IMF Country Report No. 17/276

MONTENEGRO

September 2017

2017 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 2017 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 8, 2017 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 8, 2017, following discussions that ended on June 7, 2017, 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 24, 2017.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for Montenegro.

The documents listed below have been or will be separately released.

Selected Issues

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COMMUNICATIONS DEPARTMENT

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September 13, 2017

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IMF Executive Board Concludes 2017 Article IV Consultation with Montenegro

On September 8, 2017 the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Montenegro.[1]

Montenegro's economy continues to grow at a moderate pace, and growth should continue over the medium term, boosted by the implementation of large investment projects, including the construction of the Bar-Boljare highway. Staff projects the economy to expand by 3 percent in 2017 and 2¾ percent in 2018, with planned fiscal consolidation acting as a moderate drag on growth.

While the implementation of large publicly financed infrastructure projects will add to economic growth, the accompanying use of fiscal resources has contributed to a large increase in government debt, which reached 78 percent of GDP in 2016. Large refinancing needs in coming years are also a source of fiscal vulnerability.

Recognizing the need to reduce public debt, the government has embarked on a path of fiscal consolidation, beginning in the 2017 budget. Subsequently, the government announced in June 2017 a medium-term fiscal consolidation strategy that, if implemented, would considerably strengthen the fiscal position. Staff estimates that the government's fiscal measures would raise the primary fiscal surplus to 4½ percent of GDP by 2020, allowing government debt to fall to 66 percent of GDP by 2020.

Conditions in the banking sector continue to strengthen, with improving asset quality and recovering credit growth. Non-performing loans, however, remain elevated, and the sector appears to be over-banked, presenting a challenge for bank profitability.

[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.

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. The government's plans to reform labor laws provide an opportunity to improve the flexibility of labor market outcomes, boost participation rates, and reduce informality.

Executive Board Assessment[2]

Executive Directors welcomed Montenegro's growth performance, bolstered by large investment projects and improving banking sector conditions. While the economic outlook is positive, risks stemming from the large increase in public debt and external financing needs raise concerns about fiscal sustainability and external stability. Against this background, Directors stressed the importance of continued fiscal adjustment to reduce debt and meet refinancing needs, sustained efforts to strengthen the financial sector, and fiscal and structural reforms to support higher and more inclusive growth.

Directors welcomed the authorities' well-specified, medium-term fiscal adjustment plan, which includes social protection measures for the most vulnerable. They concurred that, if fully implemented, the plan would place government debt on a strong downward path. Given the size of the intended adjustment, Directors saw merit in communicating the need and reasons for adjustment clearly to the public. They also saw scope for a further reduction in government expenditures over the medium term, including through civil service and pension reforms. Directors agreed that fiscal space does not exist to finance subsequent phases of the highway project with debt, and encouraged the authorities to explore other financing options.

Directors noted that, while the health of the banking system has improved, non-performing loans (NPLs)–while declining–continue to be high, and profitability remains weak. They concurred that the authorities should seek further reductions in the stock of NPLs while strengthening the supervisory and regulatory frameworks. Directors welcomed the authorities' intentions to undertake asset quality reviews. Noting that the system may be overbanked, they saw merit in possible efforts to promote consolidation. Directors encouraged the authorities to explore options to improve emergency liquidity assistance and welcomed their intention to expand supervision to cover the non-bank financial system. They welcomed the progress in implementing some of the FSAP recommendations and recommended that the authorities press ahead with measures to bolster financial sector resilience and further strengthen the AML/CFT framework.

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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 underscored the importance of structural reforms to boost competitiveness, productivity, and private sector investment to sustain economic growth over the longer term. They encouraged the authorities to use the new labor law under discussion to improve labor market flexibility, facilitate job creation, and reduce the informal economy. Directors supported shifting taxation from social contributions to increased coal excises to promote greater levels of formal employment, reduce energy subsidies, and decrease local pollution. Accelerating privatization of the remaining state-owned enterprises was also encouraged.

Montenegro: Selected Economic Indicators

	2013	2014	2015	2016	2017 Proj.	2018 Proj.
Output, prices and labor market (percent change, unless otherwise noted)						
Real GDP (percent change)	3.5	1.8	3.4	2.5	3.0	2.8
Nominal GDP (in millions of euro)	3,362	3,458	3,625	3,773	3,970	4,187
Industrial production	10.6	-11.4	7.9	-4.4	...	...
Tourism (Overnight stays)	7.1	-9.2	5.3	8.4	...	...
Unemployment rate (in percent)	19.5	18.0	17.6	17.7	...	...
Consumer prices (average)	2.2	-0.7	1.5	-0.3	2.1	2.6
Consumer prices (end of period)	0.3	-0.3	1.4	1.0	1.6	2.6
Average net wage (12-month)	-1.7	-0.5	0.7	4.0	...	...
General government finances (percent of GDP) [1]						
Revenue and grants	41.3	43.5	40.7	43.3	43.5	45.1
Expenditure	45.8	44.2	46.6	49.4	50.0	50.7
Overall fiscal balance	-4.5	-0.7	-5.9	-6.0	-6.4	-5.6
Primary fiscal balance	-2.4	1.6	-3.5	-3.8	-3.9	-2.9
General government gross debt	58.7	63.4	69.3	70.0	71.6	73.6
General gov't gross debt (authorities' definition) [2]	55.2	59.9	66.7	67.5	69.1	71.3
General gov't debt, including loan guarantees	66.7	71.5	76.8	78.0	79.3	81.0
Monetary sector (end-period, percent change)						
Bank credit to private sector	1.9	-0.4	2.2	6.4	7.5	6.4
Enterprises	0.3	-2.5	1.7	1.6	...	...
Households	3.7	1.7	2.7	11.1	...	...
Private sector deposits	1.8	6.1	9.0	6.0	...	...
Balance of payments (percent of GDP, unless otherwise noted)						
Current account balance	-14.5	-15.2	-13.3	-19.0	-20.2	-21.2
Foreign direct investment	9.6	10.2	17.1	9.8	10.3	10.4
External debt (end of period, stock) [3]	153.5	163.1	163.1	166.8	169.8	173.5
REER (CPI-based; average change, in percent; - indicates depreciation)	-1.1	-0.2	1.5	0.3	...	...

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 government in their definition of general government gross debt.

3/ Staff estimates, as private debt statistics are not officially published.

INTERNATIONAL MONETARY FUND

MONTENEGRO

STAFF REPORT FOR THE 2017 ARTICLE IV CONSULTATION

August 24, 2017

KEY ISSUES

Background: After a protracted period of consolidation following the global financial crisis, the economy is growing, bolstered by large investment projects. Banking-sector conditions are improving, with credit to the private sector growing, following years of deleveraging. The large cost of constructing the first phase of a highway (one quarter of annual GDP), however, is pushing government debt to high levels. The authorities took significant steps to bolster fiscal sustainability with the 2017 budget and are currently implementing a well-specified fiscal adjustment strategy in line with staff advice.

Outlook and risks: Economic growth should accelerate in 2017 to 3 percent and maintain momentum over the medium term, supported by large public and private investment projects, with some moderate drag from fiscal consolidation. The government's ability to implement its ambitious adjustment strategy is a key risk, as is rolling over existing debt and meeting external financing needs over the medium term.

Policy recommendations

Fiscal policy: The authorities should continue to implement their fiscal consolidation strategy, which is growth friendly and mindful of social protection needs. It is based on both revenue increases and expenditure reduction, aiming to deliver a primary fiscal surplus of 4½ percent of GDP by 2020. They should avoid budget-ceiling overruns. Over the medium term, the authorities should also implement reforms to public sector employment, the pension system, and local government finances, in addition to reducing the labor tax wedge by shifting some taxation to coal excises.

Financial sector: Continued vigilance is needed to maintain the downward trend in non-performing loans in the banking sector and return the system to steady profitability. An independent system-wide asset quality review would aid in the early identification of risks and strengthen the system. The supervisory action plans for problem banks should be implemented forcefully. The system appears overbanked and some measures to promote consolidation would be beneficial.

Structural reforms: Given euroization and limited fiscal space, labor market reforms and gains in the business environment and governance are needed to strengthen labor productivity and support growth. Improvements in labor market flexibility can help reduce the size of the informal economy and create more employment opportunities.

Approved By
Philip Gerson (EUR) and Yan Sun (SPR)

Discussions were held in Podgorica February 15–March 1, 2017 with follow-up discussions in Podgorica May 31–June 7, 2017. The team consisted of Martin Petri (head), William Lindquist, Jesse Siminitz (all EUR), and Mariusz Sumlinski (FIN). Ms. Kalezic (OED) joined most of the meetings. The team met with the authorities (Central Bank, plus Ministries of Economy, Finance, Justice, Transportation, and Labor), private sector representatives (unions, employers, and banks), the diplomatic community, and international agencies (EC and EBRD). Marzie Taheri-Sanjani (EUR) contributed from headquarters. Further HQ support was provided by Min Song, Ouafia Akil, and Patricia Mendoza (EUR).

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CONTEXT

1. **Montenegro is a small, open, euroized economy that is highly dependent on tourism and external financing.** It faces several challenges to sustainable and inclusive growth. The economy is concentrated in tourism, energy, real estate, services, and agriculture. Labor markets remain rigid, and weak demographics and low labor force participation constrain growth and pressure pension expenditures. Non-performing loans (NPLs) are steadily declining but remain elevated. Public spending is high, and the Bar-Boljare highway project (Box 1) is increasing public debt to very high levels. With euroization, there is no independent monetary policy. Montenegro began EU accession negotiations in 2012 and has opened 28 of 35 negotiation chapters. In the October 2016 elections, the ruling party—with new coalition partners—retained a slim majority in parliament.

Box 1. Montenegro's Highway Project[1]

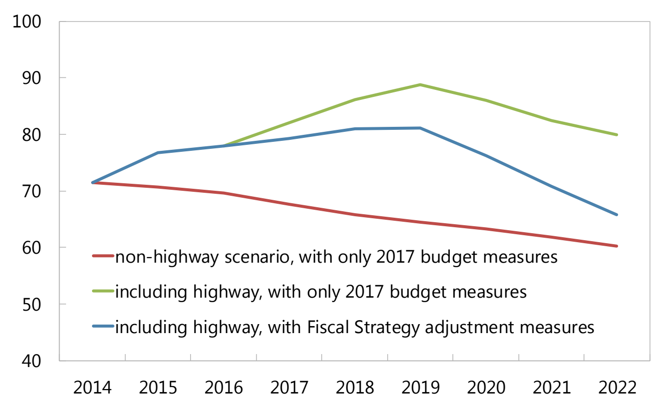
The Bar-Boljare highway will connect the main seaport of Bar with Serbia. The authorities see major benefits from the project, including regional integration, strengthened trade, and road safety.

Only the first 41 km segment connecting the outskirts of Podgorica with the less-developed northern municipality Kolašin is currently under construction. The remaining 136 km would likely cost a little more than the first segment, which presents the most difficult engineering challenges. The China Road and Bridge Corporation started construction in May 2015; completion is expected in 2019. Domestic companies are subcontracted for 30 percent of the work.

The original cost of €809 million (20 percent of GDP) has increased to nearly €1 billion (¼ of GDP) because the dollar-denominated loan from China's ExIm Bank was not hedged. The highway will have short-term demand and longer-term supply effects, but the economic and financial returns are estimated to be small.

Had the highway not been built, Montenegro's debt-to-GDP ratio would have declined to 64 percent of GDP (red line) in 2019 instead of rising to 89 percent (green line). Without the highway, the recently adopted fiscal adjustment strategy (blue line) would not have been necessary to return debt to sustainable levels.

General Government Debt with Guarantees
Percent of GDP



Sources: Montenegrin authorities and Fund staff calculations.

———————

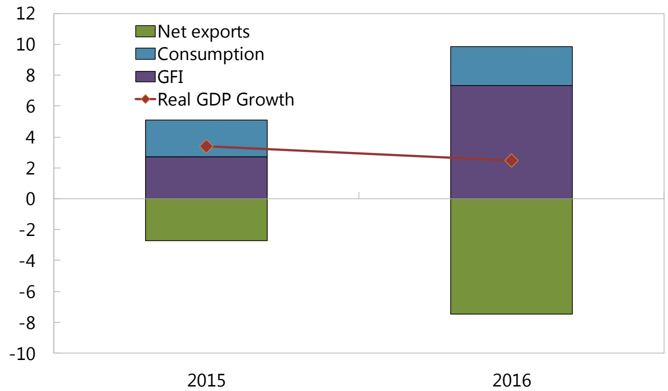
[1] See Appendix I and the Selected Issues Paper (SIP) for more details.

RECENT DEVELOPMENTS

2. **Economic growth slowed in 2016, partly due to delays in highway construction.** With less progress on highway construction than anticipated, growth slowed to 2.5 percent,

one percentage point below 2015, despite a strong tourism season. The economy experienced deflation, with prices falling 0.3 percent on average, but prices rose again at year-end. After several years of flat nominal wages, wages rose 4 percent, driven by public-sector wage increases of twice the average rate. Labor-force growth slowed for the second straight year, partly due to some women exiting the labor force to claim a poorly-designed lifetime benefit for mothers. Unemployment remained high at 18 percent.

Montenegro: Real GDP Growth Decomposition
(in percent)

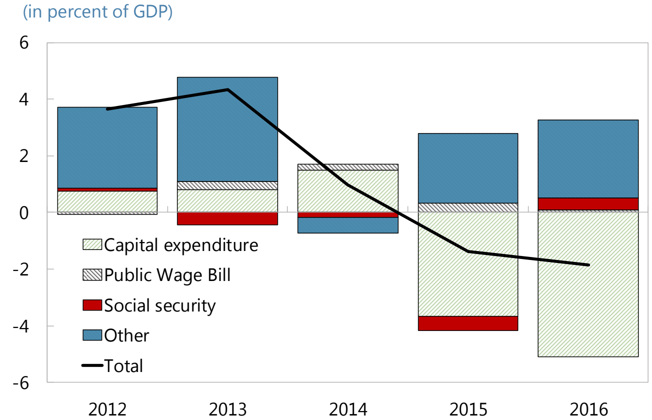


Sources: MONSTAT and staff estimates.

3. **Financial sector conditions improved.** After shrinking for a prolonged period, private sector credit increased 6 percent, and NPLs continued their decline to 11 percent of gross loans (9.5 percent at end-June 2017), less than half of their earlier peak. Banks are highly liquid. Capital ratios exceed regulatory minima, though with some variation across institutions. Bank profitability increased but remains modest with low returns on assets. Overall, banks are risk averse, citing problems with collateral execution and a dearth of profitable projects. Lending standards remain high in the context of still-elevated NPLs.

4. **External imbalances widened due to investment-related imports in 2016.** The current account deficit expanded from 13 percent of GDP in 2015 to 19 percent. While both goods and services exports grew, a 12 percent increase in the volume of goods imports—reflecting machinery for the highway, and tourism and energy investments—drove the expansion of the current account deficit. After a large inflow in 2015, foreign direct investment (FDI) inflows moderated to 10 percent of GDP. FDI covered about half of the current account deficit. Montenegro continues to rely on debt flows, including government external borrowing, to meet external financing needs. External debt increased 4 percentage points to 167 percent of GDP.

Expenditure Realization Relative to Budget Targets
(in percent of GDP)



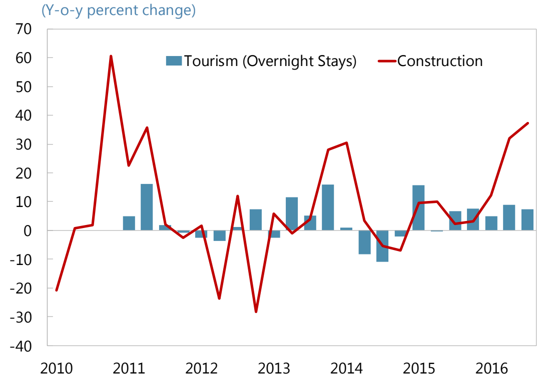
Sources: Montenegrin authorities and staff calculations.

5. **While the fiscal deficit was smaller than expected, the underlying fiscal position deteriorated.** The fiscal deficit was nearly stable at 6 percent of GDP, but capital spending was substantially less than expected due to

Figure 1. Montenegro: Real Sector Developments

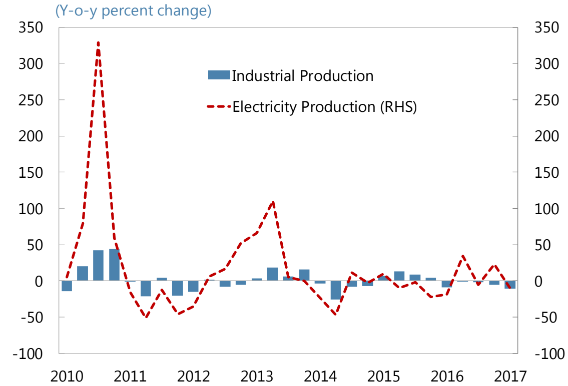
Construction activity accelerated and tourism continued its strong performance in 2016.

Indicators of Economic Activity
(Y-o-y percent change)



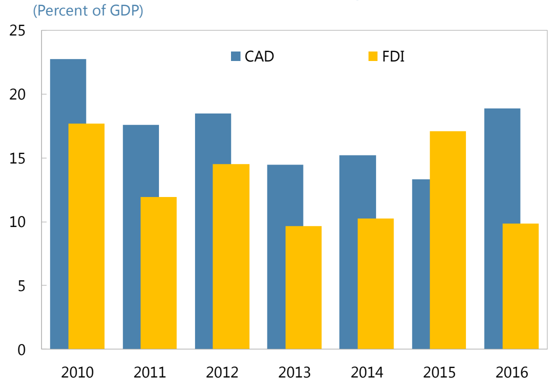
Industrial and electricity production are yet to return to steady growth.

Industrial Production
(Y-o-y percent change)



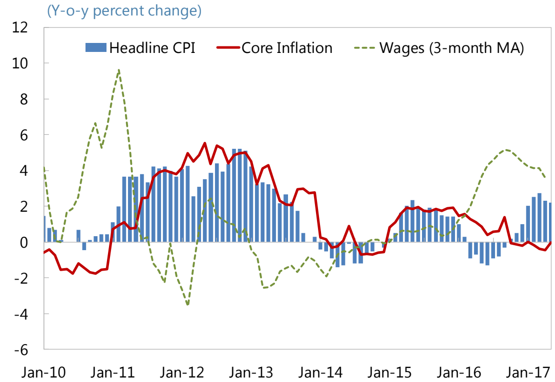
The current account deficit has widened in line with investment, and FDI is down after a record year.

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



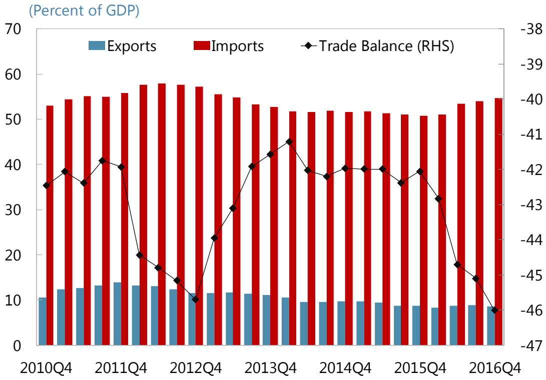
Deflation has subsided, and wage growth picked up in 2016 due to public sector wage increases.

Inflation and Wage Developments
(Y-o-y percent change)



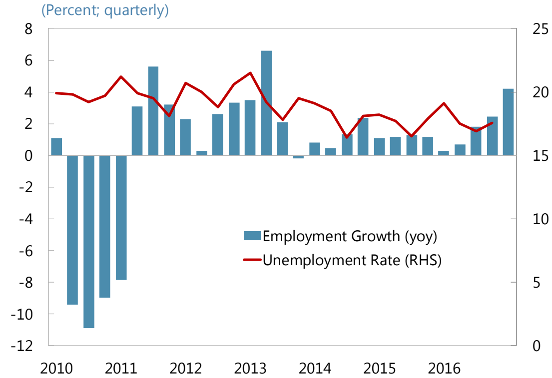
Imports for tourism, investment, and consumption offset a small, regionally oriented export base.

Merchandise Trade
(Percent of GDP)



Modest employment gains have not reduced high and entrenched unemployment.

Labor Market Indicators
(Percent; quarterly)

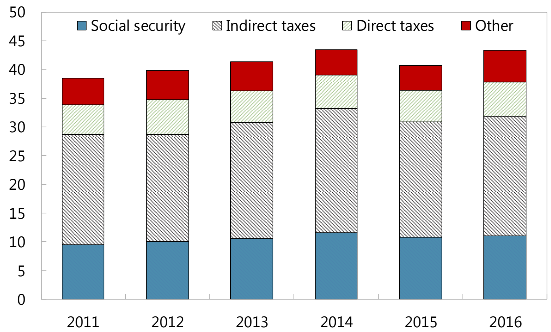


Sources: Montenegrin authorities; Haver; and Fund staff estimates.

Figure 2. Montenegro: Fiscal Developments

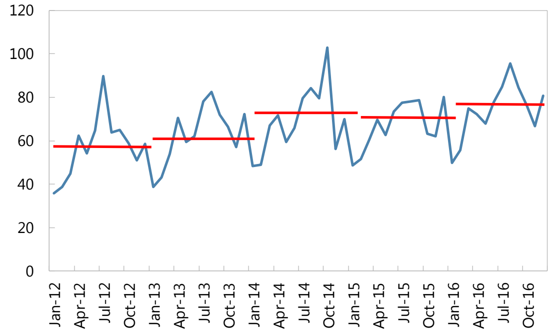
Strong revenue growth…

Composition of government revenue
(In percent of GDP)



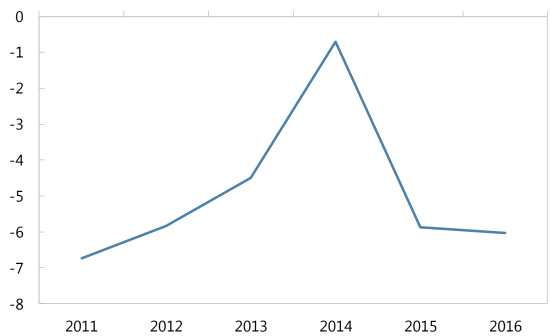
…supported by healthy tax receipts…

Monthly tax revenue
(EUR million)



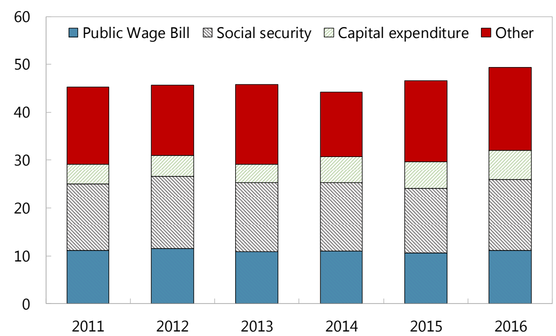
…and highway delays contained the deficit in 2016…

Fiscal balance
(in percent of GDP)



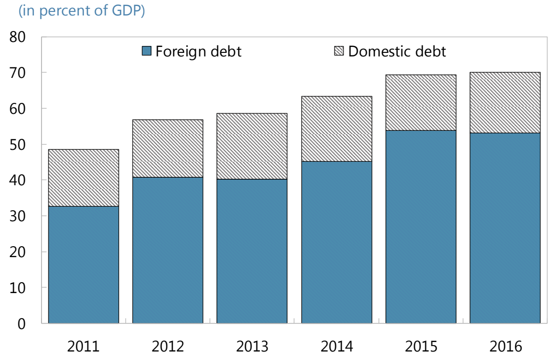
…despite wage bill and social spending growth.

Composition of government expenditure
(in percent of GDP)



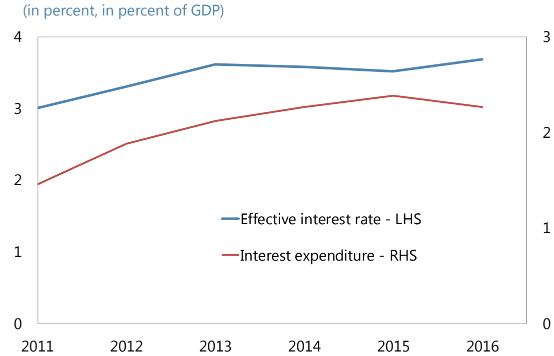
General government debt has increased sharply…

General government debt (without guarantees)
(in percent of GDP)



…as have interest payments, creating debt-related risks.

Effective interest rate and expenditure
(in percent, in percent of GDP)

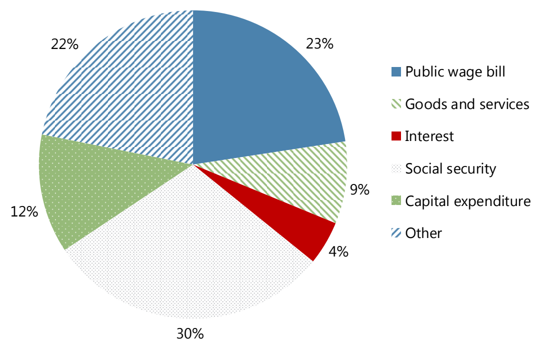


Sources: Ministry of Finance; and Fund staff estimates.

Figure 3. Montenegro: Public Expenditures

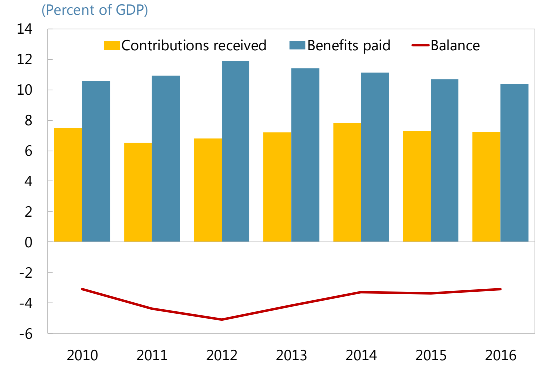
Social security/pensions and public wages are a large share of expenditures.

Composition of General Government Expenditure, 2016



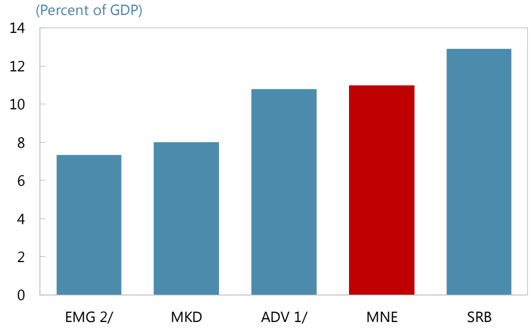
Pension expenditures remain above contributions...

Pension Funding Gap
(Percent of GDP)



...and high by international comparison...

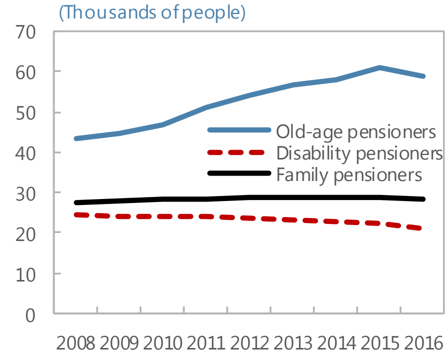
Pension Expenditure
(Percent of GDP)



1/ Average of advanced economies.
2/ Average of emerging economies.

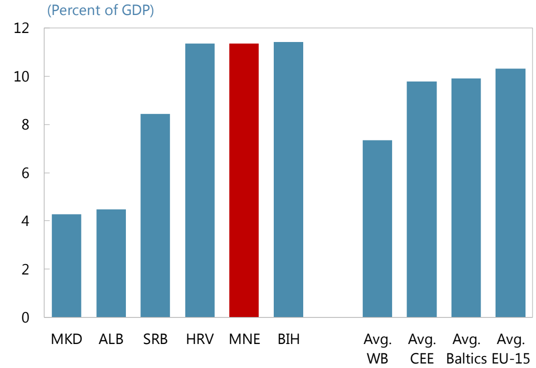
...while the number of pensioners is high and steady.

Number of Pensioners
(Thousands of people)



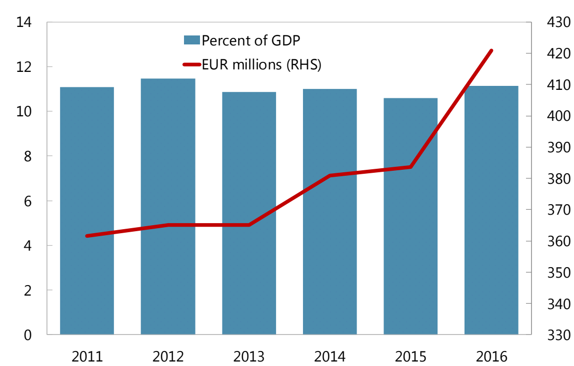
The public-sector wage bill is also high...

Compensation of Employees, 2016
(Percent of GDP)



...and increased in 2016.

Public wage expenditure



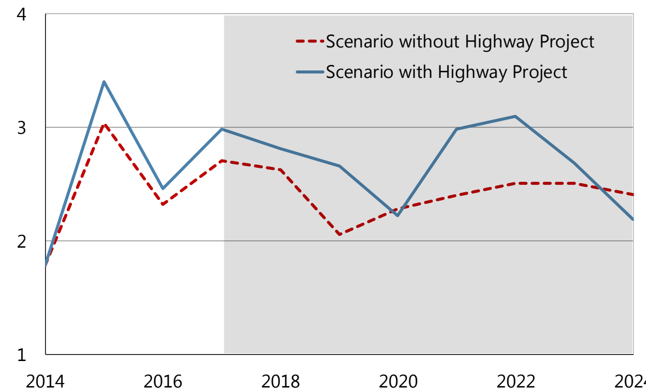
Sources: Ministry of Finance; WEO; and Fund staff estimates.

highway construction delays. Current spending, however, increased by 2¼ percentage points of GDP, driven by the new lifetime benefit (known as the "Mothers' Law") for mothers of three or more children (at a cost of nearly 2 percent of GDP), public-sector wage increases, and one-off transfers. At the same time, tax revenues improved, with gains in personal income tax and VAT collection and a one-off communications fee. General government debt including guarantees increased to 78 percent of GDP (67.5 percent in the authorities' definition without guarantees).

OUTLOOK AND RISKS

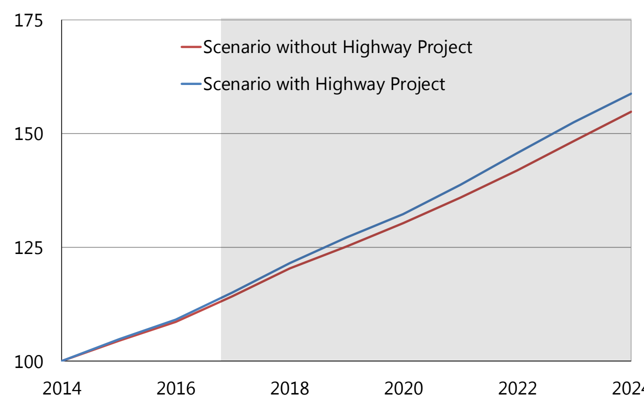
6. Activity is expected to increase in 2017, notwithstanding fiscal adjustment, boosted by the highway project and other private investments. Growth is projected to accelerate to 3 percent, driven largely by an expected doubling of highway spending to 6 percent of GDP. The highway, tourism, and energy investments are driving growth. Fiscal adjustment measures are estimated to have a modest negative impact on growth (assuming a multiplier of -0.5).[1] Over 2017–22, growth might average 2¾ percent (also supported by consumption in later years). This is slightly lower than the average over the last decade, with anticipated fiscal consolidation acting as a moderate drag.

Real GDP Growth
(in percent)



Sources: MONSTAT; and Fund staff projections.

Gross Domestic Product
(Index, in percent; 2014=100)



Sources: MONSTAT; and Fund staff projections.

- The highway adds to growth through direct demand effects during construction and indirect supply effects after its completion, although both impacts are smaller than for most investment projects (Appendix I and SIP). With the highway, GDP is projected to be only 4¼ percentage points of 2014 GDP higher in 2023—the year with the highest difference—despite costing 28 percent of 2014 GDP. Thereafter, the difference in output would decline due to higher capital depreciation in the highway scenario.

[1] Staff usually assumes a multiplier of -0.3 for Montenegro (Appendix I and SIP), but chose a slightly more conservative estimate for fiscal adjustment.

- Inflation is projected to increase to 2¼ percent on average in 2017, in line with the inflation outlook in the euro area and higher commodity prices. In 2018, the proposed increase in the VAT will add approximately 1 percentage point to inflation. With euroization and high unemployment, inflation would be contained at 2 percent over 2019–22.

