INTERNATIONAL MONETARY FUND

Montenegro

Concluding Statement of the 2013 Article IV Consultation Mission

Podgorica, May 20, 2013

The economy is recovering in 2013, but external and domestic challenges could moderate the pace of growth. High public debt and rollover risks continue to pose policy challenges. While fiscal consolidation has progressed recently, further effort is needed to meet this year's target, and additional adjustment is required in 2014 to put public debt on a declining path. Financial sector risks associated with external vulnerabilities have dissipated as banks have reduced external leverage, but there is a need to address the resolution of troubled loans, which continue to increase. Structural reforms of the metals industry, business environment and labor markets would enhance future growth.

1. **The economy is expected to recover this year, but problems in the metals sector and the weak external environment would limit GDP growth to 1-2 percent.** Good weather has boosted electricity production and exports, but a number of factors are likely to constrain growth. First, growth in tourism could be modest in the face of weak economic prospects in the euro area and Russia, and until investments to expand and upgrade capacity make progress. Second, overall credit is projected to remain stagnant because of balance sheet impairment and risk aversion. Lastly, the large decline in metal production will continue to be a drag on activity.

2. **The rapid increase in public debt since 2008 is a significant risk.** Montenegro's euroization, thin government deposit cover, shallow domestic financial markets and increasingly large rollover needs (particularly in 2015-16) make the country almost entirely reliant on external financing, and vulnerable to shifts in market conditions.

3. **The underlying structural causes of large fiscal deficits had not been addressed until this year.** Outsized increases in benefits toward the end of the boom together with increased opportunity for early retirement have widened the pension financing gap to 5 percent of GDP in 2012 from 1.2 percent in 2008; the pension indexation formula will need to be revisited. The public wage bill also remains high compared to both countries in the

region, and other small states. The authorities have tried to reduce the fiscal deficit, but until this year these attempts had largely resulted in cuts in capital spending and operations and maintenance costs, undermining the country's long-term growth potential. The steps taken this year have been in the right direction, but more will be needed (see below).

Reduce risks to fiscal sustainability from high public indebtedness

4. **A sustained, multi-year fiscal consolidation effort is needed to reduce the public debt burden to an appropriately low level over the medium term.** The lack of an exchange rate instrument and the country's vulnerability to external shocks put extra burden on fiscal policy and argue for a larger buffer than would be suggested for a typical emerging market economy. The mission recommends an ambitious public debt target of 30 percent of GDP by 2023, as indicated in earlier announcements by the authorities, and urges the timely adoption of policies needed to achieve that target.

5. **The fiscal consolidation measures adopted this year should be extended to 2014 and beyond.** Depleted fiscal buffers imply that consolidation needs to continue, though the weak economy calls for a measured approach. The freeze on pension and public sector wage adjustment, and the increase in the personal income tax rate for higher salaried workers are expected to yield a fiscal deficit reduction of 1.5 percent of GDP in 2013, and thus help slow the pace of public debt accumulation. However, a gap of 0.4 percent of GDP relative to the government's deficit target would remain, which could be closed through a prompt increase in the standard VAT rate from 17 to 19 percent, a measure currently under consideration, and which the mission supports. For next year, however, additional savings will be required to offset expected outlays to repay loan guarantees related to the aluminum company (KAP), which got a reprieve in 2013. Given the favorable financing environment at present, consideration should be given to setting aside part of this year's prospective debt issuance as a fiscal reserve to cushion against shocks.

6. **High public indebtedness and rollover risks limit the scope for additional debt to finance large infrastructure investment.** Enhancing transport links through the construction of highways could improve long-term growth prospects and facilitate the economic integration of less developed parts of Montenegro. But the relatively back-loaded payoff from such projects and the need to maintain financial market access for budget finance and high rollover need argue against using loans to finance such large projects.

Facilitate the cleanup of bank and private sector balance sheets

7. **Banking system downsizing in the aftermath of the collapse of the lending boom is advanced, though rising non-performing loans (NPLs) and continued private sector balance sheet impairment are a concern.** Banks have significantly reduced foreign liabilities since 2008 and are now entirely financed by local deposits. They have also made efforts to clean up their portfolios by selling off troubled loans to factoring companies. But there has been limited progress on the restructuring and resolution of these claims, and

household and corporate balance sheets remain burdened with very high debt. As a result of this, and bank risk aversion, credit to the economy has continued to contract.

8. **Structural distortions that hinder the cleanup of bank and private sector balance sheets should be removed.** There is a need to accelerate collateral execution that is constrained by inconsistent judicial application of the law and lengthy court procedures. Efforts should be made to improve the independence and accuracy of appraisals, introduce a private bailiff system, strengthen land registry, and improve the quality of accounting and auditing standards. The implementation of the ongoing World Bank project to facilitate out-of-court settlement and remove regulatory and legal obstacles should also be accelerated.

9. **Continued supervisory vigilance is essential, and given the high NPL level and weak profitability, it is critical the authorities maintain their proactive approach to seeking additional capital, as needed.** The authorities' regular stress tests on banks are welcome and should form the basis for assessing the need for additional capitalization. They should also continue to strictly monitor NPLs, enforce provisioning, and ensure that banks respond promptly to capital shortfalls, if needed. The authorities should ensure that the regulatory and supervisory umbrella appropriately extends to factoring companies and minimizes regulatory arbitrage. The mission encourages the authorities to continue to strengthen their contingency planning framework and implementation plans in line with recent IMF technical assistance recommendations.

Pursue structural reforms to achieve growth potential

10. **Budgetary support for KAP should be discontinued and steps should be initiated toward orderly liquidation under a clear and time-bound plan.** So far, interventions to support KAP have not succeeded in putting the company on a sustainable footing, and have contributed to misallocation of scarce resources, the need for budgetary subsidies, and accumulation of unpaid bills and contingent liabilities. The recent downsizing of the plant has helped mitigate the fiscal burden. However, prospects for a durable long-term solution—one that is subsidy-free and extinguishes outstanding debts and liabilities—are limited, and it appears inevitable that KAP cannot be sustained without unduly burdening taxpayers for years. A prompt decision on KAP's future will therefore need to be taken. While eventual liquidation of KAP, with an appropriate compensation plan for redundant employees, would entail a drag on growth and additional fiscal costs in the short term, it would also release scarce resources over the medium term, including energy for exports and activities in which Montenegro has good potential.

11. **Further improvements in the business environment would help attract FDI and enhance growth prospects, especially given the considerable untapped potential in tourism and energy.** Montenegro's ranking in international business climate surveys has improved recently, but further reforms are needed in facilitating property registration and dealing with construction permits, particularly at the municipal level. Prevalence of unregulated and informal businesses, especially in tourism, hinders high-quality investments and fiscal revenue intake. The mission welcomes the authorities' recent initiatives in these

areas. Strengthening the legal framework and judicial enforcement, notably in property rights, should also be on the policy agenda, as well as implementation of the AML/CFT regime to fight corruption.

12. **Labor market reforms should also continue.** As a small open economy without an exchange rate instrument to mitigate shocks, it is also essential that labor market outcomes be efficient. To this end, the authorities should continue to improve the collective bargaining framework in a manner that meaningfully addresses high structural unemployment, and ensure that changes in wages reflect those in productivity. The design of social protection should be enhanced to target the neediest, and to ensure it does not impede labor force participation, or impose undue burden on employers.

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The mission thanks the authorities and other counterparts for open and constructive discussions.