packages do not suffer from adverse selection, there should be limits on the number of available packages and alternatives for employees who were not admitted into the optimization program.

- *HR management:* To mitigate the risk of a migration to SOEs, the Ministry of Public Administration is creating a registry of former public employees who received severance packages.

- *Transition of employees to private sector:* The authorities should carefully take stock of active labor market policies to facilitate transitions to the private sector. Promotion of early retirements should be avoided. The plan to offer zero interest credit from the Investment and Development Fund (IDF) is not well targeted.

- *Data integration:* Comprehensive access to employee-level data necessitates the merger of salary and personnel databases and the expansion of coverage to more employees. Combining personnel and payroll database with stricter audits would help identify ghost workers. Data-driven monitoring will be especially important given the reductions and shifts of responsibilities related to EU pre-accession requirements.

- *Cooperation across governance levels:* The collection of employee data at the local level has been challenging. Implementation of the optimization needs to be sustained at the local level, which will require enhanced cooperation with municipal governments.

Annex IX. Recommendations to Strengthen AML/CFT Supervision

1. Montenegro faces money-laundering-related risks to financial stability, particularly from the banking sector. The CBM's work as the AML/CFT supervisor for the banking sector is informed by the 2015 ML/TF National Risk Assessment (NRA) analysis and conclusions, including that the banking sector is the riskiest segment of the financial sector. The authorities have initiated an update to the NRA in 2018, which is expected to be finalized by September 2019.

- *Conduct a sectoral risk assessment of the banking sector, and other sectors under CBM supervision, to improve understanding of ML/TF risks and to keep the sectoral risk assessments up-to-date.*

2. The CBM routinely gathers information from banks for the purposes of AML/CFT on-site inspections but an offsite monitoring function should be established. The information gathered by the CBM includes data on the bank's customer base, suspicious transactions, non-resident customers, politically exposed persons (PEPs), and internal controls. These data are requested two weeks before an on-site inspection and are used solely for the on-site work.

- *Expand the information questionnaire by building on the results of the sectoral risk assessments and include relevant data on non-resident clients and cross-border activity, to be collected periodically (e.g. annually, semi-annually) from all reporting entities.*

3. CBM should have a formalized process for evaluating a bank's ML/TF risk profile. The data already gathered by the CBM for on-site inspection may provide some understanding of the relative level of ML/TF risks faced by banks, but formalized risk profiles of individual financial institutions have not been developed.

- *Develop an institutional risk assessment model, using the data from the expanded information questionnaire as input, for evaluating the ML/FT risk profiles of all financial institutions under CBM supervision.*

4. The on-site inspection schedule and the inspections' focus should be guided by a risk-based approach. The CBM conducts on-site inspections in 70-100 percent of all banks every year, and each inspection is full scope, covering the same AML/CFT topics. The inspection usually involves all the CBM's AML/CFT staff (4-5 persons) and lasts around three weeks, followed by two weeks of writing the inspection report. Implementation of risk-based rather than compliance-based supervision will allow adjusting both the frequency and scope of the inspections, leading to more efficient allocation of limited resources.

- *Adjust the inspection schedule, using the results of the institutional risk assessment model, to ensure supervisory resources are allocated based on the ML/FT risk profile of financial institutions.*

- *Introduce thematic inspections targeted at implementation of specific AML/CFT requirements to ensure coverage of higher-risk areas.*

5. AML/CFT supervisory procedures, including fit and proper tests for banks' managers and owners, need to be adequately formalized. The CBM is responsible for application of the licensing controls for banks but lacks formalized procedures for gathering or verifying relevant information. The CBM may request information from other agencies (e.g. criminal records from the Ministry of Justice) whenever it suspects that the information submitted by the potential managers or owners is inaccurate or insufficient. The CBM also lacks an AML/CFT-specific manual for offsite monitoring and on-site inspections, such as procedures for sampling customer files and transaction records. The CBM has imposed sanctions on banks, including warnings and two misdemeanor applications in the past two years, but lacks formalized procedures for determining the type and the amount of sanctions based on the severity of identified breaches of the AML/CFT requirements.

