MONTENEGRO
MINISTRY OF FINANCE

Medium-Term Debt Management Strategy

2018-2020

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I. Debt management guidelines for 2018-2020

The strategic decisions outlined in this Medium-Term Debt Management Strategy Document (Strategy), have arisen from consideration of the current situation, analysis of future activities and the debt management objectives. These decisions take the form of guidelines and reflect the desired balance between expected costs and potential risks in the implementation of the Strategy.

The focal point of the Strategy is the reduction of risks, particularly refinancing risk, over a medium-term time period. Refinancing risk is regarded as the most important indicator and takes priority when compared to other debt portfolio risk indicators (average-time to maturity, average-time to refixing, interest rate risk, and exchange rate risk).

The guidelines that drive the Strategy and the Annual Financing Plan are as follows:

- Smoothening of the maturity profile of debt, by years, and an extension in the maturity of marketable debt;
- Risk mitigation through management of foreign exchange and interest rate risk;
- Gradual development of the government securities market;
- Minimization of borrowing costs, taking account the above priorities.

The guidelines translate into actions. Where the goal permits, targets are presented in the form of concrete measures or directions, outlined in Table 1 below. The rationale and background driving the guidelines are analysed in Section VI.

Table 1 Overview of guidelines, actions and targets

Guidelines	Targets/Actions
Smoothening of maturity profile of debt, by years, and an extension in the maturity of marketable debt	Improve the maturity profile: ❖ *Evenly distribute annual repayment amounts* ❖ *Maintain an average-time to maturity (ATM) of marketable debt: not less than 4 years, with a target to reach around 5 years in the medium term* ❖ *Limit the size of short-term borrowing up to 30% of total debt*
Management of foreign exchange and interest rate risk	Limit market risk as follows: ❖ *foreign exchange exposure as share of total debt: not to exceed 30%* ❖ *floating interest rate exposure as share of total debt: not to exceed 50%*
Development of the government securities market	Improve the price discovery mechanism in the domestic market and expand access to both domestic and international creditors: ❖ *Introduce a suitable market structure to offer a transparent price discovery mechanism for primary market activities and support the development of more liquid secondary market for government securities* ❖ *Provide predictability of the domestic issuance program to allow advance planning for investors*
Minimization of marketable debt borrowing costs	❖ *Improve transparency, stakeholder relations and gathering of market intelligence* ❖ *Expand of the investor base in terms of geography, type and size*

II. Introduction

The purpose of the Medium-Term Debt Management Strategy Document is to define a set of measures for the management of debt portfolio cost and risks during the 2018-2020 period, taking into account the existing macro-economic environment, existing debt structure, and available debt instruments that could be used. To that end, our objective is to present a realistic financial situation as well as investment environment in the country to the public, and current and future creditors, to continue attracting sound and good quality investments.

The legislative framework for general government debt management is defined by the adoption of the Law on Budget and Fiscal Responsibility (Official Gazette of Montenegro, No. 20/14, 56/14, and 70/17), stipulating the possible level and manner of borrowing. According to the Law on Budget and Fiscal Responsibility, the amount of annual borrowing of the State is determined by the annual budget law, whereby the total general government debt cannot exceed 60% of GDP. The same Law also envisages the budget deficit ceiling of 3% of GDP, measured at market prices. The Law envisages corrective measures if these limits are exceeded, as it was the case in recent years, which would stabilize of public finances.

The Law on Local Self-Government Financing stipulates the responsibilities, manner and amount of municipal borrowing. In addition to the Law on Budget and Fiscal Responsibility (Official Gazette of Montenegro, No. 30/17), a municipality may borrow to finance current liquidity (up to 12 months in maturity) without the consent of the Government, but requires a pre-agreed government consent in order to contract longer-term debt (debt maturing in more than 12 months).

General government debt has increased in recent years, mainly as a result from the implementation of important infrastructure projects, such as the Bar-Boljare highway section, and fiscal deficits in previous years. General government debt of Montenegro reached a level of 65.1% to GDP in 2017. At the same time, projections indicate that the general government debt will continue to increase in the next year and peak at 70.5% to GDP in 2018, but is expected to decline thereafter, and it will amount to 59.3% to GDP at the end of 2020.

Refinancing risk is considered the key debt portfolio risk and relates to Eurobond maturities of Eurobonds in 2019, 2020 and 2021, and a pro-active response is a vital part of the Strategy.

Sustained debt levels, above the minimum stipulated in the Maastricht criteria (maximum 60% of GDP), require systematic and decisive measures, to reverse the debt trend towards a downwards trajectory. In June 2017, the government adopted the Montenegro Fiscal Strategy 2017-2020, which defines a set of combined revenue- and expenditure-side measures, aimed at fiscal consolidation and general government debt reduction. The results of the Fiscal Strategy are already observable. Together with prudent debt management, the expected growth of the economy and improving tourism revenues, the intention is to reach a lower level government debt in the forthcoming years.[1]
A number of favourable factors continue to improve the economic outlook and investment opportunities in Montenegro. These include the implementation of the Fiscal Strategy,

[1] *See Section IV.*

progress achieved in Montenegro's accession negotiations with the EU, and Montenegro's NATO membership, which became effective in June 2017. External validation of the results achieved, and future prospects, have been presented in the qualitative assessments by Moody's and Standard and Poor's, credit rating agencies, which have upgraded Montenegro's sovereign credit rating outlook from negative to stable in September/October 2017. In its report at the end of September 2017, Moody's affirmed Montenegro's 'B1' rating, with a significant change of its outlook from "negative" to "stable". Meanwhile, Standard & Poor's published a new Report for Montenegro in October 2017, which changed the country outlook from "negative" to "stable", and maintaining Montenegro's 'B+/B' sovereign credit rating.

III. Objectives and scope

Securing funds for financing the State budget and its development objectives represents an ongoing priority for Ministry of Finance. Low economic growth can affect revenue collection and borrowing may be needed to finance public expenditure and the refinancing of maturing debt, and borrowing may also take place to finance high quality public investments during economic is expansion.

In accordance with generally accepted public debt management objectives, the aim of the Strategy is to minimize the costs of general government debt financing within a reasonable level of risk, with particular attention to the refinancing risk of an existing debt portfolio.

The scope of public debt management, as it pertains to the Strategy, is defined as the central government debt of Montenegro. This includes, in terms of external debt: commercial credit from bilateral, multilateral, and commercial partners (including Eurobonds), and for domestic debt: government securities in forms of treasury bills and domestic bonds, as well as commercial borrowing from local financial institutions.[2]
Although contingent liabilities, in the form of government guarantees to state-owned enterprise borrowings, pension arrears liabilities and the debt of local municipalities, constitute part of general government debt and obligations (see section V for description of debt stock), it is excluded from the definition of central government debt, and hence from the analysis.

IV. Macro-economic and fiscal developments

Gross domestic product (GDP) grew at an average rate of 2.7% during the 2014-2016 period, and this economic growth is a feature of the macro-economic environment. Over the same period, inflation was stable at an average rate of 0.2% per annum. The fiscal environment was less favourable with fiscal pressures caused by a budget deficit of 135 mil. Euro or 3.4% of GDP in 2016, as well as an increase in the level of general government debt that reached 64.4% of GDP in 2016. These developments highlighted the need for comprehensive measures aimed at sustaining macro-economic stability, especially the consolidation of public finances and increasing financial sector stability. To that end, the Government has adopted in 2016 the Measures for Budget Deficit and Public Debt in the period 2017-2020 (so-called

[2] *Included in central government debt is also a legacy stock of old currency savings, as well as a stock of restitution obligations.*

Resolution Plan) as an addendum to the Law on Budget for 2017, which stipulated measures aimed at increasing fiscal revenues, together with a reduction of expenditures. The consolidation measures included *inter alia*:

- Increase of excises on fossil fuels and derivatives (increasing revenues by 32 mil. Euro);
- Strengthening fiscal discipline (increasing revenues by 15 mil. Euro);
- Reducing benefits for mother of three or more children and other social benefits (reducing expenditures by 17 mil. Euro);
- Reducing capital expenditures (reducing capital expenditures by 10 mil. Euro).

It is estimated that these measures should have improved the state of public finances by 126.9 mil. Euro, approximately 3.2% of GDP.

In accordance with the Montenegro Fiscal Strategy 2017-2020, a comprehensive set of short- and medium-term fiscal consolidation measures and structural reforms were defined, with the objective to reverse an estimated budget deficit of 5% in 2017 to a 4.5% budget surplus in 2020. Also envisaged is a reduction in the general government debt stock to 67% of GDP in 2020 (from reaching a peak of 74.6% of GDP in 2018). Montenegro's objective is to meet the Maastricht criteria by reducing the debt to 60% of GDP.

