

**EXECUTIVE
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MEETING**

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February 4, 2022

To: Members of the Executive Board

From: The Secretary

Subject: **Montenegro—Staff Report for the 2021 Article IV Consultation**

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***Unless an objection from the authorities is received prior to the conclusion of the Board's consideration, the document will be published.**



MONTENEGRO

STAFF REPORT FOR THE 2021 ARTICLE IV CONSULTATION

February 3, 2022

KEY ISSUES

Background. COVID-19 hit the economy hard, but a strong recovery is underway. Public debt, already elevated before the pandemic, has increased further. The government has embarked on a reform program 'Europe Now', which aims to arrest outward migration through a sharp minimum wage increase, labor tax wedge reduction, and the introduction of a progressive tax code. The financial sector appears to have withstood the COVID-19 shock well.

Outlook and Risks. The strong growth momentum is expected to continue in 2022, but output is expected to stay below its pre-pandemic trend over the medium term. Permanent reductions in revenue and increases in some long-term spending commitments are projected to keep the fiscal deficit and public debt elevated. On the upside, the reduction of the labor tax wedge could encourage investment and boost growth, if accompanied by broader reforms to the business climate. As the pandemic support measures are withdrawn, non-performing loans are expected to increase but remain manageable.

Policy Priorities and Recommendations.

- **Fiscal policy.** Offsetting measures to close the fiscal gaps created by 'Europe Now' are essential. The Authorities are advised to target and maintain a primary fiscal surplus of about 1 percent of GDP over the medium term, so that debt may be put on a firm downward trajectory. Large capital expenditures should only be considered when there is adequate fiscal space.
- **Financial Sector.** The gradual and data-dependent unwinding of crisis response measures should continue. Using the Asset Quality Review findings, efforts to strengthen financial sector supervision and contingency planning should be further pursued. Further improving the AML/CFT framework is key.
- **Structural Reforms.** Key priorities are increasing labor force participation while reducing structural unemployment and informality. Risks to formal employment and competitiveness stemming from the minimum wage increase should be carefully managed. On SOE sector reform, 'Montenegro Works' would require robust institutional and legal frameworks, and deep professional expertise.

Approved By
Jörg Decressin (EUR)
and Natalia Tamirisa
(SPR)

Discussions were held virtually from October 25 – November 5, and in Podgorica from November 10 – 17, 2021. The team comprised S. Seshadri (Head), S. Eble (Regional Resident Representative for the Western Balkans), G. Minasyan, Y. Mooi, A. Pienkowski (all EUR), V. Tang (FAD), and C. Acosta (LEG). Mr. Voinea (OED) joined most of the meetings. The team met with the authorities (Central Bank of Montenegro, Ministries of Finance and Social Welfare, Economic Development, Capital Investments, and Public Administration, Digital Society and Media), private sector representatives (unions, employers, and banks), the diplomatic community, and international agencies. H. Baldev and Z. Zhu (all EUR), and A. Madaraszova (HRD) provided support from Headquarters.

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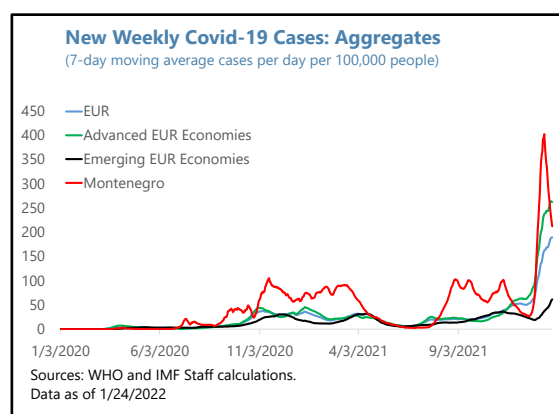
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CONTEXT

- 1. Montenegro is a unilaterally euroized economy aiming for EU accession by 2025.** It boasts a strategic and scenic location along the Adriatic coast, with significant potential to diversify beyond tourism into renewable energy production, and other sectors. After gaining independence in 2006, it was soon buffeted by the global financial crisis. Recovery was aided by a tourism boom in the years preceding the onset of COVID-19. In 2016, work began on the ambitious Bar-Boljare highway project (the first of four envisaged phases is close to completion) which boosted short-term growth, at the cost of a sharp increase in public debt.
- 2. COVID-19 hit the country hard.** In addition to the significant human toll, the economic cost was large, intensified by strong tourism dependence, constrained fiscal space, and labor market rigidities. To mitigate the impact of the economic shock on households and firms, the Authorities implemented a range of fiscal and financial measures.
- 3. Political uncertainty is high.** A new government took office in December 2020. Representing the first change of power since independence, it draws support from three parliamentary coalitions, jointly holding a one-seat majority. While the 2021 annual budget law was only adopted in mid-June,¹ the 2022 budget was passed in late-December 2021, with significant amendments by parliament.