- The current account deficit is projected to increase to 21 percent of GDP by 2018, driven by the heavy import content of large capital investments, before moderating to 14 percent on average over 2020–22 as public investment shrinks with the completion of the highway.

7. Government debt will increase over the next three years, but is projected to fall thereafter. With highway spending set to increase substantially over 2017–19, the overall fiscal deficit is expected to average 5¾ percent of GDP, causing general government debt (including guarantees) to reach 81 percent of GDP by 2019. Once highway spending is completed, the overall fiscal balance should improve significantly in 2020, placing debt on a firm downward trajectory.

8. The near-term outlook is subject to significant external and domestic risks.

- *External risks are mainly to the downside:* Large external financing needs expose Montenegro to changes in global financial conditions, especially in 2019–21 as large Eurobonds must be rolled over. Montenegro's reliance on tourism makes it vulnerable to an external demand downturn. An improvement in the security situation of Montenegro's competitors also represents a risk for tourism demand. A significant decline in FDI could result in balance-of-payments pressures, if not accompanied by a corresponding decline in imports.

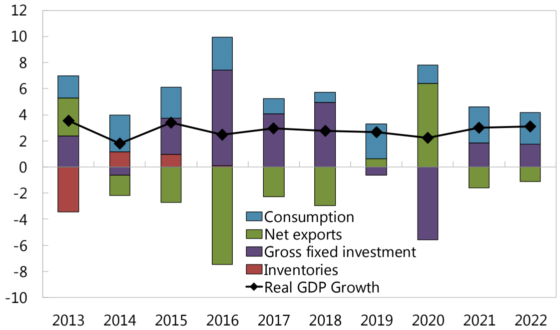
- *Domestic risks:* The governing coalition holds a narrow majority in parliament, and any loss of political support could endanger the fiscal consolidation effort. Government financing difficulties could harm holders of government bonds. Large, unexpected budget overruns on judicial claims or other budget items (as in the past) could jeopardize adjustment efforts. Fiscal adjustment could affect banking-sector profitability through its impact on growth. Delays in the implementation of investment projects would also hurt economic growth. Similarly, a prolonged compression of the non-highway capital budget would undermine future growth.

- *Upside risks:* The improvement in global growth, particularly in Europe, could have positive spillovers. The authorities project larger gains from their fiscal adjustment strategy than staff, which could result in more fiscal space. In the medium term, the construction of the Serbian part of the Belgrade-to-Montenegro highway—expected to start in 2018—could improve growth.

Figure 4. Montenegro: Medium-Term Projections, 2013-22

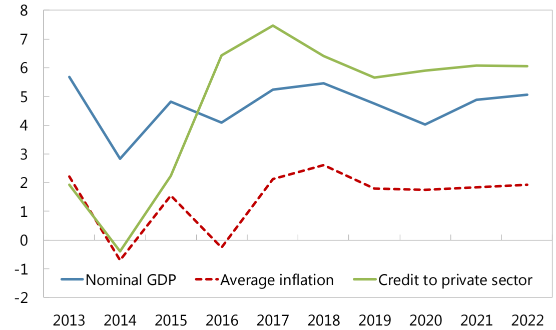
Growth is being driven primarily by investment.

Real GDP Growth Decomposition
(in percent)



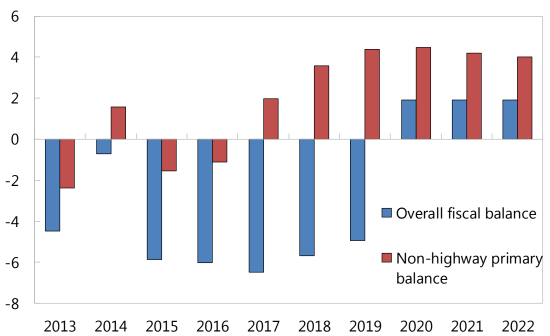
Inflation is contained, and credit growth is recovering.

Growth of Nominal GDP, Prices, and Private Sector Credit
(in percent)



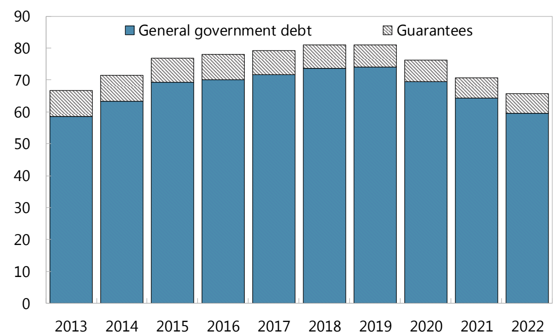
Fiscal consolidation measures are projected to produce a primary balance of 4½ percent of GDP by 2020.

Overall Fiscal Balance and Non-Highway Primary Balance
(in percent of GDP)



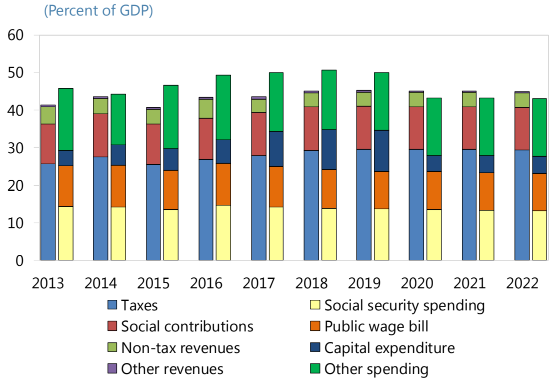
Government debt is projected to peak in 2019 at 81 percent of GDP and fall thereafter.

General Government Debt Including Guarantees
(Percent of GDP)



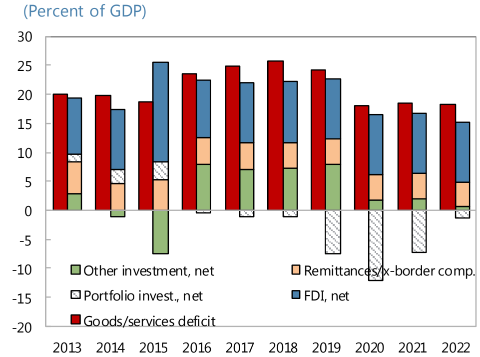
The authorities aim to raise revenues, while the end of highway construction should lower spending.

General gov't revenues and expenditures
(Percent of GDP)



FDI will remain the largest financing item for the large deficit in goods and services in the BOP.

Goods/Services Deficit and Major Financing Items
(Percent of GDP)



Sources: Montenegrin authorities and Fund staff projections.

POLICY DISCUSSIONS

9. **Policy discussions focused on three key challenges:** (i) designing a medium-term fiscal adjustment strategy to contain fiscal sustainability and refinancing risks; (ii) safeguarding financial-sector stability and supporting financial development; and (iii) improving competitiveness and the business environment.

A. Fiscal Policies

10. **After several years of fiscal expansion, Montenegro's debt has risen to high levels.** Government debt (including guarantees) more than doubled from 32 percent of GDP in 2008 to 72 percent in 2014. Subsequently, the decision to build the highway and, in 2016, the approval of a new mothers' benefit and public-sector wage increases added to expenditure pressures. Government debt reached 78 percent of GDP in 2016.

11. **Montenegro's very high debt levels and significant refinancing needs call for serious fiscal adjustment to rapidly reduce debt.** Without any adjustment, debt would likely have risen above 95 percent of GDP by 2020, which is considered unsustainable for an emerging market economy (see DSA). In addition, Montenegro faces large Eurobond refinancing needs in 2019-21 (between 6 and 11 percent of GDP each year) that would be extremely difficult to meet without a significant and front-loaded improvement in fiscal dynamics.

12. **The 2017 budget was a significant first step in reversing Montenegro's fiscal deterioration.** Recognizing the need for fiscal consolidation, the authorities included numerous adjustment measures, including some meant to mitigate the impact of spending initiatives like the mothers' benefit and increases in the public-sector wage bill granted prior to the election.

13. **The measures in the 2017 budget are estimated to deliver 2 percent of GDP in adjustment.** They are split nearly evenly between revenues and expenditures, though about one-third of the measures are temporary in nature.

- *Revenue measures:* The measures include an extension through 2019 of the 11 percent top rate for the personal income tax and an increase in the excise tax on fuels. The authorities are also taking steps to improve tax administration, though this may take time to bear fruit.

- *Expenditure measures:* The wages of senior public officials were reduced, and parts of the wages of other public employees were frozen. The monthly benefit provided to mothers was

Montenegro: Fiscal Adjustment Measures in 2017 Budget

	Estimated yield (% of GDP)		
Measure	**Staff**	**Authorities**	**Permanent Impact (Staff)**
Tax administration	0.1	0.4	0.1
Excises on fuel	0.7	0.8	0.7
Total revenue measures	0.9	1.2	0.9
Public sector wage freeze/cuts	0.2	0.2	0.2
Reduce Mothers Law benefits	0.2	0.2	0.2
Capital expenditure cuts	0.3	0.3	…
Other one-off expenditure cuts	0.5	0.9	0.1
Total expenditure measures	1.1	1.5	0.5
Total adjustment	**2.0**	**2.7**	**1.4**

Sources: Staff estimates and Montenegrin authorities.

reduced by about 20 percent. The authorities aim to reduce a range of discretionary expenditures, including non-highway capital spending.

14. Staff estimated that the policies included in the 2017 budget would result in a primary surplus of 2½ percent of GDP in 2020. Government debt would peak at 89 percent of GDP in 2019. If the primary balance were to be held at 2 percent of GDP over the longer term, debt would fall slowly, reaching a still-high 70 percent of GDP in 2030.

15. During the February/March mission, staff recommended that the authorities target a primary surplus of 4½ percent of GDP by 2020 to fully address Montenegro's fiscal challenges. With highway spending continuing through 2019, such a large primary surplus is not feasible before 2020, but adjustment measures should improve the non-highway primary balance well before. A front-loaded adjustment could also facilitate Eurobond refinancing by reducing overall financing needs and building a track record of adjustment.

16. Seeking stronger fiscal adjustment, the authorities adopted in July 2017 a medium-term "Fiscal Strategy" aiming to place debt on a strong downward path. Staff assessed the measures outlined in the fiscal strategy and believes that they would deliver an additional 2¼ percent of GDP in net non-highway fiscal adjustment by 2020, as recommended.[2] Moreover, the strategy is front-loaded, as 1½ percent of GDP in measures would be implemented in 2017 and 2018.[3] The measures are weighted more heavily towards revenue gains than expenditure reduction.[4] The authorities are in the process of implementation, with parliament having already approved the strategy and its key elements.

Revenue measures

- *VAT increase:* The VAT will rise from 19 to 21 percent. The lower-rate VAT of 7 percent—which covers basic foods, medicines, and some other services—will not be changed. The VAT increase will raise an additional 1 percent of GDP. In July 2017, the Parliament approved the VAT increase, which will take effect on January 1, 2018.

- *Excises:* Excise taxes on cigarettes, sweetened carbonated beverages, and alcohol will be increased progressively through 2020. Most significantly, the specific excise tax on cigarettes would be raised from €24 per 1000 currently to €50 by 2019, bringing Montenegro into compliance with the EU directive on cigarette taxation. The authorities also plan to introduce

[2] Staff coordinated macroeconomic policy advice closely with the World Bank, which is negotiating a Policy-Based Guarantee (PBG) with Montenegro (expected for late 2017).

[3] The overall primary balance improves significantly in 2020, when the highway spending ends, but this spending reduction can be considered exogenous.

[4] In principle, more emphasis on durable expenditure measures would be desirable. However, revenue measures are more predictable, which is appropriate given large financing needs over 2019–21.

an excise on coal at the EU minimum level in 2019, with a further increase in 2020. Parliament approved these rates in July 2017.

- *Tax debt rescheduling:* In early 2017, the authorities launched a program permitting tax debts (14 percent of GDP) to be repaid over five years. With full repayment, interest/penalties would be forgiven.[5] Taxpayers with debts representing 4 percent of GDP entered the program. Staff projects that two-thirds will be collected.

Montenegro: Staff Assessment of "Fiscal Strategy" Adjustment Measures

Permanent fiscal impact (Percent of GDP) 1/

Measure	2017	2018	2019	2020	Total	Approved
VAT increase	...	1.02	...	...	1.02	1.02
Cigarette, coal, alcohol, and sugar drinks excises	0.08	0.34	0.32	0.12	0.86	0.86
Tax debt rescheduling	0.37	-0.12	-0.05	-0.04	0.16	0.16
Contributions for previously employed mothers	0.04	0.08	-0.11	...	0.01	0.01
VAT impact of excise increases	0.02	0.10	0.06	0.03	0.21	0.21
Total revenue measures	0.51	1.42	0.23	0.10	2.25	2.25
Public sector wage bill	...	0.09	-0.06	-0.06	-0.03	-0.03
Savings from "Mothers' Law" reforms	0.23	0.04	0.21	0.14	0.63	0.63
Reduction in discretionary spending	...	0.10	0.09	0.07	0.25	...
Total expenditure measures	0.23	0.23	0.24	0.15	0.85	0.60
Total measures	0.73	1.65	0.47	0.25	3.10	2.85
Additional budgeted spending	...	-0.64	0.30	-0.02	-0.36	...
Total measures, net of new spending	0.73	1.01	0.77	0.23	2.74	2.85
Increase in social spending (social assistance)	-0.03	-0.04	-0.11	...	-0.18	...
Recommended new capital spending	...	-0.25	-0.14	...	-0.39	...
Total measures, net of new/recommended spending	**0.71**	**0.72**	**0.52**	**0.23**	**2.18**	2.85

Sources: Montenegrin authorities, and Fund staff estimates.

1/ In this table, a positive (+) sign indicates an improvement in the fiscal balance, while a negative (-) sign represents the opposite.

Expenditure measures

- *"Mothers' Law" reform:* In April, Montenegro's Constitutional Court ruled that the lifetime benefit for mothers was unconstitutional. The authorities designed and parliament approved in June 2017 compensation for former beneficiaries. Women eligible for pensions will receive pensions, the previously unemployed will be eligible for unemployment benefits, and the most vulnerable will be eligible for social assistance. Previously-employed mothers will

[5] The interest on tax debts is around 12 percent per year, which includes a penalty element. The cancelation of the combined interest and penalties results in a partial amnesty, which could undermine future tax compliance. However, results have been encouraging so far.

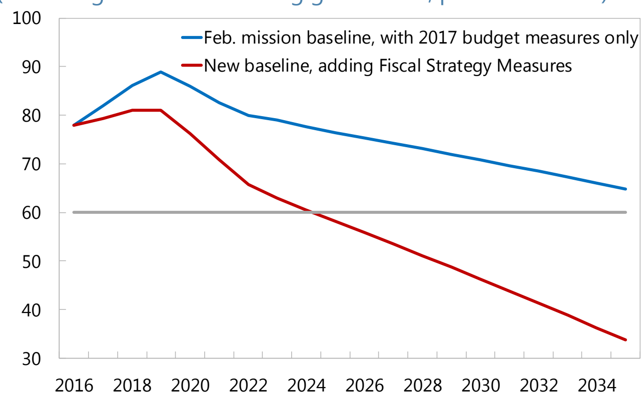
receive a time-limited monthly benefit, with shorter benefits for younger women. Importantly, the new benefits carry no permanent fiscal cost and represent a net savings of almost ¾ percent of GDP though 2022. In addition, the authorities intend to increase targeted social assistance to the poor and families with children by 0.2 percent of GDP.

- *Public-sector wage bill:* The authorities have reduced wages of senior officials by 6 percent, on top of the 8 percent 2017 cut. They also intend to freeze the workforce and refrain from granting discretionary wage increases.

- *Discretionary spending cuts:* The authorities intend to cut current and capital spending by ¼ percent of GDP through 2020.[6]

17. The fiscal strategy contains additional expenditures, which potentially provide buffers. The authorities included some new spending in the strategy (elections, defense commitments, etc.) amounting to 0.4 percent of GDP over 2017–20. In addition, staff believes that the implementation of the strategy would provide room to increase capital and social spending by 0.5 percent of GDP. Should the strategy result in less fiscal room than anticipated, this spending could be reduced to safeguard primary surplus targets.

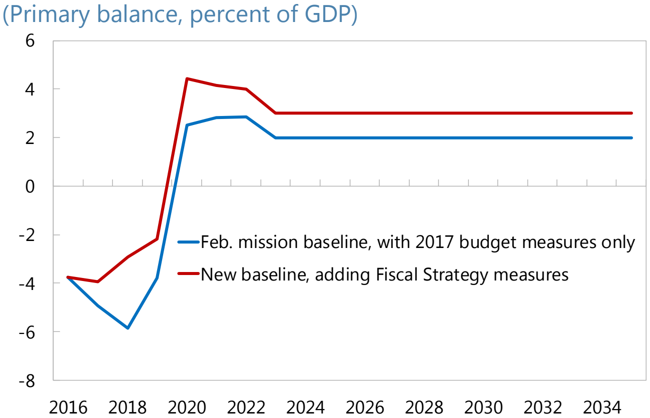
Fiscal Scenarios: 2016-2035
(General gov't debt including guarantees, percent of GDP)



Sources: Montenegrin authorities, and Fund staff estimates.

18. With full implementation of the fiscal strategy, staff projects that government debt would peak at 81 percent of GDP in 2019 and fall rapidly thereafter. After achieving a primary surplus of 4½ percent of GDP in 2020, the authorities could relax the fiscal stance by increasing capital spending on high return priority projects. However, there would likely not be any fiscal space to complete further phases of the highway (see DSA). Staff projects that general government debt (including guarantees)

Fiscal Scenarios: 2016-2035
(Primary balance, percent of GDP)



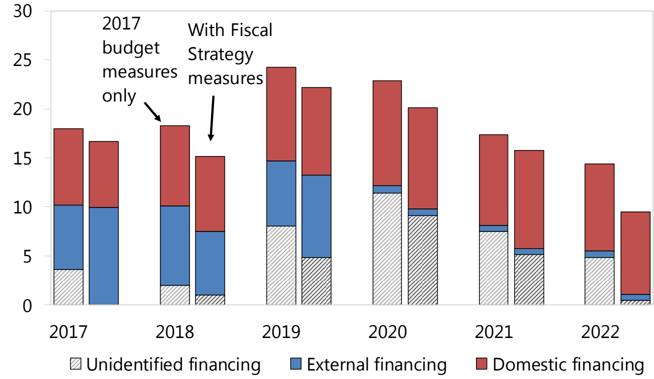
Sources: Montenegrin authorities, and Fund staff estimates.

[6] The World Bank PBG envisions larger savings in health and procurement.

would reach 66 percent of GDP in 2022.[7] After 2023, the authorities should maintain a primary surplus of 3 percent of GDP, a level sufficient to ensure a continued rapid decline in debt, preferably to below 40 percent in the long-term.

19. The fiscal strategy would also significantly strengthen market-financing prospects. Montenegro's unidentified financing needs—those not covered by identified domestic or external financing—would average 9 percent of GDP over 2019–21 without the strategy, and would likely need to be covered by the Eurobond markets. The strategy would reduce unidentified financing needs by 2–3 percentage points of GDP each year over 2019–21. More importantly, the track record implied by the implementation of the strategy should place Montenegro in a significantly stronger market-refinancing position.

Gross Financing Needs and Sources of Finance
(Percent of GDP)



Sources: Montenegrin authorities and Fund staff projections.

Summary of Fiscal Projections: With and Without Additional Adjustment Measures
(Percent of GDP, unless otherwise noted)

Former baseline - with 2017 budget only 1/	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**
Real GDP growth (percent)	3.3	3.4	2.7	2.4	3.0	3.1
Primary fiscal balance	-4.9	-5.9	-3.8	2.5	2.8	2.9
Non-highway primary fiscal balance	1.3	2.0	2.5	2.5	2.8	2.9
Unidentified fiscal financing need	3.6	2.0	8.1	11.4	7.5	4.8
General government debt, including guarantees	82.0	86.2	88.9	86.0	82.5	79.9
New baseline - adding Fiscal Strategy measures						
Real GDP growth (percent)	3.0	2.8	2.7	2.2	3.0	3.1
Primary fiscal balance	-3.9	-2.9	-2.2	4.4	4.2	4.0
Non-highway primary fiscal balance	1.9	3.5	4.3	4.4	4.2	4.0
Unidentified fiscal financing need	0.0	1.0	4.8	9.1	5.2	0.5
General government debt, including guarantees	79.3	81.0	81.1	76.2	70.8	65.8

Source: IMF staff estimates.
1/ Note: "Former baseline" is the staff baseline projection after the February 2017 Article IV mission.

[7] Debt would reach 58 percent per the definition of the Fiscal Responsibility Law, so the strategy is consistent with the law's requirement to reduce debt to below 60 percent of GDP within 5 years.

20. The authorities intend to strengthen their debt-management capabilities. They have started putting into place a debt-management strategy that would help smooth the refinancing profile and improve market access through increased transparency and better investor relations. Part of this strategy could include a market-friendly, proactive liability-management operation (LMO) to smooth the 2019–21 Eurobond redemption schedule. The authorities are receiving IMF technical assistance on LMO and are exploring possibilities with market participants.

21. Over the medium term, the authorities should consider additional reforms to strengthen growth and address longer-term challenges.[8] The authorities' fiscal strategy should address most debt-sustainability concerns, but further improvements could be considered:

- Public-sector employment remains high, particularly at the local government level, where taxation and revenue sharing could be improved. More reliance on real-estate value taxation could improve local government finances. Full cost-recovery tariffs for water and waste would create fiscal space for necessary sanitation investments.

- Though pensions are not particularly generous, pension spending is elevated due to early retirement schemes, which should be eliminated. Initial pensions should be wage-valorized and benefits CPI-indexed. Also, the retirement age should be linked to life expectancy. These reforms would make pensions more fiscally and socially sustainable.

- An accelerated coal-excise introduction could finance a reduction of social contributions (pensions, health, and unemployment) and, thus, reduce the labor-tax wedge and promote formal-employment growth. Implicit coal subsidies are estimated at 14 percent of GDP—mostly local pollution costs—which a larger coal excise would reduce significantly (see SIP).

Authorities' views

22. The authorities agreed with staff on the need for fiscal adjustment. They believe their strategy would place debt on a firm downward path, bolster market access, and improve their credit rating. They noted that fiscal outcomes in the first half of 2017 are in line with the fiscal strategy (and staff's projections), which shows the effectiveness of their efforts.

- The authorities broadly agreed with staff's economic growth assumptions and revenue projections, but believe that capital spending, pensions, interest payments, and the wage bill would be lower over the medium term.

- The authorities' desire to maintain a competitive tax system underlies their choice of revenue measures. They wished to keep low personal and corporate income tax rates to preserve Montenegro's attractiveness for FDI. While noting that they pioneered coal excises in the Western Balkans, they felt that higher excises would disrupt the energy industry and impose

[8] Details are provided in the SIP with chapters on fiscal reforms, local governments, and pensions.

costs on consumers. The authorities expect more revenues from the tax-debt restructuring and think that efforts to reduce the gray economy and improve tax administration will produce more substantial revenue gains than staff.

- Regarding expenditures, the authorities agreed that public-sector employment should be reduced through a comprehensive civil-service reform, but cautioned that they needed time for its preparation. The World Bank PBG includes specific targets for employment reductions at the central and local levels. Regarding pension reforms, the authorities felt that the 2011 reforms were robust, but expressed interest in exploring limits to early retirement and changes to pension valorization and indexation.

- The authorities agreed with staff that there was no fiscal space to complete the final highway phases through debt financing. They believe that they might complete the highway through a concession or a public-private partnership.

B. Credit and Financial Sector Policies

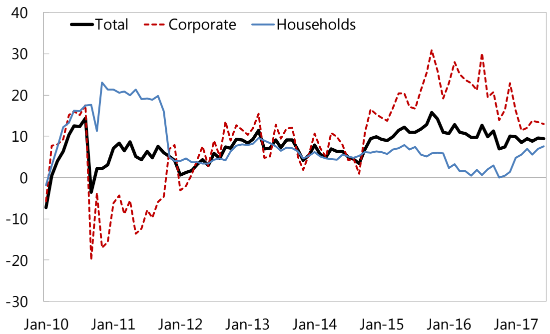
23. Banks dominate the fully euroized financial system and account for about 90 percent of system assets—equivalent to about 100 percent of GDP. Foreign subsidiaries hold over ¾ of the sector's assets. Most lending is to households (mostly mortgages), which account for 42 percent of loans. The trade sector represents 14 percent and nonresident loans 13 percent. The insurance sector is small (2 percent of GDP) but grew at a steady rate during 2000-15. The rest of the non-bank financial system plays a minor role. While the nascent stock exchange's market capitalization is significant, turnover is very low and the bond market is thin. The total asset size of the six micro-credit institutions is below 2 percent of GDP. The leasing market is insignificant and has been declining since the crisis.

24. The banking sector appears to be stable, liquid, and adequately capitalized on average. At end-June 2017, the aggregate capital assets ratio (CAR) exceeded the 10 percent minimum by 7 percentage points. The system's assets grew 11 percent year-on-year, while capital, liquid assets, and deposits increased, respectively, by 3, 4, and 11 percent. The share of liquid assets in assets was 21 percent. Nevertheless, there are challenges that banks must address individually and systemically: (i) persistent, though declining NPLs; (ii) competitive pressures; and (iii) the related low profitability—return on equity was 2 percent at end-2016 (0.3 percent on assets), but these figures improved in 2017.

Figure 5. Montenegro: Financial Sector Developments

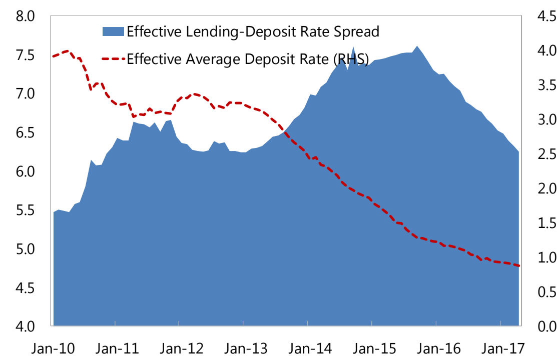
Deposits have recovered after the recession of 2011…

Bank Deposits
(in percent change, yoy)



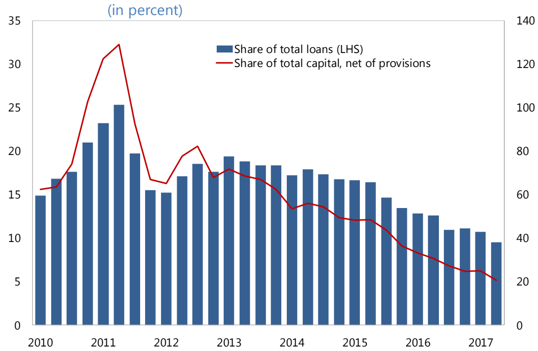
…and lending spreads have begun to decline, trailing declining deposit returns.

Bank Lending-to-Deposit Rate Spread
(in percent)



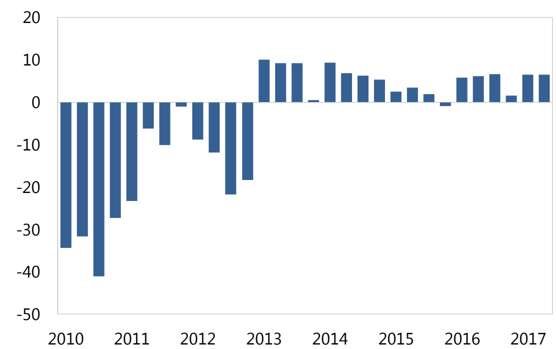
NPL levels have continued to decline.

Non-Performing Loans
(in percent)



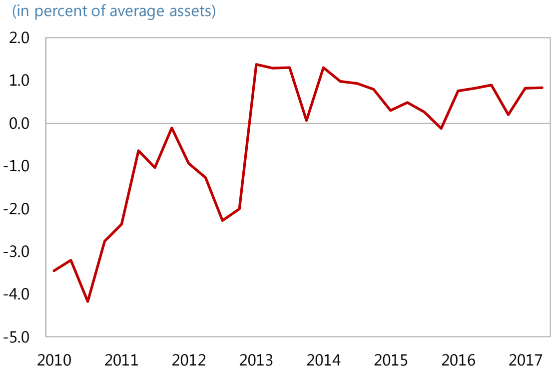
In 2016, banks returned to tentative profitability but…

Banks' Net Profits
(in percent of average capital)



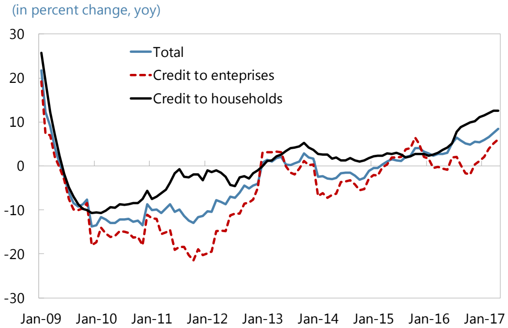
…returns on assets are low …

Banks' Net Profits
(in percent of average assets)



…as is credit growth, still overcoming the dearth of profitable projects and high interest rates.

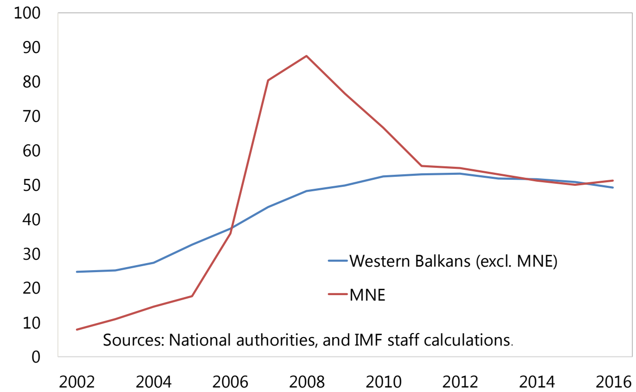
Bank Lending by Sector
(in percent change, yoy)



Sources: CBM; and Fund staff estimates.

25. Private-sector credit is recovering. It declined from nearly 90 percent of GDP before the financial crisis to 50 percent of GDP in 2012—roughly the regional average—and has remained there since. Banks have been lending cautiously because the economy expanded only moderately, collateral values decreased, and NPL resolutions took considerable time. Credit growth has been positive since 2015: 6 percent in 2016, and projected at 8 percent in 2017. Household credit grew faster than corporate credit and is close to its pre-crisis peak, possibly because lending to households appears to be more profitable. Lending is likely to remain somewhat subdued until balance sheets strengthen and the economy improves sustainably.

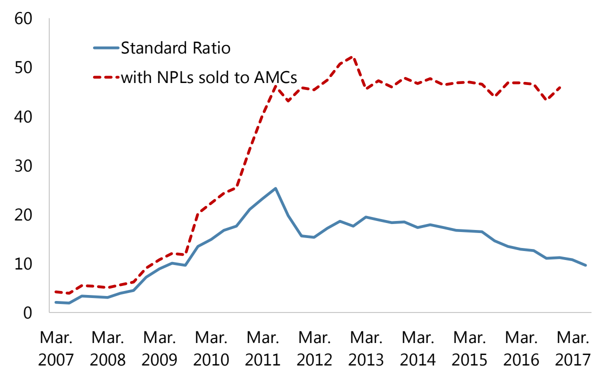
Ratio of Private Credit to GDP
(in percent)



Sources: National authorities, and IMF staff calculations.

26. Banks have been focused on reducing NPLs. NPLs peaked at more than a quarter of gross loans in mid-2011. NPLs have been declining steadily since 2012 to 9.5 percent at end-June 2017. However, much of the decline is due to shifting NPLs to asset management companies owned by foreign banks' mother houses (NPLs must be written off after 24 months). In 2015, together with the Law on Voluntary Financial Restructuring of Debts to Financial Institutions, the Central Bank of Montenegro (CBM) obliged banks to adopt three-year strategies for managing NPLs, including annual operating targets. The restructuring law was extended until May 2018 with revisions to broaden asset coverage and increase participation incentives (following FSAP recommendations).

Non-Performing Loan Ratios
(in percent of gross loans)



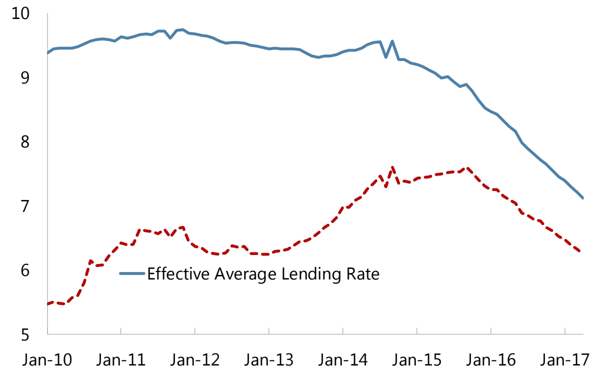
Sources: CBM and Staff calculations; NPLs sold to AMCs at nominal value at times of sale.