Table 2 Overview of key fiscal consolidation measures and structural reforms

Fiscal consolidation measures	Structural reforms
❖ Increase of excise duties on cigarettes from 1-Aug-2017, ❖ Increase of excise duties on ethyl alcohol from 1-Aug-2017, ❖ Increase of VAT rate from 19% to 21% from 1-Jan-2018, ❖ Increase of excise duties on carbonated water with added sugar from 1-Jan-18, ❖ Introduce excise duties on coal from 2019, ❖ Reduction of wages for A-B-C categories by 6% from 1-Jul-2017, ❖ Reduction of social welfare benefits (including revisiting of mother benefits in line with the Constitutional Court ruling), ❖ Reduction of discretionary spending, ❖ Reduction of gross wage bill.	❖ Public Finance Management Reform (budget planning and execution, internal and external audit), ❖ Public Administration reform, ❖ Pension system reform, ❖ Healthcare system reform, ❖ Social and child protection reform, ❖ Education system reform, ❖ Improving financial stability (Law on Recovery of Banks, new Law on Banks), ❖ Improving the business climate (new Labour Law, etc).

In accordance with its work program and regular obligations, and aimed at further analysis of macro-economic and fiscal situation, the government adopted in November 2017 the Projection of Macro-economic and Fiscal Indicators for the period 2017-2020. These projections are the starting point for the preparation of the budget for the next year, as well as for the preparation of the Economic Reform Program of Montenegro for the period 2018-2020, which is the most important document for economic dialogue between the European Union and Montenegro.[3]

[3] *http://www.gov.me/en/homepage/Montenegro_Economic_Reform_Programme/*

Table 3 Fiscal indicators 2016 and projections 2018-2020

	2016		2017[4]		2018[5]		2019		2020[6]	
	mil. Eur	%GDP	mil. Eur	%GDP	mil. Eur	%GDP	mil. Eur	%GDP	mil. Eur	%GDP
Revenues	1,487.0	37.6	1,565.9	37.0	1,765.3	40.1	1,770.0	38.7	1,822.9	38.5
Expenditures	1,622.0	41.0	1,803.6	42.6	1,904.4	43.3	1,813.3	39.7	1,615.9	34.2
Current budget consumption	1,557.2	39.4	1,548.0	36.5	1,612.6	36.7	1,529.5	33.5	1,535.9	32.5
Capital budget	64.8	1.6	255.5	6.0	291.8	6.6	283.8	6.2	80	1.7
Deficit/suficit	-135.0	-3.4	-237.6	-5.6	-139.2	-3.2	-43.3	-0.9	207.0	4.4
Primary deficit	-40.7	-1.0	-138.9	-3.3	-53.7	-1.2	48.1	1.1	298.4	6.3
Debt repayment	533.1	13.5	358.6	8.5	181.7	4.1	529.3	11.6	759.5	16.1
Gross borrowing need	-655.4	-16.6	-596.2	-14.1	-320.9	-7.3	-572.6	-12.5	-552.5	-11.7

Source:MF

According to the projections, in the next medium-term period, growth of budget revenues on the one side and expenditure reduction on the other side are expected, as a result of implementation of fiscal consolidation measures and growth of economic activity, which will lead to generating of the budget surplus in 2020. In this way, there will be fiscal savings, which will reduce borrowing needs, and therefore reduce the level of debt in the observed period.

Table 4 Macro-economic indicators 2014-2016 and projections 2017-2020 [7]

	2014	2015	2016	2017	2018	2019	2020
GDP-in mil. Euro [8]	3,457.9	3,654.5	3,954.2	4,236.5	4,397.7	4,569.4	4,729.6
Nominal growth	2.8	5.7	8.2	7.1	4.7	3.9	3.5
Real growth	1.8	3.4	2.9	4.4	3.0	2.7	2.6
Deflator	1.0	2.2	5.1	2.7	1.6	1.1	0.9
Household spending as % of GDP	80.2	79.2	76.8	76.2	77.4	77.3	77.0
Gross fixed capital formation as % of GDP	19.0	20.1	23.2	25.2	23.9	23.1	22.1
Importation of goods as % of GDP	50.1	48.9	50.6	52.8	53.2	52.0	50.8
Inflation, average %	-0.7	1.5	0.3	2.4	2.6	1.9	1.5

Source:MF

Nominal GDP is expected to grow at an average annual rate of approximately 4.6% during the 2017-2020 period, while during the same period a real GDP growth is expected to reach 3.0% in 2018, 2.7% in 2019 and 2.6% in 2020. Inflation is predicted to reach its maximum of 2.6% in 2018 and then decline to 1.5% in 2020.

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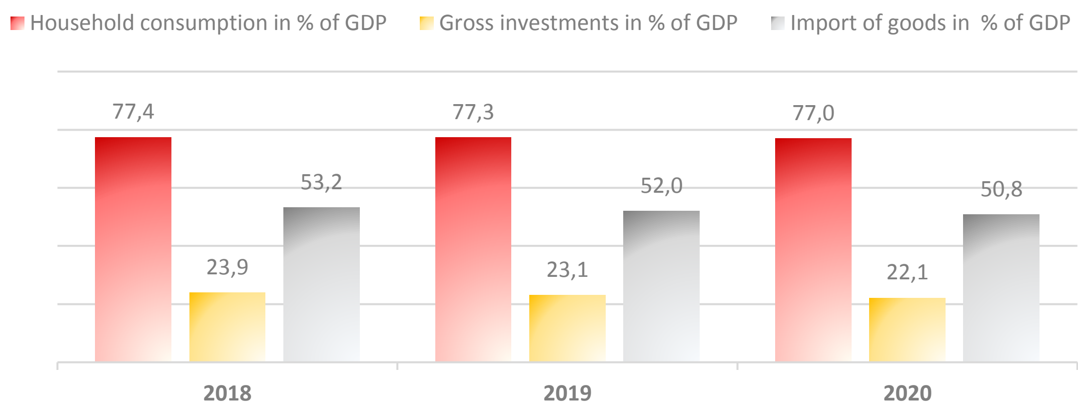
[4] *According to Report for Budget revenues and expenditures, published in Feb-2018.*
[5] *According to the Supplemental Budget Law for 2018 –March 2018*
[6] *According to Economic Reform Program for the period 2018-2020.*
[7] *Monstat released the data on GDP for the fourth quarter, and therefore the preliminary data for 2017. The annual real GDP growth rate was 4.4%, which is 0.4 pp higher than the estimations of the Ministry of Finance.*
[8] *According to Projections of macroeconomic and fiscal indicators for the period 2017-2020.*

When discussing GDP development during the period 2017-2020, it could be concluded that trends are caused by developments of household spending, gross investments, final government spending, as well exports of goods and services[9], whereby the main growth driver in the forthcoming period will continue to be household consumption, which is on average 77.23% of GDP.

Figure 1 Trend of household spending, investments and import as a % of the GDP



Source: MF

Furthermore, it is expected that household consumption will be influenced by a wage increase and growing number of employees, which will be a result of increase in demand driven by implementation of investment activities and increase in revenues from tourism and construction. During the period of 2017–2020, employment will gradually grow due to increase in economic activity, while nominal wages are expected to grow on average by 1.4% per annum.

Household spending is also expected to be affected by implementation of fiscal consolidation measures, which include controlled spending from the current budget, all having as an effect reduction in the final government spending at an average real rate of 1.1%.

Stability of the financial system [10]

According to data of the Central Bank of Montenegro, in 2017 the banking system continued to grow in both the amount of deposits and general liquidity, which were key factors for balance sheet changes. The annual increase of the aggregate balance sheet was 391.9 mil. Euro or 10.3%. Deposits grew further in 2017, thus total deposits were 3,27 bil. Euro at the end of 2017. Deposits consist of private citizens (1,70 bil. Euro), nonfinancial institutions (1,31 bil. Euro), general government (159,00 mil. Euro), financial institutions (41,50 mil. Euro), and NGO and other non profit organizations and categories “others” (55,20 mil. Euro).
Total mandatory reserves of the 15 banks, licensed to operate in Montenegro, were 233,6 mil. Euro at the end of 2017, while at the same period loans were around 2.7 bil. Euro. The composition of assets were: cash loans 22.2%, liquidity 17.7%, mortgage loans 12.3%,

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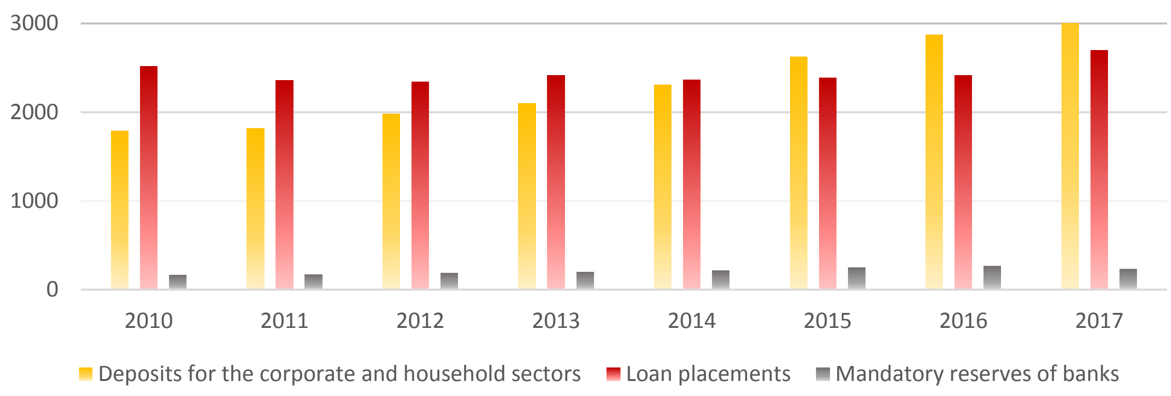
[9] Exports of goods and services is expected to grow at an average real rate of 2.1%, mostly due to the growth of revenues from services (tourism).
[10] Based on data of the Central Bank of Montenegro.

refinancing 6.2%, asset purchases 5.6%, building and adaptation of buildings 3.8%, overdraft 3.3% and other assets 29.0%.