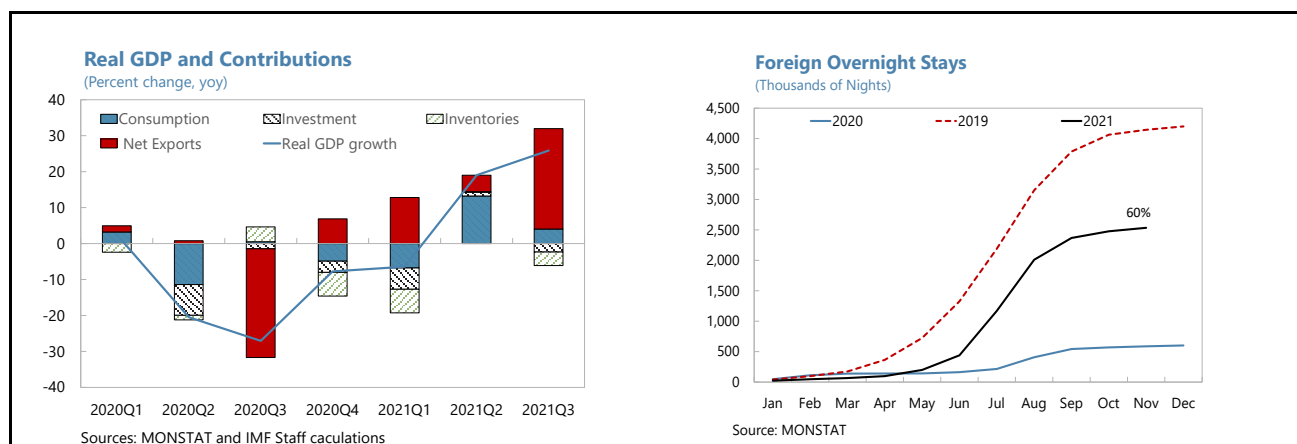
RECENT DEVELOPMENTS

- 4. Successive waves of the pandemic have been met with varying public health responses.** Initial containment measures were stringent, and highly restrictive border policies were in place for much of the tourist season in 2020. By contrast, most of the 2021 tourist season was marked by an open border policy, without vaccination or COVID-19 testing requirements. Widespread vaccinations began in May 2021. As of mid-January 2022, about half the population has received two vaccine doses.



- 5. The economic contraction in 2020 was deep, but a strong recovery is underway.** Real GDP declined by 15.3 percent in 2020 (average growth was 4 percent in the preceding four years), as tourism receipts fell by 87 percent. A strong recovery is underway, supported by a rebound in tourism. Foreign tourist overnight stays during January–November 2021 were at 60 percent of 2019 levels, largely due to visitors from neighboring countries. The strong recovery in services exports supported Q3 2021 growth of about 26 percent y-o-y, following a robust 19.0 percent in Q2 and a contraction of 6.5 percent in Q1.

¹ Temporary financing procedures were adopted for six months whereby expenditure was pro-rated on the 2020 budget for H1 2021, as per constitutional procedure.



6. The current account balance is likely to have reverted to its pre-pandemic average in 2021. The hit to tourism in 2020 was only partly offset by import compression and strong remittances. As a result, the current account deficit widened to 26 percent of GDP. On the financial account, FDI inflows held up strongly. The reserve buffer at end-2020 peaked at €1.7 billion (42 percent of GDP), boosted by financing from a €750 million Eurobond, €74 million through the IMF's Rapid Financing Instrument (RFI), and €60 million in Macro-Financial Assistance from the EU. The partial rebound of tourism in 2021 will support a recovery in the current account. The repayment of a large Eurobond in March 2021 and a modest fiscal deficit have led reserves to decline, although they remain above historical averages. The Authorities intend to keep the 2021 SDR allocation of SDR 60.5 million as reserves. The external position in 2021 was moderately weaker than the level implied by fundamentals and desirable policies (Annex II).

7. The fiscal deficit in 2021 narrowed significantly, after a sharp widening in 2020 due to the crisis. A steep decline in revenues and increased spending on emergency support measures (Table 1) widened the fiscal deficit to 11 percent of GDP in 2020. Wage subsidies have helped to preserve jobs, particularly in tourism, which supported the sector in its recovery in 2021. With the economic rebound boosting revenues alongside lower expenditures, the Authorities will comfortably meet their year-end fiscal deficit target of 3.8 percent of GDP.

8. Public debt is elevated. The Bar-Boljare highway project significantly increased public debt prior to the pandemic (79 percent of GDP in 2019). The large fiscal deficit and GDP collapse, along with a 7-year €750 million Eurobond issuance in December 2020 (pre-financed for a 2021 repayment) further increased public debt to 107 percent of GDP in 2020.² The timely issuance, at a highly favorable yield of 2.95 percent, covered baseline financing needs for 2021 and 2022. The government has commenced repayments on its USD-denominated highway-related loan with the Ex-Im Bank of China, and in July 2021, secured a currency risk hedging arrangement on this loan with several international banks.

² With the Eurobond issue, the central government accumulated sizeable deposits of over 20 percent of GDP at-end 2020. Net of deposits, general government debt (excluding guarantees) increased from around 65 percent of GDP in 2019 to around 85 percent in 2020.

Table 1. Montenegro: Net Budgetary Impact of COVID-19 Measures

Fiscal Policies: Selected COVID-19 Measures		Net Fiscal Impact on Budget	
		2020	
		EUR mn	Percent of GDP
Health Spending	Tests, protective equipment, transportation of supplies, higher salaries for medical personnel for overtime work.	25.3	0.60
Wage Subsidies	Wage subsidies for workers in pandemic-affected sectors, those unable to work due to childcare for children aged under 11, those who have to quarantine; and the newly employed in SMEs.	36.4	0.87
Payment Deferrals	Deferral of income taxes, social security contributions, and tax debt.	34.6	0.83
Social Benefits	One-off financial assistance for the vulnerable population.	2.5	0.06
Foregone Revenue	Lower VAT rate in the catering and hospitality sector, suspension of fees for games of chance; reduction in cost of space rental.	6.0	0.14
Other	Interest rate subsidies for loans to farmers and fishermen, Programme for Market Intervention, other measures.	10.1	0.24
TOTAL		114.9	2.74