27. Competition in the banking sector is growing. Currently, 15 banks are operating in Montenegro. With one bank for every 40,000 residents, the system appears to be "overbanked".[9] Banks report that margins are under pressure and that some banks appear to be fighting for market share. Staff analysis suggests that lending activities are unprofitable system-wide mainly because of high provisioning (see SIP). This could lead to a reversal of the declining NPL trend. As evidence of growing competition, interest rate spreads have declined since 2014. The effective average lending rate declined to 7 percent. The declining trend of interest rates might continue

[9] In 2015, there were 43 bank branches per 100,000 adults in Montenegro versus about 30 in Bosnia and Herzegovina, Croatia, Serbia, Slovenia, and the Euro area, and 9 in small Caribbean states.

given ample liquidity. Increasing the minimum capital from €5 million to €10 million might facilitate a consolidation of the sector and boost capital buffers.

Bank Lending Rates and Interest Margins
(in percent, weighted average)



Sources: CBCG and staff calculations.

28. The CBM monitors banks through off- and on-site inspections. The three banks with qualified audits are subject to strict supervisory action plans with one bank supervised daily. These banks are not systemically important, and their CARs exceed required levels. If the action plans do not produce results, these banks would be resolved within a year. Staff encouraged steadfast implementation of the action plans. Staff also cautioned that the fiscal adjustment may dampen banks' prospects if the economy slows in response.

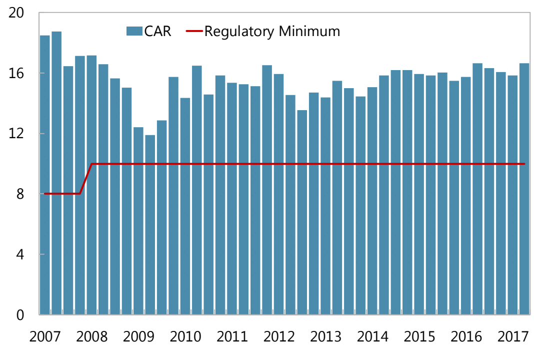
29. An asset quality review (AQR) should be conducted as soon as practicable. Supervisors lack the capacity to challenge banks' real-estate collateral valuations and there might be under-provisioning, particularly for the weaker banks. Also, the application of IFRS-9 norms for loan classification might reveal losses. An AQR would provide an important review of loan classification and provisioning practices and should start with the banks with qualified audits. Banking-system stress tests suggest that banks are most vulnerable to credit and liquidity risks, while market risk was assessed as low. Sensitivity analysis of interest rate changes revealed manageable impairment of the systemic capital adequacy ratio. The exposure of the Montenegrin banking system to direct foreign exchange risk is low because most non-resident exposure is in euros.

30. The CBM is monitoring the exposure to government. Currently, banks are exposed to government mostly through T-bills. In March 2017, the CBM disallowed holding T-bills for required reserves (previously up to 25 percent), while lowering the reserve requirement by 2 percentage points to 7 percent. At end-March 2017, the system-wide exposure to the government amounted to €510 million (13 percent of GDP), which is significant, but not excessive.

Figure 6. Montenegro: Banking Sector

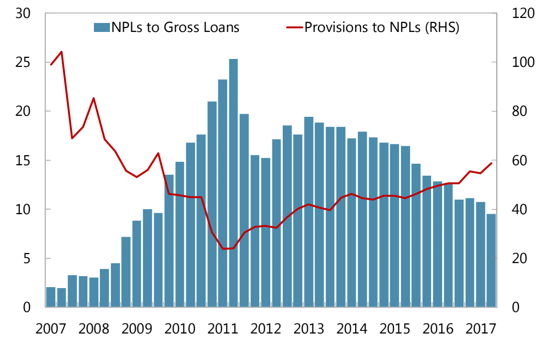
Bank capitalization has exceeded regulatory minimums…

Regulatory Capital
(as percent of risk-weighted assets)



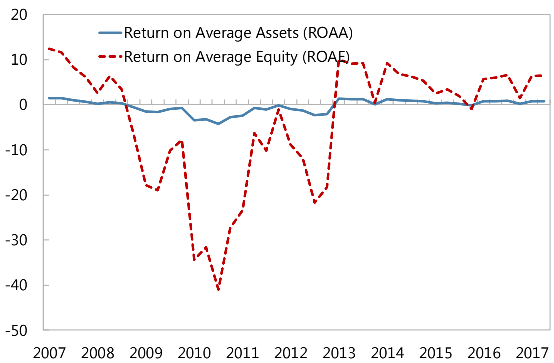
…but the quality of assets has been slow to improve.

Non-Performing Loans and Bank Provisioning
(in percent)



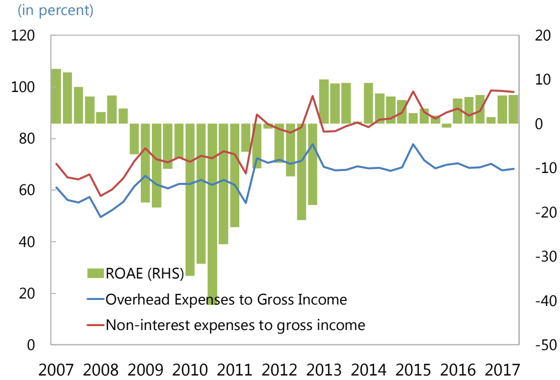
Banks struggle to remain profitable…

Bank Sector Net Profits
(in percent)



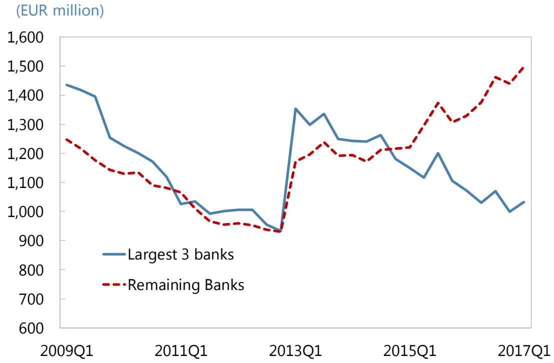
…and to contain operating costs…

Bank Efficiency and Profitability
(in percent)



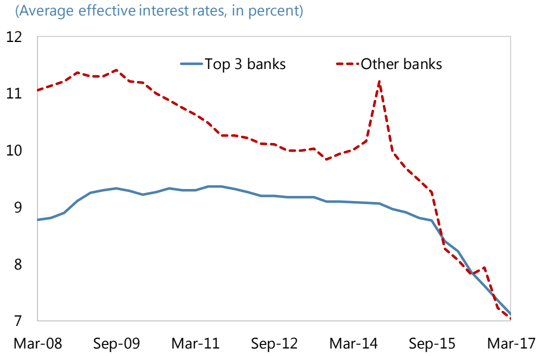
…as the sector is becoming more competitive…

Loan Portfolios by Bank Size
(EUR million)



…and interest rates are declining across the board.

Lending Rates by Bank Size
(Average effective interest rates, in percent)

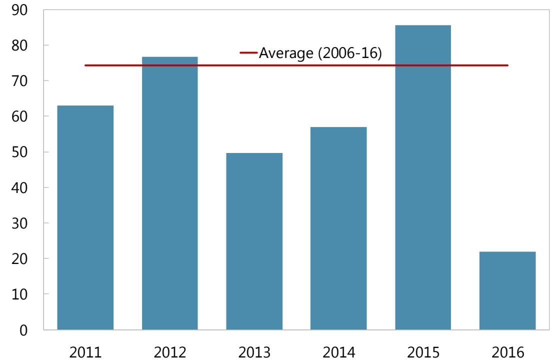


Sources: CBM; and Fund staff estimates.

Figure 7. Montenegro: Credit Conditions and Competition

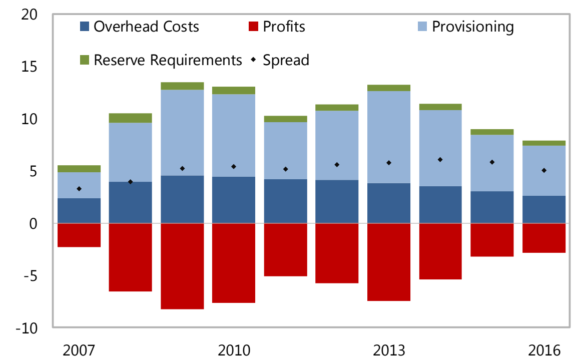
A high proportion of investment is funded externally, limiting lending opportunities for domestic banks.

Ratio of Foreign Direct Investment to Capital Formation
(Percent)



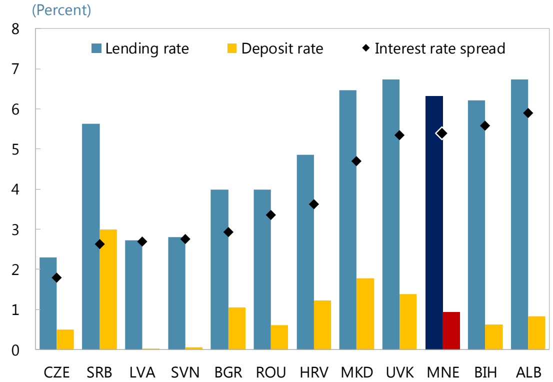
Spreads should decline in line with provisioning as improved risk assessments allow lower lending rates.

System Wide Implied Interest Spread Decomposition
(in percent)



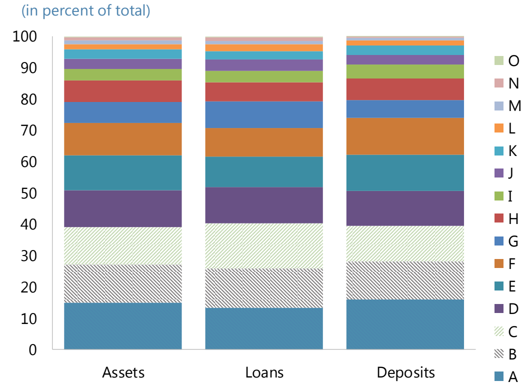
Lending conditions in Montenegro are comparable to regional peers.

Interest Rates, 2016
(Percent)



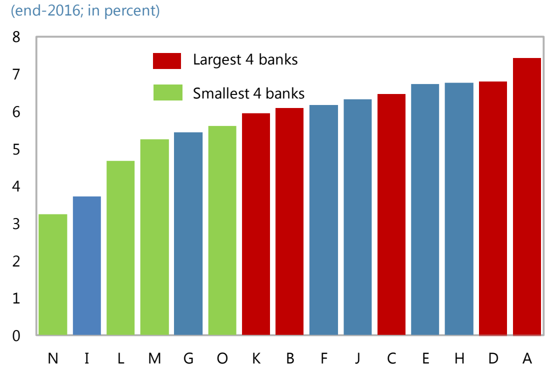
The lending market is fragmented, with four banks holding a slim majority position.

Market Concentration
(in percent of total)



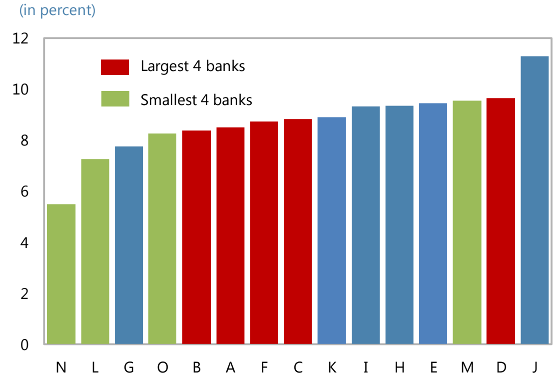
Larger banks typically have higher-than-average lending margins…

Interest-Deposit Rate Spreads by Bank
(end-2016; in percent)



…but also lower lending rates.

Average Effective Lending Rates, 2013-17
(in percent)



Sources: Bankscope, CBM and other regional central banks, MONSTAT, World Bank's Doing Business Survey (2014).

31. The CBM is implementing FSAP recommendations, which will be incorporated into six new laws and related directives: (i) Central Bank Act; (ii) Banking Law; (iii) Law on Financial Institutions;[10] (iv) Law on Recovery and Resolution of Banks; (v) Law on Voluntary Loan Restructuring; and (vi) Deposit Insurance Law. The CBM expects the laws to be adopted by end-2017.[11] The FSAP recommendations comprised defining systemically-important banks, organizing rehabilitation units, strengthening prudential provisions for NPLs, improving the regulatory framework for liquidity and credit risks, regulating the consolidated supervision of banks, insurance, and factoring companies, and meeting EU requirements on deposit guarantee schemes. The laws will elevate CBM directives and regulations for prudential supervision to the level of national legislation. A problematic consumer bankruptcy law was revoked by the Constitutional Court in February 2017.

32. There are not many options to expand Emergency Liquidity Assistance (ELA) resources. In an emergency, the CBM can lower required reserves. Currently, the banking sector is highly liquid. The nine foreign-owned banks, which account for ¾ of assets/liabilities would likely receive assistance from their owners. For residual needs, per FSAP recommendations, the CBM should ask for credit lines from foreign banks, but this has not been pre-arranged. Under EU regulations, fiscal funds can be used in a systemic crisis, but fiscal capacity is limited. The CBM is considering a resolution fund with risk-based contributions from banks, which could help supplement and back-stop ELA efforts.

Authorities' views

33. The authorities stressed that the banking system was stable, solvent, and highly liquid, and they expected continued improvement. They pointed to relatively high NPL ratios and low credit demand as the two most important vulnerabilities facing banks. They agreed that banks needed to control credit risk and reduce operational costs to improve profitability. They believed that the proposed legislation on NPLs would accelerate their resolution. They hoped that growing bank competition would boost credit supply, lower interest rates, and, thus, support the economy. Previously, they contemplated administrative measures to decrease interest rates, but disregarded them in view of their potential negative effects. The authorities are reviewing staff's suggestion to raise the minimum capital requirements to encourage bank consolidation.

34. The authorities stressed their commitment to strictly enforce prudential regulation and control risks. They assured staff that prudential limits meet the required standards and that the frequency of reporting allows for a quick correction of violations. For example, there are only three cases of large exposures, and the exposure to nonresidents (¾ of which are to banks) was only 10 percent of assets. The CBM closely watches banks' exposure to the government, as high

[10] This law also implements some recommendations regarding the macroprudential framework, particularly regarding unified supervision by the CBM.

[11] Laws (iv) and (vi) require review by the European Commission, which could lead to delays.

liquidity allows for increased lending, which should be reasonable if the government implements its fiscal strategy.

35. The authorities intended to implement a system-wide AQR in 2018/19. They explained that CBM capacity constraints and the considerable costs borne by banks recovering from the crisis argued in favor of slower implementation beginning with systemically-important banks. They thought that AQR benefits would be greater following adoption of the planned supportive legislation and IFRS-9 implementation (planned for 2018). The CBM is intensely engaged with the auditors of the three weakest banks as suggested by the FSAP and believes that their action plans will lead to improvements. The authorities appreciated the need to develop a framework for ELA and believe that current vulnerabilities are relatively low.

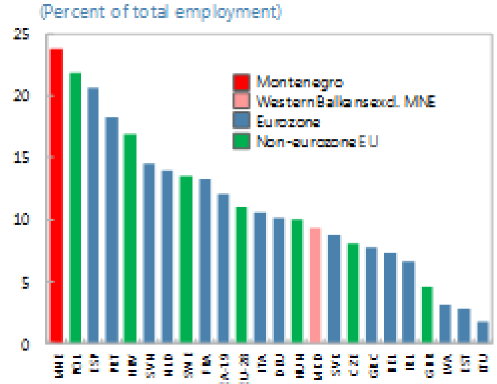
C. Structural Reforms

36. Structural reforms to improve the business environment are crucial for strengthening Montenegro's competitiveness (Figure 8 and SIP). Montenegro's score in the Doing Business (DB) survey has been improving along with its peers, but its ranking fell this year from 48th to 51st place. However, DB indicators may be outdated, given recent improvements in electricity and EU trade law convergence. The latest DB's most noticeable improvement was in "paying taxes," where Montenegro reduced the number of payments for businesses. "Trading across borders" is administratively expensive for exporters and high compliance costs are damaging price competitiveness, contributing to weak goods exports.

37. An effective implementation of the AML/CFT framework would assist efforts to address corruption. Montenegro has submitted updated information on AML/CFT regulations to MONEYVAL, and a new MONEYVAL report will be published later this year. In light of the perceived level of corruption, the authorities are encouraged to mobilize the AML/CFT framework, especially with respect to preventive measures for politically exposed persons (PEPs). They should also strengthen guidance to financial and non-financial institutions on identifying and reporting possible suspicious transactions related to PEPs, including when they are the beneficial owners of companies. Risk-based supervision should also be strengthened, with proportional and dissuasive sanctions for non-compliance.

38. Labor market rigidities cause high levels of long-term and youth unemployment and disincentives for open-ended employment (Figure 9 and SIP). Unemployment has been stubbornly high despite large fluctuations in business cycles. Firms constrained by firing restrictions are reluctant to hire in the first place, increasing long-term unemployment, which accounts for three-fourths of total unemployment. Montenegro also has one of the highest rates of temporary employment in

Temporary Employment, 2015
(Percent of total employment)



Sources: Eurostat and Monstat, Labor Force Survey.

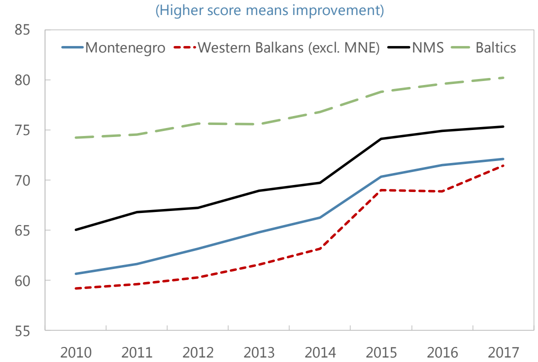
Figure 8. Montenegro: Business Environment

Business environment indicators are improving along with peers…

… though lag the region in getting electricity and trading across borders

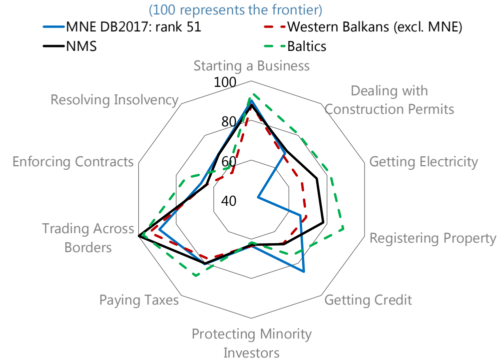
Doing Business Indicator

(Higher score means improvement)



Business Environment, Distance to Frontier

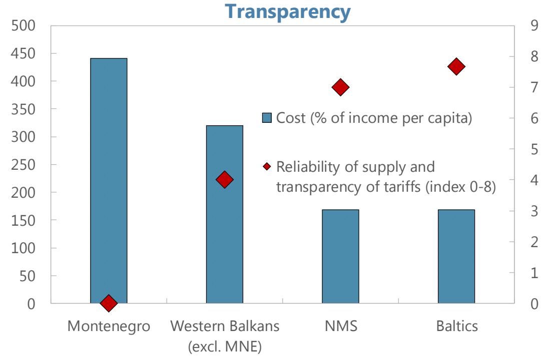
(100 represents the frontier)



Electricity access costs are high and supply reliability lowest amongst peers…

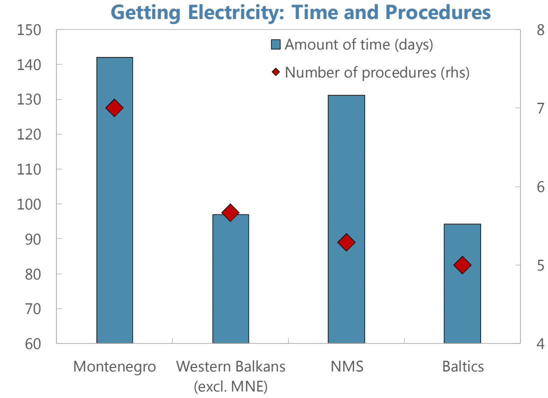
…while the number of procedures required causes long delays for business to gain access to electricity.

Getting Electricity: Costs, Supply and Tariff Transparency



Source: World Bank, Doing Business Database.

Getting Electricity: Time and Procedures

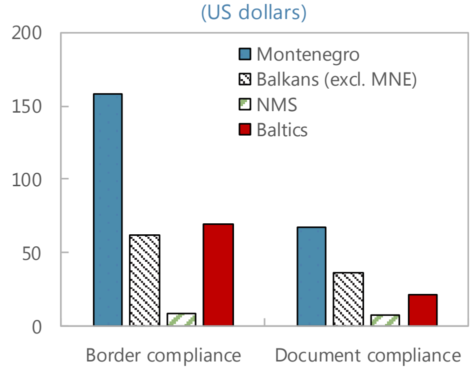


High indirect costs are worsening price competitiveness.

…while high administrative costs are burdening exporters.

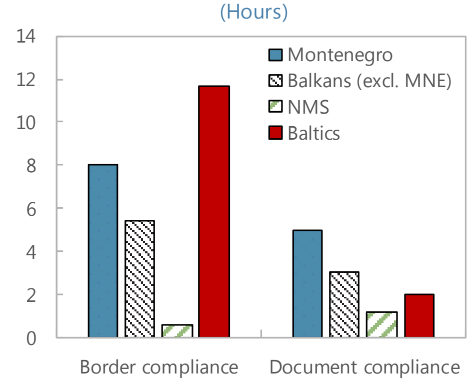
Cost to Export

(US dollars)



Time to export

(Hours)

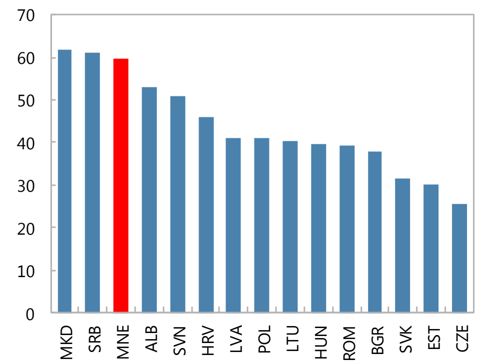


Source: World Bank, Doing Business Database.

Europe, which disproportionally affects young workers. High tax burdens on low-income workers and the relatively high minimum wage drive a quarter of the workforce into informality. Public sector employment is high and pays more than the private sector, thus reducing overall productivity.

39. Improving labor-market flexibility and encouraging job creation for the long-term and unemployed youth should be a priority. Allowing firms to adjust their workforce would encourage them to hire more workers with open-ended contracts. Reducing the tax burden on low-paid individuals would encourage hiring and lessen informal employment. The level of the minimum wage should be reviewed carefully as it is relatively high compared to peer countries and likely binding for a significant share of young workers. The impact of active labor market policies (ALMPs) has been limited, due to inadequate funding. Additionally, most funding has been allocated to university graduates, a group with the lowest unemployment rate. The authorities should review ALMPs to reallocate resources to the most promising programs, in line with successful EU programs. They should align curricula of education and training programs with labor needs to reduce skill mismatches, particularly for low-education workers. They should also enforce active job-search verification and participation in activation programs to receive unemployment benefits.

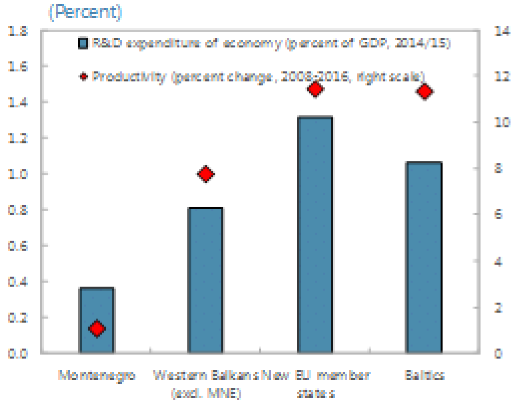
Minimum Wage
(Percent of GDP per capita; 2015)



Source: Eurostat.

40. External competitiveness is weakened by high costs and low productivity (Figure 10 and SIP). With a current account deficit of 19 percent of GDP, the external position in 2016 was weaker than that consistent with medium-term fundamentals. The real effective exchange rate has appreciated with the nominal effective rate. Staff considers the real exchange rate to be moderately overvalued (see Annex IV and SIP). Labor productivity has stagnated as an inflexible labor market has driven up unit-labor costs.

R&D Expenditure and Labor Productivity
(Percent)



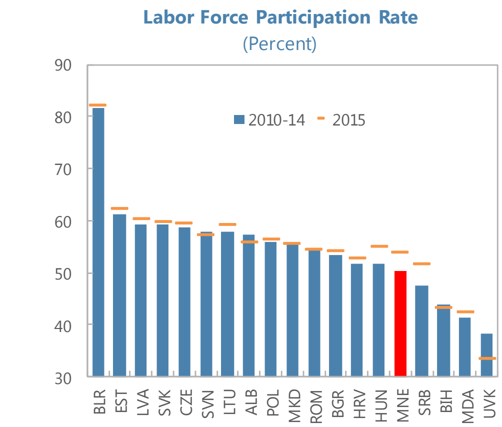
Sources: Eurostat; and IMF, WEO.

Productivity and Labor Costs
(Index; 2008=100)

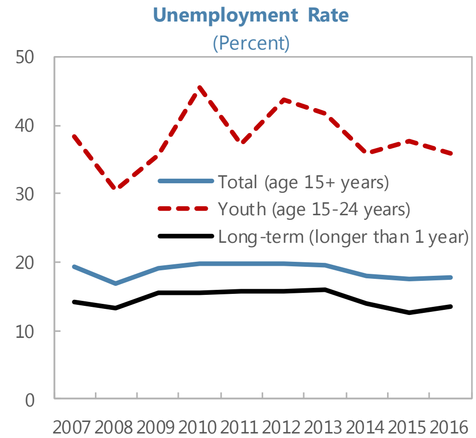
Sources: Monstat; and IMF, WEO.

Figure 9. Montenegro: Labor Markets

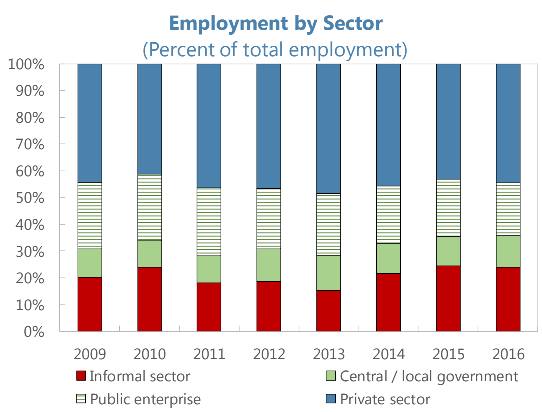
Labor force participation is low compared to peers, but has been rising recently...



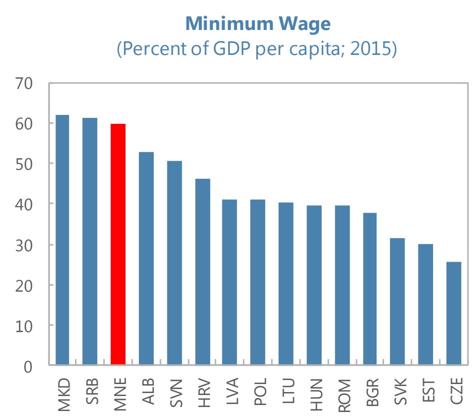
...despite persistently high levels of youth and long-term unemployment.



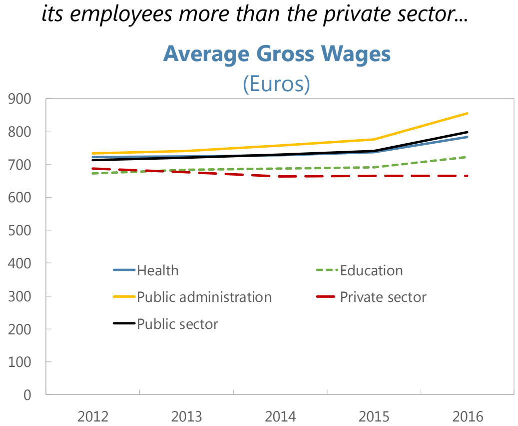
Informal employment is highest among the young and those of lower levels of education.



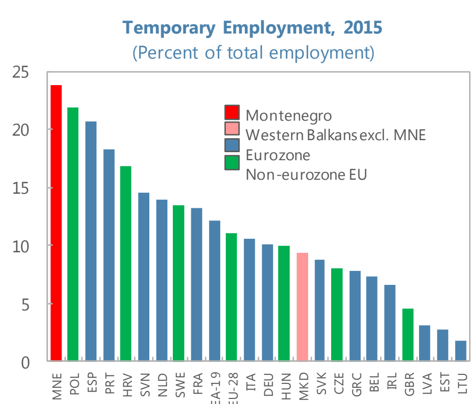
The minimum wage is relatively high and likely binding for a significant share of young workers.



The public sector employs one-third of workers and pays its employees more than the private sector...



...while employment protection is a large disincentive for employers to offer open-ended positions.



Sources: Monstat, Labor Force Survey; ILO; Eurostat; IMF, WEO database; and Fund staff estimates.

Productivity gains are limited by low levels of R&D spending. The goods-export base is becoming increasingly concentrated in low value-added sectors, which are exposed to volatile commodity prices and from competition from low-cost countries. Export shares to the euro area and the world have fallen despite euroization and convergence towards EU standards. Tourism, though one of the most productive sectors, is vulnerable to high costs because many tourists come from price-sensitive countries. Montenegro's heavy dependence on external financing reinforces the importance of fiscal and structural reforms to safeguard market access.

41. Some state-owned enterprises (SOEs) are a drag on public finances and productivity. The privatization process seems to have slowed recently. For example, the tender for the Port of Bar was cancelled. There are SOEs without public policy functions that are loss making and/or have significant tax arrears (Montenegro Airlines, Plantaže winery, etc.). Municipal SOEs are often the employer of first resort. Staff recommended reaccelerating the privatization process and merging some municipal SOEs to achieve efficiency gains. The pending exit of a minority foreign investor in EPCG, the electricity utility, requires finding a new strategic investor or purchasing shares valued at €250 million (6 percent of GDP).

Authorities' views

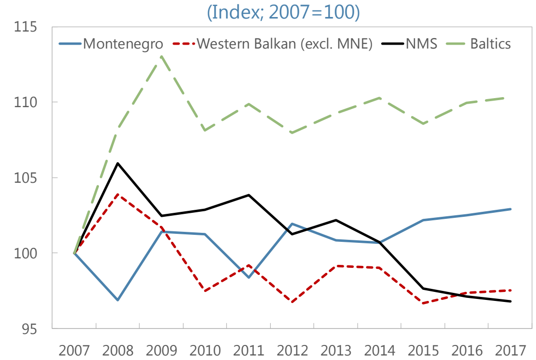
42. The authorities are addressing underdeveloped infrastructure with substantial investments in electricity generation and transport. They believe that the construction of an undersea cable with Italy, improving interconnections with Serbia, building a second thermal power-plant, and completing smaller hydro-stations will improve energy-network stability and help develop regional energy markets. They believe the Bar-Boljare highway will connect underdeveloped northern regions with the capital and alleviate transport bottlenecks. Other infrastructure projects amounting to €1.1 billion over three years are in line with EU priorities under an agreed-upon connectivity agenda. The authorities believe that they have improved the AMF/CFT framework and that their ratings in the next MONEYVAL report could be upgraded.

43. The authorities envisage approval of a new labor law in 2017/18. The present labor law is already in line with EU directives, but a new law would improve competitiveness and is envisaged for the World Bank PBG. The labor-law working group includes social partners, who are debating how to improve labor-market flexibility, improve sanctions for unregistered work, better target AMLPs, and increase market participation. The authorities plan to maintain discipline over public-sector wages. They believe that their privatization program is on track.