Figure 2 Trend of deposits for the corporate and household sectors, loan placements and mandatory reserves of banks in the period from 2010 to 2016, in mil. Euro



Source: CBMNE

Banks' liquidity continued to grow in 2017. According to data of the Central Bank, at the enf of 2017 liquid assets were 1.1 bil. Euro, and have annual growth of 0.8%. Due to an inflow of deposits and the slower credit growth, both the corporate sector and household sector were net creditors to the banking system at the end of 2017. The credit to deposit ratio has recorded a multi-year decline and has remained below 100% since 2015.

V. Existing Debt Portfolio

According to the Law on Budget and Fiscal Responsibility, the General Government debt is defined as debt at the Central and Local Government levels. The Central Government is comprised of the State authorities and State administration authorities, as well as legal persons and business organisations predominantly providing services in the public interest which are controlled and mostly financed by the State. The Local Government is comprised of the municipal authorities, as well as legal persons and business organisations, predominantly providing services in the public interest, which are controlled and mostly financed by the municipalities.

General Government debt consists of Central Government debt and debt of local municipalities. Central Government debt can be further divided into foreign and domestic debt. Table 5 provides a breakdown of the debt stock in Montenegro in absolute terms, as well as relative to GDP.

Over the period 2014-2017, General Government debt grew from 59.9% to 65.1% of GDP.

Table 5 Debt developments over the period 2014-30.09.2017, in mil. Euro

	2014	2015	2016	2017
Domestic debt	381.2	320.3	400.2	413.9
Foreign debt	1,561.7	1,956.4	2,002.8	2,213.9
Central Government	**1,942.9**	**2.276,7**	**2,403.0**	**2,627.9**
Local Self-Government	128.8	142.2	143.1	130.9
General Government debt	**2,071.7**	**2,418.9**	**2,546.1**	**2,758.8**
General Government debt/GDP	**59.9%**	**66.2%**	**64.4%**	**65.1%**

Source: MF

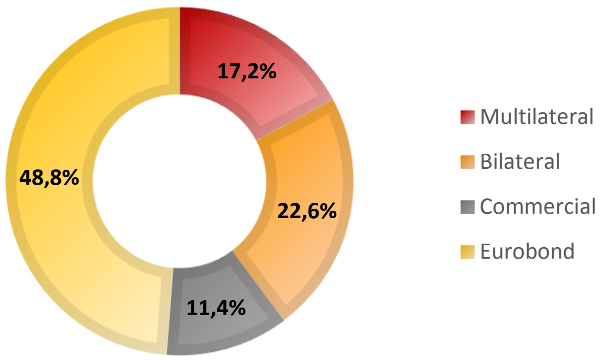
During the same period, Ministry of Finance deposits, which consist of cash and gold deposits, ranged from 49.5 mil. Euro in 2014, to 57.25 mil. Euro in 2015, and 47.36 mil. Euro in 2016. At the end of 2017, deposits grew to 70.90 mil. Euro, which was mainly caused by an increase in regular cash deposits.

Subsequently, the government's current debt portfolio is presented in more detail.

Foreign Debt

Foreign debt comprises the majority of the Central Government's debt portfolio, accounting for approximately 84% of total debt (or 2,213.9 mil. Euro). Figure 3 presents a further breakdown of the Central Government's foreign debt stock. This consists of three Eurobonds due in 2019, 2020, and 2021, multilateral loans from international institutions, bilateral loans, as well as commercial loans.

Figure 3 Share of Instruments in Total Foreign Debt as of end 2017



The largest liabilities under foreign debt are the Eurobonds with a share of 48.8%, which amounts to approximately 1,080.0 mil. Euro (Table 6). The next largest foreign debt liabilities of the Central Government consist of loans used to finance infrastructure spending.

Table 6 Largest foreign debt liabilities at end of 2017

	in mil. Euro
Eurobonds 2019-2021	1,080.0
China EXIM bank	337.4
International Bank for Reconstruction and Development (IBRD)	197.6
Credit Suisse bank	138.4
European Investment Bank (EIB)	98.2

Source: MF

Domestic Debt

Domestic debt is predominantly composed of the debt resulting from restitution, the domestic bond issue 'GB16', Treasury bills, and credit lines extended by commercial banks. Debt of legal persons and businesses predominately providing services in the public interest is also included in the domestic debt stock. Table 7 shows the largest domestic liabilities to domestic holders of Central Government debt.

Table 7 Largest domestic liabilities at end of 2017

	in mil. Euro
Credit lines from commercial banks	107.5
Liabilities for restitution compensation	87.8
Domestic bonds GB16	80.4
Treasury bills	77.5

Source: MF

Treasury bills

Treasury bills, in accordance with regulations, serve to secure funds for to maintain budget liquidity, without affecting the annual debt increase limit set by the Annual Government Budget Law; with the aim at the timely payment of all planned liabilities in the current fiscal year.

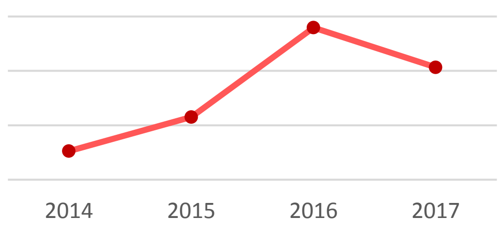
Until the beginning of 2017, commercial banks had the opportunity to use their mandatory reserves funds to buy Treasury bills. Subsequently, however, this opportunity was removed in the first quarter of 2017 by the Central Bank of Montenegro, which was one of the conditions for the opening of EU accession negotiations, in Negotiating Chapter No. 17 Economic and Monetary Union. Nonetheless, demand from banks to buy Treasury bills kept pace, while yields fell. Namely, during 2017 the average weighted interest rates for Treasury bills ranged from 2.4% to 0.2%, which indicates a downward trend; thus, issuing Treasury bills to manage general short-term liquidity needs has been a favourable form of borrowing.

Public service enterprise debt, local government debt and government guarantees

Public Service Enterprises [11]

Total debt stock of Public Service Enterprises, as of 30-Dec-2017 was 39,13 mil. Euro.

Figure 4 Trend of Debt of Legal Persons and Business Organisations in the period 2014-



Investment loans comprised the majority portion of the debt of legal persons and business organisation in the amount of 37.87 mil. Euro, which were taken by the Railway Transport of Montenegro (Željeznički prevoz Crne Gore) for procurement of new electric locomotives and of the Railway Infrastructure of Montenegro (Željeznička infrastruktura Crne Gore) for reconstruction and improvement of the railways.

[11] *In accordance with the definition for legal persons and business organizations from the Law on Budget and Fiscal Responsibility.*

Local Government

Consolidated local government debt by end-2017 amounted to approximately 166.9 mil. Euro, according to the data provided by municipalities and the Ministry of Finance, which is lower by 8.8 mil. Euro compared to end-2016. Consolidated local government debt is presented through foreign and domestic debt in the General Government Report: the foreign government debt stock includes municipal debt for loans which the Government signed with foreign creditors and transferred through on-lending agreements with municipalities, which were 36.0 mil. Euro at end-2017 (amount of disbursed, unpaid funds), and through the "local government debt" stock which was 130.9 mil. Euro at end-2017. [12]

At the end of 2015, the Ministry of Finance had issued guarantees to local governments in the total amount of 42.9 mil. Euro. Credits, for which the guarantees were issued, were solely used for implementation of resolution plans of some municipalities, in need of financial consolidation. A small share of this amount, 0.65 mil. Euro, was used for investment projects. Municipalities are regularly servicing loan facilities which were used for the implementation of resolution plans.

Government Guarantees

Debt resulting from contracted guarantees issued by the Government ranged from 307.5 mil. Euro (8.9% of GDP) in 2014 to 312.8 mil. Euro (7.4% of GDP) at the end of 2017.