- *List the minimum level of procedures and fit and proper tests that need to be followed in every application for a banking license or for a change of ownership or management functions regardless of the supervisor's suspicion.*
- *Develop an AML/CFT-specific supervisory manual, including procedures for offsite monitoring and on-site inspections (full scope and thematic).*
- *Develop procedures for determining sanctions and remedial actions to ensure that effective, proportionate and dissuasive actions are applied.*

INTERNATIONAL MONETARY FUND

MONTENEGRO

August 8, 2019

STAFF REPORT FOR THE 2019 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By

The European Department
(In Consultation with Other Departments)

CONTENTS

FUND RELATIONS

(As of June 30, 2019)

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

General Resources Account:	**SDR Million**	**% Quota**
Quota	60.50	100.00
Fund Holdings of Currency	45.65	75.45
Reserve Position	14.85	24.55

SDR Department:	**SDR Million**	**% Allocation**
Net cumulative allocation	25.82	100.00
Holdings	18.21	70.52

Outstanding Purchases and Loans: None.

Latest Financial Arrangements: None.

Projected Obligations to Fund (In millions of SDR):

	Forthcoming				
	2019	2020	2021	2022	2023
Principal	0.00	0.00	0.00	0.00	0.00
Charges/Interest	0.04	0.08	0.08	0.08	0.08
Total	0.04	0.08	0.08	0.08	0.08

Implementation of HIPC Initiative: Not Applicable.

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

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

Exchange Arrangement: Montenegro does not issue its own currency and has been using the euro as legal tender since 2002. It has accepted the obligations under Article VIII, Sections 2, 3, and 4. Montenegro maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions, except with respect to restrictions maintained for security purposes that have not been notified to the Fund.

Latest Article IV Consultation: May 18, 2018 (IMF Country Report No. 18/121).

FSAP Participation: A Financial Sector Assessment Program was initiated in August 2015, jointly with the World Bank, and concluded during the 2015 Article IV consultation. The Executive Board discussed the Financial System Stability Assessment in January 2016.

Technical Assistance in the Past 12 Months:

Department	Timing	Purpose
MCM	July 19	Debt Management
MCM	May 19	Bank Supervision
FAD	April 19	Revenue Administration
FAD	March 19	Tax Policy
FAD	Feb 19	Revenue Administration
MCM	Jan 19	Debt Management
STA	Dec 18	Monetary and Financial Statistics
FAD	Nov 18	Tax Policy/Expenditure Policy
STA	Sep 18	National Accounts
STA	Sep 18	Government Financial Statistics

In addition, technical assistance was available through regional advisors covering public financial management.

Resident Representative: None.

RELATIONS WITH OTHER INTERNATIONAL FINANCIAL INSTITUTIONS

EBRD: https://www.ebrd.com/where-we-are/montenegro/overview.html

European Investment Bank: https://www.eib.org/en/projects/regions/enlargement/the-western-balkans/montenegro/index.htm

World Bank: https://www.worldbank.org/en/country/montenegro

STATISTICAL ISSUES

I. Assessment of Data Adequacy for Surveillance
General: Data provision has some shortcomings but is broadly adequate for surveillance. The most affected areas are labor market indicators and government finance statistics. The Statistical Office of Montenegro (MONSTAT) suffers from resource constraints and limited capacity.
Real Sector Statistics: The Statistical Office of Montenegro (MONSTAT) suffers from resource constraints and limited capacity.
National Accounts: MONSTAT compiles annual GDP by the production and expenditure approach in current and previous year's prices. The quality of the annual GDP is good. MONSTAT disseminates quarterly GDP series by expenditure but the methodology has room for improvement. Recent national accounts TA missions have focused on: (i) the development of robust quarterly GDP estimates by expenditure approach, including the improvement of estimates of changes in inventories and the use of the commodity flow approach; (ii) the development of supply and use tables; and (iii) the use of foreign trade statistics in national accounts. MONSTAT is participating in a Dutch funded project, delivered by the IMF, which will run until end of 2019 to improve the national accounts. There is a need to improve the industrial production index.
Price Statistics: MONSTAT compiles and disseminates a monthly consumer price index that broadly follows international standards. The coverage of the PPI could be expanded to include services.
Labor Market Statistics: MONSTAT reports labor and wage statistics based on data from the labor force survey (LFS) and administrative sources. The unemployment rate from the LFS is computed according to the ILO definition. The quality of wage indicators is relatively good, but information on foreign employment remains limited. The presence of a large informal sector impedes the accurate assessment of the unemployment rate. Frequent methodological revisions also impair time series analyses.
Government Finance Statistics: Fiscal data are compiled, on a cash basis, by the Ministry of Finance (MOF) based on the new GFS institutional classification, and, since 2006, include data on local governments and social security funds. The latter were merged with the treasury account in 2010. The chart of accounts introduced in 2001 has been implemented at the local level from mid-2005. Although progress is being made, there are still some gaps in coverage, and fiscal data do not include all units that should be classified in general government according to the GFSM 2001/2014 guidelines. Own revenues and associated expenditures of extrabudgetary units (including schools and hospitals) are also excluded. Fiscal data reporting suffers from frequent re-classifications, and the classification of some revenues and expenditures is not fully aligned with GFSM 2001/2014. The MOF has established a unit responsible for data collection for state-owned enterprises, but a satisfactory compilation of the public sector fiscal balance requires significant further effort. Data on enterprises owned by municipalities are rarely available. Data on the stock of local government arrears need to be significantly strengthened and disseminated. Data on stocks of financial assets and liabilities are incomplete. Montenegro does not report either annual or high frequency *GFSM 2001* based data to the IMF. However, renewed technical assistance aimed at improving fiscal data compilation and reporting to both the IMF and EU resumed in 2017 and STA has field diagnostic missions.