Figure 10. Montenegro: External Competitiveness

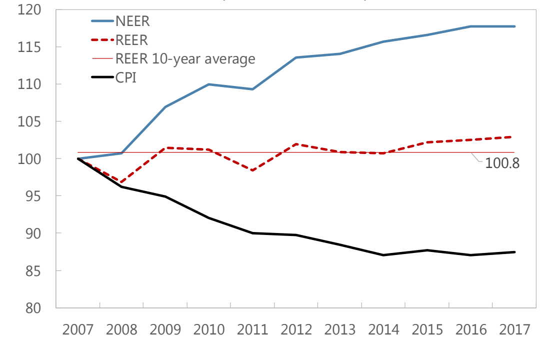
The real exchange rate appreciated modesty, driven by appreciation of nominal rate relative to trading partners

Real Effective Exchange Rate
(Index; 2007=100)



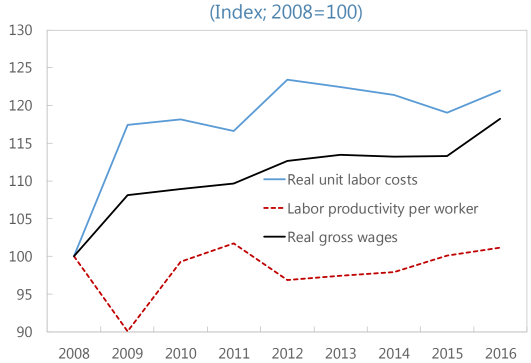
… while inflation differentials have kept appreciation in check.

CPI-based REER Components
(Index 2007=100)



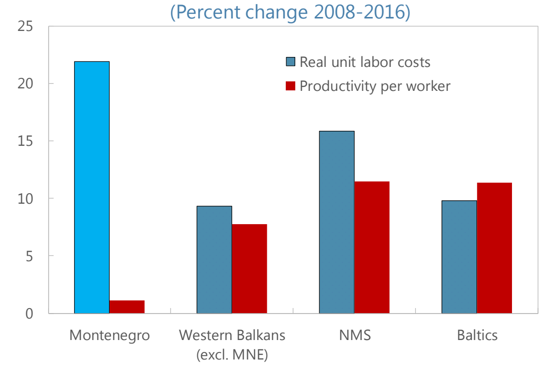
Labor productivity has stagnated as real unit labor costs have risen with wages.

Productivity and Labor Costs
(Index; 2008=100)



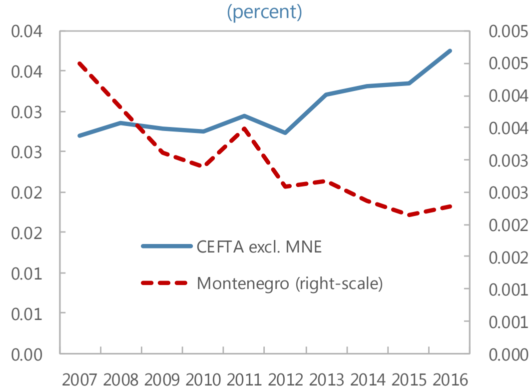
Montenegro has lost cost competitiveness compared to peers as labor costs have greatly outpaced productivity.

Productivity and Real Unit Labor Costs
(Percent change 2008-2016)



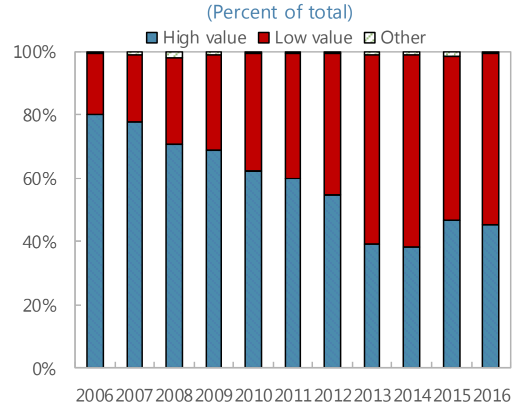
Montenegro has fallen in comparison to regional peers in the share of world exports…

Share in World Exports
(percent)



…due to a loss in market share in euro area countries and a shift of production to lower value-added goods.

Montenegro Goods Exports 1/
(Percent of total)



Sources: Monstat, UN Comtrade; IMF, WEO, INS, and DOTS; and Fund staff estimates.
Note: 1/ Low value-added goods are represented by a sum of SITC 0-4 categories including food, beverages, crude materials, mineral fuels, and animal oils. High value-added goods are a sum of SITC 5-8 categories including chemicals, manufactured goods, machinery and transport equipment, and miscellaneous manufactured articles.

STAFF APPRAISAL

44. Economic growth should gather speed this year and maintain momentum over the medium term, despite a moderate drag from fiscal consolidation. Highway construction and other large investment projects will sustain growth over the next few years, partially offsetting the concurrent fiscal adjustment.

45. After a post-crisis debt build-up—caused partly by the highway—the authorities' focus on fiscal adjustment is appropriate. Although infrastructure development is needed, government debt is now reaching levels that may not be sustainable and thus debt needs to be reduced urgently. The authorities should front-load significant fiscal adjustment to meet large refinancing needs in coming years and reduce debt quickly after construction of the highway finishes. Fiscal space does not exist to finance the remaining phases of the highway with debt. Fiscal and structural reforms are also paramount to safeguard market access and ensure external stability given Montenegro's dependence on external financing.

46. The authorities' medium-term fiscal adjustment plan is well specified, growth friendly, and socially balanced, and will require steadfast political efforts to implement. Implementation has started, with parliament having approved the bulk of the fiscal measures, and if completed, it will place government finances on sustainable footing. Including the measures already implemented in the 2017 budget, staff projects that the authorities' fiscal strategy should result in a primary surplus of 4½ percent of GDP by 2020, leading debt to fall quickly after peaking at 81 percent of GDP in 2019 (74 percent without guarantees). The authorities should continue their communications strategy to support the political acceptability of their ambitious adjustment program, particularly considering past implementation difficulties.

47. After 2020, the primary surplus could be relaxed gradually to accommodate additional capital and social spending, while maintaining a primary surplus of 3 percent of GDP over the longer term. Potential future fiscal space should be used for high-quality projects and only after debt is firmly on a downward path. The authorities should limit government guarantees for SOEs and reinvigorate the privatization process.

48. Over the medium term, the authorities should reduce the public-sector workforce, restrict early-retirement pensions, and lower social contributions. A well-designed civil-service reform would present an opportunity to reform salary structures and right-size the public-sector workforce. Local government finances should be strengthened by increased reliance on real-estate value taxes. Eliminating early-retirement pensions would strengthen pension sustainability, and shifting pensions to wage-valorization and CPI-indexation would ensure long-term fiscal and social sustainability. In the context of high unemployment and a large informal economy, the authorities should also consider using resources from an increased coal excise to lower social contributions and/or shift some of the burden away from employers. Such measures could expand employment and boost economic growth.

49. In the financial sector, there are opportunities to cement gains and advance reforms. The authorities should support banks' efforts to reduce NPLs. They should steadfastly implement supervisory action plans for problem banks. AQRs should be undertaken as soon as practically possible. The system is overbanked, and an increase of the minimum capital requirement should be considered, as it should lead to a welcome consolidation with improved competitive outcomes. The CBM's intention to expand supervision to cover the non-bank financial system, such as factoring companies and insurance providers, is welcome. Options to improve ELA should be explored further in line with best practice and EU requirements. The authorities should continue to improve the AML/CFT framework and seek to implement the outstanding recommendations of the 2015 FSAP.

50. Greater labor-market flexibility and improved productivity would sustain Montenegro's longer-term growth. Montenegro faces competitiveness challenges, and its external position is weaker than that consistent with medium-term fundamentals. With euroization and fiscal-adjustment needs constraining the capacity to absorb shocks, the authorities should accelerate structural reforms. Improving labor market flexibility and reducing the informal economy should encourage formal employment. Public-sector wages should be carefully calibrated to support cost competitiveness. Improvements to the business environment, including through advances in energy infrastructure and improvements in governance, can also support productivity growth.

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

Table 1. Montenegro: Selected Economic Indicators, 2012–22

(Under current policies)

	2012	2013	2014	2015	2016 Last SR	2016 Prelim.	2017 Last SR	2017	2018	2019	2020	2021	2022
								Projections					
Real economy													
Nominal GDP (millions of €)	3,181	3,362	3,458	3,625	3,840	3,773	3,989	3,970	4,187	4,385	4,562	4,785	5,027
Gross national saving (percent of GDP)	1.9	5.1	5.0	6.7	10.0	6.1	9.8	7.8	9.9	10.2	10.2	10.5	11.2
Gross investment (percent of GDP)	20.6	19.6	20.2	20.0	28.6	25.0	28.9	27.9	31.1	29.9	23.8	24.5	25.1
Unemployment rate (percent)	19.7	19.5	18.0	17.6	...	17.7	...	...	...	...	...	...	...
						(percent change)							
Real GDP	-2.7	3.5	1.8	3.4	4.6	2.5	2.5	3.0	2.8	2.7	2.2	3.0	3.1
Industrial production	-7.1	10.6	-11.4	7.9	...	-4.4	...	...	...	...	...	...	...
Tourism													
Arrivals	4.0	6.6	-2.6	8.5	...	10.2	...	...	...	...	...	...	...
Nights	0.1	7.1	-9.2	5.3	...	8.4	...	...	...	...	...	...	...
Consumer prices (period average)	4.1	2.2	-0.7	1.5	0.9	-0.3	1.3	2.1	2.6	1.8	1.7	1.8	1.9
Consumer prices (end of period)	5.1	0.3	-0.3	1.4	1.4	1.0	1.4	1.6	2.6	1.9	1.8	1.9	2.0
GDP deflator (percent change)	0.2	2.1	1.0	1.4	0.8	1.6	1.3	2.2	2.6	2.0	1.7	1.8	1.9
Average net wage (12-month)	0.7	-1.7	-0.5	0.7	...	4.0	...	...	...	...	...	...	...
Money and credit (end of period)													
Bank credit to private sector 1/	-3.5	1.9	-0.4	2.2	2.7	6.4	3.4	7.5	6.4	5.7	5.9	6.1	6.0
Enterprises	-5.7	0.3	-2.5	1.7	...	1.6	...	...	...	...	...	...	...
Households	-1.1	3.7	1.7	2.7	...	11.1	...	...	...	...	...	...	...
Private sector deposits	7.1	1.8	6.1	9.0	...	6.0	...	...	...	...	...	...	...
General government finances 2/						(as percent of GDP)							
Revenue and grants	39.9	41.3	43.5	40.7	42.2	43.3	41.9	43.5	45.1	45.2	45.1	45.0	44.9
Expenditure	45.7	45.8	44.2	46.6	51.4	49.4	50.8	50.0	50.7	50.0	43.2	43.2	43.0
Overall balance	-5.8	-4.5	-0.7	-5.9	-9.2	-6.0	-8.9	-6.4	-5.6	-4.9	1.9	1.9	1.9
Primary balance	-4.0	-2.4	1.6	-3.5	-6.8	-3.8	-6.5	-3.9	-2.9	-2.2	4.4	4.2	4.0
Domestic financing (net)	-0.6	-0.4	-2.5	-0.3	1.8	3.0	-0.4	-0.3	0.1	0.5	0.4	0.6	-0.8
Privatization receipts	0.2	0.8	0.3	0.3	0.1	0.3	0.2	0.2	0.2	0.0	0.0	0.0	0.0
General government gross debt	56.9	58.7	63.4	69.3	70.5	70.0	77.1	71.6	73.6	74.1	69.5	64.4	59.7
General government gross debt (authorities' definition) 3/	53.4	55.2	59.9	66.7	...	67.5	...	69.1	71.3	71.9	67.3	62.3	57.7
General government debt, including loan guarantees	68.4	66.7	71.5	76.8	84.1	78.0	90.2	79.3	81.0	81.1	76.2	70.8	65.8
Balance of payments													
Current account balance	-18.5	-14.5	-15.2	-13.3	-18.6	-19.0	-19.1	-20.2	-21.2	-19.7	-13.7	-14.1	-14.0
Foreign direct investment	14.5	9.6	10.2	17.1	12.0	9.8	12.3	10.3	10.4	10.4	10.5	10.3	10.2
External debt (end of period, stock) 4/	155.9	153.5	163.1	163.1	154.8	166.8	161.4	169.8	173.5	174.5	171.6	168.5	164.8
REER (CPI-based; annual average change, in percent)													
(- indicates depreciation)	3.6	-1.1	-0.2	1.5	...	0.3	...	...	...	...	...	...	...
Memorandum:													
GDP per capita (USD)	6,590	7,189	7,390	6,465	...	6,707	...	...	...	...	...	...	...
Nominal GDP Growth (in percent)	-2.6	5.7	2.8	4.8	5.5	4.1	3.9	5.2	5.5	4.7	4.0	4.9	5.1
Gross international reserves in millions of USD	459	584	661	734	731	822	799	925	967	1,010	1,048	1,083	1,117
Months of imports	2.4	2.9	3.6	4.0	3.8	4.3	3.2	4.2	4.3	4.8	4.7	4.6	4.8
Overall balance excluding Highway Project (in percent GDP)	-5.8	-4.5	-0.7	-3.9	-1.2	-3.4	-1.3	-0.6	0.9	1.7	1.9	1.9	1.9

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

1/ A change in classification in off-balance sheet items has resulted in a structural break in 2012; the annual changes for credit growth in 2013 are distorted by the change in methodology.

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

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

4/ There is a series break between 2013 and 2014 equal to approximately 2 p.p. of GDP, as local government external debt data are only available starting in 2014.

Table 2. Montenegro: Savings and Investment Balances, 2012–22

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

	2012	2013	2014	2015	2016	2016	2017	2017	2018	2019	2020	2021	2022
					Last SR	Prelim.	Last SR	Projections					
Gross national savings	1.9	5.1	5.0	6.7	10.0	6.1	9.8	7.8	9.9	10.2	10.2	10.5	11.2
Non-government	5.0	7.5	2.1	9.0	8.9	7.9	8.7	7.3	7.3	6.6	6.2	6.0	6.4
Government	-3.0	-2.4	2.9	-2.3	1.1	-1.8	1.0	0.5	2.6	3.7	4.0	4.5	4.8
Gross domestic investment	20.6	19.6	20.2	20.0	28.6	25.0	28.9	27.9	31.1	29.9	23.8	24.5	25.1
Non-government	16.3	15.7	14.8	14.4	16.4	18.8	16.8	18.7	20.5	19.0	19.5	20.0	20.5
Government	4.3	3.9	5.5	5.7	12.2	6.2	12.1	9.2	10.6	10.9	4.3	4.5	4.6
Savings - investment balance	-18.6	-14.5	-15.2	-13.3	-18.6	-18.8	-19.1	-20.1	-21.1	-19.6	-13.6	-14.0	-13.9
Non-government	-11.3	-8.1	-12.7	-5.4	-7.4	-10.9	-8.1	-11.4	-13.2	-12.4	-13.3	-14.0	-14.1
Government	-7.4	-6.3	-2.5	-7.9	-11.2	-8.0	-11.0	-8.7	-7.9	-7.2	-0.4	0.0	0.2
Current account balance	-18.5	-14.5	-15.2	-13.3	-18.6	-19.0	-19.1	-20.2	-21.2	-19.7	-13.7	-14.1	-14.0
Foreign direct investment (net)	14.5	9.6	10.2	17.1	12.0	9.8	12.3	10.3	10.4	10.4	10.5	10.3	10.2
External debt	155.9	153.5	163.1	163.1	154.8	166.8	161.4	169.8	173.5	174.5	171.6	168.5	164.8
Consumption	103.8	100.5	99.6	98.6	94.6	98.5	94.8	96.9	94.6	94.2	94.1	93.8	93.1
Non-government	82.7	81.0	80.2	79.2	77.7	78.1	78.2	78.8	76.9	77.3	77.2	76.6	75.8
Government	21.1	19.5	19.4	19.4	16.8	20.4	16.6	18.1	17.7	16.9	17.0	17.1	17.3

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

Table 3. Montenegro: Contribution to Real Gross Domestic Product, 2012–22

(Contribution to Real GDP growth)

	2012	2013	2014	2015	2016 Last SR	2016 Prelim.	2017 Last SR	2017	2018	2019	2020	2021	2022
								Projections					
Gross domestic product	-2.7	3.5	1.8	3.4	4.6	2.5	2.5	3.0	2.8	2.7	2.2	3.0	3.1
Consumption	-2.9	1.7	2.8	2.4	12.4	2.5	2.6	1.1	0.8	2.7	1.4	2.8	2.4
Government	0.6	0.3	0.3	0.4	0.0	0.2	0.2	-1.8	0.1	-0.3	0.4	0.7	0.7
Private	-3.5	1.4	2.5	2.0	12.4	2.3	2.4	2.9	0.7	2.9	1.0	2.0	1.7
Investment	1.9	-1.0	0.6	3.7	1.6	7.4	1.2	4.1	4.9	-0.6	-5.6	1.8	1.7
Gross fixed capital formation	-0.5	2.4	-0.6	2.7	1.6	7.3	1.1	4.1	4.9	-0.6	-5.6	1.8	1.7
Government	-0.1	-0.3	1.8	0.4	4.9	0.8	0.2	3.5	1.8	0.6	-6.8	0.4	0.2
Private	-0.4	2.6	-2.4	2.3	-3.3	6.5	1.0	0.6	3.2	-1.3	1.3	1.5	1.5
Changes in inventories	2.4	-3.4	1.2	1.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net Exports	-1.7	2.9	-1.6	-2.7	-9.4	-7.5	-1.3	-2.3	-2.9	0.6	6.4	-1.6	-1.1
Exports	-0.4	0.0	-0.5	3.9	-0.1	1.5	1.5	1.8	1.7	1.6	1.3	1.6	1.7
Goods	-2.4	0.5	-1.4	-1.3	0.1	0.4	0.2	0.6	0.4	0.4	0.3	0.3	0.4
Services	2.0	-0.5	0.9	5.2	-0.2	1.1	1.3	1.2	1.4	1.2	1.0	1.2	1.3
Imports	-1.3	2.9	-1.1	-6.6	-9.3	-9.0	-2.8	-4.1	-4.7	-1.0	5.1	-3.2	-2.8
Goods	0.8	1.1	-1.2	-3.8	-8.0	-7.4	-2.4	-3.4	-4.0	-0.7	4.9	-2.7	-2.3
Services	-2.1	1.7	0.1	-2.8	-1.3	-1.6	-0.4	-0.7	-0.7	-0.3	0.3	-0.5	-0.5

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

Table 4. Montenegro: Consolidated General Government Fiscal Operations, 2012-22 1/

(Millions of Euro, GFSM 2014)

	2012	2013	2014	2015	2016	2016	2017	2017	2018	2019	2020	2021	2022
					Last SR		Last SR				Projections		
1. Revenue	**1,263**	**1,381**	**1,497**	**1,468**	**1,614**	**1,631**	**1,661**	**1,724**	**1,886**	**1,976**	**2,052**	**2,150**	**2,252**
Taxes	786	864	950	926	986	1,013	1,025	1,107	1,226	1,296	1,346	1,411	1,478
Personal income tax	110	124	137	136	136	160	141	170	179	187	187	197	206
Corporate income tax	64	41	45	42	49	45	51	50	53	56	58	60	63
Property taxes	14	14	15	15	31	13	32	14	15	15	16	17	17
Value added tax	355	429	498	457	501	501	521	540	615	645	671	703	737
Excises	152	161	156	170	170	183	176	214	240	264	279	293	308
Taxes on international trade	29	22	22	23	24	24	25	25	27	28	29	31	32
Local government taxes	58	67	71	76	69	77	72	81	86	89	93	97	101
Other taxes	4	5	6	7	6	9	7	12	12	13	13	14	14
Social security contributions	320	357	401	392	443	416	460	453	481	501	520	545	571
Nontax revenues	142	152	137	138	152	186	158	143	161	167	174	182	191
Grants	16	10	9	12	32	16	18	21	17	12	11	12	12
2. Expense	**1,313**	**1,404**	**1,350**	**1,479**	**1,507**	**1,627**	**1,547**	**1,622**	**1,681**	**1,717**	**1,774**	**1,847**	**1,928**
Gross salaries and other personal income	378	380	395	403	409	436	425	445	446	455	477	498	520
Use of goods and services	229	139	140	188	153	187	151	175	180	178	183	204	225
Interest payments	60	71	78	86	90	85	98	100	111	117	117	109	105
Subsidies to enterprises	27	18	19	20	23	28	24	28	29	31	32	34	35
Other current outflows	16	35	37	45	46	51	47	50	60	54	56	58	61
Social security transfers	482	483	492	488	558	556	574	565	581	602	617	639	663
Other transfers	76	155	154	230	212	263	213	240	250	257	266	278	291
Repayment of guarantees	25	107	18	0	0	0	0	0	0	0	0	0	0
Reserves	22	16	16	19	16	21	17	19	23	24	25	26	28
3. Gross operating balance (= 1 - 2)	**-51**	**-23**	**147**	**-11**	**107**	**4**	**114**	**102**	**205**	**259**	**279**	**303**	**323**
4. Net acquisition of nonfinancial assets	**132**	**124**	**181**	**198**	**462**	**228**	**474**	**360**	**438**	**471**	**193**	**212**	**227**
Capital revenue	-5	-9	-7	-8	-8	-4	-8	-4	-5	-5	-5	-5	-6
Capital expenditure	138	132	189	205	470	232	482	364	442	476	198	217	233
5. Net lending (+) / borrowing (-) (= 3 - 4)	**-183**	**-147**	**-34**	**-209**	**-355**	**-224**	**-360**	**-258**	**-233**	**-212**	**86**	**91**	**96**
6. Net acquisition of financial assets	**9**	**-45**	**-4**	**1**	**-68**	**-31**	**5**	**-15**	**-11**	**-1**	**1**	**1**	**1**
Domestic	9	-45	-4	1	-68	-31	5	-15	-11	-1	1	1	1
Currency and deposits	13	-22	18	7	-61	-23	14	-7	-5	-2	0	0	0
Loans	3	4	-10	4	-3	4	-3	-2	1	1	1	1	1
Equity and investment fund shares	-6	-27	-12	-10	-5	-11	-6	-6	-7	0	0	0	0
7. Net incurrence of liabilities	**192**	**102**	**30**	**210**	**-49**	**193**	**111**	**240**	**186**	**-11**	**-521**	**-334**	**-119**
Domestic	-6	-37	-68	-5	9	89	-4	-19	1	18	16	30	-39
Foreign	198	139	98	215	-59	104	115	258	185	-29	-537	-363	-80
8. Discrepancy (= 5 - 6 + 7)	**0**	**0**	**0**	**0**	**-336**	**0**	**-253**	**-4**	**-36**	**-222**	**-436**	**-244**	**-24**
Memorandum items:													
Primary balance	-123	-76	44	-122	-265	-138	-262	-158	-122	-95	203	200	201
Nonhighway primary balance	-123	-76	44	-52	…	-38	…	75	149	192	203	200	201
Current balance	-66	-33	138	-23	…	-11	…	81	188	247	267	291	312
Nominal GDP	3,181	3,362	3,458	3,625	3,840	3,773	3,989	3,970	4,187	4,385	4,562	4,785	5,027

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

Table 5. Montenegro: Consolidated General Government Fiscal Operations, 2012-22 1/
(in percent of GDP, GFSM 2014)

	2012	2013	2014	2015	2016 Last SR	2016	2017 Last SR	2017	2018	2019	2020	2021	2022
								Projections					
1. Revenue	**39.7**	**41.1**	**43.3**	**40.5**	**42.0**	**43.2**	**41.7**	**43.4**	**45.0**	**45.1**	**45.0**	**44.9**	**44.8**
Taxes	24.7	25.7	27.5	25.5	25.7	26.8	25.7	27.9	29.3	29.5	29.5	29.5	29.4
Personal income tax	3.4	3.7	4.0	3.7	3.5	4.2	3.5	4.3	4.3	4.3	4.1	4.1	4.1
Corporate income tax	2.0	1.2	1.3	1.2	1.3	1.2	1.3	1.3	1.3	1.3	1.3	1.3	1.3
Property taxes	0.5	0.4	0.4	0.4	0.8	0.4	0.8	0.3	0.3	0.3	0.3	0.3	0.3
Value added tax	11.1	12.8	14.4	12.6	13.1	13.3	13.1	13.6	14.7	14.7	14.7	14.7	14.7
Excises	4.8	4.8	4.5	4.7	4.4	4.8	4.4	5.4	5.7	6.0	6.1	6.1	6.1
Taxes on international trade	0.9	0.7	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	1.8	2.0	2.1	2.1	1.8	2.1	1.8	2.0	2.0	2.0	2.0	2.0	2.0
Other taxes	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.3	0.3	0.3	0.3	0.3	0.3
Social security contributions	10.0	10.6	11.6	10.8	11.5	11.0	11.5	11.4	11.5	11.4	11.4	11.4	11.4
Nontax revenues	4.5	4.5	4.0	3.8	4.0	4.9	4.0	3.6	3.8	3.8	3.8	3.8	3.8
Grants	0.5	0.3	0.3	0.3	0.8	0.4	0.4	0.5	0.4	0.3	0.2	0.2	0.2
2. Expense	**41.3**	**41.8**	**39.0**	**40.8**	**39.2**	**43.1**	**38.8**	**40.9**	**40.1**	**39.2**	**38.9**	**38.6**	**38.4**
Gross salaries and other personal income	11.9	11.3	11.4	11.1	10.6	11.6	10.6	11.2	10.7	10.4	10.4	10.4	10.3
Use of goods and services	7.2	4.1	4.1	5.2	4.0	4.9	3.8	4.4	4.3	4.1	4.0	4.3	4.5
Interest payments	1.9	2.1	2.3	2.4	2.4	2.3	2.4	2.5	2.6	2.7	2.6	2.3	2.1
Subsidies to enterprises	0.8	0.5	0.5	0.6	0.6	0.7	0.6	0.7	0.7	0.7	0.7	0.7	0.7
Other current outflows	0.5	1.0	1.1	1.2	1.2	1.3	1.2	1.3	1.4	1.2	1.2	1.2	1.2
Social security transfers	15.2	14.4	14.2	13.5	14.5	14.7	14.4	14.2	13.9	13.7	13.5	13.4	13.2
Other transfers	2.4	4.6	4.4	6.4	5.5	7.0	5.3	6.0	6.0	5.9	5.8	5.8	5.8
Repayment of guarantees	0.8	3.2	0.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Reserves	0.7	0.5	0.5	0.5	0.4	0.6	0.4	0.5	0.5	0.5	0.5	0.5	0.5
3. Gross operating balance (= 1 - 2)	**-1.6**	**-0.7**	**4.3**	**-0.3**	**2.8**	**0.1**	**2.9**	**2.6**	**4.9**	**5.9**	**6.1**	**6.3**	**6.4**
4. Net acquisition of nonfinancial assets	**4.2**	**3.7**	**5.2**	**5.4**	**12.0**	**6.0**	**11.9**	**9.1**	**10.5**	**10.8**	**4.2**	**4.4**	**4.5**
Capital revenue	-0.2	-0.3	-0.2	-0.2	-0.2	-0.1	-0.2	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Capital expenditure	4.3	3.9	5.5	5.7	12.2	6.2	12.1	9.2	10.6	10.9	4.3	4.5	4.6
5. Net lending (+) / borrowing (-) (= 3 - 4)	**-5.7**	**-4.4**	**-1.0**	**-5.8**	**-9.2**	**-5.9**	**-9.0**	**-6.5**	**-5.6**	**-4.8**	**1.9**	**1.9**	**1.9**
6. Net acquisition of financial assets	**0.3**	**-1.3**	**-0.1**	**0.0**	**-1.8**	**-0.8**	**0.1**	**-0.4**	**-0.3**	**0.0**	**0.0**	**0.0**	**0.0**
Domestic	0.3	-1.3	-0.1	0.0	-1.8	-0.8	0.1	-0.4	-0.3	0.0	0.0	0.0	0.0
Currency and deposits	0.4	-0.7	0.5	0.2	-1.6	-0.6	0.3	-0.2	-0.1	0.0	0.0	0.0	0.0
Loans	0.1	0.1	-0.3	0.1	-0.1	0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Equity and investment fund shares	-0.2	-0.8	-0.3	-0.3	-0.1	-0.3	-0.2	-0.2	-0.2	0.0	0.0	0.0	0.0
7. Net incurrence of liabilities	**6.0**	**3.0**	**0.9**	**5.8**	**-1.3**	**5.1**	**2.8**	**6.0**	**4.4**	**-0.3**	**-11.4**	**-7.0**	**-2.4**
Domestic	-0.2	-1.1	-2.0	-0.1	0.2	2.4	-0.1	-0.5	0.0	0.4	0.4	0.6	-0.8
Foreign	6.2	4.1	2.8	5.9	-1.5	2.8	2.9	6.5	4.4	-0.7	-11.8	-7.6	-1.6
8. Discrepancy (= 5 - 6 + 7)	**0.0**	**0.0**	**0.0**	**0.0**	**-8.8**	**0.0**	**-6.3**	**-0.1**	**-0.9**	**-5.1**	**-9.6**	**-5.1**	**-0.5**
Memorandum items:													
Primary balance	-3.9	-2.2	1.3	-3.4	-6.9	-3.7	-6.6	-4.0	-2.9	-2.2	4.5	4.2	4.0
Nonhighway primary balance	-3.9	-2.2	1.3	-1.4	...	-1.0	...	1.9	3.6	4.4	4.5	4.2	4.0
Current balance	-2.1	-1.0	4.0	-0.6	...	5.0	...	2.0	4.5	5.6	5.9	6.1	6.2

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

1/ Includes republican budget and local governments.

Table 6. Montenegro: Consolidated General Government Fiscal Operations, 2012–22 1/

(Millions of Euro)

	2012	2013	2014	2015	2016	2016	2017	2017	2018	2019	2020	2021	2022
					Last SR		Last SR			Projections			
Total revenues and grants	**1,268**	**1,390**	**1,505**	**1,476**	**1,622**	**1,635**	**1,670**	**1,728**	**1,890**	**1,981**	**2,057**	**2,155**	**2,257**
Total revenues	1,253	1,380	1,495	1,464	1,590	1,619	1,652	1,707	1,873	1,969	2,046	2,144	2,246
Current revenues	1,247	1,372	1,488	1,456	1,582	1,615	1,644	1,703	1,869	1,964	2,041	2,138	2,240
Taxes	786	864	950	926	986	1,013	1,025	1,107	1,226	1,296	1,346	1,411	1,478
Personal income tax	110	124	137	136	136	160	141	170	179	187	187	197	206
Corporate income tax	64	41	45	42	49	45	51	50	53	56	58	60	63
Taxes on turnover of real estate	14	14	15	15	31	13	32	14	15	15	16	17	17
Value added tax	355	429	498	457	501	501	521	540	615	645	671	703	737
Excises	152	161	156	170	170	183	176	214	240	264	279	293	308
Taxes on international trade	29	22	22	23	24	24	25	25	27	28	29	31	32
Local government taxes	58	67	71	76	69	77	72	81	86	89	93	97	101
Other taxes	4	5	6	7	6	9	7	12	12	13	13	14	14
Social security contributions	320	357	401	392	443	416	460	453	481	501	520	545	571
Nontax revenues	142	152	137	138	152	186	158	143	161	167	174	182	191
Capital revenues	5	9	7	8	8	4	8	4	5	5	5	5	6
Grants	16	10	9	12	32	16	18	21	17	12	11	12	12
Total expenditures and net lending	**1,454**	**1,541**	**1,529**	**1,689**	**1,974**	**1,863**	**2,027**	**1,984**	**2,124**	**2,194**	**1,972**	**2,065**	**2,162**
Total expenditures	1,451	1,537	1,539	1,685	1,977	1,859	2,029	1,986	2,123	2,193	1,971	2,064	2,161
Current expenditures	1,313	1,404	1,350	1,479	1,507	1,627	1,547	1,622	1,681	1,717	1,774	1,847	1,928
Gross salaries	365	365	381	384	394	421	409	429	430	437	459	479	500
Other personal income	13	15	14	20	15	15	15	16	17	17	18	19	20
Goods and services	201	115	115	163	127	161	124	148	151	147	152	165	178
Current maintenance	28	24	25	25	26	26	27	28	29	30	32	39	46
Interest payments	60	71	78	86	90	85	98	100	111	117	117	109	105
Rent	7	8	9	9	9	10	10	11	11	12	12	13	13
Subsidies to enterprises 2/	27	18	19	20	23	28	24	28	29	31	32	34	35
Other outflows 2/	9	27	28	37	36	41	37	39	49	42	44	46	48
Social security transfers	482	483	492	488	558	556	574	565	581	602	617	639	663
Other transfers	76	155	154	230	212	263	213	240	250	257	266	278	291
Repayment of guarantees	25	107	18	0	0	0	0	0	0	0	0	0	0
Reserves	22	16	16	19	16	21	17	19	23	24	25	26	28
Capital expenditures	138	132	189	205	470	232	482	364	442	476	198	217	233
Non-highway capital expenditures	138	132	189	135		132		131	172	190	198	217	233
Highway capital expenditures	0	0	0	71		100		233	271	286	0	0	0
Net lending	3	4	-10	4	-3	4	-3	-2	1	1	1	1	1
Overall Balance	**-186**	**-151**	**-24**	**-213**	**-352**	**-227**	**-357**	**-256**	**-234**	**-213**	**85**	**90**	**95**
Financing 3/	**186**	**151**	**24**	**213**	**352**	**227**	**357**	**256**	**234**	**213**	**-85**	**-90**	**-95**
Domestic financing	-19	-14	-85	-12	70	112	-17	-12	6	20	16	30	-39
Use of gov. deposits (- increase)	-13	22	-18	-7	61	23	-14	7	5	2	0	0	0
Net borrowing from other sources	-6	-37	-68	-5	9	89	-4	-19	1	18	16	30	-39
Disbursements	67	157	50	239	71	353	71	103	149	191	250	239	183
Amortization	-66	-120	-112	-247	-59	-241	-59	-82	-137	-169	-224	-210	-225
Repayment of other liabilities 4/	-7	-74	-5	3	-16	-24	-16	-40	-11	-4	-9	1	2
Foreign financing	198	139	98	215	-59	104	115	258	185	-29	-537	-363	-80
Disbursements	258	191	210	661	261	325	261	405	279	321	33	54	33
Amortization	-60	-53	-113	-322	-321	-310	-146	-146	-94	-409	-570	-417	-113
Change in foreign accounts receivable 5/				-124		89		0	0	59			
Privatization receipts	6	27	12	10	5	11	6	6	7	0	0	0	0
Unidentified	0	0	0	0	336	0	253	4	36	222	436	244	24
Discrepancy	0	0	0	0	0	0	0	0	0	0	0	0	0
Memorandum items:													
Primary balance	-126	-80	54	-127	-262	-142	-259	-156	-123	-96	203	199	201
Nonhighway primary balance	-126	-80	54	-56	…	-42	…	77	148	191	203	199	201
Nonhighway overall balance	-186	-151	-24	-142	-352	-127	-357	-23	37	73	85	90	95
Current balance	-66	-33	138	-23	74	-11	96	81	188	247	267	291	312

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

1/ Includes republican budget and local governments.