Considering the structure of the issued guarantees, domestic guarantees were primarily a form of support for companies implementing certain social welfare activities, as well as support in the implementation of local self-government resolution plans. Foreign guarantees, on the other hand, were primarily in the form of loans implementing various infrastructure projects, shipbuilding and ensuring support for the development of small and medium-sized enterprises, provided to the banking sector of Montenegro. Furthermore, foreign guarantees were issued to some enterprises in order to support reconstruction and modernization of railways, airports, and the energy system.

Table 8 Loan guarantees trend 2014-2017, in mil. Euro

		2014	2015	2016	2017
Foreign loan guarantees	Contracted amount	481.8	527.7	531.2	486.4
	Disbursed amount	384.2	405.9	436.1	400.7
	Debt Stock	**298.6**	**295.2**	**293.9**	**262.5**
Domestic loan guarantees	Contracted amount	12.7	58.7	58.7	65.5
	Disbursed amount	11.8	47.9	58.1	60.9
	Debt Stock	**8.9**	**44.9**	**51.0**	**50.3**
TOTAL stock of loan guarantees		**307.5**	**340.1**	**344.9**	**312.8**

Source: MF

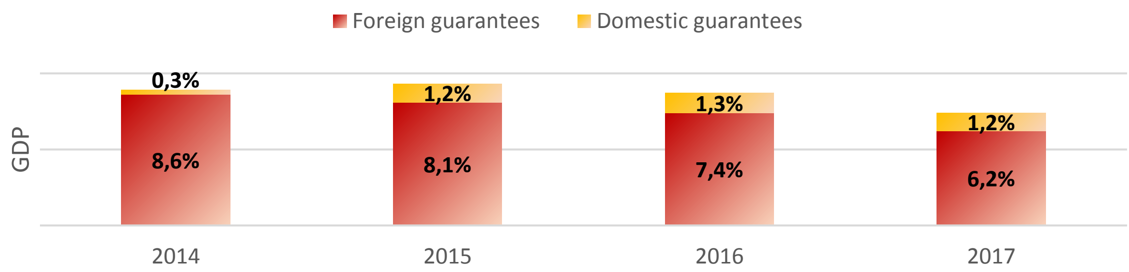
Table 8 provides a breakdown of foreign and domestic loan guarantees outstanding over the period 2014-2017. No new guarantees were issued in 2016, while at the beginning of 2017 the Government

[12] The Local Government Debt is an integral part of the Report on the General Government debt, which is published once a year, at the end of the first quarter of the current year for the previous fiscal year.

of Montenegro issued guarantees in the total amount of 13.7 mil. Euro. From these newly-issue guarantees, an amount of 7.0 mil. Euro was guaranteed for the Railway Infrastructure of Montenegro, and an amount of 6.7 mil. Euro was guaranteed for the Regional water supply of the Montenegrin coast.

As a share of GDP, guarantees have been declining in recent years (Figure 5). This is partially the result of the Government of Montenegro's newly-implemented restrictive policy on issuing guarantees, with priority given to projects of strategic importance.

Figure 5 Stock of guarantees as a share of GDP, 2014 to 2017



Source: MF

Borrowing structure

The increase of Central Government debt in the previous period was mainly a result of Eurobonds issued in 2014, 2015, and 2016 in the amount of 1,080.00 mil. Euro. In addition to these, debt increased due to the loan from the China EXIM Bank for the construction of the first section of the Bar-Boljare Highway.

Box 1 Loan Facility with the China EXIM Bank for the Project "Design and Construction of the Bar-Boljare Highway, Section Smokovac-Uvač-Mateševo"

The Government of Montenegro and the China EXIM Bank have signed a Contract on Financing the Bar-Boljare Highway (Smokovac-Mateševo) on 30-Oct-2014, for 943,991,500.00 USD, with effectiveness coming into effect in 2015. Construction of 42 tunnels and 92 bridges and viaducts is planned for the 41km section of the Bar-Boljare Highway. Works on Construction of the Bar-Boljare Highway have officially began on 11-May-2015. Construction of the priority section Smokovac–Uvač–Mateševo will last four years. The total estimated cost of construction of highway section is around 809.6 mil. Euro, out of which 85% of the total amount is provided from the loan of the China Exim Bank, while 15% is provided from the Government budget or other financing sources. The loan facility was signed with 20-year maturity and 6 years grace period, with an interest rate of 2%. Furthermore, a commitment fee of 0.25% is paid on undisbursed funds. During 2015, committed amount was 188.8 mil. USD, while there was a delay in implementation of works during 2016 which resulted in 10.8 mil. USD being disbursed. In 2017, the committed amount was 205.6 mil. USD.

During the period 2014-2016, the domestic debt oscillated. After its decline in 2015, it increased in 2016 as a result 80.4 mil. Euro of domestic bonds issued.

Table 9 Overview of domestic and foreign bonds in 2014, 2015, and 2016

Bond issue year	Bond maturity year	Volume of issue (mil. Euro)	Interest rate	Market
2014	2018	43,15	5%	Domestic
2014	2019	280	5.375%	Foreign
2015	2020	500	3.875%	Foreign
2016	2020	80,41	4%	Domestic
2016	2021	300	5.75%	Foreign

Source: MF

As for the infrastructure projects, loan facilities in the amount of 110 mil. Euro, 48.8 mil. Euro, 28.5 mil. Euro and 88.9 mil. Euro respectively were concluded in the period 2014-2017. These loan facilities were pertaining to the needs of construction and reconstruction of pre-school facilities, road rehabilitation, energy efficiency, industrial waste management, water supply and wastewater treatment, institutional development and agriculture strengthening. Loan facilities concluded for the needs of railway infrastructure reconstruction, environmental protection, procurement of medical equipment, administration needs (tax administration reform, land administration and management, trade and customs, financing export, etc.) are also included in the foreign debt.

Table 10 Infrastructure borrowing, 2014 to 2017, in mil. Euro [13]

Area	Contracted Amount	Cancelled Funds	Committed amount until 31-Dec-2017	Debt Stock as of 31-Dec-2017
Highway	783.5	0.0	337.9	337.9
Transport (roads and railways)	256.2	2.6	182.4	85.8
Water-supply	225.2	0.0	85.4	49.0
Environmental Protection	150.5	33.1	69.5	43.1
Energy Efficiency	63.1	0.6	50.0	30.9
Administration	45.8	0.5	45.3	20.1
Education	40.9	0.1	33.3	21.4
Social Welfare	45.0	17.2	17.8	16.9
Agriculture	24.0	0.2	17.6	7.8
Healthcare	21.0	0.2	20.8	9.5
TOTAL	**1,655.3**	**54.4**	**860.0**	**622.4**

Source: MF

Moreover, special attention was dedicated to investments in infrastructure, healthcare, school system, environmental protection and agriculture in the previous period, as such investments drive the economic growth, generate synergy effects on the entire Montenegrin economic system, and enable the creation of new jobs. Adequate choice of investments will enable also for a more efficient use of public resources. In addition, the Government of

[13] *According to exchange rate on 30-Dec-2017.*

Montenegro is aiming to increase investments in infrastructure, especially those that would contribute to the development of tourism, as a development sector of the Montenegrin economy.

Cost and risk dynamics of current portfolio

For purposes of calculating cost and risk indicators of existing debt, the whole foreign debt is used, while debt of private enterprises and business organizations and debt for pension arrears are excluded from domestic debt; this is because the costs of debt repayment of companies are not included in budget expenditures, while in the case of arrears, there are no interest payments.[14] Debt of local municipalities is also excluded as part of general government debt, because the costs arising from the repayment of interest on credit arrangements concluded by the local self-government unit are not calculated into budget expenditures.

The structure of the debt has a real weighted average interest rate of 3.1% (Table 11). The weighted average interest rate of external debt amounts to 3.3%, while for domestic debt it amounts to 2% as a result of low interest rates for Treasury bills and commercial loans.

Table 11 Cost and risk indicators for existing debt at the end of 2017 [15]

		Foreign debt	Domestic debt	Total debt
Cost of debt	Interest payment as % of GDP	1.7	0.2	1.9
	Weighted Average Interest rate (%)[16]	3.3	2.0	3.1
Refinancing risk	ATM[17] (years)	4.5	5.2	4.6
	Debt maturing in 1 yr (% of total)	4.4	17.1	6.2
	Debt maturing in 1 yr (% of GDP)	2.3	1.5	3.8
Interest rate risk	ATR[18] (years)	3.4	5.0	3.6
	Debt refixing in 1yr (% of total)	28.2	29.3	28.4
	Fixed rate debt (% of total)	73.4	84.0	74.9
FX risk	Non-EUR FX debt (% of total debt)			16.1

Source: MF

The average time to maturity for foreign debt is 4.5 years, while for domestic debt is 5.2 years, in most cases because of restitution repayment, which is estimated up to 2041.

The analysis of the debt structure at the end of 2017 shows 17.1% of total domestic debt matures in one year, compared with the foreign debt where only 4.4% of total foreign debt matures.