Monetary and Financial Statistics (MFS): The Central Bank of Montenegro (CBM) reports monthly monetary statistics covering the CBM balance sheet and the balance sheet of commercial banks only. The CBM has not yet reported MFS using the Standardized Report Forms (SRFs). Data for other financial corporations are not reported.
Montenegro reports data on some key series and indicators of the Financial Access Survey (FAS), including the two indicators (the number of commercial bank branches per 100,000 adults and the number of ATMs per 100,000 adults)adopted by the UN to monitor Target 8.10 of the Sustainable Development Goals (SDGs).

Financial Soundness Indicators (FSIs): The CBM does not currently report FSIs to the Fund for dissemination on the Fund's external website.

External Sector Statistics: Balance of payments (BoP) statistics are compiled by the CBM according to the sixth edition of the *Balance of Payments and International Investment Position Manual (BPM6)*. The CBM adjusts export and import data from MONSTAT from CIF to FOB basis. One of the challenges to the BoP statistics is the positive and persistent net errors and omissions, suggesting understated inflows, due to the compilation of data based on an international transaction reporting system from banks. Tourism-related and remittances inflows could especially be underestimated due to the share of cash transactions. Using a new set of surveys, the CBM released in June 2019 the first International Investment position (IIP) data for 2016-17, with 2018 IIP data planned for September 2019. In July 2019 the CBM revised the BoP changes in international reserves, and the related Primary Income in the BoP current account to exclude CBM's holdings of Montenegrin government securities and SDR misclassifications over 2015-17. The CBM has received technical assistance from STA and plans to implement methodological changes that will reduce net errors and omissions and produce quarterly IIP data.

Montenegro participates in the IMF's Coordinated Direct Investment Survey (CDIS) reporting inward direct investment positions, but not outward direct investment positions. It has not yet participated in the Coordinated Portfolio Investment Survey (CPIS) or prepared the Reserves Data Template.

II. Data Standards and Quality

Participant in the Fund's Enhanced General Data Dissemination System (e-GDDS) since December 2011. Montenegro's National Summary Data Page (NSDP) went live in September 2017. The NSDP disseminates key macroeconomic indicators recommended in the context of the Enhanced General Data Dissemination System (e-GDDS).	No data ROSC available.

Montenegro: Table of Common Indicators Required for Surveillance

(As of July 17, 2019)

	Date of latest Observation	Date Received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	May-2019	Jun-2019	M	M	M
Reserve/Base Money [1]	May-2019	Jun-2019	M	M	M
Central Bank Balance Sheet [1]	May-2019	Jun-2019	M	M	M
Consolidated Balance Sheet of the Banking System [1]	May-2019	Jun-2019	M	M	M
Interest Rates[2]	May-2019	Jun-2019	M	M	M
Consumer Price Index	Jun-2019	Jul-2019	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2018	Mar-2019	A	A	A
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	Apr-2019	Jun-2019	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Q4-2018	Mar-2018	Q	Q	Q
External Current Account Balance	Q1-2019	Jun-2019	Q	Q	Q
Exports and Imports of Goods and Services	Q1-2019	Jun-2019	Q	Q	Q
GDP/GNP	Q1-2019	Jun-2019	Q	Q	Q
Gross External Debt	Q4-2017	Jul-2019	A	A	A
International Investment Position[6]	Q4-2017	Jul-2019	A	A	A