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

3/ Financing for the highway is included under foreign financing (including the ExIm loan as well as the remaining 15 percent); unidentified financing is a residual, including all remaining financing needs for which specific sources have not been identified yet--however this does not constitute a financing gap.

4/ Reflects the repayment of arrears and other liabilities from previous periods.

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

Table 7. Montenegro: Consolidated General Government Fiscal Operations, 2012–22 1/

(in percent of GDP)

	2012	2013	2014	2015	2016	2016	2017	2017	2018	2019	2020	2021	2022
					Last SR		Last SR			Projections			
Total revenues and grants	**39.9**	**41.3**	**43.5**	**40.7**	**42.2**	**43.3**	**41.9**	**43.5**	**45.1**	**45.2**	**45.1**	**45.0**	**44.9**
Total revenues	39.4	41.0	43.2	40.4	41.4	42.9	41.4	43.0	44.7	44.9	44.8	44.8	44.7
Current revenues	39.2	40.8	43.0	40.2	41.2	42.8	41.2	42.9	44.6	44.8	44.7	44.7	44.6
Taxes	24.7	25.7	27.5	25.5	25.7	26.8	25.7	27.9	29.3	29.5	29.5	29.5	29.4
Personal income tax	3.4	3.7	4.0	3.7	3.5	4.2	3.5	4.3	4.3	4.3	4.1	4.1	4.1
Corporate income tax	2.0	1.2	1.3	1.2	1.3	1.2	1.3	1.3	1.3	1.3	1.3	1.3	1.3
Taxes on turnover of real estate	0.5	0.4	0.4	0.4	0.8	0.4	0.8	0.3	0.3	0.3	0.3	0.3	0.3
Value added tax	11.1	12.8	14.4	12.6	13.1	13.3	13.1	13.6	14.7	14.7	14.7	14.7	14.7
Excises	4.8	4.8	4.5	4.7	4.4	4.8	4.4	5.4	5.7	6.0	6.1	6.1	6.1
Taxes on international trade	0.9	0.7	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	1.8	2.0	2.1	2.1	1.8	2.1	1.8	2.0	2.0	2.0	2.0	2.0	2.0
Other taxes	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.3	0.3	0.3	0.3	0.3	0.3
Social security contributions	10.0	10.6	11.6	10.8	11.5	11.0	11.5	11.4	11.5	11.4	11.4	11.4	11.4
Nontax revenues	4.5	4.5	4.0	3.8	4.0	4.9	4.0	3.6	3.8	3.8	3.8	3.8	3.8
Capital revenues	0.2	0.3	0.2	0.2	0.2	0.1	0.2	0.1	0.1	0.1	0.1	0.1	0.1
Grants	0.5	0.3	0.3	0.3	0.8	0.4	0.4	0.5	0.4	0.3	0.2	0.2	0.2
Total expenditures and net lending	**45.7**	**45.8**	**44.2**	**46.6**	**51.4**	**49.4**	**50.8**	**50.0**	**50.7**	**50.0**	**43.2**	**43.2**	**43.0**
Total expenditures	45.6	45.7	44.5	46.5	51.5	49.3	50.9	50.0	50.7	50.0	43.2	43.1	43.0
Current expenditures	41.3	41.8	39.0	40.8	39.2	43.1	38.8	40.9	40.1	39.2	38.9	38.6	38.4
Gross salaries	11.5	10.9	11.0	10.6	10.3	11.2	10.3	10.8	10.3	10.0	10.1	10.0	10.0
Other personal income	0.4	0.4	0.4	0.5	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Goods and services	6.3	3.4	3.3	4.5	3.3	4.3	3.1	3.7	3.6	3.4	3.3	3.4	3.6
Current maintenance	0.9	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.8	0.9
Interest payments	1.9	2.1	2.3	2.4	2.4	2.3	2.4	2.5	2.6	2.7	2.6	2.3	2.1
Rent	0.2	0.2	0.2	0.2	0.2	0.3	0.2	0.3	0.3	0.3	0.3	0.3	0.3
Subsidies to enterprises 2/	0.8	0.5	0.5	0.6	0.6	0.7	0.6	0.7	0.7	0.7	0.7	0.7	0.7
Other outflows 2/	0.3	0.8	0.8	1.0	0.9	1.1	0.9	1.0	1.2	1.0	1.0	1.0	1.0
Social security transfers	15.2	14.4	14.2	13.5	14.5	14.7	14.4	14.2	13.9	13.7	13.5	13.4	13.2
Other transfers	2.4	4.6	4.4	6.4	5.5	7.0	5.3	6.0	6.0	5.9	5.8	5.8	5.8
Repayment of guarantees	0.8	3.2	0.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Reserves	0.7	0.5	0.5	0.5	0.4	0.6	0.4	0.5	0.5	0.5	0.5	0.5	0.5
Capital expenditures	4.3	3.9	5.5	5.7	12.2	6.2	12.1	9.2	10.6	10.9	4.3	4.5	4.6
Non-highway capital expenditures	4.3	3.9	5.5	3.7	…	3.5	…	3.3	4.1	4.3	4.3	4.5	4.6
Highway capital expenditures	0.0	0.0	0.0	1.9	…	2.7	…	5.9	6.5	6.5	0.0	0.0	0.0
Net lending	0.1	0.1	-0.3	0.1	-0.1	0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Overall Balance	**-5.8**	**-4.5**	**-0.7**	**-5.9**	**-9.2**	**-6.0**	**-8.9**	**-6.4**	**-5.6**	**-4.9**	**1.9**	**1.9**	**1.9**
Financing 3/	**5.8**	**4.5**	**0.7**	**5.9**	**9.2**	**6.0**	**8.9**	**6.4**	**5.6**	**4.9**	**-1.9**	**-1.9**	**-1.9**
Domestic financing	-0.6	-0.4	-2.5	-0.3	1.8	3.0	-0.4	-0.3	0.1	0.5	0.4	0.6	-0.8
Use of gov. deposits (- increase)	-0.4	0.7	-0.5	-0.2	1.6	0.6	-0.3	0.2	0.1	0.0	0.0	0.0	0.0
Net borrowing from other sources	-0.2	-1.1	-2.0	-0.1	0.2	2.4	-0.1	-0.5	0.0	0.4	0.4	0.6	-0.8
Disbursements	2.1	4.7	1.4	6.6	1.8	9.4	1.8	2.6	3.6	4.4	5.5	5.0	3.6
Amortization	-2.1	-3.6	-3.2	-6.8	-1.5	-6.4	-1.5	-2.1	-3.3	-3.9	-4.9	-4.4	-4.5
Repayment of other liabilities 4/	-0.2	-2.2	-0.2	0.1	-0.4	-0.6	-0.4	-1.0	-0.3	-0.1	-0.2	0.0	0.0
Foreign financing	6.2	4.1	2.8	5.9	-1.5	2.8	2.9	6.5	4.4	-0.7	-11.8	-7.6	-1.6
Disbursements	8.1	5.7	6.1	18.2	6.8	8.6	6.5	10.2	6.7	7.3	0.7	1.1	0.7
Amortization	-1.9	-1.6	-3.3	-8.9	-8.4	-8.2	-3.7	-3.7	-2.2	-9.3	-12.5	-8.7	-2.2
Change in foreign accounts receivable /5				-3.4		2.4		0.0	0.0	1.3			
Privatization receipts	0.2	0.8	0.3	0.3	0.1	0.3	0.2	0.2	0.2	0.0	0.0	0.0	0.0
Unidentified	0.0	0.0	0.0	0.0	8.8	0.0	6.3	0.1	0.9	5.1	9.6	5.1	0.5
Discrepancy	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:													
Primary balance	-4.0	-2.4	1.6	-3.5	-6.8	-3.8	-6.5	-3.9	-2.9	-2.2	4.4	4.2	4.0
Nonhighway primary balance	-4.0	-2.4	1.6	-1.6	…	-1.1	…	1.9	3.5	4.3	4.4	4.2	4.0
Nonhighway overall balance	-5.8	-4.5	-0.7	-3.9	…	-3.4	…	-0.6	0.9	1.7	1.9	1.9	1.9
Current balance	-2.1	-1.0	4.0	-0.6	1.9	-0.3	2.4	2.0	4.5	5.6	5.9	6.1	6.2
General government debt (gross)	56.9	58.7	63.4	69.3	70.5	70.0	77.1	71.6	73.6	74.1	69.5	64.4	59.7
Gen. govt debt, including guarantees	68.4	66.7	71.5	76.8	84.1	78.0	90.2	79.3	81.0	81.1	76.2	70.8	65.8

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

1/ Includes republican budget and local governments.

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

3/ Financing for the highway is included under foreign financing (including the ExIm loan as well as the remaining 15 percent); unidentified financing is a residual, including all remaining financing needs for which specific sources have not been identified yet--however this does not constitute a financing gap.

4/ Reflects the repayment of arrears and other liabilities from previous periods.

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

Table 8. Montenegro: Summary of Accounts of the Financial System, 2012–17 1/
(Millions of Euros)

	2012	2013	2014	2015	2016 Last SR	2016	2017 Last SR	2017 Proj.
I. Central Bank								
Net foreign assets	318	395	514	641	675	780	738	815
Assets	348	424	545	674	708	803	771	838
Liabilities	30	29	31	33	33	23	33	23
Net domestic assets	-227	-297	-408	-525	-553	-651	-611	-679
Net credit to the nonfinancial public sector	-24	-12	-25	-30	-30	-31	-30	-31
Of which: general government	-24	-12	-25	-30	-30	-31	-30	-31
Net credit to the banking system	-237	-319	-416	-525	-564	-654	-596	-646
Required reserves	-129	-150	-171	-196	-210	-226	-217	-193
Giro account	-108	-169	-245	-329	-354	-427	-379	-452
Claims on depository institutions	-1	-1	0	0	0	-1	0	-1
Other assets net	34	34	33	31	41	34	16	-3
Deposits included in broad money	31	39	46	55	58	65	60	69
Equity	60	59	60	61	65	64	67	67
II. Banking System								
Net foreign assets	-156	-162	-74	-152	-161	-290	-160	-301
Assets	543	561	613	591	615	527	640	610
Liabilities	700	723	687	743	776	818	800	910
Net domestic assets	2,034	2,172	2,176	2,365	2,501	2,627	2,597	2,746
Net assets held in the central bank	236	318	415	524	563	653	596	645
Net credit to nonfinancial public sector	16	33	-59	-25	241	-9	240	-23
Of which: general government	62	129	94	173	241	281	240	269
Credit to the private sector	1,744	1,777	1,770	1,810	1,860	1,926	1,923	2,070
Other domestic assets	38	43	49	56	-163	57	-163	53
Liabilities	1,878	2,010	2,103	2,213	2,340	2,336	2,437	2,447
Private sector deposits	1,462	1,481	1,571	1,712	1,834	1,813	1,898	1,935
Other items, net	415	529	531	501	506	523	538	512
o/w capital	289	390	441	465	515	497	536	531
III. Consolidated System								
Net foreign assets	161	233	440	489	514	490	578	515
Net domestic assets	1,807	1,875	1,768	1,840	1,948	1,976	1,986	2,067
Net credit to the nonfinancial public sector	-9	21	-84	-56	211	-40	210	-53
Of which: general government	37	117	68	142	211	250	210	238
Credit to the private sector	1,744	1,777	1,770	1,810	1,860	1,926	1,923	2,070
Other net domestic assets	72	76	82	86	-122	90	-147	50
Liabilities	1,908	2,049	2,148	2,268	2,398	2,402	2,497	2,516
Equity capital of the central bank	60	59	60	61	65	64	67	67
IV. Ratios								
Net assets held in CBCG/Deposits	16.2	21.5	26.4	30.6	30.7	36.0	31.4	33.3
Effective required reserves ratio	8.8	10.1	10.9	11.4	11.4	12.5	11.4	10.0
Credit to private sector / GDP	54.8	52.9	51.2	49.9	48.4	51.1	48.2	52.1
Banks' capital / credit to private sector	16.6	21.9	24.9	25.7	27.7	25.8	27.9	25.6
CBCG reserves / bank deposits	23.8	28.6	34.7	39.4	38.6	44.3	40.6	43.3
Banks' foreign liabilities / credit to private sector	40.1	40.7	38.8	41.1	40.0	42.5	40.0	44.0
Memo item:								
Broad money	1,614.3	1,697.8	1,851.6	2,052.9	…	2,248.7	…	2,515.6
BM growth	8.4	5.2	9.1	10.9	…	9.5	…	11.9

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

Table 9. Montenegro: Balance of Payments, 2012–22

(Under current policies)

	2012	2013	2014	2015	2016	2016	2017	2017	2018	2019	2020	2021	2022
					Last SR	Prelim.	Last SR	Projections					
						(Millions of euros)							
Current account balance	-588	-487	-526	-483	-715	-715	-762	-802	-889	-866	-625	-674	-706
Trade balance	-1,384	-1,329	-1,376	-1,464	-1,662	-1,657	-1,763	-1,791	-1,925	-1,956	-1,790	-1,902	-2,004
Exports	388	396	357	325	331	345	342	381	398	418	437	459	483
Imports	-1,772	-1,724	-1,734	-1,789	-1,993	-2,003	-2,105	-2,172	-2,323	-2,375	-2,227	-2,361	-2,487
Services account	613	653	690	789	772	769	819	804	846	898	967	1,021	1,083
Receipts	951	994	1,031	1,214	1,198	1,255	1,264	1,321	1,394	1,467	1,536	1,620	1,713
Expenditures	-338	-341	-340	-425	-426	-486	-445	-517	-548	-569	-569	-599	-630
Income account	54	66	46	93	62	53	64	56	59	61	64	67	70
Compensation of employees, net	174	185	194	214	219	224	228	236	249	261	271	284	299
Investment income, net	-120	-120	-148	-122	-157	-171	-163	-180	-190	-199	-207	-217	-228
Current transfers, net	130	123	114	99	113	120	118	130	131	131	134	139	145
Government, net	18	22	24	4	13	24	13	29	25	19	18	18	17
Other sectors (remittances), net	112	101	90	95	100	96	104	101	106	111	116	122	128
Capital and financial account	534	464	399	464	124	651	300	649	694	475	13	244	483
Foreign direct investment, net	462	324	354	619	460	372	490	409	435	456	477	495	514
Portfolio investment, net	-25	42	84	112	-135	-19	-140	-41	-43	-325	-547	-349	-64
General government	-1	82	149	217	...	74	...	0	0	-280	-500	-300	-12
Amortization	0	0	13	187	...	180	...	0	0	280	500	300	12
Disbursements	0	0	280	500	...	300	...	0	0	0	0	0	0
Other investment, net	89	95	-40	-267	-201	298	-49	281	302	344	82	98	32
Public sector	203	-43	-34	113	-59	-37	115	258	185	251	-37	-87	-68
General government	203	-43	-34	113	-59	-37	115	258	185	251	-37	-87	-68
Amortization	60	53	100	135	321	130	146	146	94	129	70	117	101
Disbursements	258	191	-70	161	263	25	261	405	279	321	33	54	33
Change in foreign accounts receivable 3/	0	0	0	-124	...	89	...	0	0	59	0	-24	0
Commercial banks	-192	71	-62	36	8	151	-1	10	10	11	11	11	11
Other sectors	78	68	57	-416	-151	184	-163	12	107	83	109	174	90
Errors and omissions	99	100	246	144	289	224	271	184	194	204	212	222	233
Unidentified financing 1/	0	0	0	0	336	0	253	4	36	222	436	244	24
Change in official reserves (- denotes increase)	-45	-77	-118	-126	-35	-161	-63	-35	-35	-35	-35	-35	-35
Memorandum items					(percent of GDP)								
Current account balance	-18.5	-14.5	-15.2	-13.3	-18.6	-19.0	-19.1	-20.2	-21.2	-19.7	-13.7	-14.1	-14.0
Trade balance	-43.5	-39.5	-39.8	-40.4	-43.3	-43.9	-44.2	-45.1	-46.0	-44.6	-39.2	-39.7	-39.9
Exports	12.2	11.8	10.3	9.0	8.6	9.2	8.6	9.6	9.5	9.5	9.6	9.6	9.6
Imports	-55.7	-51.3	-50.1	-49.3	-51.9	-53.1	-52.8	-54.7	-55.5	-54.2	-48.8	-49.3	-49.5
Services account	19.3	19.4	20.0	21.8	20.1	20.4	20.5	20.2	20.2	20.5	21.2	21.3	21.5
Receipts	29.9	29.6	29.8	33.5	31.2	33.3	31.7	33.3	33.3	33.5	33.7	33.9	34.1
Payments	-10.6	-10.1	-9.8	-11.7	-11.1	-12.9	-11.2	-13.0	-13.1	-13.0	-12.5	-12.5	-12.5
Income account	1.7	1.9	1.3	2.6	1.6	1.4	1.6	1.4	1.4	1.4	1.4	1.4	1.4
Current transfers, net	4.1	3.7	3.3	2.7	2.9	3.2	2.9	3.3	3.1	3.0	2.9	2.9	2.9
Foreign direct investment, net	14.5	9.6	10.2	17.1	12.0	9.8	12.3	10.3	10.4	10.4	10.5	10.3	10.2
Portfolio investment, net	-0.8	1.2	2.4	3.1	-3.5	-0.5	-3.5	-1.0	-1.0	-7.4	-12.0	-7.3	-1.3
Other investment, net	2.8	2.8	-1.1	-7.4	-5.2	7.9	-1.2	7.1	7.2	7.8	1.8	2.0	0.6
General government	6.4	-1.3	-1.0	3.1	-1.5	-1.0	2.9	6.5	4.4	5.7	-0.8	-1.8	-1.4
Other sectors	2.4	2.0	1.7	-11.5	-3.9	4.9	-4.1	0.3	2.5	1.9	2.4	3.6	1.8
Errors and omissions	3.1	3.0	7.1	4.0	7.5	5.9	6.8	4.6	4.6	4.6	4.6	4.6	4.6
Gross external debt 2/	155.9	153.5	163.1	163.1	154.8	166.8	161.4	169.8	173.5	174.5	171.6	168.5	164.8
of which: Government	40.7	40.2	47.6	56.1	61.5	55.3	68.5	59.7	62.7	63.1	58.4	53.2	49.5
Real goods import growth	-1.4	-1.3	2.0	6.5	12.8	12.4	3.6	5.1	6.0	0.9	-7.1	4.4	3.7
Real goods export growth	-15.1	4.9	-10.2	-10.3	-0.2	6.7	3.6	5.4	3.4	3.4	2.8	3.1	3.4
Real service export growth	2.6	3.2	3.2	17.7	...	3.1	...	3.7	4.0	3.5	2.8	3.6	3.8

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

1/ Unidentified financing is a residual, including all remaining financing needs for which specific sources have not been identified yet--however this does not constitute a financing gap.

2/ This includes only estimates of private external debt as private debt statistics are not officially published. There is also a series break in 2014 (equal to approximately 2 p.p. of GDP due to the lack of availability of local government external debt data before 2014.

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

Table 10. Montenegro: Financial Soundness Indicators of the Banking Sector, 2010-17

	2010	2011	2012	2013	2014	2015	2016				2017	
	Dec	Dec	Dec	Dec	Dec	Dec	Mar	Jun	Sep	Dec	Mar	Jun
Capital adequacy												
Regulatory capital as percent of risk-weighted assets	15.9	16.5	14.7	14.4	16.2	15.5	15.7	16.7	16.3	16.1	15.9	16.6
Capital as percent of assets	10.6	10.9	10.3	13.4	14.2	13.3	13.6	13.9	13.4	12.9	13.1	12.9
Asset composition and quality												
Distribution of bank credit by borrower												
Central government, local government, government agencies	2.1	4.9	4.8	6.7	5.2	4.6	4.4	4.6	4.5	5.3	7.0	7.1
Funds	0.1	0.5	0.2	0.0	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.0
State-owned companies	2.7	2.8	3.1	2.1	1.8	1.7	1.9	1.7	1.4	1.3	1.3	1.1
Private companies, entrepreneurs	54.8	47.7	47.6	35.7	34.9	36.5	37.2	39.2	35.0	37.9	37.3	36.7
Banks	0.0	0.0	0.0	15.8	16.7	15.5	14.1	11.0	16.7	10.6	10.1	11.2
Financial Institutions	0.4	0.5	0.1	0.2	0.4	0.4	0.5	0.4	0.4	0.5	0.4	0.4
Citizens	37.1	40.5	41.3	35.6	37.2	37.8	38.7	40.0	39.2	41.6	41.2	41.0
Credit cards	2.2	2.1	2.1	1.4	1.2	1.0	0.9	0.8	0.7	0.7	0.7	0.7
Other	0.6	0.9	0.8	2.6	2.6	2.5	2.3	2.2	2.0	2.0	2.0	1.7
Distribution of bank credit by sectoral economic activity												
Agriculture, hunting, fishing	0.4	1.2	1.6	1.5	1.6	2.0	1.6	1.4	1.4	1.3	1.2	1.4
Mining and energy	2.5	1.8	1.9	2.0	1.3	1.5	1.3	1.2	1.3	1.3	1.2	1.1
Civil engineering	8.1	6.7	6.6	4.9	5.5	6.4	7.2	7.0	7.2	7.2	7.5	7.2
Trade	22.9	20.7	19.7	19.0	20.1	18.5	17.9	17.9	16.0	15.5	15.8	15.1
Services, tourism	7.4	6.1	6.8	4.0	4.3	5.6	5.9	6.0	6.1	7.1	7.2	7.5
Transport, warehousing, communications	3.0	3.1	3.0	3.6	3.1	3.7	3.3	3.8	3.2	2.8	2.7	2.5
Finance	1.7	2.7	2.2	2.1	0.8	1.0	1.0	0.8	0.9	0.9	0.9	1.2
Real estate trading	3.0	2.3	2.3	1.5	1.3	1.0	1.0	0.9	0.9	1.1	0.8	1.2
Administration, other public services	3.1	4.3	4.2	12.0	10.2	8.7	8.9	9.0	8.8	9.4	11.1	11.2
Consumer loans	39.3	42.6	43.4	44.5	47.3	47.5	47.7	47.6	49.7	49.3	47.9	48.1
Other	9.0	8.4	8.4	5.0	4.5	4.2	4.2	4.3	4.5	4.1	3.8	3.4
Asset quality												
Non-performing loans (NPL), in percent of gross loans	21.0	15.5	17.6	18.4	16.8	13.4	12.9	12.6	11.0	11.1	10.7	9.5
Provisions, in percent of NPL	30.7	32.8	40.2	44.7	45.6	48.3	49.7	50.5	50.6	55.5	54.6	58.8
Provisions, in percent of total loans	6.4	5.1	7.1	8.2	7.6	6.5	6.4	6.4	5.6	6.2	5.9	5.6
NPL net of provisions, in percent of capital	102.8	66.9	68.0	62.4	49.3	36.3	33.1	30.8	27.3	24.8	24.8	20.5
Earnings and profitability												
Gross profits, in percent of average assets (ROAA)	-2.7	-0.1	-2.0	0.1	0.8	-0.1	0.8	0.9	0.9	0.3	0.9	0.9
Gross profits, in percent of average equity capital (ROAE)	-27.0	-0.6	-18.1	0.9	5.7	-0.5	6.0	6.4	6.9	1.9	6.7	6.9
Net profits, in percent of average assets (ROAA)	-2.8	-0.1	-2.0	0.1	0.8	-0.1	0.8	0.8	0.9	0.2	0.8	0.8
Net profits, in percent of average capital (ROAE)	-27.3	-1.1	-18.3	0.5	5.4	-0.9	5.7	6.1	6.6	1.5	6.4	6.5
Net interest margin 1/	4.9	4.8	5.0	4.3	4.5	4.5	1.1	2.2	3.4	4.3	1.0	2.0
Gross income, in percent of average assets	5.4	5.2	5.2	5.2	5.2	10.1	4.6	4.8	4.7	4.7	1.2	2.3
Net interest income, in percent of gross income	71.6	70.5	73.1	68.2	72.4	70.4	76.0	72.7	72.9	72.6	70.8	71.7
Non-interest income, in percent of gross income	28.4	29.5	26.9	31.8	27.7	29.6	24.0	27.3	27.1	27.4	29.2	28.3
Net fee income, in percent of net interest income	30.3	28.6	24.2	32.5	31.5	30.9	26.2	28.8	29.7	30.2	27.5	29.5
Trading income, in percent of gross income	6.7	9.4	9.2	9.7	4.9	7.9	4.1	6.3	5.5	5.4	9.7	7.1
Aggregate overhead expenses, in percent of gross income	64.0	70.7	77.7	69.1	71.0	69.9	70.4	68.6	68.8	70.3	67.6	68.2
Non-interest expenses to gross income	75.0	85.6	96.5	86.2	90.1	90.0	91.6	89.0	90.7	98.7	98.5	98.0
Liquidity												
Liquid assets, in percent of total assets	19.1	19.9	24.0	20.0	22.2	24.8	21.9	22.6	26.8	24.5	20.3	21.2
Liquid assets, in percent of short-term liabilities	32.9	32.8	40.1	32.2	35.7	40.1	32.8	34.4	38.6	34.8	29.0	29.9
Deposits, in percent of assets	60.8	64.7	70.5	71.6	74.2	76.1	76.4	75.3	76.7	76.1	75.6	75.2
Loans, in percent of deposits	122.9	107.6	94.0	105.8	95.1	85.4	85.6	85.2	83.4	79.3	82.9	84.6
Sensitivity to market risk												
Off-balance sheet operations, in percent of assets	429.5	464.0	370.5	319.7	293.1	274.0	270.2	223.0	211.1	202.6	205.0	198.1
Original maturity of assets (in percent of total)												
Less than 3 months	34.4	21.5	32.1	38.7	43.2	42.8	37.7	38.1	40.3	39.9	35.8	36.7
3 months to 1 year	17.2	28.2	23.4	16.6	16.0	13.6	16.5	16.4	13.8	13.1	14.5	13.7
1 to 5 years	33.6	35.4	31.5	31.6	28.9	31.1	31.3	32.7	33.1	33.9	36.4	36.1
Over 5 years	14.8	14.9	13.0	13.1	12.0	12.5	14.5	12.9	12.9	13.1	13.3	13.5
Original maturity of liabilities (in percent of total)												
Less than 3 months	38.5	21.9	31.3	40.4	38.9	33.1	39.4	36.9	47.5	55.0	59.9	60.3
3 months to 1 year	27.1	47.1	27.9	31.7	34.0	38.7	38.5	40.0	33.2	26.3	21.1	21.7
1 to 5 years	24.4	23.4	23.8	22.9	21.3	22.0	18.4	18.9	15.4	14.6	14.8	14.1
Over 5 years	10.0	7.7	4.3	5.0	5.7	6.2	3.7	4.2	3.9	4.0	4.2	4.0

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. **Structurally weak growth in key advanced economies**	**High** Low productivity growth (U.S., the Euro Area, and Japan), a failure to fully address crisis legacies and undertake structural reforms, and persistently low inflation (the Euro Area, and Japan) undermine medium-term growth in advanced economies.	**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). Further "low-flation" could be imported from the euro area which, if protracted, would adversely impact debt dynamics, consumption, and bank profitability.	• Let automatic fiscal stabilizers work, within limited fiscal space. • Accelerate structural reforms to increase competitiveness and reduce structural bottlenecks that impede credit to the private sector.
2. **Financial conditions: tighter global financial conditions**	**High** Fed normalization and tapering by ECB increase global rates and term premia, strengthen the U.S. dollar and the euro vis-à-vis the other currencies, and correct market valuations. Adjustments could be disruptive if there are policy surprises. Higher debt service and refinancing risks could stress leveraged firms, households, and vulnerable sovereigns, including through capital account pressures in some cases.	**High** Montenegro is highly reliant on external financing. Gross public financing needs average 15 percent of GDP during the next five years, with large Eurobond rollover needs in 2019–21.	• Let automatic fiscal stabilizers work, within limited fiscal space. • Continue to implement the medium-term fiscal consolidation plan that puts debt on a strongly downward trajectory.
3. **Intensification of the risks of fragmentation/security dislocation in part of the Middle East, Africa, Asia, and Europe,** leading to socio-economic disruptions.	**High** Intensifying conflicts in the Middle East increased the number of terrorist attacks on European soil and refugee flows into Europe. Heightened security concerns may weaken confidence and disrupt socio-economic activities. The lack of a common cooperative policy to deal with asylum seekers to the European Union (EU) could	**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 to absorb shocks.	• Let automatic fiscal stabilizers work, within limited fiscal space. • Speed up structural reforms to improve the business environment and competitiveness. • Accelerate structural reform and policies to facilitate the resolution of problem loans and encourage

[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
	stop the relocation of refugees within the Union, triggering domino effects by increasing processing times and restricting the free movement of goods, services, and labor across the single market. Limited integration of asylum seekers into the labor force could raise unemployment rates, put pressure on national budgets, and put social cohesion at risk. The failure to collectively address the refugee surge could further raise euroskepticism.		a revitalization of bank lending.
4. **Insufficient fiscal discipline**	**High** The authorities do not have a strong track record concerning fiscal consolidation. The highway is a source of fiscal pressures. 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 and increasing public debt, a loss of fiscal discipline could lead to financing difficulties and potentially result in debt distress.	• Sustain medium-term fiscal consolidation plans; reduce public wage and pension spending over time, strengthen tax administration, and reduce tax exemptions. Improve public communication regarding the need for fiscal adjustment.
5. **Delays and withdrawals from capital investment projects**	**Medium** Ongoing geopolitical tensions, weak administrative procedures on land development, and concerns regarding public 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.	• Put in place a credible strategy to safeguard fiscal sustainability and implement structural reforms to improve the business environment and strengthen anti-corruption and AML/CFT frameworks.
6. **Supervisory action plans fail to improve the banks with qualified audit reports**	**Low** Inability of weak banks to comply with minimum supervisory requirements and with required capital increases.	**High** Could negatively affect the perceptions of the system's stability.	• Steadfastly implement agreed supervisory action plans. Require shareholders to contribute additional capital. Adjust action plans as needed.

Annex II. Public Debt Sustainability Analysis

Debt is sustainable under the baseline if the authorities implement their fiscal strategy, but sustainability and financing risks remain significant. General government debt (including guarantees) increased from 36 percent of GDP in 2006 to 78 percent of GDP in 2016. In the baseline, debt is projected to rise to 81 percent of GDP in 2019 before falling to 66 percent of GDP in 2022, based on front-loaded fiscal adjustment measures and the end of highway spending that will improve the fiscal deficit substantially by 2020. The projected debt trajectory is highly susceptible to shocks, especially a negative economic growth shock. Gross financing needs are very high, a particular concern as Montenegro is highly dependent on external financing. Under the baseline scenario, in which the authorities fully implement their fiscal adjustment plan, debt begins a strong downward trend in 2020, but the authorities would still have to manage finances carefully to maintain market access.