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[14] *At the end of 2017, debt stock for pension arrears amounted to 1.9 mil. Euro, while debt of private enterprises and business organizations was 39.1 mil. Euro.*

[15] *According to the debt stock at the end of 2017, according to the exchange rate as of 31-Dec-2017. For the projection, a MTDS analytical model was used, which does not include the stock of debt for pension arrears and debt of legal entities and companies.*

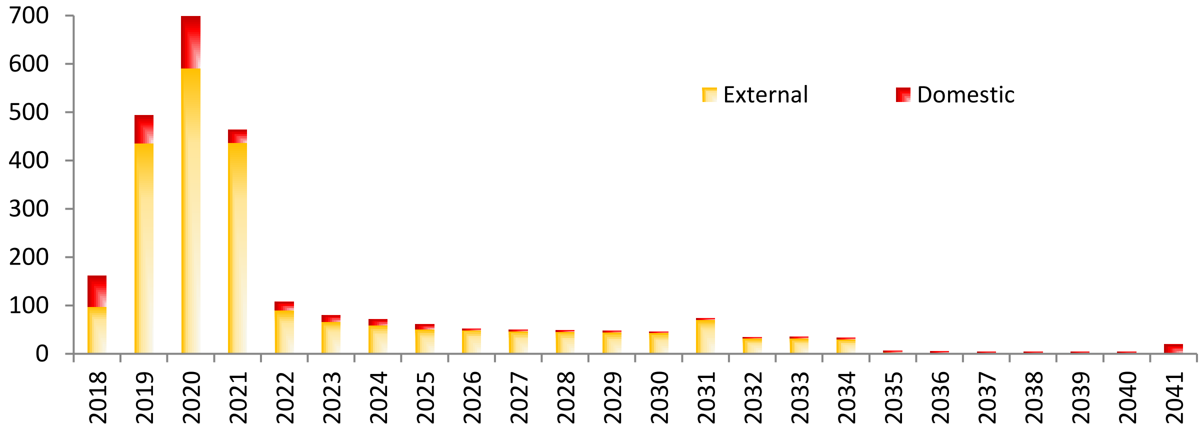
[16] *The average interest rate computed for the central government debt, which does not include the stock of debt for pension arrears, restitution, foreign currency savings and legal entities and companies, in the total amount of about 142.6 mil.Euro.*

[17] *Average Time to Maturity.*

[18] *Average Time to Refixing.*

The debt repayment projection shows an increased burden on the budget in the period 2019-2021., when the obligations from Eurobonds issued during 2014-2016 in the total amount of 1,080.00 mil. Euro mature.

Figure 6 Redemption profile of total existing debt at end 2017, in mil. Euro [19]



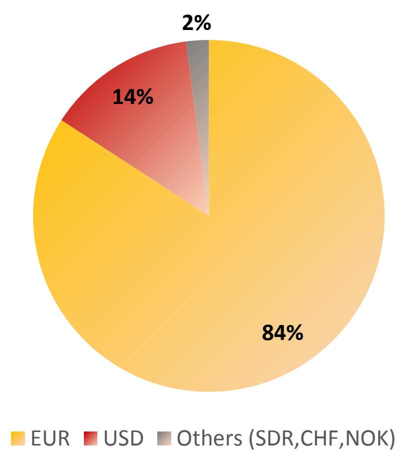
Source: MF

Also, during 2020, the obligation for a bond issued on the domestic market matures in the amount of 80.4 mil. Euro. After the repayment of obligations in this period, a significant reduction in the burden on government finances is expected.

Currency structure of the debt

In addition to the national currency (Euro), the government debt portfolio has exposures in the following currencies: US dollar (USD), Swiss franc (CHF), Norwegian kroner (NOK), and Special Drawing Rights (SDR) unit of the International Monetary Fund.

Figure 7 Currency share in the Central Government debt as of 2017



Foreign exchange risk does not feature prominently in the debt portfolio of the Central Government. Figure 7 illustrates that presently only 15.8% of the existing debt portfolio is issued in non-Euro denominated instruments.

The largest non-Euro exposure is to the US dollar through various loan facilities, up to 13.8% as of 30-Dec-2017. These include loans from the Paris Club and the China EXIM Bank for the first section of the Bar-Boljare Highway; the latter was the major driver of the increase in debt and foreign exchange risk from 2014 to 2015 (Table 12). Foreign exchange exposure in other currencies (NOK, CHF, SDR) is relatively minor, comprising only 2.1% of the Central Government debt portfolio.

[19] *In the presented debt repayment, the debt repayment for pension arrears and legal entities and business organizations are excluded. According to the exchange rate on 31-Dec-2017. MTDS analitical tool was used.*

A more detailed breakdown of currency exposures for the period 2011-2017 is presented in Table 12, with amounts also reported as a share of the total debt portfolio.

Table 12 Debt stock in foreign currencies

	2011	2012	2013	2014	2015	2016	2017
Debt in foreign currencies, in mil. Euro	122.4	119.0	108.2	107.4	279.3	287.7	416.3
Total Central Government debt, in mil. Euro	1,483.5	1,699.5	1,933.0	1,942.9	2,276.7	2,403.0	2,627.9
Debt in foreign currencies / Total Central Government debt (%)	**8.3%**	**7.0%**	**5.6%**	**5.5%**	**12.3%**	**12.0%**	**15.8%**

Source: MF

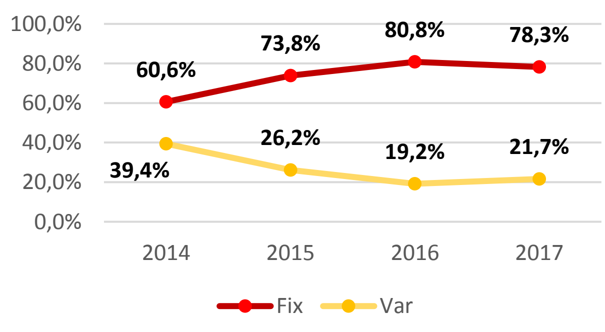
Foreign debt stock is expected to increase due to borrowing for the Bar-Boljare highway construction. The government is considering various hedging arrangements to manage foreign currency risk before principal payments on the loan from the China EXIM bank, commence in 2021. According to preliminary analysis, hedging against foreign exchange risk could be implemented for a period of up to 10 years but longer periods could make the hedging unfeasible due to the cost.

Interest rate structure of the debt

According to the Central Government debt data as of 30-Dec-2017, the share of the debt with a fixed interest rate is approximately 78%, while loans with variable interest rates comprise only 22% of the central government debt.

In the period from 2014 to 2017, the share of foreign debt with a fixed interest rate grew relative variable-rate debt; from 62.4% as a share of the Central Government's total debt portfolio in 2014, fixed-rate debt reached 66.2% in 2017. It should be noted that the reference interest rate for the majority of variable-rate instruments is the 6-month EUROIBOR, which is at a historically low level.

Figure 8 Composition of the Central Government debt by interest rate type, share in %



The majority of the domestic debt is held in variable-rate loans, while the issued bonds carry fixed interest rates: average rates are 4% and 5% respectively.

During 2017, the average interest rate of Central Government debt was 3.1%. The composition varied between foreign and domestic debt; whereas the average interest rate on foreign debt was 3.3% and 2.0% for domestic debt.[20]

[20] *For the estimations, the MTDS analytical tool was used. Debt for the pension arrears, foreign currency savings, restitution and legal entities and companies is excluded from the estimation, which amounts to approximately 142,6 mil. Euro.*

Average interest rates for international markets borrowing during the 2014-2017 period had a moderately declining trend, bearing in mind that most of the new borrowings were with a more favourable interest rate, rather than previous borrowings. Interest rates at the domestic market were fluctuating due to varying new Treasury bill issues from year to year, while the interest rate for loans from commercial banks were lower than in the previous period.

Table 13 Average interest rate for the Central Government debt 2014-2017 [21]

	2014	2015	2016	2017
Foreign Market	4.4%	3.6%	3.7%	3.3%
Domestic Market	3.2%	3.3%	4.1%	2.0%
Average interest rate for the Central Government debt	4.3%	3.6%	3.7%	3.1%

Source: MF

VI. Debt Trend Projections and Risk Analysis 2018-2020

Baseline Scenario and strategy of the Central Government debt Developments 2018–2020

Under baseline assumptions, central government debt will likely follow an upward trend in the period 2017-2018, before taking a downward trend in 2019. The highest central government debt level is expected in 2018 at around 67.5% of GDP, while its level in 2020 will be at 56.5% of the estimated future GDP.

The central government debt stock at the end of 2017 was 62.0% of GDP. Further growth of debt in 2018 is expected to be driven by costs for the highway construction primarily, as well as because of borrowing needs for budget financing, taking central government debt in 2018 to 67.5% of GDP, while in 2019, the ratio will amount to 62.8% of GDP. Bearing in mind that there will be no scheduled borrowing for the highway project in 2020, the central government debt will be at the level of 56.5% of estimated GDP.