[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. In July 2019, the CBM revised international reserves and its NFA to correct misclassification of CBM's holdings of Montenegrin government bonds and SDR holdings.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Includes external gross financial asset and liability positions vis-à-vis nonresidents. The annual IIP and external position data were released for the first time in June 2019, starting with the data for 2016 and 2017.
[7] Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).

Statement by Mr. Richard Doornbosch, Alternate Executive Director for Montenegro and Mr. Miroslav Josic, Advisor to the Executive Director
September 6, 2019

On behalf of the Montenegrin authorities, we would like to thank staff, led by Mr. Seshadri, for their productive engagement during the Article IV mission and express our appreciation for the constructive policy findings and recommendations reflected in their report. The authorities broadly agree with staff's appraisal.

The authorities have continued implementing the fiscal consolidation measures as well as the Medium-Term Debt Management Strategy (MTDMS), which should put the debt on a steady downward path and reduce the refinancing risks, as recognized in the report. The banking system is very liquid, well-capitalized, and adequately profitable, despite the recent challenges associated with two small banks. At the same time, the authorities are progressing with the improvements in the AML/CFT framework, implementation of the remaining 2016 FSAP recommendations as well as following up on recent technical assistance recommendations. In parallel with ensuring long-term macro-financial sustainability, the authorities continued with the implementation of their Economic Reform Program (ERP) for 2019-2021. These combined efforts should warrant stable economic growth after the end of the first phase of the highway project while smoothing the negative effects of a possible global slowdown and worsening of global financial markets conditions.

Recent Economic Development and Outlook

The first results published by Monstat showed that the positive economic developments from 2018 continued during the first quarter of 2019. The growth of economic activity in the first quarter was broad-based across sectors, particularly supported by a further increase in tourism activities and investments. Real GDP growth in the medium-term is projected to remain robust, although the average annual growth rates will decelerate to 3 percentage points due to the end of the first phase of the highway. However, this is still higher compared to the average growth rate recorded in 2014-2016 period as well as the expected rise in economic activity in most EU countries. At the same time, the authorities expect, similar to the European Commission's Spring Forecast, that the further expansion of tourism and investments in the renewable energy sector and agriculture, supported by the ambitious set of structural reforms will sustain domestic demand and exports.

Fiscal Policy and Debt Management

The authorities remain strongly committed to the fiscal consolidation strategy (FCS) that started in 2017 and will put public finances on a stable footing over the medium term. The fiscal consolidation measures outlined in the 2017–2021 Budget Deficit and Public Debt Recovery Plan, supplemented by the 2017–2020 Fiscal Strategy, have been largely implemented. The main fiscal policy objective in the following medium-term period is to preserve public finance sustainability, defined by maintaining the primary surplus of 2 percent of GDP and reducing the level of public debt, excluding state guarantees close to 60% by 2022.

In this context, they remain committed to the continuation of fiscal consolidation in the upcoming election year.

Cognizant of development needs, and the fact that Montenegro did not have even one kilometer of highway, the authorities have launched the long-term Bar-Boljare highway project in 2014, envisaged to be built in four phases. The financing of the first and most expensive phase of the project, was secured on an international tender and on the most favorable terms at the time. As envisaged, this large infrastructural project increased public debt, but also significantly boosted economic growth. The authorities are aware that launching the second phase of the project at the current level of public debt would not be in line with the FCS or the MTMDS. Therefore, **they will refrain from any new major debt-financed investment project, and to continue with the second phase of the highway only after public debt is put on more sustainable level, and favorable financing conditions are secured, potentially with a grant element.**