1. 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 7.9 percent of GDP in 2016.[1] A key driver of the increase in public debt since 2014 has been an external loan to fund construction of the Bar-Boljare highway. Denominated in U.S. dollars, this loan is projected to increase the foreign currency share of public debt to 24 percent by 2020 from 7 percent in 2016.

- **Macroeconomic assumptions**. Growth is projected to increase to 3 percent in 2017, slightly above average growth in 2015–16, as the acceleration of highway construction is partially offset by fiscal adjustment measures.[2] Growth is projected to slow marginally to 2¾ percent in 2018–19 as fiscal adjustment gains steam, but with still-strong highway spending. Growth would then slow in 2020 as the demand stimulus from the highway is withdrawn. Highway expenditures are assumed to add almost 2 percentage points to non-highway GDP over 2015 to 2019, considering a highway-spending multiplier of 0.2 during the construction phase. Over the medium term, growth is expected to reach 3 percent, receiving a modest boost from supply effects related to the completed highway section.

- **Fiscal scenario.** Staff's baseline projections assume a fiscal adjustment of 2 percentage points of GDP in 2017 and the full implementation over 2017–20 of the additional measures outlined in the authorities' fiscal adjustment strategy, which entail and additional fiscal adjustment of 2¼ percent of GDP in the non-highway budget. These adjustment measures

[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 7.9 percent of GDP in 2016. Data on public enterprise debt is not available.

[2] The impact of the highway on growth is explained in more detail in Appendix I and the SIP.

and the path of highway spending explain the surge and fall in the primary deficit over 2015–20. Staff projects that the authorities' fiscal consolidation plan, if fully implemented, will result in a primary surplus of 4½ percent of GDP in 2020, when the primary balance will adjust sharply upward due to the completion of the first phase of the highway.

- **Heat map and debt profile vulnerabilities.** Risks from the debt level are deemed high as debt exceeded the 70 percent of GDP benchmark for the first time in 2014. Debt stays above the benchmark in the baseline projections (except for 2022) and expands substantially under several shock scenarios. Gross financing needs remain above the 15 percent benchmark (except 2018 and 2022), which constitutes a major vulnerability, particularly as Eurobond financing has become more expensive. Public debt held by non-residents (mostly Eurobonds and the Chinese ExIm loan) also constitutes a vulnerability. Growth shocks have a very large impact on the debt profile.

- **Realism of baseline assumptions.** The median forecast errors for real GDP growth and inflation (actual minus projection) in 2007–2015 suggest 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 in line with outcomes on average. With a large projected adjustment in the cyclically-adjusted primary balance, the key risks are high dependence on external financing and vulnerability to macro shocks. However, the projected adjustment in the primary balance of 8.2 percent of GDP over 2016-20 includes the reduction in highway spending; the primary balance without the highway adjusts by 5½ percentage points.

2. Shocks and 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 Phase 2-3.** In this scenario, the authorities decide to proceed with the debt-financed construction of the second and third phase of the Bar-Boljare highway, which staff assumes would cost €1.2 billion, equally spent over 2020–22. Assuming a spending multiplier of 0.2 during the construction phase and modest supply effects upon completion (the same assumptions as for the first phase), economic growth would increase ¾ percentage point on average in 2020–22 relative to the baseline. In this scenario, the primary balance declines in line with highway spending, and the public debt ratio increases to 88 percent of GDP by 2022 (compared to 66 percent in the baseline). Gross financing needs peak at 29 percent of GDP in 2020, 9 percentage points higher than in the baseline. This demonstrates that the authorities cannot afford to take on new debt to complete the second and third phase of the highway over the medium term.

3. Standard stress tests

- **Growth shock.** Under this scenario, real output growth rates are lowered during 2018 and 2019 by one standard deviation (4.5 percentage points), also lowering inflation and raising interest rates. The public debt ratio increases peaks at 99 percent of GDP in 2019 before falling to 84 percent of GDP in 2022, while the gross financing needs ratio in 2019 increases 9 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 200 basis points (in addition to the baseline assumption of 100 bps) in 2018–22. Debt increases by 3 percentage points in 2022 in this scenario relative to the baseline, while financing needs are affected only marginally.

- **Combined macro shock.** This scenario comprises a recession in 2018 and 2019, a 200 basis-point increase in interest rates, a real exchange rate shock, and a sharp rise in expenditures. It pushes the debt to GDP ratio up by 22 percentage points to 88 percent of GDP by 2022 and substantially impacts gross financing needs.

- **Financial contingent liability shock.** Expenditures increase in 2018 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 by 17 percentage points to 83 percent of GDP by 2022. Meanwhile, gross financing needs would peak at 27 percent of GDP in 2019 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 greater than two percentage point deterioration in the primary balance in 2019 and 2020. The combined shocks lead to deterioration in the debt ratio by about 5 percent of GDP by 2022, while the impact on gross financing needs peaks at 3 percentage points of GDP in 2019.

- **Real exchange rate shock.** The scenario assumes a 13 percent depreciation of the real exchange rate in 2018. The Chinese ExIm loan would be issued piecemeal over the course of highway construction. The debt ratio would fall by 2 percent of GDP from the baseline by 2020, based on a larger GDP deflator, with the impact depending critically on the extent of exchange rate pass-through to inflation.

Montenegro: Public Sector Debt Sustainability Analysis (DSA) - Baseline Scenario

(in percent of GDP unless otherwise indicated)

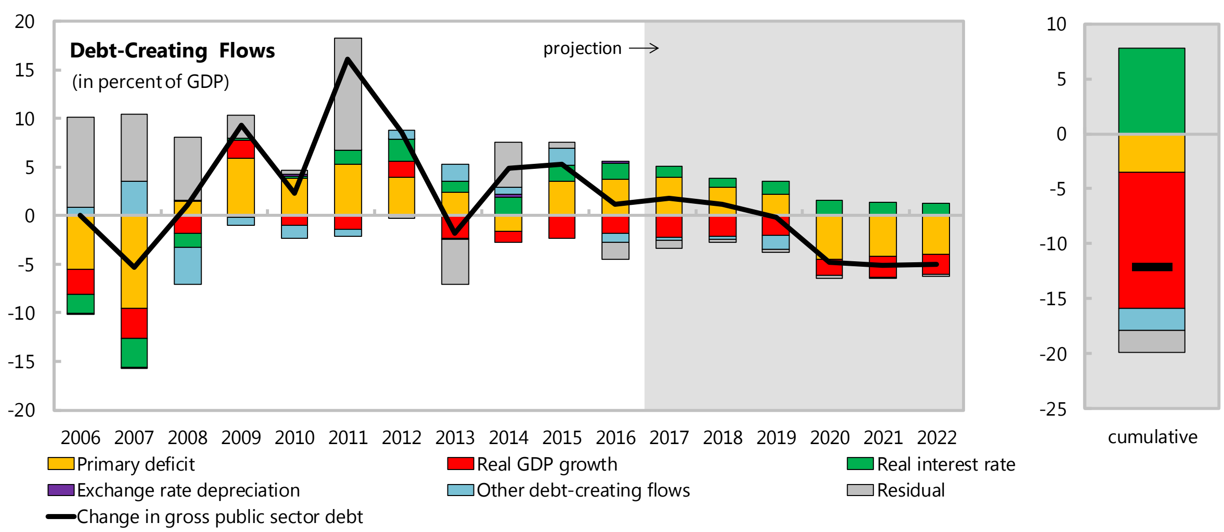
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2006-2014 [2/]	2015	2016	2017	2018	2019	2020	2021	2022
Nominal gross public debt	50.1	76.8	78.0	79.7	80.9	80.7	75.9	70.8	65.9
Of which: guarantees	6.6	7.5	7.9	7.7	7.3	7.0	6.7	6.4	6.1
Public gross financing needs	4.5	14.0	21.5	16.6	14.7	22.1	20.4	16.6	11.1
Real GDP growth (in percent)	3.2	3.4	2.5	3.0	2.8	2.7	2.2	3.0	3.1
Inflation (GDP deflator, in percent)	4.3	1.4	1.6	2.2	2.6	2.0	1.7	1.8	1.9
Nominal GDP growth (in percent)	7.8	4.8	4.1	5.2	5.5	4.7	4.0	4.9	5.1
Effective interest rate (in percent) [4/]	3.6	3.9	3.4	3.8	3.9	3.9	3.9	3.8	3.9

As of June 26, 2017		
Sovereign Spreads		
EMBIG (bp) 3/	380	
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							
	2006-2014	2015	2016	2017	2018	2019	2020	2021	2022	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	3.9	5.3	1.2	1.8	1.2	-0.2	-4.8	-5.1	-5.0	-12.1	
Identified debt-creating flows	-0.2	4.7	2.9	2.6	1.5	0.2	-4.6	-5.0	-4.8	-10.1	
Primary deficit	0.7	3.5	3.8	3.9	2.9	2.2	-4.4	-4.2	-4.0	-3.5	-0.8
Primary (noninterest) revenue and gra	44.3	40.7	43.3	43.5	45.1	45.2	45.1	45.0	44.9	268.9	
Primary (noninterest) expenditure	45.0	44.2	47.1	47.5	48.1	47.4	40.7	40.9	40.9	265.3	
Automatic debt dynamics [5/]	-1.0	-0.6	0.0	-1.0	-1.2	-0.6	-0.1	-0.8	-0.8	-4.6	
Interest rate/growth differential [6/]	-1.0	-0.6	-0.2	-1.0	-1.2	-0.6	-0.1	-0.8	-0.8	-4.6	
Of which: real interest rate	0.1	1.7	1.7	1.2	0.9	1.4	1.6	1.4	1.3	7.8	
Of which: real GDP growth	-1.1	-2.3	-1.8	-2.2	-2.1	-2.1	-1.7	-2.2	-2.1	-12.3	
Exchange rate depreciation [7/]	0.0	0.0	0.2	...	...	...	...	...	...	...	
Other identified debt-creating flows	0.1	1.8	-0.9	-0.3	-0.3	-1.4	0.0	0.0	0.0	-2.0	
Privatization and deposits (negative)	-0.5	1.8	-0.9	-0.3	-0.3	0.0	0.0	0.0	0.0	-0.7	
Contingent liabilities	0.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Use of foreign account receivable	0.0	0.0	0.0	0.0	0.0	-1.3	0.0	0.0	0.0	-1.3	
Residual, including asset changes [8/]	4.1	0.6	-1.7	-0.8	-0.3	-0.3	-0.2	-0.2	-0.2	-2.0	



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 - π(1+g) - g + ae(1+r)]/(1+g+π+gπ)) 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).

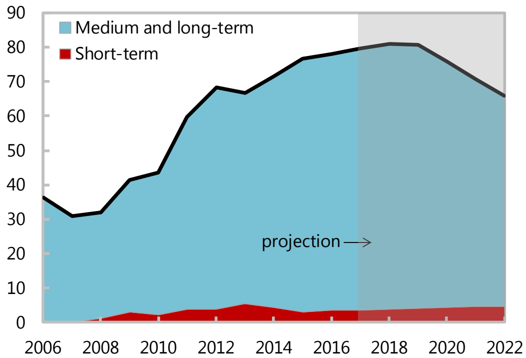
8/ Includes changes in the stock of guarantees, asset changes, and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

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.

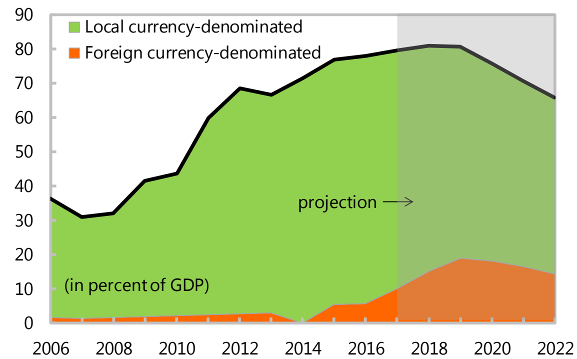
Montenegro: Public DSA - Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(in percent of GDP)



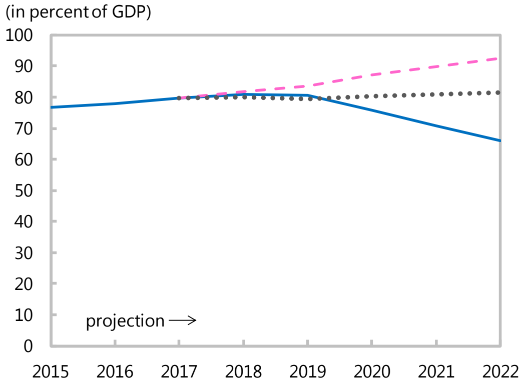
By Currency
(in percent of GDP)



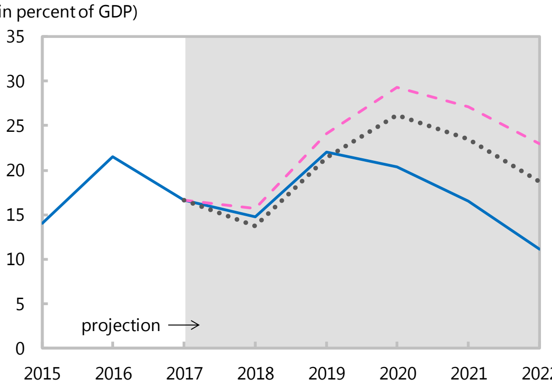
Alternative Scenarios

Baseline   Historical   Constant Primary Balance

Gross Nominal Public Debt
(in percent of GDP)



Public Gross Financing Needs
(in percent of GDP)



Underlying Assumptions
(in percent)

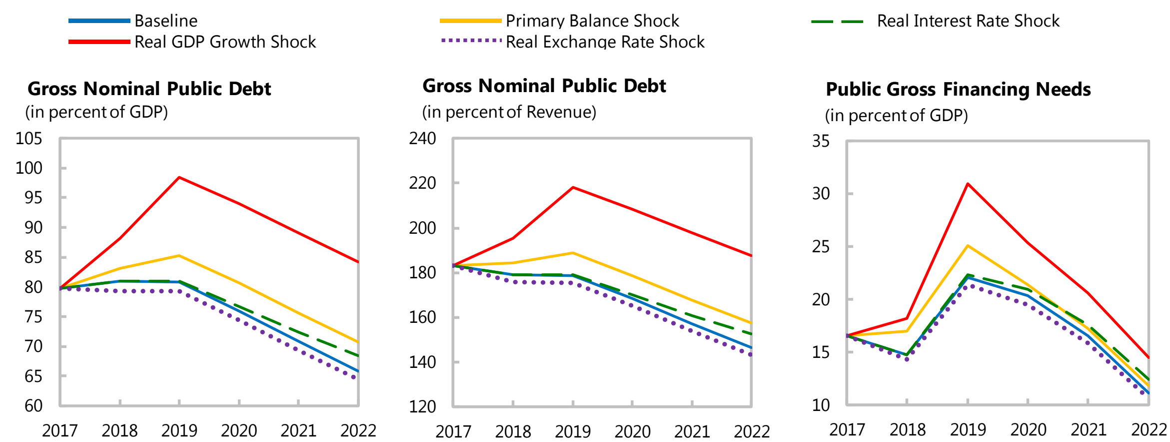
Baseline Scenario	2017	2018	2019	2020	2021	2022
Real GDP growth	3.0	2.8	2.7	2.2	3.0	3.1
Inflation	2.2	2.6	2.0	1.7	1.8	1.9
Primary Balance	-3.9	-2.9	-2.2	4.4	4.2	4.0
Effective interest rate	3.8	3.9	3.9	3.9	3.8	3.9
Constant Primary Balance Scenario						
Real GDP growth	3.0	2.8	2.7	2.2	3.0	3.1
Inflation	2.2	2.6	2.0	1.7	1.8	1.9
Primary Balance	-3.9	-3.9	-3.9	-3.9	-3.9	-3.9
Effective interest rate	3.8	3.9	3.9	3.8	3.8	3.9

Historical Scenario	2017	2018	2019	2020	2021	2022
Real GDP growth	3.0	2.6	2.6	2.6	2.6	2.6
Inflation	2.2	2.6	2.0	1.7	1.8	1.9
Primary Balance	-3.9	-1.9	-1.9	-1.9	-1.9	-1.9
Effective interest rate	3.8	3.9	3.7	3.4	3.0	2.8

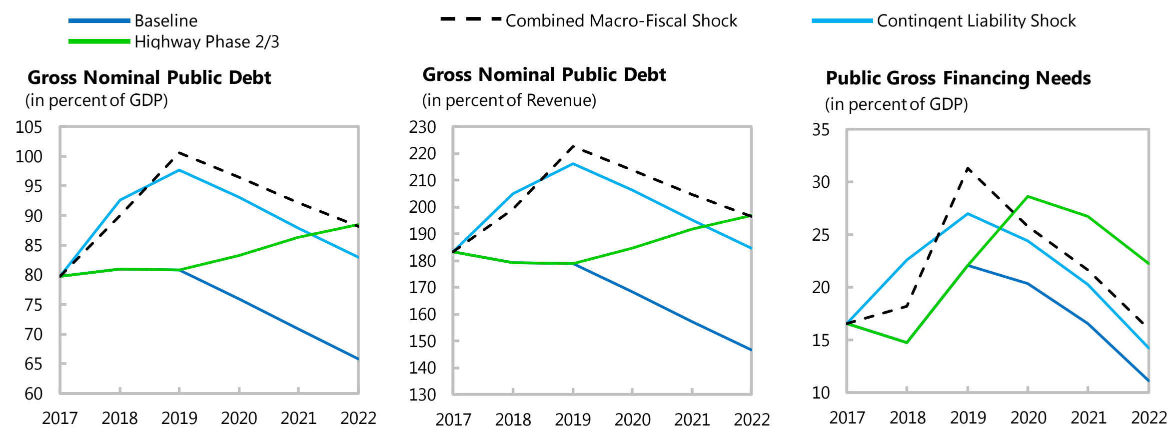
Source: IMF staff.

Montenegro: Public DSA - Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions
(in percent)

	2017	2018	2019	2020	2021	2022
Primary Balance Shock						
Real GDP growth	3.0	2.8	2.7	2.2	3.0	3.1
Inflation	2.2	2.6	2.0	1.7	1.8	1.9
Primary balance	-3.9	-5.2	-4.4	4.4	4.2	4.0
Effective interest rate	3.8	3.9	4.0	4.1	4.0	4.1
Real Interest Rate Shock						
Real GDP growth	3.0	2.8	2.7	2.2	3.0	3.1
Inflation	2.2	2.6	2.0	1.7	1.8	1.9
Primary balance	-3.9	-2.9	-2.2	4.4	4.2	4.0
Effective interest rate	3.8	3.9	4.3	4.6	5.0	5.5
Combined Shock						
Real GDP growth	3.0	-1.7	-1.9	2.2	3.0	3.1
Inflation	2.2	1.5	0.9	1.7	1.8	1.9
Primary balance	-3.9	-5.7	-7.8	4.4	4.2	4.0
Effective interest rate	3.8	4.0	4.2	4.6	5.0	5.4

	2017	2018	2019	2020	2021	2022
Real GDP Growth Shock						
Real GDP growth	3.0	-1.7	-1.9	2.2	3.0	3.1
Inflation	2.2	1.5	0.9	1.7	1.8	1.9
Primary balance	-3.9	-5.7	-7.8	4.4	4.2	4.0
Effective interest rate	3.8	3.9	4.0	4.3	4.2	4.3
Real Exchange Rate Shock						
Real GDP growth	3.0	2.8	2.7	2.2	3.0	3.1
Inflation	2.2	7.1	2.0	1.7	1.8	1.9
Primary balance	-3.9	-2.9	-2.2	4.4	4.2	4.0
Effective interest rate	3.8	4.0	3.9	3.8	3.8	3.8
Contingent Liability Shock						
Real GDP growth	3.0	-1.7	-1.9	2.2	3.0	3.1
Inflation	2.2	1.5	0.9	1.7	1.8	1.9
Primary balance	-3.9	-9.9	-2.2	4.4	4.2	4.0
Effective interest rate	3.8	4.2	4.2	4.1	4.0	4.1

Source: IMF staff.

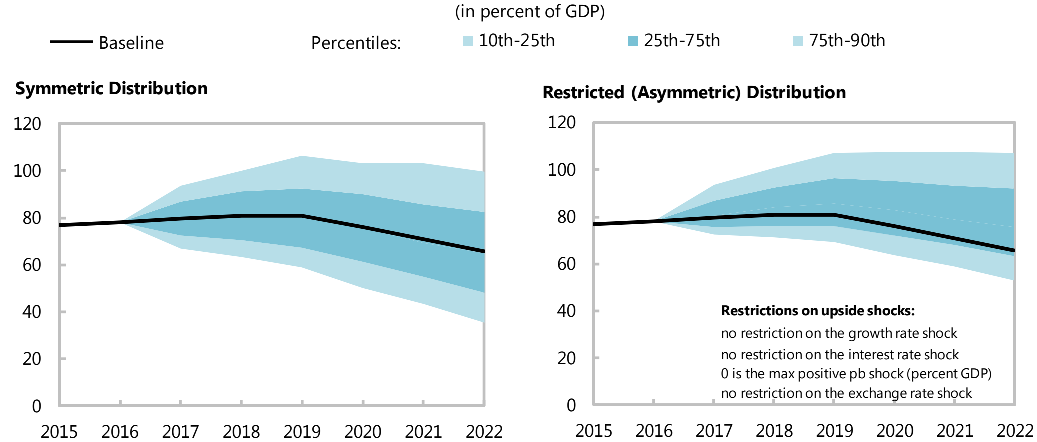
Montenegro: Public DSA Risk Assessment

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

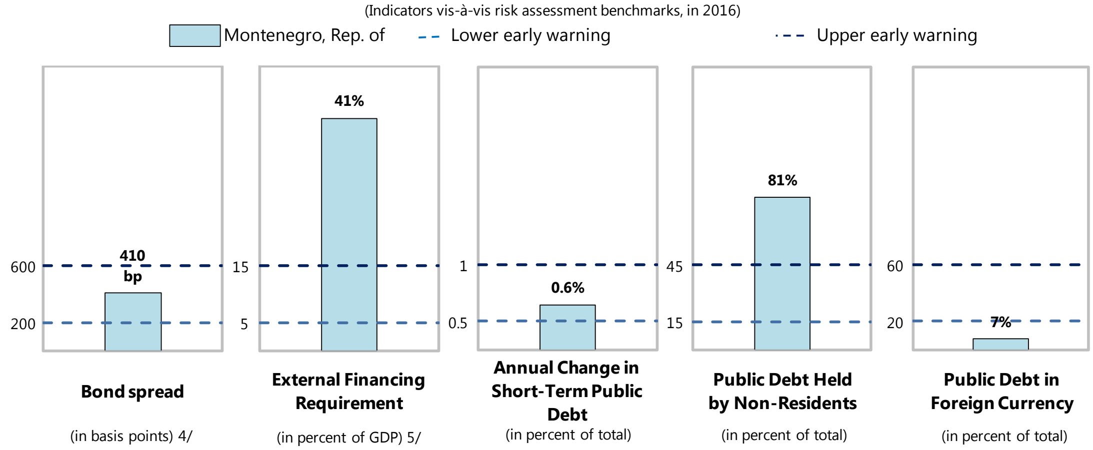
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2016)



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.

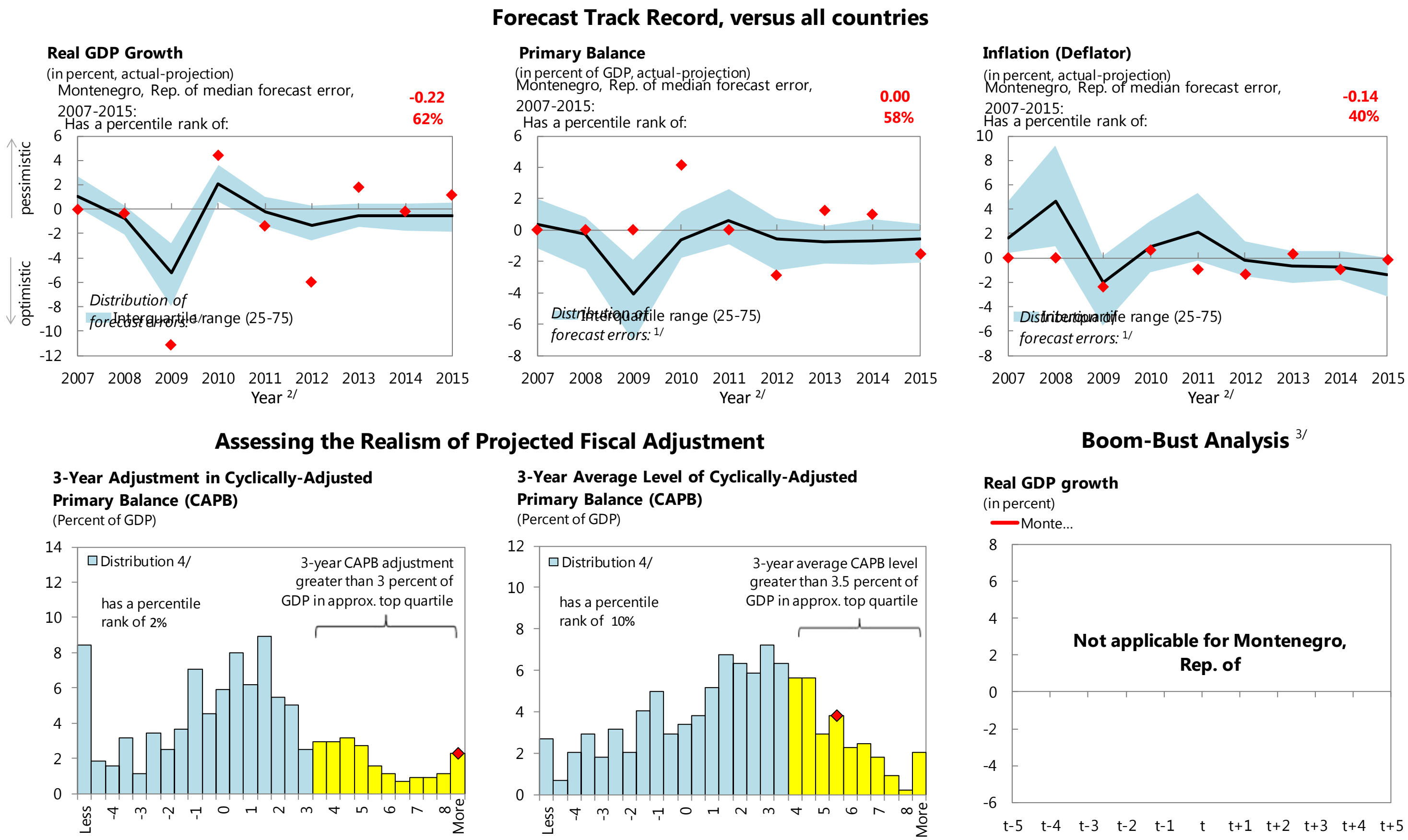
Lower and upper risk-assessment benchmarks are:

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, 28-Mar-17 through 26-Jun-17.

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.

Montenegro: Public DSA - Realism of Baseline Assumptions



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.

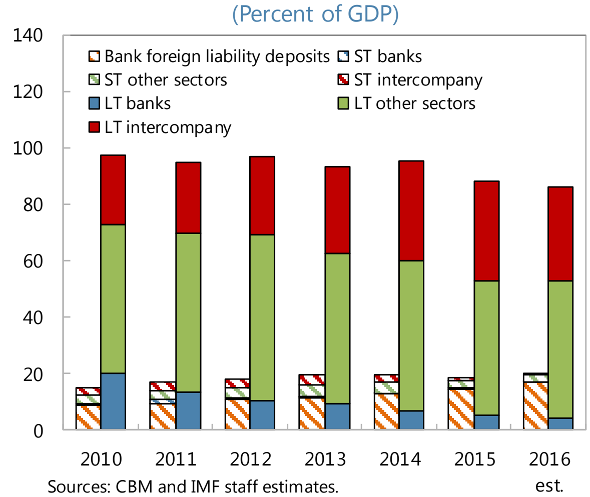
4/ Data cover annual observations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Annex III. External Debt Sustainability Analysis

External debt has increased by 35 percentage points of GDP since 2008, to an estimated 167 percent of GDP in 2016.[1] This was driven partly by the sharp increase in public debt, which more than doubled over this period and comprises about 33 percent of total external debt. Under the baseline, external debt is projected to peak at 175 percent of GDP, before declining to 165 percent in 2022. The projected debt trajectory is highly sensitive to various shocks, particularly a depreciation of the euro. Montenegro's heavy dependence on external financing reinforces the importance of fiscal and structural reforms to safeguard market access.

Long-term private external debt has fallen over the past few years, and its composition has improved as the share of more stable inter-company loans increased, while short-term private external debt has increased modestly. Recently, and going forward, most of the increase in external debt is due to government 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.

1. Shocks and stress tests

- **Standardized stress tests indicate that external debt is particularly sensitive to currency depreciation**. Current account shocks—possibly related to highway project cost overruns—and a combined deterioration in the macroeconomic environment would also affect external sustainability, with significant implications for gross financing needs.

2. 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 2016. This corresponds to an average growth rate during 2018–22 of 0.5 percent, compared with baseline average growth of 2.3 percent. Under this scenario, the external debt ratio increases by 13 percentage points (compared to the baseline) to 180 percent of GDP in 2022.

- **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 2018–22. Stable average external interest rates historically imply only a modest

[1] Data on external debt (mainly private) were revised upwards since the last Article IV consultation.

average increase in interest rates of 22 basis points in this scenario and, consequently, a reduction in external debt by 0.4 percentage point to 166.5 percent of GDP by 2022.

- **Non-interest current account shock**. This scenario permanently increases the non-interest current account by one-half standard deviation in 2018–22. Given historically-high current account deficits, this amounts to an increase of 6.1 percentage points. In the absence of offsetting non-debt-creating flows, external debt increases by 27 percentage points to 193 percent of GDP by 2022.

- **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 2018–22. The combined shock pushes the external debt ratio up by 21 percentage points to 188 percent of GDP and increases gross financing needs by 26 percent of GDP cumulatively over the shock period.

- **Real exchange rate shock.** The scenario assumes a one-time 30 percent devaluation in the real exchange rate in 2018 applied to the stock of external debt. Second-round impacts (in terms of potential increases in competitiveness and improved trade balances) are not considered. Given the large stock of external debt, the shock increases the external debt-to-GDP ratio by 84 percentage points of GDP in 2018. Gross financing needs are correspondingly higher, by about 20 percent of GDP on average over 2018–22 relative to the baseline.

Table 1. Montenegro: External Debt Sustainability Framework, 2010–20

(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2012	2013	2014	2015	2016			2017	2018	2019	2020	2021	2022	Debt-stabilizing non-interest current account 6/
Baseline: External debt	155.9	153.5	163.1	163.1	166.8			**169.8**	**173.5**	**174.5**	**171.6**	**168.5**	**164.8**	**-16.1**
Change in external debt	10.9	-2.4	9.6	0.0	3.8			3.0	3.6	1.1	-2.9	-3.1	-3.7	
Identified external debt-creating flows (4+8+9)	7.8	-3.6	0.7	-11.3	2.7			5.2	6.4	4.9	-0.5	-1.1	-1.2	
Current account deficit, excluding interest payments	14.9	11.1	12.0	10.6	16.8			18.0	19.1	17.6	11.6	11.9	11.9	
Deficit in balance of goods and services	24.2	20.1	19.8	18.6	23.5			24.9	25.8	24.1	18.0	18.4	18.3	
Exports	42.1	41.3	40.1	42.5	42.4			42.9	42.8	43.0	43.2	43.5	43.7	
Imports	66.3	61.4	60.0	61.1	66.0			67.7	68.6	67.1	61.3	61.9	62.0	
Net non-debt creating capital inflows (negative)	-14.5	-9.6	-10.2	-17.1	-9.8			-10.3	-10.4	-10.4	-10.5	-10.3	-10.2	
Automatic debt dynamics 1/	7.4	-5.0	-1.1	-4.8	-4.2			-2.6	-2.3	-2.3	-1.6	-2.7	-2.8	
Contribution from nominal interest rate	3.6	3.4	3.2	2.7	2.1			2.1	2.1	2.1	2.1	2.1	2.1	
Contribution from real GDP growth	4.1	-5.2	-2.7	-5.3	-3.9			-4.7	-4.5	-4.4	-3.8	-4.9	-5.0	
Contribution from price and exchange rate changes 2/	-0.3	-3.2	-1.6	-2.2	-2.5			...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	3.2	1.1	8.8	11.3	1.1			-2.2	-2.8	-3.9	-2.4	-2.0	-2.6	
External debt-to-exports ratio (in percent)	370.7	371.3	406.3	384.0	393.4			396.3	405.2	405.9	396.9	387.8	377.2	
Gross external financing need (in billions of Euro) 4/	0.9	0.9	1.0	1.2	1.5			1.5	1.6	2.0	2.0	2.0	1.8	
in percent of GDP	29.6	26.1	29.2	34.0	40.9	10-Year	10-Year	38.5	38.9	45.4	43.5	40.9	35.1	
Scenario with key variables at their historical averages 5/								**169.8**	**169.6**	**167.4**	**166.3**	**165.7**	**164.6**	**-22.4**
						Historical	Standard							
Key Macroeconomic Assumptions Underlying Baseline						Average	Deviation							
Real GDP growth (in percent)	-2.7	3.5	1.8	3.4	2.5	2.6	4.5	3.0	2.8	2.7	2.2	3.0	3.1	
GDP deflator in US dollars (change in percent)	0.2	2.1	1.0	1.4	1.6	3.3	3.9	2.2	2.6	2.0	1.7	1.8	1.9	
Nominal external interest rate (in percent)	2.4	2.3	2.1	1.8	1.4	2.3	0.4	1.4	1.3	1.3	1.3	1.3	1.3	
Growth of exports (Euro terms, in percent)	-2.6	3.9	-0.1	10.9	3.9	6.9	12.9	6.4	5.3	5.2	4.6	5.4	5.6	
Growth of imports (Euro terms, in percent)	1.3	-2.1	0.4	6.7	12.4	5.5	18.3	8.1	6.8	2.5	-5.0	5.9	5.3	
Current account balance, excluding interest payments	-14.9	-11.1	-12.0	-10.6	-16.8	-20.8	12.2	-18.0	-19.1	-17.6	-11.6	-11.9	-11.9	
Net non-debt creating capital inflows	14.5	9.6	10.2	17.1	9.8	16.7	7.9	10.3	10.4	10.4	10.5	10.3	10.2	

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 Euro 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).