Financing of the highway project construction, section Smokovac - Mateševo, will require 190.0 mil. Euro in 2018 and 203.7 mil. Euro in 2019.[22] These funds were already secured and will be disbursed as scheduled from a loan facility with the China EXIM Bank.

The Supplement Law on Budget for 2018 was adopted at the beginning of 2018, which envisages an increase in revenues and expenditures, as well as increase of financing needs by 25 mil. Euro. Therefore, borrowing of 320.0 mil. Euro is planned for 2018 to finance the budget deficit, compared to the initial amount of 296.0 mil. Euro foreseen in the Law on Budget. Funds for financing the budget increased by 25 mil. Euro, which compared to the Law on Budget presents an increase of around 106.0 mil. Euro to around 131. Mil. Euro. Therefore, up to 250.0 mil. Euro will be provided with a Facility Loan supported by the World Bank

[21] *For the estimations the MTDS analytical tool was used. Debt for the pension arrears, foreign currency savings, restitution and legal entities and companies is excluded from the estimation, which was in the total amount of about 183 mil.Euro in 2014, about 175 mil. Euro in 2015, about 163 mil. Euro in 2016 and about 143 mil. Euro in 2017.*

[22] *According to agreed fix exchange rate EUR/USD 1,3718.*

guarantee. The rest of mentioned funds, provided under this Facility loan will be used as a deposit for repayment of debt in the following 2019. Mentioned Facility is planned with a repayment period of 12 years and a variable interest rate with a margin of 2.95%. Total liabilities for repayment of debt amount to about 182.0 mil. Euro in 2018.

For 2019, amount of the borrowing required for debt repayment and deficit financing will grow to approximately 573.0 mil. Euro, while total liabilities for debt repayment will amount to about 530.0 mil. Euro, which is primarily caused by the 2014 Eurobond of 280.0 mil. Euro coming due. Having in mind that at the end of 2018 deposits will be at the espected level of around 120.0 mil. Euro, the mentioned amount will be used for debt repayment in 2019. Liabilities for repayment of debt in 2020 will amount to about 760.0 mil. Euro and the largest portion of liabilities concerning the debt repayment in 2020 refers to the 2015 Eurobond in amount of 500.0 mil. Euro. However, considering the planned surplus in 2020 of around 207.0 mil. Euro, as well as lower level of planned funds for financing the capital budget due to completion of the Project for construction of the Smokovac - Mateševo highway section, the financing needs in 2020 will amount to about 553.0 mil. Euro.

Table 14 Central Government debt developments 2017-2020, in mil. Euro [23]

	2017	2018	2019	2020
GDP	4,236.5	4,397.7	4,569.4	4,729.6
Domestic debt	413.9	348.3	291.1	183.4
Foreign debt	2,213.9	2,621.5	2,578.9	2,488.9
Central Government debt	**2,627.9**	**2,969.8**	**2,870.0**	**2,672.3**
Central Government debt as % of GDP	**62.0%**	**67.5%**	**62.8%**	**56.5%**

Source: MF

Over the term of the Strategy, total borrowing of approximately 186.0 mil. Euro of funds for financing infrastructure and other projects is expected. Out of this amount, borrowing for new infrastructure projects total amounts to approximately 55.0 mil. Euro.

The following parameters were also incorporated in the analysis:

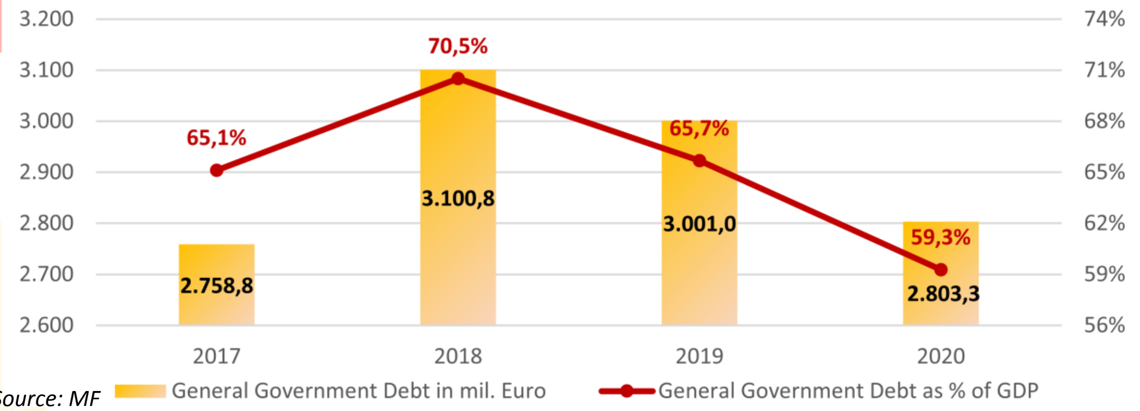
- For borrowings under loan facilities with variable interest rates, margins in effect at the end of 2017 were used, while for borrowings under loan facilities with fixed interest rates, the latest interest rate of the financial institution from which the loan was contracted were used;
- For loans in non-euro currencies, interest and exchange rates as of 31-Dec-2017 were used;
- Loan facilities for implementation of infrastructure projects will be committed and disbursed at an average amount of 60 mil. Euro annually;
- Borrowing for financing the budget in the period 2018-2020 is planned with a maturity of 10 years, including a 4-year grace period and interest rate of up to 4%;
- For projections of General Government debt developments in the period 2018-2020, the latest data on the local self-government debt were used, in the average amount of 130.9 mil. Euro annually.

[23] *Debt presented in the Table does not include deposits of the Ministry of Finance.*

Box 2 General Government debt developments in Baseline Scenario, 2017-2020

General Government debt will have an upward trend until the 2018, when it will reach a maximum of 70.5% of GDP, after which it will take the downward path, and at the end of the observed period, in 2020, it will be at the level of 59.3% of estimated GDP.

Figure 9 General Government debt developments 2017-2020



Source: MF

According to the Budget Law for 2018, and the Supplement Budget Law for 2018, the Ministry of Finance retains the flexibility to consider pre-funding opportunities for the existing Eurobonds due 2019-2021. Therefore, the Ministry of Finance will remain open to proposals related to managing its liabilities, within the context of underlying market conditions. In line with the objectives outlined above, the goal would be to extend the maturity profile and improve the debt repayment dynamics by reducing the volume of redemptions due in 2019-2021.

Stylized quantitative analysis of alternative strategies

For the achievement of the medium-term goals, a borrowing strategy following well-defined borrowing guidelines is necessary. In order to understand the mechanics of various borrowing options and for the expansion and deepening of the analysis, the IMF-World Bank jointly developed Medium-term Debt Management Strategy (MTDS) framework and quantitative tool was used. Four alternative strategies were constructed with the purpose of examining stylized situations to help reach borrowing objectives. It is important to state at this stage that these are only a few of the many possible borrowing strategies, but that these four were selected to highlight the major alternative broad options among the possible strategies.

The four strategies under examination are the following:

Strategy 1 (baseline): ***Current strategy*****.** Under this Strategy the market financing is undertaken primarily in EUR and USD[24] foreign loans and bonds, whilst in the domestic market the share of Treasury bills remains roughly stable, mirroring the current borrowing trends.

[24] *Loan with Exim China Bank for the Highway Project.*

Strategy 2: *Lengthen foreign maturities.* This Strategy is similar in its parameters to Strategy 1, except for the Eurobond refinancing maturities being tested at 10 years, with the appropriate market-derived cost.

Strategy 3: *Balanced strategy.* This Strategy is similar in its parameters to a combination of Strategy 2 and Strategy 4. It illustrates an active, yet gradual, domestic debt market development strategy, coupled with a lengthening of external borrowing maturities. This combination strategy also effectively addresses foreign exchange risk by increasing the relative EUR financing in the projected period.

Strategy 4: D*omestic debt market development.* This option presumes a higher financing in the domestic market compared to previous periods, which was stipulated in the first two strategies. Hence, issuances increase in volume in domestic securities, moving the composition gradually from Treasury bills to longer-term domestic bonds.

The strategies were subject to interest rate and exchange rate shocks under four scenarios.

- **Scenario 1: *interest rate shock***. Short term foreign and domestic interest rates rise by 1%, long term rates by 2% or 3%. Euribor rates for other floating interest debt increase by 1%. This is a permanent shock applied to the whole 3-year period starting in year 2018.

- **Scenario 2: *severe interest rate shock***. Under this scenario interest rates increase by a double magnitude as under Scenario 1. This is a permanent shock applied to the whole 3-year period.

- **Scenario 3: *depreciation of domestic currency***. An exchange rate depreciation of 15% of the EUR against the USD as well as to the other currencies composing the SDR basket is applied in the first year 2018. In order to arrive to the shock magnitude of 15%, the standard deviation of historical exchange rate EUR-USD was calculated. The shock was then computed as twice as large as the historic standard deviation, i.e. 30%.