Sources: Ministry of Finance and Social Welfare, and IMF Staff calculations

9. Headline banking system metrics indicate resilience, but the presence of masked underlying vulnerabilities cannot be ruled out. The overall banking system appears to be well-capitalized and liquid as of Q3 2021. Deposit growth has been strong and there has been recovery in private credit. The Central Bank (CBCG) had introduced various crisis support measures in 2020 (Table 2). While most of these measures have been withdrawn over the past months, some of them were still in effect as of Q3 2021. Therefore, 'forbearance' could mask the true deterioration in asset quality experienced by banks during the pandemic. Financial Stability Indicators (FSIs) also need to be updated given the recently completed Asset Quality Review (AQR), which was a long-standing Fund recommendation (see Financial Sector Policies section). The results of the AQR paint an overall comforting picture. Weaknesses identified in one bank are being addressed.

Table 2. Montenegro: Central Bank Support Measures

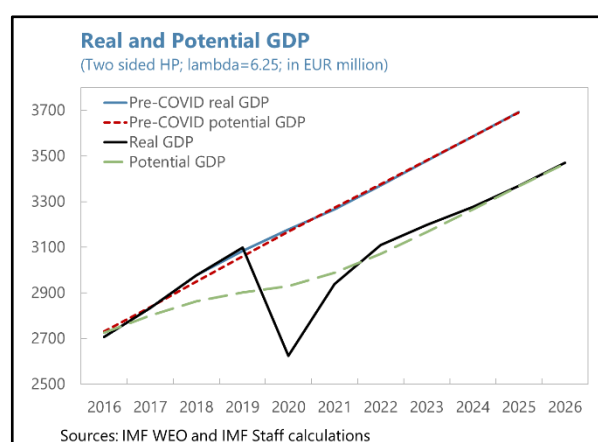
Measure	Status
(i) Temporary and targeted loan moratoria aimed at supporting the tourism sector as well as businesses and individuals that suffered significant income losses due to the pandemic	Introduced in 1H 2020 and expired for corporates during 2021. Currently in effect only for households.
(ii) A temporary increase of exposure limits to single or related parties	Introduced in Q1 2020 and expired in June 2021.
(iii) Loan restructuring agreements: banks were allowed to adjust terms and conditions of eligible loans without reclassifying them as NPLs	Introduced in several rounds in 1H 2020. As of end-October 2021 the measure has expired for corporates but is in effect for households.
(iv) Prohibition of paying out dividends to shareholders	Introduced in Q1 2020 and in effect until further notice.
(v) A reduction in the share of demand deposits counted as due liabilities from 30 to 20 percent.	Introduced in Q1 2020 and in effect until further notice.
(vi) A reduction in the reserve requirement rate and the fee for withdrawing reserve liquidity	Introduced in Q1 2020 and in effect until further notice.

Source: Central Bank of Montenegro

OUTLOOK AND RISKS

10. A partial growth rebound of 12 percent is expected for 2021, driven mostly by tourism. Household consumption is projected to have recovered strongly, supported by a bounce-back in net trade. Fiscal retrenchment, from lower spending, is expected to have contributed a negative 3.7 percentage points to growth. Growth is expected to remain significantly above its long-term average in 2022 assuming, *inter alia*, continued normalization of tourism. Driven mainly by global commodity and food prices, inflation is expected to increase to 4.7 percent (e-o-p).

11. Despite high near-term growth rates, output is expected to stay below its pre-pandemic trend. Baseline projections imply a permanent 8.7 percent loss of output relative to pre-crisis trends, which is significantly higher than the non-EU CESEE average (4.1 percent). This primarily reflects Montenegro's reliance on tourism, which is currently projected to return to 2019 levels only in 2023. The authorities are more optimistic than staff, and project growth to average 5.3 percent in 2022–24, essentially implying there will be no permanent output loss relative to the pre-pandemic trend. The current account deficit is expected to stabilize at around 15 percent of GDP, close to its historic average, as the recovery in tourism is largely offset by a larger fiscal deficit. As a result, external debt is expected to remain quite elevated (at 197 percent of GDP, see Annex III). As phase 1 of the Bar-Boljare highway nears completion, the government is proposing a new program of capital investments starting in 2022.



12. The Authorities have passed a landmark reform program beginning in 2022. The program – ‘Europe Now’ – was passed (with amendments) by Parliament alongside the 2022 budget. It aims to arrest outward migration by increasing employment and living standards, reduce labor market informality, and improve the business environment. The program aims to achieve these objectives through a near doubling of the net minimum wage; a substantial reduction in the labor tax wedge; and the introduction of a progressive tax code (Box 1). In the short term, staff's baseline expects ‘Europe Now’ to provide a boost to growth (through higher household consumption) but possibly with higher inflation. Credit growth will likely increase, if higher formal wages increase officially ‘bankable’ income, particularly for those at the lower end of the wage distribution. Staff project the fiscal position to deteriorate, as a net loss in revenues is expected from the elimination of healthcare contributions and, to a lesser extent, due to other changes to the tax code.