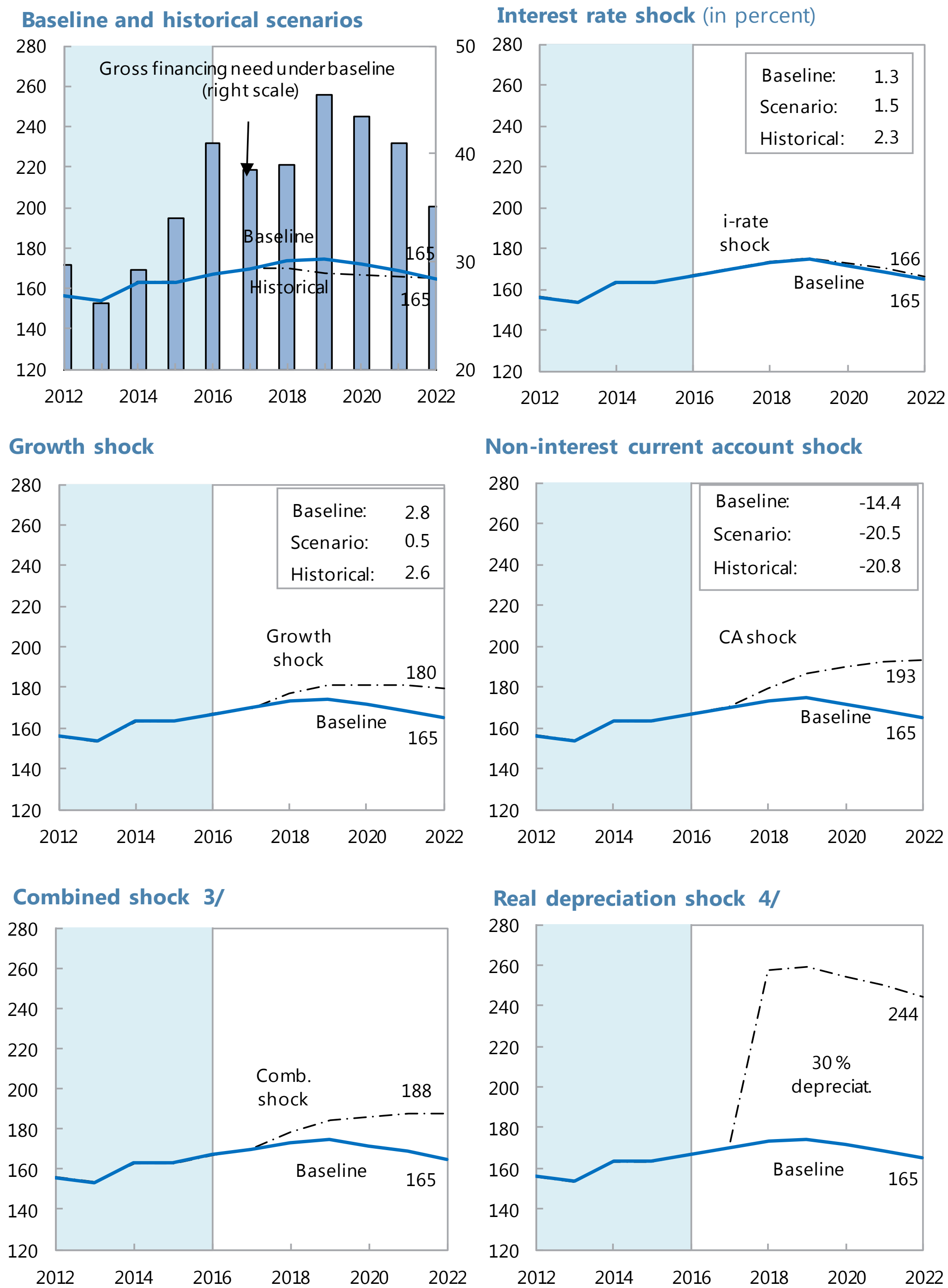
3/ For projection, line includes the impact of price and exchange rate changes.

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; Euro 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, Euro 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/]



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 2018.

	Montenegro	Overall Assessment
Foreign asset and liability position and trajectory	**Background**. The authorities are in the early stages of constructing international investment position (IIP) statements and TA missions for this effort are planned for this year. Despite current data limitations, it is estimated that gross external debt has reached a new high of 167 percent of GDP at end-2016 and is projected to reach a peak of 175 percent by 2019. One-third of external debt is government debt, which has expanded 12 percentage points of GDP since 2012. One-half of government debt corresponds to non-bank private sector (mostly Eurobonds). Short-term debts of the private sector (maturing in less than one-year) account for only 4 percent of total private external debt. **Assessment**. In the absence of comprehensive IIP data, staff cannot assess the underlying vulnerabilities related to foreign assets and liabilities, nor whether there is a mismatch between currencies and maturities. Given the high levels of external debt and current account deficits, IIP data would be crucial for accessing external sustainability.	**Overall Assessment**: *The external position of Montenegro in 2016 was weaker than that consistent with medium-term fundamentals and desirable policies. In 2017, the current account deficit is projected to worsen as construction-related imports and commodity prices increase.* However, staff accesses that EBA-lite systematically over-estimates the current account norm of Montenegro compared to the average country of the EBA-lite sample due to additional
Current account	**Background**. Current account deficits (CAD) have persisted for years and reached 19 percent of GDP in 2016. The strong tourism-driven service trade surplus has not offset the importation of construction goods for large-scale infrastructure projects. From a savings-investment perspective, non-government savings fell 1 percent of GDP and non-government investment grew by 4½ percentage points to 19 percent of GDP. The CAD is forecast to widen to 21 percent of GDP by 2018, when construction-related imports and commodity prices are expected to peak and total investment will grow to 31 percent of GDP. **Assessment**. The EBA-lite model estimates a current account gap of -9.7 percent of GDP for 2016, with a cyclically-adjusted CA norm of -9.2 percent of GDP. Staff considers that the model systematically over-estimates the current account norm of Montenegro compared to the average country of the EBA-lite sample due to additional country-specific factors not captured in the model, unavailable data (such as capital control index), and the limited time range of	

	data. Factors that likely overstate the measured current account deficit are data uncertainties related to errors and omissions in the BOP (which have averaged almost 5 percent of GDP), relatively high FDI inflows, and the highway construction project (which partly explains the large deterioration in the CAD in 2016). Considering the uncertainties in the model-based estimates, staff assesses the CA gap to be in the range of -3 to -4 percent of GDP for 2016, which is consistent with a CA norm in the range of 14 to 15 percent of GDP. In order to estimate a CA-norm more in line with current CA values, staff averaged the previous three years of the current account deficit (2013-2015), which results in a proxy CA-norm of 14 percent of GDP. That would imply a 5 percent of GDP current account gap in 2016 and an overvaluation of 10 percent.		country-specific factors not captured in the model, unavailable data (such as capital control index), and the limited time range of data.
	Background. Stagnant productivity and rising labor costs have resulted in a modest 3 percent appreciation of the CPI-based real effective exchange rate (REER) since 2007, which recently registered a new high of 2 percent above its 10-year average. A comparison of price-based indices suggests the appreciation has exceeded that of the Baltics and new EU member states averages by 5 to 6 percentage points. The low inflation differentials have kept appreciation in check and the nominal effective exchange rate weighted by trading partners has been the driver of appreciation. The more recent depreciation of the euro has further eased the appreciation of the REER, subduing the high competitiveness costs of Montenegro. **Assessment**. The EBA-lite REER regression model estimates the REER to be undervalued by 13 percent, while the CA regression model suggests the REER is overvalued by 20 percent, which average to a 3.5 overvaluation.[1] Data limitations are the main impediment to an accurate estimation of the REER for Montenegro. On balance, staff believes that the real exchange rate is overvalued by perhaps 10 percent on account of the persistently large current account deficits (see above), high unit labor costs that continue to grow while productivity stagnates, and weak export performance. A real depreciation through wage constraint and structural reforms to strengthen competitiveness would help reduce economic imbalances in the medium term.		**Potential policy responses**: The government's fiscal consolidation plans over the medium-term should help improve the current account by boosting national savings. Structural reforms to reduce the cost of doing business, labor market reform, and productivity enhancing reforms would help to restore

[1] The External Stability (ES) approach cannot be calculated in the absence of the International Investment Position (IIP).

Capital and financial accounts: flows and policy measures	**Background**. Mirroring the 2016 CA deficit, Montenegro experienced a net capital inflow of 17 percent of GDP from 13 percent in 2015, largely driven by FDI and other investment inflows. 2016 reflected another strong year for FDI inflows, despite a one-off dividend payment accounting for one half of FDI outflows, meaning net FDI would be 5 percentage points of GDP higher if not for this payment. Since 2012, FDI inflows related to real estate purchases have declined from 6 to 3½ percent of GDP in 2016, while intercompany debt and investments in companies and banks have increased. Other investments had the largest increase from the previous year, amounting to a total net reversal of 15 percent of GDP. Montenegro has not made use of capital controls. **Assessment**. Large external financing needs in the public and private sector leave Montenegro vulnerable to sudden changes in market sentiment and spillovers from Europe.		competitiveness and address the external imbalance.
FX intervention and reserves level	**Background**. Montenegro has adopted the euro as its currency, which provides a strong monetary anchor. **Assessment**. The euro currency is free floating.		

Annex V. Implementation of Past IMF Recommendations

In the 2015 Article IV consultation, Directors noted the need for sound fiscal policies to reduce the risks to fiscal and external sustainability posed by the heavy reliance on large infrastructure projects to support growth, while also encouraging the authorities to reduce financial sector vulnerabilities and to implement structural reforms to boost potential growth and increase resilience.

Key recommendations	**Implemented Policies**
Fiscal Policies	
Implement immediate and durable fiscal consolidation measures to maintain sustainability and preserve market access.	Fiscal discipline waned in the run-up to the 2016 general elections. However, the authorities implemented a range of fiscal adjustment measures in the 2017 budget, and launched a fiscal strategy in line with staff recommendations in June 2017 to address debt sustainability and financing concerns. With parliamentary approval of amendments to the Law on Social and Child Protection, the Law on Excise Taxes, and the Law on the Valued Added Tax, the authorities have implemented the bulk of their fiscal strategy.
Take measures to contain the public wage bill, improve the sustainability of the pension system, and strengthen revenue collection.	The authorities granted a large increase in public sector wages in 2016 but implemented elements of a wage freeze in the 2017 budget. The fiscal strategy is consistent with previous Fund advice and is expected to result in a sustained increase in revenue collections. The Montenegrin Tax Administration is implementing a tax debt restructuring program to reduce the stock of tax arrears and is receiving technical assistance (TA) from the Fiscal Affairs Department (FAD) to strengthen revenue administration.
Design a stronger fiscal framework, including detailed medium-term plans, public financial management reform, and tax administration reforms.	The annual budget includes medium-term fiscal projections, but their relevance could be improved. The authorities are receiving TA from FAD on public financial management and designing a medium-term fiscal framework in addition to TA on revenue administration. Generally, the authorities have a good track record for implementing FAD TA advice, particularly for revenue administration.

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) and bank resolution capacity.	The authorities advanced implementation on several FSAP recommendations, including through the preparation of recommended legislation and enhanced supervision. They have been considering options to strengthen ELA capacity. The AQR is planned for 2018/19.
Take steps to enhance the regulatory, supervisory, and resolution frameworks and develop the macro-prudential framework.	The authorities are drafting a new financial institutions law to eliminate supervisory gaps and in February 2017 received a TA report from the Monetary and Capital Markets Department (MCM) on the adoption of a macro-prudential policy framework. The authorities are preparing a strategy for assigning the macro-prudential policy mandate to the CBM, which will be in the form of a publicly available document.
Structural Policies	
Improve labor market flexibility and the investment environment and reduce non-wage disincentives to employment. Maintain discipline over public sector wages to ensure cost competitiveness.	The authorities are preparing a new labor law that would aim to improve labor market flexibility, increase labor market participation, and reduce informal employment. While public wages rose significantly in 2016, the authorities have contained wage growth in 2017.

Appendix I. Spillovers from the Highway Project[1]

The Bar-Boljare Highway is a three-phase project to connect Bar (Montenegro's main southern seaport) to the road network of Serbia in the north. The first phase, to be constructed from 2015 to mid-2019, comprises a 41-kilometer section between Podgorica and the poorest Northern region in Montenegro. It runs north through the mountainous terrain in the center of the country. Due to its large cost (25 percent of GDP), the first phase of the highway has used up most of Montenegro's fiscal space and will crowd out other productive spending. For the foreseeable future, the second and third parts of the highway could only be financed with concessional funds, because loans would destabilize Montenegro's debt sustainability.

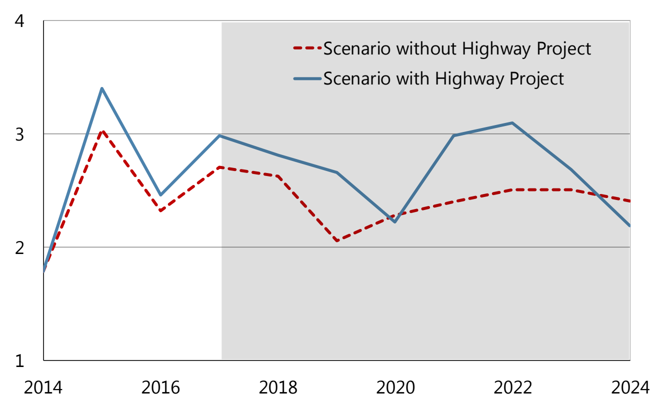
3. **The government's main motivation for this large project is the need to improve connectivity, particularly to Europe through Serbia, boost tourism and trade, improve road safety, and strengthen national security.** The Bar-Boljare Highway is to provide a much safer and more efficient transport route, especially in the northern part of the country.

4. **The original cost of €809 million (20 percent of 2017 GDP) increased to nearly €1 billion (1/4 of 2017 GDP),** because the dollar-denominated loan from China's ExIm Bank was not hedged. ExIm Bank is financing 85 percent of the first segment with a 20-year US dollar loan, with a fixed 2 percent interest rate and a six-year grace period on repayment of principal. The remaining 15 percent of the cost is being financed by the government.

5. **Construction started in May 2015 and is scheduled to be completed in 2019.** The China Road and Bridge Corporation (CRBC) is leading the construction.[2] Domestic companies are subcontracted for 30 percent of the works. Once the segment is completed, the authorities intend to help fund repayments with toll revenues.

6. **The construction of the highway can be expected to generate instantaneous demand spillovers for local goods and services with a multiplier effect through the economy.** Staff generally assumes a fiscal multiplier of 0.3 for Montenegro given its status as a small, open economy with a fixed exchange rate. However, given the large import content of the project, staff used an

Real GDP Growth
(in percent)



Sources: MONSTAT; and Fund staff projections.

[1] For further details, please refer to the SIP.

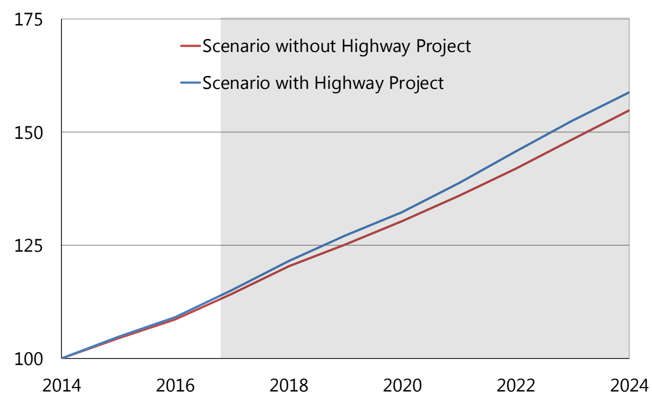
[2] The authorities record highway spending when CBRC is paid, whereas staff uses CRBC's actual spending and integrates the increased cost due to exchange rate depreciation.

instantaneous demand multiplier of 0.2 during the construction phase.

7. The highway, when completed in 2019, will generate positive supply effects. Staff used estimates from the IMF's 2014 October WEO on the impact of infrastructure investment adjusted for Montenegrin public investment efficiency, and considering a low estimated economic rate of return. A World Bank report estimated the return of the whole highway at about half of the normal benchmark of 12 percent used for Bank investment projects.[3] The return for the first phase could be even lower since the costs are very high, owing to the challenging terrain, the cost increase due to euro depreciation, and the low expected traffic on the section located in a sparsely populated area. Staff estimates the total supply multiplier to be 0.5 spread over five years—1/3 of the output effects estimated in the 2014 WEO.

8. Total GDP including the highway in 2023—the year with the largest difference—would be about 4¼ percentage points of 2014 GDP higher than without it. This is a modest increase given the cost of 28 percent of 2014 GDP. Growth thereafter would be slightly lower in the scenario with the highway because the higher capital stock would imply larger depreciation. In the very long run, GDP would be the same in the two scenarios.

Gross Domestic Product
(Index, in percent; 2014=100)



Sources: MONSTAT; and Fund staff projections.

9. The highway threatened Montenegro's debt sustainability and crowded out more productive spending. Without the highway, debt would have declined to 60 percent of GDP by 2022 based on the policies of the 2017 budget. Instead, with the highway, debt was projected to grow to 89 percent of GDP in 2019 and would have stayed at high levels. These high projected debt levels necessitated the launching of the authorities' fiscal strategy. If the authorities had invested the same amounts in highly productive investment projects, GDP could have been 13 percent of 2014 GDP higher instead of 4¼ percent. The DSA shows that Montenegro cannot afford a debt-financed completion of phases 2&3 of the highway, but would have to rely on concessional financing or public-private partnerships.

10. Serbia plans construction of a connecting highway from Belgrade. In May 2017, the Serbian infrastructure ministry signed a memorandum of understanding with CBRC. The works are expected to start in 2018. CRBC has expressed interest in completing phases 2&3 of the

[3] The future economic return has increased with Serbia's recent decision to connect to the Montenegrin border with a highway from Belgrade.

Montenegrin highway, but funds are lacking. If realized, the Serbia-Montenegrin connection would improve the medium-term growth outlook for both countries.

Appendix II. Pension Reform in Montenegro[1]

The pension system in Montenegro is in deficit, with benefits consistently outweighing contributions. Past reforms strengthened its sustainability, but ad-hoc early retirement initiatives have undermined it. An aging population will put increasing pressure on pension expenditures. Staff baseline projections suggest that pensions would become socially unsustainable in the long run. Reforms to the indexation formula, retirement age and contributions could lead to a long-term viable system.

1. **Montenegro's pension system has a consistently large funding gap** (Figure 1), reaching 3.1 percent of GDP in 2016. Pension spending has outpaced contributions for years and is high relative to international levels. At 10.4 percent of GDP, pension spending is higher than averages in advanced economies (9 percent) or emerging economies (5 percent). An aging population and high levels of early retirement have increased the number of old-age pensioners, which has increased by 36 percent since 2008. Since the last major reform in 2010, about 70 percent of new pensioners were early retirees below the statutory retirement age of 66 for men and 61 for women. Early-retirees constitute about one third of pensioners and pose a high cost for the system. At the same time, low levels of labor participation and formal employment constrain pension contributions.

2. **Previous pension reforms have had mixed outcomes, resulting in several outstanding issues** (Table 1).

- The formula used for pension valorization and indexation (¼ wages, ¾ CPI) is problematic. It underestimates lifetime earnings by not fully reflecting 100 percent wage growth over working lives. Similarly, pension indexation over the retirement period allows retirees to benefit from productivity growth to which they did not contribute.
- Attempts to increase the retirement age were undermined by early-retirement eligibility.
- Ad-hoc measures partially undo pension reforms, such as unplanned increases in pension benefits and special privilege pensions for certain occupations.
- The list of hazardous occupations with accelerated-rate pensions is too broad and contributions are insufficient to finance early retirements.
- The mothers' law has incentivized mothers to either give up pension rights and/or exit the labor force. 26,500 women claimed the new benefit (4.8 thousand left the pension system).

[1] See SIP for more details. Projections are based on FAD's pension tool.

Table 1. Montenegro: Major Changes to the Pension System		
Reform period	Major reforms	Number of pensioners impacted, as of Dec 2016
2004 reform	Point formula system introduced (from accrual based)	
	Introduction of Swiss formula with 50% CPI and 50% wage valorization and indexation	
	Widened calculation period for benefit (best 10 years to full career in 2-year increments)	
	Increased retirement age (60 to 65 for men, 55 to 60 women)	
	Began phasing out early retirement	
	Tightening disability and survivor eligibility and control	
2010 reform	Raised retirement age further to 67 (phase in for men by 2025, women by 2041)	
	Introduction of 75% CPI and 25% wage valorization and indexation	
	Under penalty free early retirement at 40 years of service regardless of age, increased requirement for women from 35 to 40 by 2033	11,263
	Introduced early retirement at 62 with 15 years of service	4,856
	Reintroduced special early retirement options, since eliminated	3,084
	Accelerated rate early retirement pensions extended for miners	590
	Early retirement for parents of a child with disability	325
Adhoc reforms post 2010	Life-time mothers' benefit	4,761
	Penalty-free retirement introduced for police/military and for workers in bankrupt companies of majority state ownership and metallurgy, equalized after 2012-13	2,782
Total penioners benefiting		16,398
Source: Fond Pio.		

4. **Staff projects the pension deficit to turn into surplus by 2040, as spending declines and contributions stabilize** (Figure 2). In the baseline scenario, in which no reforms are enacted, pension spending is projected to decrease from 10.7 percent of GDP in 2015 to 7.4 percent by 2050, falling below the advanced and emerging economies average (Table 2). While the fall in pension expenditure would improve fiscal outcomes, it comes at the expense of falling replacement rates, meaning that pensions will become significantly less sustainable over time due to the poor level of income they provide pensioners.

Baseline Projections
(Percent of GDP)

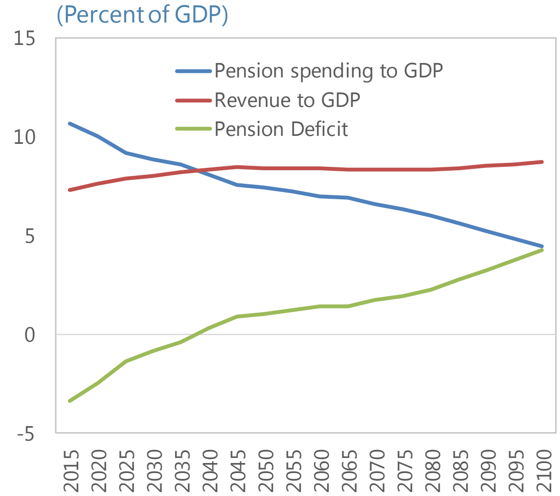


Table 2: Pension Projections						
	Pension Expenditure (% of GDP)			2015-2050 Expenditure Increase		Accrued Pension Liability (% of GDP)
	2015	2030	2050	Percentage Points	Present Discounted Value (% of GDP)	
Montenegro	10.7	8.9	7.4	-3.3	-52.2	200.8
Advanced Average	8.7	9.3	9.7	1.0	17.3	219.9
Emerging Average	5.0	6.0	8.0	3.0	36.7	124.7
Developing Average	1.8	2.2	3.3	1.6	17.3	44.6

Source: IMF, pension expenditure tool developed by FAD; and IMF staff calculations.
Note: Accrued Pension Liability shows the present discounted value of all future pension obligations owed if the system were to be shut down today.

5. Pension reform should focus on stabilizing replacement rates at socially sustainable levels, while preserving fiscal sustainability:[2]

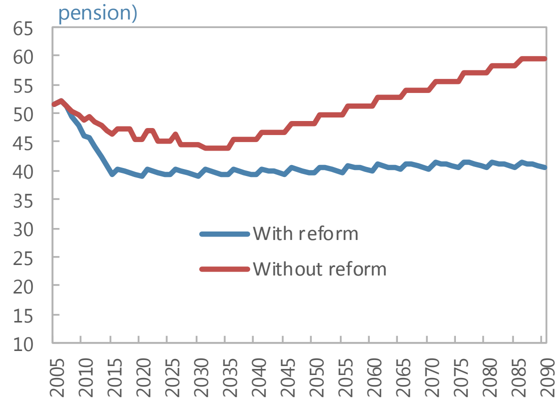
- Pensions should be valorized with wage growth and indexed with CPI growth. Wage valorization ensures that new pensions are based on lifetime earnings and productivity (stabilizing the replacement rate). CPI indexation preserves the purchasing power of pensioners. This should lead to fiscally and socially sustainable pensions in the long run.

- Restricting early retirement would reduce pension expenditures and discourage early labor market exits. It would be advisable to (i) eliminate the possibility to retire with 40 contribution years without penalty; (ii) limit early retirement to 2–3 years instead of 5 years; and (iii) introduce an actuarial penalty for early retirement.

- Hazardous-occupation pensioners should come from only health-damaging occupations and be ineligible for additional early retirement options. Contributions should be actuarially fair.

- Phasing in the planned retirement age increases more quickly for women so that it reaches 67 by 2025 instead of 2042 will reduce the fiscal costs of paying pensioners for longer periods and keep them in the labor force for longer. Additionally, linking the statutory retirement age to expected life expectancy to stabilize the ratio of pension years to contribution years would contribute to inter-generational fairness.[3]

Pension Years to Working Years
(In percent, average expected years of pension to number of working years contributing to pension)



Sources: UN; Monstat; Fond Pio; and IMF staff estimations.

6. The authorities should accelerate efforts on pension reform and focus on the long-term viability of the system (Table 3). The combination of the reforms discussed above could make the pension system sustainable (Figure 3). The costs of delaying reform are substantial and politically destabilizing if benefits fall to unsustainable levels. Sharp adjustments in the form of increased taxes, large spending cuts, or increased debt could weigh on long-term growth. Successful reforms will aim at delaying exit from the labor market while incentivizing more to join the formal labor market.

[2] The authorities are working on pension reform options in the context of the WB PBG. Reform options should be costed with the more precise WB PROST model.

[3] Life expectancy at retirement is projected to increase by almost one year every decade. With an average of 33 contribution years and 17 pension years, the retirement age would have to increase by 7½ months every decade to keep the ratio constant.

7. The authorities could consider complementary reforms as well. Gradually shifting contributions from employers to employees could reduce the grey economy and improve pension system coverage. Additional reforms to improve labor market participation would also strengthen the pension system's social protection functions. Higher-paid pensioners could contribute to healthcare system and personal income tax, since pension income is currently tax free and pensioners are the largest users of the health system.

Table 3. Pension Reform Projections

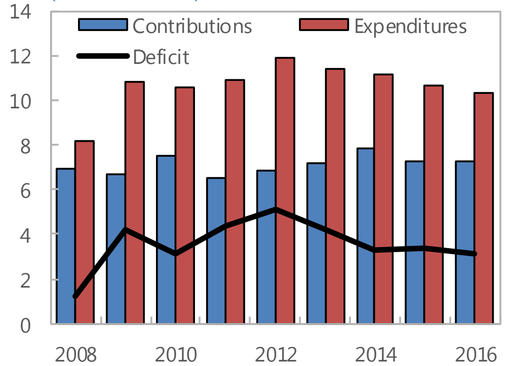
Reforms	Projected Cost / Savings (% GDP, per year)
Valorizing new pensions at 100% wage growth	Costs 2% GDP per year by 2050 and 10.5% by 2100
Indexing existing pensions at 100% CPI	Save up to 0.35% of GDP per year by 2050
Reducing or eliminating early retirement schemes	Save 1% GDP per year
Accelerating retirement age phase-in for women	Save up to 1.1% GDP per year during phase-in period
Linking statutory retirement age to life expectancy	Save up to 0.8% GDP per year by 2050
Increases in contribution rates	Long-term revenue source
Introduction of healthcare contribution and PIT for higher-earning pensioners	Long-term revenue source

Source: IMF staff estimates.

Figure 1. Recent Pension Trends

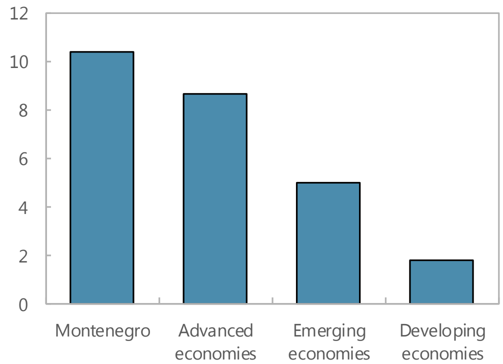
The pension system is consistently underfunded…

Pension Funding Gap
(Percent of GDP)



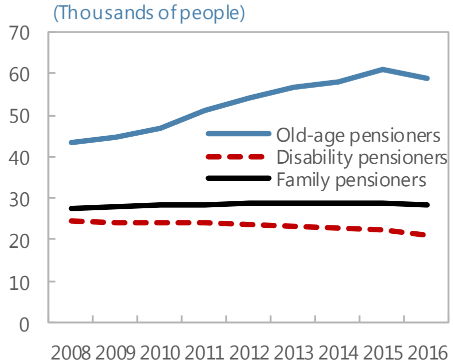
…with pension spending above international levels.

Pension Expenditure, 2016
(Percent of GDP)



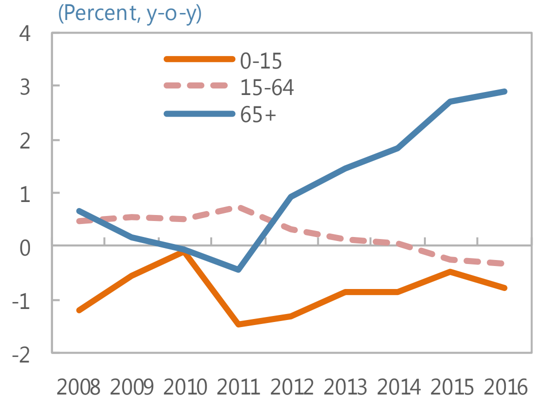
The system is stressed by an increasing number of old-age pensioners…

Number of Pensioners
(Thousands of people)



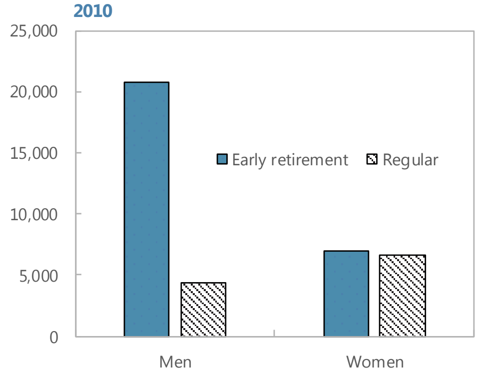
…caused by an aging population…

Population growth rates by Age Group
(Percent, y-o-y)



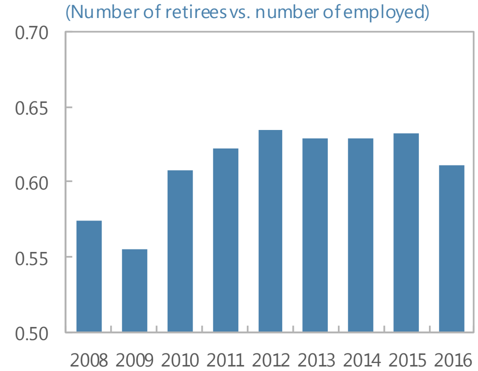
…and high levels of early retirement.