- **Scenario 4: *combination shock***. This is a shock to both the interest and exchange rate parameters, combining Scenario 1 and Scenario 3, wherein the planned an exchange rate depreciation amounts 15%.

Cost-risk analysis under alternative strategies

The cost-risk analysis is particularly insightful when examined using the various MTDS tool outputs. It is important to highlight, however, that the tool only captures a broad analysis and trendline, given its purpose. The results are to be interpreted with caution since the analysis is made on an indicative basis and it should not be understood that the illustrated results will represent the actual exact cost and risk outcomes.

In the stylised analysis, the average cost remains rather stable under all strategies considered. The alternative strategies' cost impact ranges between 2.9% and 3% at the end of the programming period from 3.1% at the start of the programming period. At the same time, compared to the current strategy, there is an increase in the average maturity, and accordingly, the risk of refinancing is reflected. The maturity indicators achieve improved rates within Strategies 2 and 3 by the end of 2020, primarily due to programmed longer-term borrowing, both in international and domestic markets.

An overview of cost-risk indicators under the alternative strategies is presented in the table below.

Table 15 Cost risk indicators under the alternative strategies [25]

Risk indicators		2017	As at end 2020			
		Current	**S1**	**S2**	**S3**	**S4**
Interest payment as % of GDP		1.9	1.7	1.7	1.8	1.8
Implied interest rate (%)		3.1	2.9	2.9	3.0	3.0
Refinancing risk	Debt maturing in 1 yr (% of total)	6.2	25.6	25.6	23.0	23.0
	Debt maturing in 1 yr (% of GDP)	3.8	14.2	14.2	12.8	12.8
	ATM External Portfolio (years)	4.5	5.8	6.9	6.6	5.7
	ATM Domestic Portfolio (years)	5.2	3.2	3.2	4.4	4.4
	ATM Total Portfolio (years)	4.6	5.3	6.1	6.0	5.3
Interest rate risk	ATR (years)	3.6	4.1	4.8	4.9	4.3
	Debt refixing in 1 yr (% of total)	28.4	51.1	51.1	45.3	45.3
	Fixed rate debt (% of total)	74.9	69.1	69.1	73.0	73.0
FX risk	Non-EUR FX debt as % of total	16.1	26.1	26.1	24.2	24.2

Source: MF

Strategy 1 presents a more favourable cost outcome but not necessarily for refinancing risk. The outcome shows the lowest level of average financing cost among other strategies. At the same time the risk indicators (except refinancing risk) are favourable relatively among all strategies, with no particular risk indicator lagging behind that of any other strategy.

Strategy 2 is found to address refinancing risk most effectively, as evidenced by the improvement in relative average time to maturity (ATM) readings. Also, this Strategy achieves favourable cost outcome together with S1.

Strategy 3 is, together with S4, the most detrimental in terms of relative cost but within very small margins. Meanwhile, in accordance to its parameters, it addresses refinancing risk as effectively as in S2.

Strategy 4 refinancing and interest rate risk indicators rank positive among the four strategies.

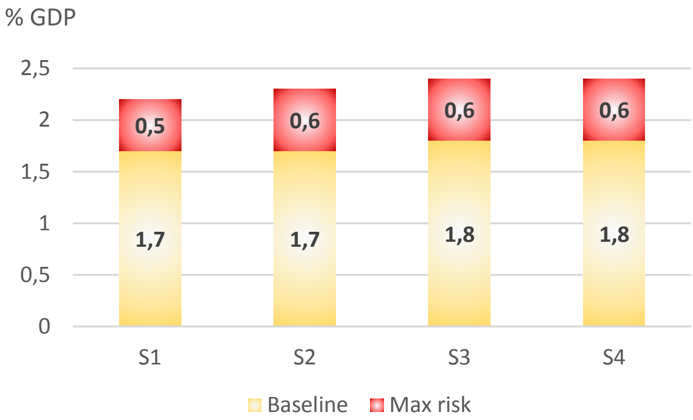
[25] *For the debt stock projection, the MTDS analytical tool was used for the Central government debt stock, which does not include the debt for pension arrears and legal entities and business organizations.*

Table 16 Interest Payments to GDP Ratio, as at end 2020, within 4 different scenarios [26]

Scenarios	S1	S2	S3	S4
Baseline scenario	1.7	1.7	1.8	1.8
Exchange rate shock (30%)	1.8	1.8	1.9	1.8
Interest rate shock 1 (Moderate Shock)	2.0	2.0	2.1	2.1
Interest rate shock 2 (Extreme Shock)	2.2	2.3	2.4	2.4
Combined shock (15% depreciation and interest rate shock 1)	2.0	2.1	2.2	2.1
Max risk	**0.5**	**0.6**	**0.6**	**0.6**

Source: MF

Figure 10 Interest payments to GDP, as at end of 2020



Applying four pricing scenarios to the alternative strategies, we can conclude that, in the case of the worst risk scenario, outcome of all four strategies will not have a big impact in relation to the baseline scenario. The maximum risk of each Strategy presents the biggest shock impact of different interest rates and exchange rate, as in the case of shocks combination, set out by the MTDS tool. Figure 10 shows the maximum risk impact on the existing scenario for all four examined strategies. Interest payments to GDP assesses each strategy's potential impact on the government's budget through yearly interest payments. Risk in the MTDS context for a given financing strategy is the difference between its cost outcome under a risk scenario and under the baseline scenario.

Strategy selection

The performance of the four strategies was assessed in both risk and cost aspects, with risk implications generally overweighing against cost advantages, given the small cost differentials across examined strategies. Considering the overall cost-risk trade off, as well as the principles and objectives set out in the Guidelines for 2018-2020, Strategy 3 was selected to be a good candidate to pursue in the medium term.

The debt profile is partially smoothened as there is less concentration of future repayments in the short to medium term following the end of the strategy period. This Strategy seems to be contributing to the management of refinancing risk most effectively among the stylized examined options.

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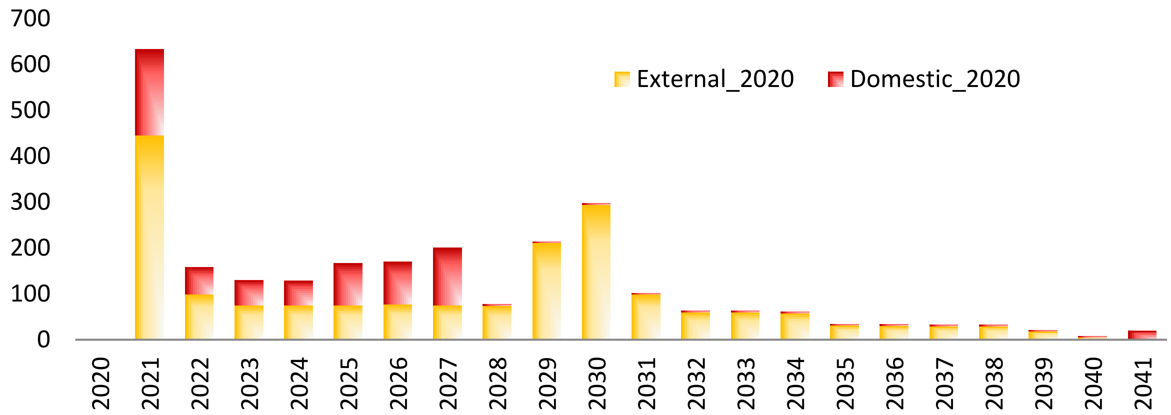
[26] For the debt stock projection, the MTDS analytical tool was used for the Central Government debt stock, which does not include the debt for pension arrears and legal entities and business organizations.

Figure 11 Redemption Profile of the Central Government debt in 2020, for Strategy 3, in mil. Euro[27]



Source: MF

Strategy 3 helps promote the development of domestic primary and secondary market by moving gradually from Treasury bills to a higher share of domestic bonds while allowing sufficient scope for borrowing in the international market, and thus the promotion and expansion of the investor base that can be reached without the need of issuing in a foreign currency.

To summarize, Strategy 3 is consistent with the overall aim of reducing the existing debt portfolio refinancing risk since it leads to a more favourable debt maturity profile than the current one and that of any other strategy. Its cost impact in terms of the implied interest rate is within the framework outlined in the Guidelines and it does not indicate a severe impact on debt sustainability. More importantly, the interest rate risk indicators perform robustly among the four strategies and the foreign exchange risk exposure is kept at a relatively low level, which is the result of a lower share of foreign currency debt. The marketable debt risk indicators, which effectively represent that part of debt that the Strategy can affect over the period, improve considerably as with regards the average-time to maturity, highlighting the benefits of this Strategy.