At the same time, they will continue to work on the preparation of the second phase project, mostly by securing the legal documentation, for which the EU grant funding was secured. Through the grant of the Western Balkan Investment Framework, the EU's program for infrastructure investments in the region, the Ministry of Transport and Maritime Affairs of Montenegro and the Directorate for State Roads will prepare the Preliminary Design and Environmental and Social Impact Assessment for the second phase section of Bar-Boljare highway. In addition, a Cost Benefit Analysis and Feasibility Study for the entire Bar-Boljare project will be prepared with the aim to present the financial viability of the planned infrastructure works and justify the current planning of investments. Furthermore, the authorities would like to emphasize that the EU representatives have identified investments in the project of national, regional and international significance for the Western Balkans, and that once the Bar-Boljare highway is fully operational, it will significantly decrease travel time, reduce emissions and accidents and lower vehicle operating costs, improve trade flows with countries in the region and bring other tangible benefits, such as better living conditions and thus induce a positive impact on the broader economy of Montenegro, its citizens and its neighbors.

On the revenue side, activities will focus on the expansion of the tax base and improvement of tax discipline. In this regard, the Parliament granted the Montenegrin Tax Administration (MTA) as of January 1, 2019 full autonomy, which has already improved their efficiency and significantly reduced tax arrears. At the same time, the MTA has adopted a reform program with the aim of improving the core processes, supported by IMF technical assistance. Furthermore, a system of electronic issuing of fiscal invoices will be introduced as of January 1, 2020. Significant positive effects in generating revenues, primarily through attracting new investments, are also expected from the implementation of the Economic Citizenship Program which implies acquiring Montenegrin citizenship based on the implementation of an investment program that contributes to Montenegro's economic and commercial development. For this purpose, the authorities have signed a contract with three international and reputable agencies that will be responsible for the due diligence to minimize risks. The expected budget impact could be around 30 million EUR in three years from fees, and 500 million EUR in investments with further multiplying effects on budget revenues and economic activity (0.6 and 10.6 percent of GDP respectively). Lastly, a further increase in excise taxes on carbonated water and ethyl alcohol, the introduction of coal excise, the reduction of tax arrears through the implementation of the Law on Rescheduling Tax Receivables, as well as the implementation of the Law on Local Self-Government Financing and legalization of informally constructed buildings is also scheduled for 2019 and 2020.

On the expenditures side, the strategic commitment is to further rationalize the current expenditures, which is in line with staff's recommendations. The focus will be on the further implementation of the 2018–2020 Public Administration Optimization Plan and a freeze on employment in the public sector. This will facilitate a reduction in the number of employees in the public sector and a further reduction in the aggregate gross wage bill. The authorities agree with staff on the limited progress so far. However, they would like to emphasize that in a small state and a country in transition, it takes more time for such important reforms to make visible progress. In addition, implementation of the new concept of "consolidated public procurement" will create the conditions for rationalization of the "common" costs of the state authorities.

The authorities share staff's concerns that robust investment management and Public-Private-Partnership (PPP) frameworks are important. As a small state with high development needs, Montenegro needs to strike a proper balance between the availability of fiscal space and the development needs. Cognizant of development needs, the authorities are currently preparing a strong legislative and institutional PPP framework that could help them achieve these goals. Bearing in mind the risks that PPP projects could bring, the draft version of the law on PPP was prepared and agreed upon with the European Commission to ensure integrated regulation of this area. The authorities are also working jointly with the IFC, the IMF and several bilateral partner countries in preparing an appropriate law. It is paramount for the authorities to include the strong role of the Ministry of Finance in the process of approving the PPP projects as well as their supervision, both at the national and local level. This also includes putting limits on the number of projects as well their value, at all levels of the government. In this regard, the Ministry of finance has requested PFRAM support by FAD to proactively engage in further staff capacity development on this matter.

Regarding the strengthening of oversight of the implementation of fiscal policy, options are being considered for the identification of the most adequate model for establishing a Fiscal Council, and expert assistance has been sought from the European Union for this purpose. In addition, three-year budgeting will be formally introduced in the budget system as of 2020, where the first year will be mandatory, and the following two will be indicative.

Financial System and Policies

The banking system is very liquid, well-capitalized, and adequately profitable, despite the recent challenges associated with the resolution of two small banks. Interventions in two non-systemic banks had no spillovers effects to the broader banking sector and financial stability. Key performance indicators (KPIs) of the banking system for 13 banks (without Atlas bank and Invest bank Montenegro), improved by end-2018 and their positive trend continued in 2019, with assets, loans, deposits and capital recording growth compared to December 2018 (4.2%, 7.6%, 1.3% and 14.3% respectively).