Box 1. Key Features of the 'Europe Now' Program

The 'Europe Now' program includes:

- An increase of the net minimum wage from €250 to €450 per month.
- The elimination of the flat rate employee (8.5 percent) and employer (2.3 percent) healthcare contribution on earnings.
- The introduction of a progressive personal income tax, with a tax-free allowance of €700 per month, a rate of 9 percent on earnings of €700-1,000 and a higher rate tax of 15 percent for earnings above €1,000. The existing regime has a flat rate of 9 percent with no allowance.
- The introduction of a progressive tax based on corporate profits (9 percent on anything below €100,000; 12 percent on €100,001-1,500,000; and 15 percent on anything above €1,500,000). The existing regime has a flat rate of 9 percent.
- A range of tax administration measures.

Parliament did not approve measures to increase a range of excise taxes and to introduce fuel marking that were initially proposed as part of this program.

13. 'Europe Now' has desirable objectives but also carries potentially significant risks. The intent to lower the high labor tax wedge and tackle the grey economy represents a break from the past. If carefully enacted in conjunction with credible reforms that improve the business environment, it could attract investment and jobs. Still, unintended risks may arise from design and sequencing of the measures as well as resource and administrative capacity challenges (in tax enforcement and labor inspection). Major challenges arise from the inability to accurately measure the overall size of the grey economy, as well as the variation and concentration of prevailing undeclared 'grey' wages across regions and sectors of the economy. These factors would imply risks to employment, corporate profits, and investment. There are also important fiscal risks, as not all the revenue-raising measures proposed by the government were approved by Parliament, whereas all the revenue-reducing measures in the program were passed (see paragraph 16).

14. Uncertainty is exceptionally high. On the upside, scarring could be lower than projected, if labor and capital are reallocated to viable firms and sectors promptly, and if the lowering of the labor tax wedge indeed leads to more investment, as the authorities envisage. As such, the economy could respond more dynamically to 'Europe Now' without negative inflationary and formal employment effects. Given the degree of informality, private sector balance sheets could be more resilient than available data suggest. On the downside, unexpected developments related to the pandemic in 2022 could stymie the recovery of tourism, with attendant implications for growth as well as external and fiscal balances. Heightened geopolitical tensions could place prolonged pressure on energy prices and risk premia, again with potentially negative implications for external and fiscal balances. On the domestic front, political uncertainty, if unresolved, could significantly hamper investment. Disruptions in the operations of a major company (an aluminum smelter) due to energy prices may hurt exports and growth.³ Asset quality in the financial sector could be worse than indicators currently suggest, placing a high premium on preparedness of the authorities. The Public

³ The aluminum smelter accounts for 15-20 percent of the country's merchandise exports.

Debt Sustainability Analysis (Annex IV) indicates that the medium-term debt trajectory needs to be put on a firm downward path, along with continued active debt management to bring down high gross financing needs.

POLICY DISCUSSIONS

Policy discussions centered on three key areas: (i) reforms to address longstanding issues of the labor tax wedge and tax progressivity while preserving fiscal sustainability; (ii) proactively managing financial sector vulnerabilities, which might have increased after the crisis; and (iii) structural policies focusing on the labor market, including an increase in the minimum wage; and state-owned enterprise (SOE) reforms. In the area of governance, discussions focused on financial sector oversight and the AML/CFT framework.

A. Fiscal Policies

15. The fiscal deficit in 2021 declined significantly. The 2021 budget targeted a deficit of 3.8 percent, with a reduction in all categories of discretionary spending. Revenues have met budget projections, from a robust summer tourism season and successful e-fiscalization measures. While expenditures declined relative to 2020 due in part to less spending on support measures, the under-execution of capital spending and a sharp curtailment of administrative expenses also contributed to reducing the deficit, which is projected at around 2 percent of GDP.

16. The 2022 budget deficit, however, will rise once again. The 2022 budget targets a deficit of 5 percent of GDP. The rise in the deficit relative to 2021 is primarily due to the fiscal implications of 'Europe Now'. Healthcare contributions to earnings (some 4 percent of GDP) were permanently removed from revenues starting in 2022. However, not all the proposed revenue-raising measures to offset the fiscal loss were passed (e.g., excise tax increases, fuel marking, a VAT increase for the hospitality industry). For the revenue-raising measures that were adopted, there is notable uncertainty in the yields and durability. Several measures (e.g., tax debt rescheduling, taxation of undeclared income) assume strong enforcement and administrative capacity. Given the ongoing merger of the revenue administration entities, successfully implementing these reforms could prove challenging. The implications of the proposed tax changes on local government finances also need to be durably addressed. Given all these factors, as well as other increases in permanent spending (including newly legislated family benefits), staff currently project that the fiscal deficit in 2022 will exceed 6 percent of GDP to be durably addressed. Given all these factors, as well as other increases in permanent spending (including newly legislated family benefits), staff currently project that the fiscal deficit in 2022 will exceed 6 percent of GDP

Changes in 2022 Fiscal Deficit Relative to 2021	percentage points of GDP
Revenues	
Health contributions on earnings	-3.5
Non-tax revenues	-0.5
Expenditures	
Long-term spending commitments	0.5
Capital expenditures	1.0
Other expenditures	-1.3
<i>of which COVID-related expenditures</i>	-0.8
Source: IMF Staff calculations	

17. Some of the risks associated with ‘Europe Now’, in its current form, must be moderated by adopting initially proposed revenue measures. During the mission, staff suggested that introducing the program in carefully calibrated steps would allow for stronger administrative and enforcement preparedness. It could also provide for course corrections, should the economy react to these measures in a significantly different manner than envisaged. With fiscal space limited, staff also proposed that revenue-raising measures could be front-loaded, while revenue-reducing measures could be brought in more gradually. Such a phased-in approach would have also concomitantly raised the minimum wage and tax-free allowance in pre-announced stages, enabling a smoother adjustment for the economy and labor market (see ‘Structural Policies’ section, and Annex V). Looking ahead, any political scope to refine the implementation of the plan by adopting the revenue-raising measures initially proposed by the government should be fully utilized to regain some fiscal space, in staff’s view.