Number of New Old-Age Pensions Since 2010



Contributions are insufficient due to low levels of labor participation and formal employment.

Dependency Ratio
(Number of retirees vs. number of employed)

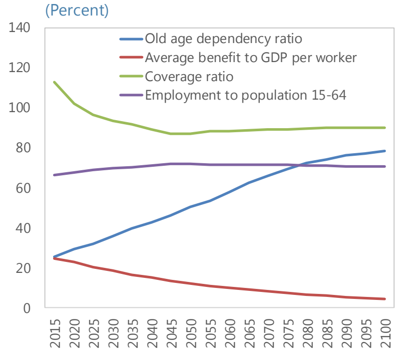


Sources: Monstat; Ministry of Finance; Fond Pio; and Fund staff estimates.

Figure 2. Baseline Scenario and Reform Options

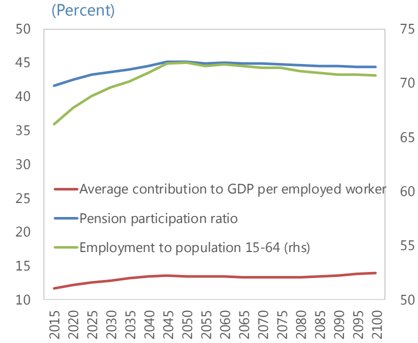
In the baseline, the working-age population will face an increasing financial burden to support the elderly and the replacement rate will decline to an unsustainable level.

Pension Expenditure Model
(Percent)



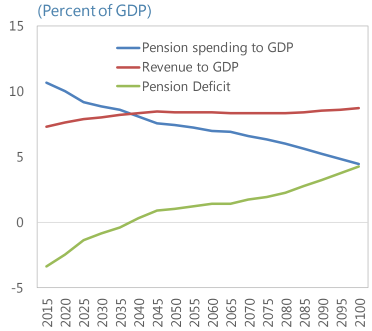
Pension contributions depend mostly on the number of contributors, which are unlikely to change significantly in the absence of reform.

Pension Contribution Model
(Percent)



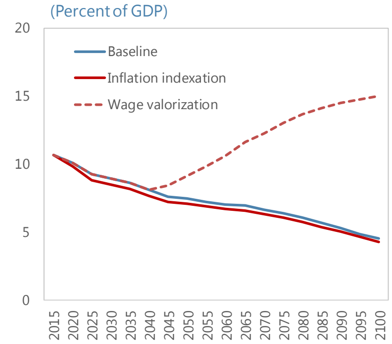
The pension deficit would begin running surpluses by 2040, given stable pension contributions and declining expenditures.

Baseline Projections
(Percent of GDP)



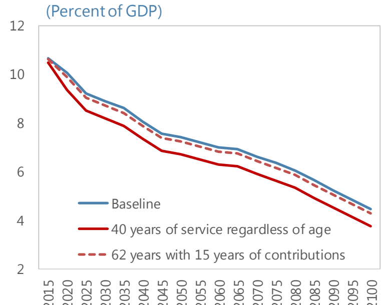
Stabilizing the replacement rate through pension formula reform is costly but necessary for pension sustainability.

Pension Expenditure: Pension Formula Reform
(Percent of GDP)



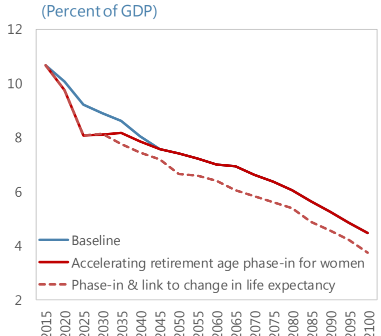
Restricting early retirement would permanently reduce pension expenditures and result in higher GDP growth since laborers would work for longer periods.

Pension Expenditure: Early Retirement Reform Options
(Percent of GDP)



Increasing the pension statutory retirement age would reduce expenditures and contribute to inter-generational fairness.

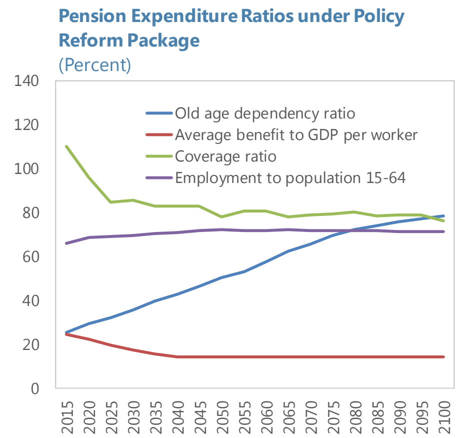
Pension Expenditure: Increasing Statutory Retirement Age
(Percent of GDP)



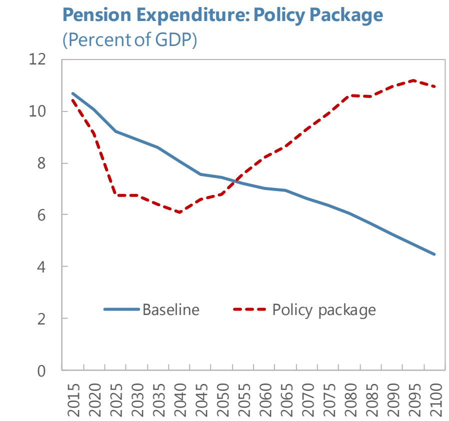
Source: Fund staff projections.

Figure 3. Pension Reform Package

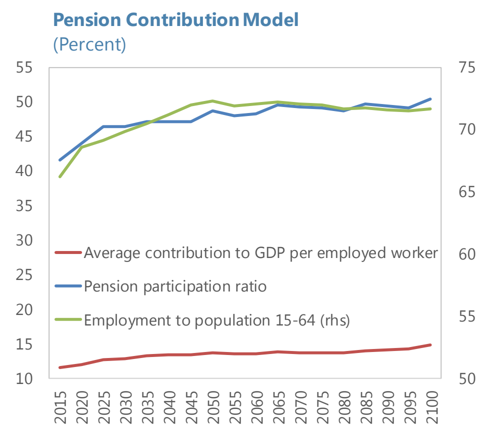
The most important result of the reforms is that the modified replacement rate stabilizes.



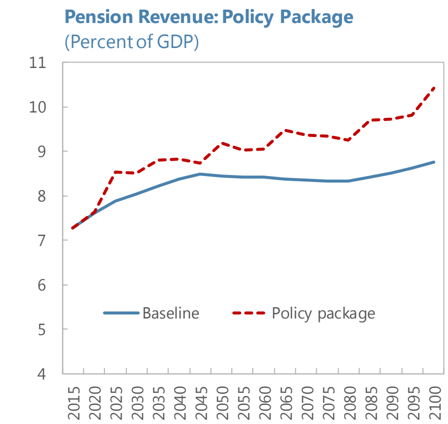
Pension spending would decline to 6 percent by 2040, but would rise again before stabilizing in the long-term.



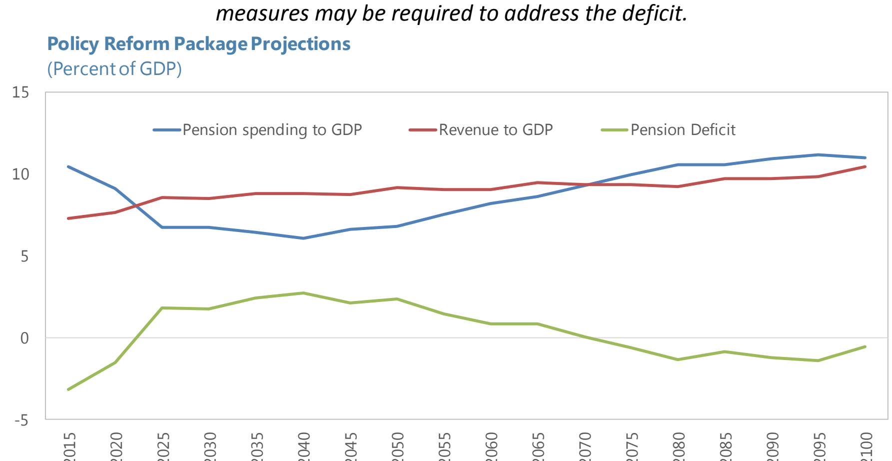
The number of contributors is permanently increased, due to elimination of early retirees...



...pension revenues would increase from around 7.3 percent of GDP today to 10.3 percent by 2100.



The pension deficit would turn into surplus by 2025 compared to 2040 for baseline. In the long-run, additional measures may be required to address the deficit.



Source: Fund staff projections.

Appendix III. Macro-Financial Linkages[22]

Montenegro's financial development and financial inclusion compares well with its regional and income based peers. Further financial sector deepening spread equitably among the population is likely to aid growth. Lending decisions should prudently incentivize ongoing corporate and household balance sheet repair and avoid excessive indebtedness.

1. **Financial policies in Montenegro aim to reap the benefits of continued financial development.** Given Montenegro's starting point, increased financial development would likely support higher growth**.** The estimated degree of financial development below the estimated turning point where the relationship between the financial development and growth becomes negative.

2. **Credit growth in Montenegro is highly correlated with contemporaneous economic activity.** The correlation is the highest among Western Balkan states, and noticeably larger than for regional comparators and developed European states. Bank lending is important for the construction, retail, and tourism sectors.

3. **The level of financial inclusion in Montenegro is consistent with its level of economic development** and has improved in recent years. While still below the new EU member states (NMS)—where about 80 percent of adults maintain a bank account—financial penetration in Montenegro is in line the size of the economy.

4. **There is room to improve financial inclusion across different sections of the population.** The poor, women, rural areas, and less educated are still underserved by the financial industry. In addition, there is a need to incentivize a movement from the gray economy to legitimate financial services.

5. **Credit conditions in Montenegro are slowly improving following the 2008 crisis.** Corporate lending by domestic banks is at 58 percent of its pre-crisis level, but household lending at 101 percent has recovered to its pre-crisis level.

6. **Corporate balance sheets have somewhat improved alongside banks' tackling of NPLs.** NPLs are around 10 percent and are bound to continue declining even if hampered by the lack of a vibrant secondary market for distressed assets and slow judicial proceedings. Corporates have substituted indebtedness to non–residents for domestic credit, and nominal total domestic and foreign indebtedness of the corporate sector has broadly recovered to its the pre-crisis peak.

7. **Households are taking on new debt, and implied private sector leverage is estimated to have increased since the crisis.** The ratio of credit to the private sector and the

[22] See SIP for more details.

index of real estate prices suggests that the leverage of the overall private sector is broadly unchanged compared to the peak of the crisis. However, the implied leverage of households is much higher than for corporate borrowers. This is consistent with the observed recovery of lending to households and calls for vigilance and prudence in lending and supervision.

8. The implementation of the fiscal strategy could impact banking sector profitability. The strategy entails a reduction of consumption over time, which might affect credit growth negatively. Staff does not see this as a central case, but the authorities should follow developments in this area closely.

INTERNATIONAL MONETARY FUND

MONTENEGRO

STAFF REPORT FOR THE 2017 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

August 24, 2017

Prepared By

The European Department
(In Consultation with Other Departments)

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FUND RELATIONS

(As of June 30, 2017)

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	18.11	70.12

Outstanding Purchases and Loans: None.

Latest Financial Arrangements: None.

Projected Obligations to Fund (In millions of SDR):

	Forthcoming				
	2017	2018	2019	2020	2021
Principal	0.00	0.00	0.00	0.00	0.00
Charges/Interest	0.02	0.05	0.05	0.05	0.05
Total	0.02	0.05	0.05	0.05	0.05

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 pre-1992 blocked foreign currency savings accounts and restrictions maintained for security purposes that have not been notified to the Fund.

Latest Article IV Consultation: Concluded on February 19, 2016 (IMF Country Report No. 16/79).

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
STA	Jun-17	Enhanced General Data Dissemination System
MCM	May-17	Debt Management
STA	Apr-17	Public Financial Management
STA	Apr-17	Government Finance Statistics
FAD	Apr-17	Tax Policy
FAD	Mar-17	Tax Administration
MCM	Nov-16	Macroprudential Policy Framework
STA	Sep-16	National Accounts Statistics

In addition, technical assistance was available through resident advisors covering tax administration and public financial management.

Resident Representative: None.

WORLD BANK GROUP RELATIONS

1. **Montenegro joined the World Bank Group (WBG) as an independent country in January 2007.** The Systematic Country Diagnostic from January 2016 identified the following priority objectives as fundamental for the achievement of the twin goals in Montenegro, around which the new Country Partnership Framework (CPF) is designed:

(i) Strengthening resilience to shocks and volatility;

(ii) Reducing unemployment and inactivity, amongst the young; and

(iii) Facilitating private sector development.

2. **The new, third Montenegro Country Partnership Framework FY16-20 (CPF) has two focus areas**: (i) Enhance macroeconomic and financial resilience, whereby the primary objectives are to improve the sustainability and efficiency of public finances, and increase the stability and efficiency of the financial sector; (ii) Expand access to economic opportunities and jobs, whereby the main objectives are to increase the alignment between skills and labor market demand; strengthen incentives for work; enhance private sector investments and job creation in high-potential sectors; and enhance environmental sustainability.

3. **The committed funds currently amount to US$123.6 million, of which two-thirds remained undisbursed.** Under the previous CPF, the overall IBRD delivered program amounted to US$262 million, while IFC committed two long-term finance projects totaling US$26.5 million in the infrastructure sector. Four IBRD projects are currently active. The portfolio also includes two EU Trust Funds and one regional GEF project.

Montenegro: World Bank Project Portfolio, June 2017

Project Name	Date, Board App	Net Comm Amt ($m)	Total Percent Disb.	Percent Disb. Ratio FY17 (as of June 2017)
Higher Education and Research for Innovation and Competitiveness	01/24/2012	15.98	74.0	46.0
Energy Efficiency	12/09/2008	15.67	85.0	73.0
Montenegro Institutional Development and Agriculture Strengthening (IBRD)	04/21/2009	19.04	76.0	16.9
Montenegro Institutional Development and Agriculture Strengthening (GEF)		4.0	98.0	87.0
Industrial Waste Management and Cleanup	09/19/2014	68.90	3.5	0.0
		123.59	**45.94**	**6.6**

4. **Pipeline projects in the new FY18/19 include:** (i) a Revenue Administration Reform Project to be presented to Board in July 2017, building on the recent tax administration assessment that aims to increase the effectiveness and efficiency of tax administration as well as reduce the cost of compliance for the taxpayer; (ii) Fiscal and Financial Sector Resilience Development Policy Loan/Policy Based Guarantee, and (iii) a follow up operation to the ongoing Institutional Development and Agriculture Strengthening project (MIDAS2)

5. **The World Bank and the IMF teams are exchanging information on the areas of macroeconomic, structural and financial sector policies.** Bank and Fund teams coordinated closely during the preparation of the 2017 Article IV mission and providing advice to the new

government on the Fiscal Consolidation Plan in December 2016 and the Fiscal Strategy adopted in June 2017. The World Bank Group, through its ongoing and planned operations, as well its complementary economic and sector work, will continue to provide input to the IMF on issues such as (i) public expenditure, including pension and health reforms; (ii) business climate and competitiveness, including labor market reform and the resolution of nonperforming loans; (iii) public sector institutions and fiduciary reviews, and (iv) poverty monitoring. Fund and Bank staff have sought each other's input in internal review processes and will continue to maintain a coordinated support to the government's fiscal consolidation reform agenda.

Montenegro: Joint Management Action Plan - Bank and Fund Planned Activities in Macro-critical Structural Reform Areas, January—December 2017

Title	Products	Provisional Timing of Missions	Expected Delivery Date
1. Fund work program	Article IV staff report	February, June 2017	August 2017
2. Bank work program	Revenue Administration Project DPL/PBG	May 2017 April, May, September 2017	July 2017 January 2018
3. Joint work program	None	None	

Prepared by World Bank staff. Questions may be addressed to Carla Pittalis, Sr. Country Officer (cpittalis@worldbank.org) and Sanja Madzarevic Sujster, Senior Country Economist (smadzarevic@worldbank.org).

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 production and expenditure accounts in current and previous year's prices. The production GDP estimates are reconciled with the expenditure GDP estimates through the supply and use framework (i.e. reconciling supply and use). The quality of the annual GDP is good. Montenegro started disseminating quarterly GDP by production using an indirect method in 2012, but the methodology has room for improvement. The estimates are compiled at an aggregated level (mostly NACE section level). Recent national accounts TA missions have focused on developing robust quarterly GDP estimates by expenditure approach. Quarterly GDP estimates have been compiled for 2010-2016. MONSTAT is participating in a Dutch funded project, delivered by the IMF, which will run until end of 2019 to improve the national accounts and price statistics. The project will assist MONSTAT to improve coverage of agriculture and services in the quarterly estimates of GDP, and the consistency between the quarterly and annual estimates of GDP. There is need to improve the industrial production index.
Price Statistics: MONSTAT compiles and disseminates a monthly consumer price index that broadly follows international standards. The Dutch funded project will assist MONSTAT to expand the coverage of the PPI to include some services and update index calculation methods.
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 suffer 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 earlier this year–STA fielded an initial diagnostic mission to Podgorica in April 2017. Further missions are planned for later this year.
Monetary and Financial Statistics: The Central Bank of Montenegro (CBM) reports monthly monetary statistics covering the CBM balance sheet and the balance sheet of commercial banks only. However, the monetary data are not reported in accordance with STA's Standardized Report Forms and, thus, follow the older format. **Financial Soundness Indicators (FSIs):** Montenegro does not report FSIs to the IMF.
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 biggest challenges to the BoP statistics are the large and persistent net errors and omissions –with positive sign. This could be caused by understated inflows, especially in travel and remittances. The CBM made progress in improving the recording of transactions via the international transactions reporting system (ITRS) by refining the transactions coding system and increasing interaction with commercial banks. However, the ITRS remains inadequate for recording a broad range of BoP transactions such as reinvested earnings and trade credits. The CBM has received TA on International Investment Position (IIP) statistics, but does not yet disseminate these data, along with gross external debt, as they still lack capacity to produce the data. The authorities have requested further IMF TA in these areas. 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. In July 2017 Montenegro received an e-GDDS Implementation mission—the National Summary Data Page (NSDP) is scheduled to go live in September 2017.	No data ROSC available.

Montenegro: Table of Common Indicators Required for Surveillance

(As of August 3, 2017)

	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]	Jun-2017	July-2017	M	M	M
Reserve/Base Money	Jun-2017	July-2017	M	M	M
Central Bank Balance Sheet	Jun-2017	July-2017	M	M	M
Consolidated Balance Sheet of the Banking System	Jun-2017	July-2017	M	M	M
Interest Rates[2]	Jun-2017	July-2017	M	M	M
Consumer Price Index	Jun-2017	July-2017	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2016	March-2017	A	A	A
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	Jun-2017	July-2017	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Dec-2016	March-2017	Q	Q	Q
External Current Account Balance	Q1-2017	May-2017	Q	Q	Q
Exports and Imports of Goods and Services	Q1-2017	May-2017	Q	Q	Q
GDP/GNP	Q1-2017	July-2017	Q	Q	Q
Gross External Debt	--	--	NA	NA	NA
International Investment Position[6]	--	--	NA	NA	NA

[1]Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic 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 authorities do not currently have the capacity to provide data on gross external debt and the international investment position and have requested IMF TA.
[7] Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).

Statement by Anthony De Lannoy, Executive Director for Montenegro and Zorica Kalezic, Advisor to Executive Director September 8, 2017

On behalf of the Montenegrin authorities, we thank staff for the constructive policy dialogue and for their helpful policy recommendations. The authorities broadly agree with staff on the policy challenges. They implemented measures in line with staff's recommendations, and are considering additional policy measures in response to staff's advice.

The authorities are actively addressing pressures in the medium term on the public finances, and recognize the challenges related to increasing debt. They are committed to a sequenced medium-term fiscal consolidation plan that would put debt steadily on a downward path after the highway is finished in 2019. At the same time, the authorities are making the financial system more resilient by expediting the implementation of the Financial Sector Assessment Program (FSAP) recommendations, and are addressing structural bottlenecks to improve labor market flexibility.

Recent Developments and Economic Outlook

Notwithstanding the lower than expected growth in 2016 of 2.5 percent due to a delay in the highway project, the medium-term growth outlook remains favorable. Projected growth of 3 percent in 2017 (3.2 in Q12017) will likely be surpassed, driven by accelerated highway construction, electricity and tourism related investments, and will average at 2.7 percent, over the period 2018-2020. At the same time, with a robust fiscal consolidation in place, targeting a primary surplus of 4.5 percent of GDP by 2020 is expected to be only a moderate inhibitor of growth, with an assumed fiscal multiplier reaching 0.2-0.3[1]. Inflation over the medium-term is expected to range between 2.3 percent in 2017 and 3.1 in 2018, mirroring inflation developments of the Eurozone and accounting for fiscal adjustment measures such as an increase in VAT and excises. A negative contribution from the external sector to growth will remain over the medium term. The current account deficit in 2018-2019 is projected to remain elevated, averaging 17.7 percent of GDP, due to the import needs related to capital investments, partially offset by growing tourism-related export of services.

[1] The authorities fully understand and are appreciative of Staffs' conservatism in using a fiscal multiplier of 0.5. However, in the absence of empirical evidence, based on Montenegro's resemblance with Caribbean small states, the authorities argue that this multiplier could be much lower, as found in the IMF Working paper Gonzalez-Garcia J., et al. (2011) on the Eastern Caribbean Currency Union (ECCU).

Fiscal Policy

Cognizant of rising debt levels, large market refinancing needs, and a deteriorated fiscal position, due to fiscal loosening in the 2016 election year, the authorities pressed ahead with a two-phased fiscal consolidation. The first phase is built in the 2017 Budget, balancing expenditure and revenue measures and delivering fiscal savings of 2.7 percent of 2017 GDP (2 percent according to staff). Measures range from increasing the excise tax on fuel, extending the progressive crisis personal income tax, partial cuts in Mothers law benefits to reduce public sector wages of senior officials, wage coefficients and performance bonuses. The first set of measures primarily targeted the reversal of negative fiscal developments in 2016, but was insufficient to secure fiscal buffers that would stabilize the debt over the medium term. Given that the authorities' aim was to implement measures that will put debt on a strong downward path over the medium term, they, in close collaboration with IFIs, proceeded with the second phase—a medium-term fiscal consolidation plan, summarized in Fiscal Consolidation Strategy (FCS).

The FCS, robust yet mindful of social implications, is in place, and will put public finances on stable footing over the medium term. In July 2017, the Parliament adopted the FCS and related legislation, which enables the implementation of its measures. The FCS targets a primary surplus of 4.5 percent of GDP by 2020, bringing net 2.5 percent of GDP in additional fiscal adjustments over and above the fiscal effects of measures adopted in the 2017 Budget.

Revenue generating measures dominate in the consolidation package, mostly because their yield is highly reliable. They include: the increase in the standard VAT rate, excises on cigarettes, alcohol, sugary drinks, and a new excise on coal. These measures are leveraged by an enacted program of tax arrears repayments, with incentives (interest forgiveness) to be granted, if corporates repay tax arrears in monthly installments over five years. So far, the tax debt rescheduling program meets its targets (4.5 percent of 2017 GDP), and already delivered 0.3 percent of 2017 GDP in revenues in the first month of operation (end August 2017). The Tax Administration reform is well on track. The Montenegrin Tax Administration (MTA) following the assessment of the Tax Administration Diagnostic Assessment Tool (TADAT) in late 2015, made improvements with tax debt management, with a decline in tax debts as well as tax arrears. Addressing an inadequate penalty regime and the lack of a criminal investigation function as inhibitors to the effective treatment of deliberate non-compliance are next planned activities.

Expenditure measures include abolishing the Mothers' lifetime benefit and adopting the time-limited provisions to compensate formerly-employed mothers, an additional reduction in wages of senior officials supported by a freeze in public sector employment. Given the sizable fiscal consolidation in motion, the FSC includes an increase of targeted social spending. With the aim of not compromising the primary balance target in 2020, the FCS a priori provides a buffer of 0.4 percent of the 2017 GDP for envisaged additional expenditures, which could be delayed if some measures underperform. Given that the Bar-Boljare highway has exhausted non-highway capital spending, the authorities will not engage in new major debt-financed investment projects over the medium-term, including the second phase of the highway.

The volatile fiscal discipline of the past and the current challenging fiscal consolidation targets are risks that could compromise the consolidation outcome. The authorities are aware that they need to improve their policy credibility. With this in mind, they already undertook this year, multi-faceted initiatives to prove their consolidation efforts, relying on Staffs recommendations. To that end, the FSCs implementation is supported (i) exogenously- the FSC is embedded in the prior actions policy matrix of the World Bank's Policy Based Guarantee (PBG) currently under negotiation, and (ii) endogenously- measures outlined in the FCS, although most of them are designed to take place in the medium term, have already been extensively discussed with targeted stakeholders, and adopted by the Parliament.

The authorities share staff's view that medium-term fiscal consolidation could be used as the backbone for additional streamlining of public expenditures, more conducive to medium-term growth. To that end, the authorities, supported by the WBG, are assessing the size of needed public sector staff rationalization over the medium-term. Pension system reform assuring sustainability reclaimed the authorities' focus, and in 2017 the authorities acquired the World Bank's Pension Reform Options Simulation Toolkit (PROST) model, which together with staff's recommendation will help the authorities to make informed policy choices. The elimination of early retirement and acceleration of an increase in retirement age are low hanging fruits that will be considered first. The authorities welcomed the recommendations to lower social contributions reducing tax wedge and making upper band of the personal income tax (PIT) permanent, and will consider them in the context of the ongoing IMF TA on tax policy.

The authorities are aware that the dynamic of sovereign debt is under pressure. Dollar-denominated highway investments increased commercial foreign currency disbursements. Debt has a short maturity and is increasingly reliant on external market financing, amidst risks of normalization of monetary policies in the US and the EU. The very liquid banking system holds manageable levels of government bonds and loans; however, it has limits including internal exposure limits for foreign banks and there are private sector crowding out considerations. There is some refinancing risk given Eurobond redemptions of about Euro 1bn concentrated in 2019-2021 and unidentified fiscal financing needs.

The authorities are taking active steps to strengthen market refinancing prospects, currently focused on (i) the FCS implementation, (ii) formalizing a pro-active, forward looking Medium-Term Debt Management Strategy 2018-2021 and well-articulated market relations strategy, with the help of IMF TA, by end October 2017 (iii) finalizing the World Bank Policy Base Guarantee (PBG). With FCS implementation, they will substantially address unidentified fiscal financing needs and significantly blunt the peak of the general government debt (including guarantees) in 2019 (from 89% percent as projected after the first stage of consolidation to 81% percent), falling rapidly thereafter, reaching 66 percent of GDP by 2022. The authorities are formulating a Debt Management Strategy 2018-2021 and considering a market-friendly Liability Management Operation that would reduce the Eurobond debt redemption concentration over 2019-2021.

Financial System and Policies

The banking system shows a solid track record of balance sheet recovery and stable lending, after a prolonged period of deleveraging and an episode of almost uninterrupted credit contraction. With the capital adequacy ratio at 17.6 percent, liquidity coefficient at 21.2 percent, and annual lending growth reaching 7.4 percent (end June 2017), the banking system is stable, solvent, and highly liquid.

However, elevated NPL levels and low profitability are the most prominent vulnerabilities in the system. Noteworthy efforts aimed at addressing NPLs are evident in the steady decline of NPLs, from 25.6 percent of gross loans at the end 2011, reaching 10.3 percent at end 2016, to 8.2 percent end July 2017. In an effort to further decrease NPLs, the Parliament adopted Amendments to the Law on Voluntary Loan Restructuring. It broadens restructuring asset coverage and increases participation incentives. In order to expedite the resolution of NPLs offloaded from banks' balance sheets into factoring companies, the CBM with a new Law on Financial Institutions will supervise factoring companies. Collateral execution and the speed of judicial proceedings are slow, but data on resolved cases show acceleration.

The authorities are aware that with 15 banks, there might be overcapacity in the sector, putting a drag on profitability (ROA amounted to 0.84 end June 2017). Simultaneously, they note that operations of new banks have compressed interest margins and replenished lending. The authorities are concerned that overcapacity might result in looser lending standards, especially after the hard-learned lessons in post-lending boom period evident in the present risk aversion. Therefore, close monitoring of market behavior, especially of smaller banks and new entrants (5 new banks since 2014) is in place.

The authorities plan to conduct system-wide AQRs in 2019. Implementation in 2018 of the International Financial Reporting Standard 9 (IFSR 9) will affect the balance sheets of banks through stricter impairment loss models, leading to higher provisioning requirements and potentially new recapitalization needs. To that end, the authorities see more merit in conducting AQRs only after such strong adjustment in accounting standards has been introduced and is fully reflected in the banks' balance sheets. Three not systemically-important solvent banks with qualified audits remain under special supervision and fully adhere to corrective measures of their supervisory action plans, ranging from additional recapitalizations to keeping the solvency ratios constant and well above prescribed minima

Limitations in funding Emergency Liquidity Assistance (ELA) resources, given the constrains stemming from euroization and scarce fiscal space, will be reduced by establishing a resolution fund with risk-based contributions planned in the Law on Recovery and Resolution of Banks.

The authorities made significant progress with implementing the 2016 FSAP recommendations. Most notably during 2016/17 the authorities prepared pivotal regulatory frameworks, aligned with the EU standards: (i) Central Bank Act – fully aligned with the ESCB/ECB Treaty and the Statute; (ii) Banking Law - defines systemically-important banks, assumes rehabilitation units and mechanisms for early intervention, strengthens prudential provisions for NPLs (iii) Law on Financial Institutions - fills the gap in and consolidates financial oversight responsibilities in Montenegro by putting factoring companies under the supervision of the Central Bank of Montenegro (CBM) (iv) Law on Recovery and Resolution of Banks - establishing a framework for the recovery and resolution of credit institutions, including creation of the resolution fund with risk-based contributions from banks; and (vi) Deposit Insurance Law- adheres to EU requirements on deposit guarantee schemes. These Laws will be adopted by the Parliament in 2017.

In parallel, the CBM, following the 2016 FSAP recommendations, benefited from MCM TA related to the establishment of a macroprudential policy framework. Consequently, the authorities are currently reforming the macroprudential policy mandate of the CBM. In addition, during 2017/2018, the Montenegrin authorities will rely on IMF TA to strengthen consolidated banking supervision including assessing group-wide risks, and fortify insurance risk-based supervisory framework, including the implementation of the Solvency II regime.

The authorities improved the AML/CFT framework with the new Law on Prevention of Money Laundering and Financing of Terrorism further harmonizing with the recommendations of MONEYVAL, the new Recommendation of the Financial Action Task Force (FATF) from 2012 and the new EU Directive 2015/849, strengthening risk based approach and treatment of politically exposed persons. The Law will be adopted in Q4 2017. In June 2017, Parliament adopted Amendments to the Law on International Restrictions compliant with the standards of Recommendation 6 of FATF.

Structural Policies

In parallel with actions taken to restore macro-fiscal sustainability, the authorities are focused on facilitating private sector job creation, through increasing productivity and competitiveness. The return of economic growth does not guarantee a return to jobs growth, and catching up with modern market economies is yet to happen. With high (long-term) unemployment, especially of the youth, low female labor force participation, and a large informal economy, Montenegro shares many elements of the Western Balkan labor markets.

Stern focus is on diminishing structural impediments contributing to low labor productivity, subpar labor market flexibility and informality. To that end, the authorities have prepared the Draft Labor Law, which reduces excessive state influence, abolishing general collective agreement, easing entrance and exit procedures, including for collective dismissals, and extending the length of fixed-term contracts for hard-to-employ individuals. The Law is to be adopted by end 2017. In parallel, to spur productivity of the public sector, the authorities prepared the Draft Law on Civil Servants and State Employees with the help of the European Commission, targeting professionalization of the civil servants, performance grading and easier dismissal procedures of state employees.

The authorities are trying to compensate, by business enabling reforms, Montenegro's limited productive base and the lack of economies of scale characteristics for most small states. This year, the authorities made significant reforms related to reliability of energy supply, tariff transparency and getting construction permits. In parallel, the authorities believe that ongoing robust investments in transport and energy address the core structural constraints of Montenegro as a small state, bringing returns over the medium term.