The level of non-performing loans (NPLs) also recorded further improvement. The authorities' efforts aimed at addressing NPLs in the last two years have been effective, and the systemic level of NPLs decreased to 4.8 percent at end-June 2019, compared to 8.2 percent in July 2017. At the same time, NPLs are adequately provisioned, with the provision coverage ratio standing at 83.2 percent at end-June 2019 and the coverage with regulatory reserves at 94.7 percent. However, they recognize that although the level of NPLs is not a systemic risk, it is still a challenge for some small banks. In this context, they will remain vigilant about the developments in these banks and stand ready to act appropriately. Lastly, the authorities announced the amendments to the Decision on Minimum Standards for Credit Risk Management in Banks, introducing a strict non-performing loans definition that does not exclude impaired assets that are deemed to have adequate or prime collateral.

The authorities agree that strong banking supervision is of utmost importance. In this context, they have already established a Supervisory Committee to better support decisions made by senior management as well as to allow another layer of oversight. At the same time, staffing of off-site supervision is ongoing, which will enable the implementation of the risk-based approach to supervisory assignments. The Supervision Department also underwent organizational improvements, with the establishment of a separate unit for off-site banking supervision, and thus, contributing to further improvement and strengthening of the risk-based supervision approach. An additional separate organizational unit was established which will be responsible for issuing and monitoring measures, compliance issues, and penalties. Lastly, the authorities are actively preparing for AQR that should be executed by end-2020. In order to assure the quality and transparency of the process, the AQR will be carried out by reputable international assessors. In addition, the CBM will hire a reputable international provider to assist the institution in assuring robustness of the process.

The authorities share staff's recommendation on the need for further improvements in the supervision of AML/CFT risks. In this context, significant changes were made in the organization and staffing of the CBM's Unit for Supervision of prevention of money laundering and terrorist financing in the period from September 2018 to August 2019. In February 2019, a separate Directorate for supervision in the field of money laundering (ML) and terrorist financing (TF) and a sub-unit for protection of users of financial services were established. A highly qualified Director has already been appointed and with the almost finalized procedure of employing a higher examiner, the leadership and expertise of the Directorate will be significantly strengthened. In addition, the Service for the Protection of Financial Services Users, which is part of the Directorate, also hired a new employee. It is planned to fill all the vacancies of the Directorate with highly qualified personnel. Immediately after the establishment of the Directorate, an act of the "Guidelines for developing risk analysis and risk factors for the purposes of the prevention of ML and TF by reporting entities under the supervision of the Central Bank of Montenegro", was drafted and adopted by the Council of the Central Bank. Guidelines were sent to the Fund Mission team for comments and suggestions. Lastly, the process of developing an AML/CFT manual is underway as part of a twining project, within which it is planned to develop a risk-based approach for control of reporting entities, that would guide the capacity of the Directorate in right direction with good allocation of resources.

Structural Reforms and Competitiveness

Montenegro's strategic development objective, defined in the ERP, is sustainable and inclusive economic growth will contribute to reducing the country's development gap relative to the EU average and increase the quality of life of all its citizens. The authorities are aware that high growth rates needed to achieve this can be sustained in the medium term only by pushing forward a wide set of structural reforms, of which some of them are also emphasized by staff. They agree that migration and labor shortages in the key industrial sectors, are the two single biggest challenges the Montenegrin economy faces today. To mitigate this, the authorities have already passed a decision on decreasing employers' health insurance contributions by 2 percentage points. This will decrease the already high tax wedge and lower labor costs for employers. At the same time, they have submitted the draft version of the new labor law in coordination with the European Commission which will ease the currently rigid labor protection.

One of the goals set out by the Vocational Education Development Strategy to 2020 is to ensure that vocational education is relevant to the labor market. To achieve this goal and eliminate the structural mismatch between the supply and demand of the labor force, the authorities are already developing qualifications, based on learning outcomes, that match the labor market needs and, in line with them, design modular curricula. The authorities plan to fully implement new curricula in the next two years.

The authorities would like to emphasize that the implementation of the reform measures from the ERP is monitored through regular reports by the Competitiveness Council, established by the Government in 2017 and in accordance with the recommendations of the European Commission.