18. A flat-rate corporate income tax, with a special SME regime, would reduce distortions. ‘Europe Now’ includes a CIT regime that progressively taxes profits. The Authorities are aiming to attract higher corporate investment with a combination of a lower profit taxes and a lower labor tax wedge. However, the new CIT regime could create distortions and compliance issues (e.g., through ‘shell’ companies, and/or through opaque transfer pricing mechanisms) as firms seek to avoid moving into a higher tax bracket. A flat-rate regime with a special regime for SMEs, merits consideration. Increasing the CIT rate to 15 percent would not only raise revenue but would also limit revenue leakage due to arbitrage between CIT and PIT.

19. A significant medium-term fiscal effort is imperative, for the trajectory of debt to be put on a firm downward path. The Authorities’ Medium-Term Fiscal Strategy sets out a fiscal path for the deficit to fall to under 1 percent of GDP by 2024, based largely on an expenditure reduction of about 5 percent of GDP and optimistic economic growth projections that exceed most empirically based estimates of potential growth and presume virtually no scarring from the pandemic. Based on currently prevailing policies, staff project the fiscal deficit to remain high over the medium term, putting public debt once again on an upward trajectory from 2023 onwards, back towards the currently elevated level of 90 percent of GDP. Therefore, it is imperative that policy measures to implement the needed and sizeable fiscal consolidation be clearly identified and their yields carefully estimated.

Authorities’ Medium-Term Fiscal Strategy

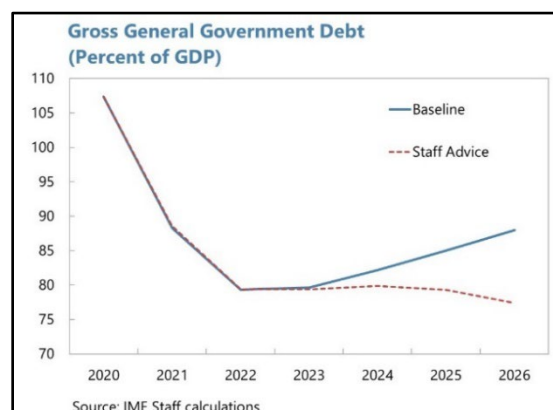
	2022	2023	2024
Fiscal balance (% of GDP)	-5.0	-1.9	-0.6
Primary balance (% of GDP)	-3.2	-0.3	0.8
Real growth (%)	6.4	5.1	4.5
Public debt ^{1/} (% of GDP)	76.6	73.2	69.9

^{1/} does not include local government arrears

Source: Ministry of Finance and Social Welfare

20. The Authorities are advised to target and maintain a primary surplus of around one percent of GDP by 2026.

This would be consistent with aspirations of EU accession, ensure the downward trajectory of debt, and entail a similar rate of fiscal adjustment undertaken between 2015 and 2019. Staff estimates that fiscal measures to the tune of 4 percent of GDP are needed to achieve this target. This would support a reduction in general government debt to about 77 percent of GDP by 2026. It can be achieved through a mix of



expenditure and revenue measures specified over four years, including the introduction of revenue-raising measures initially envisaged in 'Europe Now' that were not passed in the 2022 Budget. Table 3 provides an illustrative set of policies for consideration, with associated impact on the primary deficit in 2026 to achieve a primary surplus of 1 percent of GDP.

Table 3. Montenegro: Illustrative Measures to Achieve One Percent Primary Surplus

Measures	2026 impact (% GDP)
Enact excise policies envisioned in Europe Now (from 2022)	0.3
Enact fuel marking policy envisioned in Europe Now (from 2022)	0.3
Increase VAT by 1 percentage point (from 2023)	0.7
Close selected tax exemptions (from 2023)	0.5
Flat increase of CIT to 15 percent (from 2023)	0.4
Reduce public sector workforce by 2% a year (from 2023)	0.8
Hold growth in goods and services to inflation (from 2023)	0.3
Hold growth in capital spending at inflation (from 2024)	0.5
Hold public sector wage increases to CPI (from 2023)	1.4

Source: IMF Staff calculations

21. Large capital expenditures should be considered only when there is adequate fiscal space. The Authorities have expressed interest in building further phases of the Bar-Boljare Highway, and are exploring feasibility studies and models of implementation. They are also considering plans for other highway projects that would connect Montenegro to Croatia, Bosnia and Herzegovina, and Albania. Any consideration of large capital expenditures should be contingent on the availability of adequate fiscal space (including through sizable grant financing) and public debt being on a sustainable footing. The Authorities have also expressed interest in using PPP as a mechanism to finance and operate some new investments (e.g., in the energy sector, highway, and urban and municipal public building projects). A new agency (Montenegro Investment Agency) was set up in March 2020, which includes a role in promoting, setting up, and monitoring PPPs across the public sector. Any new arrangements for managing PPPs should be integrated into a robust public investment management process, with fiscal risks identified and monitored. Extra caution is needed with regard to possible PPP arrangements which could introduce significant fiscal liabilities (2019 Article IV).