For the selection of a Strategy 3, it was deemed more pragmatic to place a higher weight on the baseline cost-risk indicators and less on the potential shock scenarios. This is due to the fact that this deterministic scenario analysis does not account for the probability of a shock scenario occurring, although it can not be suggested either that any of the examined shocks have a low probability of realization. Despite the limitations in the shock analysis, the sensitivity of the borrowing strategy under alternative scenarios for market rates is very relevant and cannot be neglected in the choice of an appropriate strategy. In this context, it is important to highlight that the MTDS tool is a part of the motivation for the Strategy and not an exclusive means of decision making. While its outcome is highly useful, the stylised results have been examined and adjusted with judgement to reach the final conclusion as to which medium-term direction to follow.

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[27] *According to the exchange rate on 31-Dec-2017, using the MTDS analytical tool. The projection does not include debt for pension arrears and debt of legal entities and companies.*

Macro risks for the Strategy

Lower economic growth

In addition to the previously presented portfolio risks that would have an impact on the baseline scenario, a lower economic growth was also examined (Table 17 and Figure 12). In case of slowing down of the economic growth and reduction of revenues, the government debt dynamics during the three-year period would deviate in relation to the baseline scenario. Reduction of revenues and stagnating investment inflow, may lead to additional deficit financing.

According to this projection, during the observed period the central government debt will reach its peak in 2018 and would be 68.7% of GDP, after which it would take a downward trend, which is a result of cessation of borrowing under loan facilities in 2019 for the highway construction Project , the same as in the baseline scenario.

Table 17 Debt trend 2017-2020 in the case of low-growth scenario, in mil. Euro [28]

	2017	2018	2019	2020
GDP	4,326.5	4,323.6	4,440.3	4,590.0
Domestic debt	413.9	348.3	291.1	183.4
Foreign debt	2,213.9	2,621.5	2,618.9	2,568.9
Total Central Government debt	**2,627.9**	**2,969.8**	**2,910.0**	**2,752.3**
Total Central Government debt as % of GDP	**62.0%**	**68.7%**	**65.5%**	**59.9%**

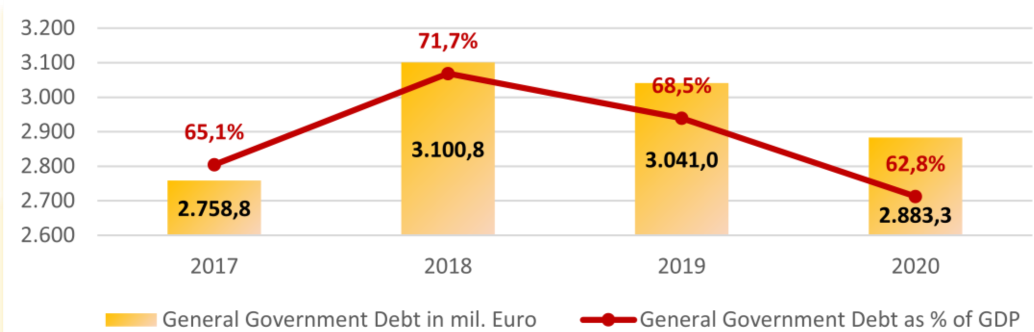
Source: MF

In the low growth scenario, the debt repayment during the period will not change compared to the baseline scenario, since the future borrowings are planned with 4-year grace period in order to avoid burdening the budget in the period of repayment of Eurobonds until 2021.

Box 3 General Government debt developments in the low growth scenario, 2017-2020

In the case of Low growth scenario, during the observed period, the general government debt will reach its peak in 2018 and will be 71.7% of GDP, after which it would take downward trend, but up to 2020 it will not reach the planned level of below 60% of GDP, as it is expected in the baseline scenario.

Figure 12 General Government debt developments (low growth scenario), 2017-2020



Source: MF

[28] *Debt presented in the Table does not include deposits of the Ministry of Finance.*

However, borrowing needs will be slightly higher in this period by on average 40 mil. Euro annually, which will also affect the debt growth in nominal amount. Also, considering the lower GDP output, as presented in the previous table, the central government debt stock to GDP will be higher and would almost reach a level of 60% of GDP in 2020.

In accordance with the choice of Strategy 3, the effects of this Strategy in the case of lower economic growth were also examined and outlined in the following table.

Table 18 Cost risk indicators under selected Strategy in case of low growth scenario [29]

Risk indicators		At the end of 2020	
		S3 Baseline	S3 Low growth
Interest payment as % of GDP		1.8	1.9
Implied interest rate (%)		3.0	3.0
Refinancing risk	Debt maturing in 1 yr (% of total)	23.0	22.1
	Debt maturing in 1 yr (% of GDP)	12.8	13.2
	ATM External Portfolio (years)	6.6	6.8
	ATM Domestic Portfolio (years)	4.4	4.4
	ATM Total Portfolio (years)	6.0	6.2
Interest rate risk	ATR (years)	4.9	5.1
	Debt refixing in 1 yr (% of total)	45.3	44.3
	Fixed rate debt (% of total)	73.0	73.3
FX risk	Non-EUR FX debt as % of total	24.2	24.2

Source: MF

In the case of lower economic growth, an increase of the average cost of the Strategy 3 is felt, but only moderately in relation to the baseline scenario.

VII. Institutional Arrangements and Implementation Issues

The general government debt management function is the responsibility of the Directorate for State Treasury. Within the Directorate, management of the public debt was recently reorganised along the functional disciplines of a front and back-office. Work is now divided into two divisions:

- ❖ Department for debt management, debt analysis and international relations (Front office) and
- ❖ Department for cash management, debt servicing, recording of the Government Debt and Debt of Local Self-Governments (Back office).

Additionally, the Ministry has been the beneficiary of technical assistance from the International Monetary Fund (IMF), covering capacity building related to drafting the Medium-term Debt Management Strategy and Market Relations Strategy, as explained previously.

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[29] For the projection MTDS analytical tool was used, for the central government debt stock, and it does not include the debt for pension arrears and legal entities and companies.

The Ministry of Finance recognises that public debt management is one of the most important fields of its operations. Consequently, further capacity building will be considered, to build and maintain a team of debt management professionals with the requisite skills needed to effectively and efficiently manage the State's public debt portfolio.

VIII. Investor relations and market intelligence

A Markets Relations Strategy (MRS) articulates and integrates communications, economics, finance and marketing. The aim is to foster productive two-way dialogue between a government, its creditors, the financial community in general and other interested stakeholders. The MRS expresses the government's commitment to deliver transparent and predictable public debt management.

An MRS also provides debt management officials with a communication framework to exchange information and views with creditors during stable times, yet supporting transparency when the government is addressing looming challenges. The dialogue may help reduce a government's exposure to volatility in market sentiment and support the government's re-entry into capital markets. Discussions with creditors provide valuable insights into market sentiment and perceptions of the sovereign risk, as well as insights on current and future credit risk appetite. Gathering intelligence from external counterparts should therefore help inform internal strategy development.

The PDM recognizes the need to further develop and improve its market intelligence gathering and stakeholder relations activities. This will help the PDM to have a better understanding of the environment it operates in and allow it to respond better and faster to changes to market conditions while it will also facilitate the development of a more proactive approach to investors.

The objectives of the market relations function are to create visibility and a better understanding of the strengths of the Montenegro "credit story", create direct relationships and essentially reach out to more investors.

Improved market relations will be implemented by providing:
- Consistent and accurate information on the Montenegro economy in a timely and frequent manner
- Communication of a clear, long-term focused funding strategy

The activities of the market relations function will include:
- Organisation of roadshows, reverse roadshows and conference calls for creditors and other interested parties;
- Participation in industry and peer conferences;
- Production and distribution of marketing information;
- Maintenance of a Stakeholders Database, tracking contact details for banks, creditors and media counterparts. The team will use the database to analyse creditor behaviour and fine-tune various marketing efforts accordingly;

The PDM is actively engaged in constructing a dedicated and visible public debt management website, within the existing Ministry of Finance web portal, providing direct transparency on PDM activities and editorial access to the team. The PDM will regularly populate its pages with data, forecasts and information on debt management, borrowing activity and strategy, rating agency reports, marketing materials, links to other government stakeholders (e.g. CBCG and MONSTAT), and archives of reports, presentations and press releases.

Market intelligence is fundamentally based on efficient market relations but its scope is broader. Market intelligence comprises a good grasp and analytical capacity to generate own intelligence from market data, research, the press and peer experiences. To this extent, the PDM will continuously monitor and analyse the financial markets. Variables such as new issue premiums and new issue performances among the country's peers will be monitored and considered for their relevance to Montenegro's own activities. Additionally, in the context of market contacts, market demand and expectations will be assessed. Building onto these, the PDM will be in a strong position to serve as a source of market information for other government entities and stakeholders.

For copies of the Strategy, please contact the Directorate for State Treasury of the Ministry:

Ministry of Finance
Directorate for State Treasury
Debt Management and International Relations Department
Stanka Dragojevića St. No 2
81 000. Podgorica
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The Medium Term Debt Management Strategy 2018-2020 is also available at the Ministry of Finance Website at: http://www.mf.gov.me/en/library/Strategic_document