22. Significant structural fiscal issues still need to be addressed.

- *Merger of revenue administrations.* The ongoing merger of the tax, customs, and gambling administrations into a single Revenue Administration entity has faced challenges, including organizational and staffing issues. A smooth implementation of the merger will be crucial to strengthening capacity to implement 'Europe Now' fully, and minimizing disruptions to revenue collection operations.
- *Fiscal Council.* Under an EU-funded project, options are being considered for the development of a Fiscal Council. This will require legislation and careful design.
- *Public Investment Management Assessment (PIMA).* The recently concluded PIMA found that the underlying investment framework is relatively strong, but is not necessarily adhered to regarding project selection, planning, and risk appraisal. The key challenge will be to fully utilize the existing framework in these areas, and also to restrict the labeling of projects as 'strategic' within clearly defined and stringent standards.
- *Program-based budgeting (PBB).* While the Authorities have taken welcome steps in introducing PBB, reforms need to continue to deepen it through all relevant public sector budgeting units.

23. Additional reforms would create more fiscal space in the long-term. These initiatives are not included in the baseline.

- *Public Administration Reform Strategy.* The Authorities plan to design a new Public Administration Reform Strategy to replace the previous one which stalled (2016–2020), with intentions to undertake a substantive functional review.
- *Pensions:* In July 2020, the Parliament adopted new pension legislation that introduced changes to the pensionable age, the basis of pension calculations, and formula for indexation. The Authorities are discussing reform plans with the World Bank to ensure the social and fiscal sustainability of pensions, including by avoiding a long-term decline in replacement rates.
- *Tax expenditures:* Tax expenditures, particularly in VAT, are significant and estimated at over 2 percent of GDP. Not all tax expenditures have been fully identified, and a simple, transparent benchmark tax system is needed.

24. A safeguards assessment was completed in April 2021 in connection to the 2020 RFI purchase. The first-time assessment found strong operational controls at the central bank, supported by external audits and a transparent financial reporting framework. However, several amendments were recommended to the Central Bank Law to address issues related to governance structures. Technical assistance on this has been concluded.

25. The Authorities have completed the financial audit related to COVID-19 related spending. The financial audit and regularity audit report ‘Verification of the healthcare costs related to COVID-19’ was completed and published in December 2021. The performance audit is still ongoing. It is particularly important that oversight bodies actively undertake ex-post assessments of COVID-19 program effectiveness and investigate for any potential abuse. Additionally, there should be transparency on the distribution of relief funds and loans, including by publishing beneficial ownership information of successful bidders and using open public procurement processes. Once the crisis abates, ex-post controls should be conducted, e.g., through selective audit of procurement contracts.

Authorities’ Views

26. The Authorities are more optimistic regarding the fiscal position and debt trajectory. They believe that the reforms associated with ‘Europe Now’ will result in strong and sustained economic growth. They remain hopeful that further revenue-raising measures to narrow the fiscal gaps will eventually be adopted later in 2022. They plan to reintroduce the excise and VAT increases previously proposed as part of the 2022 Budget as well as a new law on games of chance. They understand the need to reduce the fiscal deficit in the medium term with clearly identified measures. The Authorities stressed that they would not increase the debt burden of the country in the consideration of any large capital projects.

B. Financial Sector Policies

27. The gradual unwinding of crisis response measures is welcome. The targeted loan moratoria introduced by the CBCG reached a peak of 47 percent of total loans in April 2020. These have now been mostly phased out, with only moratoria for some retail borrowers currently in place, amounting to 0.8 percent of total loans. The option to restructure distressed loans without reclassification ended as of end-October 2021 for firms, and is still in effect for retail borrowers (about 1 percent of total loans). The CBCG is monitoring the unemployment rate and activity in the key sectors of tourism, construction, and trade, before deciding on the withdrawal of the remaining measures. On lifting the prohibition on dividend distributions, the CBCG is appropriately cautious in waiting until risks from the pandemic to banks’ capital have largely subsided.

28. Continued progress in updating supervisory data to reflect the recently completed AQR is an important priority. The AQR found no systemic issues as of 2019; it assessed that the banking system’s overall capital adequacy ratio was 16.2 percent, compared to the previously reported 17.8 percent (€40 million lower), but still well above the regulatory minimum of 10 percent. The need for capital conservation measures was identified with one bank (all other banks met or exceeded the regulatory minimum). This bank has taken important steps to address the shortfall (including asset sales and reducing its operations) and remains under intensive supervision. Starting October 2021, all banks are required to incorporate the AQR findings from the reviews of credit files, exposure classification, and individual impairment and provisioning into their financial reporting. Beginning in 2022, banks will also be required to incorporate the assessment of adequacy of credit impairment classifications.

29. New laws and regulations taking effect in 2022 should help strengthen financial sector institutions. The Law on Credit Institutions, the Law on Resolution of Credit Institutions, and all associated implementing regulations will become effective in January 2022, achieving the important goal of aligning regulation and supervision with current EU frameworks.⁴ They are also consistent with the FSAP recommendations of (i) enhancing of supervision on consolidated basis; (ii) improving the regulatory and supervisory frameworks for liquidity and credit risks; (iii) tightening prudential norms for identification, classification, and reclassification of non-performing loans (NPLs); and (iv) setting the criteria for determining the systemic importance of credit institutions. These new laws and regulations will also help operationalize the macroprudential policy framework, adopted in 2018. Staff welcome the planned introduction of the countercyclical capital buffer, capital conservation buffer and systemic institutions buffer in 2022. The CBCG is encouraged to continue monitoring bank practices and potential macroprudential indicators, with the view of setting the appropriate levels for macroprudential tools in the future.

30. Some deterioration of reported asset quality is expected in the coming months. The withdrawal of crisis-support measures, incorporating the AQR findings in the financial reporting of banks, and tightening of norms for identification, classification, and reclassification of loans will likely reveal a higher ratio of NPLs. While preliminary indications are that any deterioration in asset quality should be manageable, as the share of banks' portfolios still affected by crisis support measures is low and the corrections called for by the AQR findings appear moderate, the CBCG should monitor closely and react swiftly to any emerging pockets of vulnerability.

31. Work on strengthening contingency planning should continue. The Law on Deposit Protection Fund (DPF) that became effective in January 2020 is in line with international best practice. Consistent with FSAP recommendations, it allows the DPF to perform purchase and assumption, and incorporates risk-based insurance premiums, which have already been implemented. Currently, all deposits below €50,000 are guaranteed, and the DPF's goal is to reach a coverage of 10 percent of guaranteed deposits by 2024. The EBRD credit line of €50 million has also helped to bolster the DPF's available resources. Within the CBCG, a dedicated Directorate for Resolution (independent from supervision) has been established. The CBCG has already adopted internal procedures for drafting resolution plans and has begun work on resolution plans for individual banks, starting with the systemic banks.

32. Continued progress in improving the AML/CFT framework should be a key area of focus. Progress in the implementation of the AML/CFT framework is supported by the upcoming MONEYVAL AML/CFT assessment (expected to take place in 2023), notably in relation to the legal framework and to implement relevant EU legislation. The Authorities are also making progress in addressing the 2019 Article IV Recommendations to strengthen AML/CFT supervision of financial institutions (e.g., the development of a manual for risk-based supervision) and staff encourage the continual implementation of these reforms. The Authorities also concluded a second national ML/FT risk assessment in December 2020 and developed an Action Plan with mitigating measures. Staff

⁴ These include 24 regulations from the area of supervision of credit institutions and 14 regulations from the area of resolution of credit institutions.

encourage the Authorities to implement these measures to further strengthen the effectiveness of the AML/CFT regime, including the use of financial intelligence, and a risk-based approach to financial investigations, focusing on ML/TF related risks from the banking sector. These measures are important to avoid being subjected to MONEYVALs enhanced follow-up measures or FATF enhanced monitoring ('gray-listing').

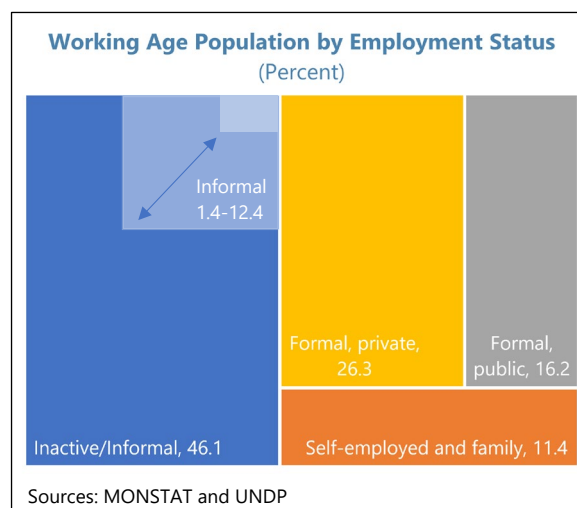
33. The Investor Citizenship program was expected to expire at end-2021, but was extended to end-2022, with modifications.⁵ The Authorities are encouraged to (i) establish adequate financial integrity safeguards (e.g., robust vetting of applicants, enhanced measures for transparency and oversight, transparency regarding source of wealth and source of income of applicants, publishing the names of successful applicants); and (ii) mitigate other risks, such as impacts on specific sectors leading to economic imbalances (e.g., property bubbles), reputational damage, increasing risks of corruption, money laundering, tax evasion, and other crimes.

Authorities' Views

34. The Authorities agreed that gradual and data-dependent withdrawal of crisis support measures in the financial sector should continue. They emphasized that the moratoria and loan restructuring options for natural persons still affected by the COVID-19 crisis are important for social reasons while at the same time representing an insignificant risk for the banking sector due to their small size relative to bank assets. The Authorities assessed that the expected combined effects on banks' financial soundness from (i) reflecting the AQR results in the most recent data; (ii) the adoption of more stringent loan classification standards starting in 2022; and (iii) the withdrawal of crisis support measures; will be small, and do not envisage a significant increase in NPLs. They are also confident that the areas of weakness that were identified by the AQR were being appropriately addressed.

C. Structural Policies

35. The labor market is characterized by low employment and participation rates, and high informality. Only a little more than half of the working-age population has employment in the formal sector. While similar to other Western-Balkan countries, this is well below European levels. Unemployment is structurally high at around 15 percent (Figure 8), and is particularly acute for women and the youth.⁶ The share of the population working without a formal contract is estimated to be between 1–12 percent of the working population;



⁵ Applicants are required to provide a bank guarantee of 50 percent of their investment value. All new applicants are now required to pay €100,000 to the national budget plus €100,000 to the regional development fund.

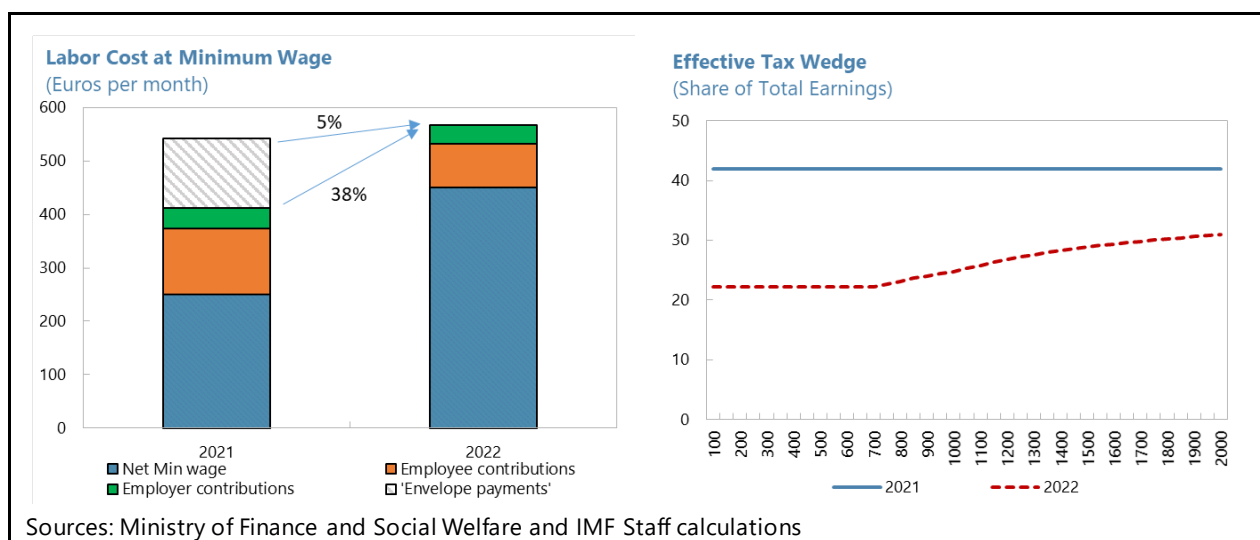
⁶ See Montenegro Selected Issues, IMF Country Report No. 18/122

and anecdotal evidence suggests that a significant proportion of employers do not pay the full tax and social contributions on earnings – the ‘envelope payments’ problem.

36. Tax and regulatory burdens, along with weak enforcement, exacerbate this problem.

While the overall labor tax wedge is similar to the European average, the flat nature of the 2021 personal income tax and social contribution regimes made for a relatively high tax burden on low-wage employees. This, and other factors, contributes to the high-rates of informality amongst low-wage earners. Historically, inflexible labor legislation, including significant obstacles to dismiss employees and limits on fixed-term contracts, hindered mobility. A new Labor Law introduced in January 2020 addressed some of these issues, including by narrowing the gap between temporary and regular contracts. However, the pandemic makes a current assessment of this new law difficult. Finally, anecdotal evidence suggests that lax enforcement makes it relatively easy for employers and employees to evade at least some taxes and regulation.

37. ‘Europe Now’ aims to reduce the tax wedge and raise the minimum wage. Under the package, the overall tax wedge on those earning below €700 per month declined substantially from 42 to 22 percent of the gross wage; while for those earning €1,500 per month, the effective rate fell from 42 to 31 percent. In addition, the net minimum wage increased substantially from €250 to €450 per month (see Annex V). The impact on overall labor costs will be partially absorbed by the large decline in the tax wedge. The Authorities also believe that many low-wage earners receive substantial informal ‘envelope payments’, of at least €130 per month, which are not declared to the tax administration. They believe that the increase in the minimum wage would force employers to formalize these payments, but not substantially increase the cost of labor.



38. There are risks to formal employment and competitiveness from the minimum wage hike. While there is some evidence that these ‘envelope payments’ exist, there is significant uncertainty over the size of these payments, as well as substantial differences between regions and industries. Some employers, therefore, could face a very significant increase in the cost of labor, which could reduce formal employment and weaken competitiveness. In addition to measures

related to the business climate, the authorities are urged to consider the use of active labor market policies (ALMPs) that facilitate better training and education of the workforce.

39. The Authorities wish to embark upon wide-reaching reforms to the management and oversight of the SOE sector. There are around 40 SOEs in Montenegro, with fixed assets estimated at around 70 to 100 percent of GDP and a widely varying economic performance across sectors (Annex VI). In an effort to improve the sector's performance, the Authorities established a holding company 'Montenegro Works' LLC in August 2021, with the aims to monitor and analyze the financial situation in SOEs, and provide expert support in implementing reforms. While the institutional arrangements of Montenegro Works are still being set out, it will be important to ensure clearly defined ownership backed by strong legal and institutional arrangements, to guard against capture by vested interests; and sufficient professional expertise.

Authorities' Views

40. The Authorities recognize the structural weaknesses in the labor market. The Authorities stated that the primary motivation for 'Europe Now' is to decisively arrest what is seen as a rapid 'brain drain'. This is also why they believe that the plan needed to be urgently implemented in a single step beginning in 2022. The Authorities are confident that the increase in the minimum wage will not have a detrimental effect on official employment, or on inflation, given the proposed substantial decline in the tax wedge for low-wage earners and the existence of large envelope payments. They also emphasized that the package has the support of the Social Council which comprises both employers and unions. The Authorities also viewed that these reforms would support financial deepening by allowing employees to better demonstrate their income to financial institutions, thereby making them more bankable.

41. The Authorities envisage strong reforms to the SOE sector, through 'Montenegro Works'. They are confident that the new company will obtain the required decision-making power and expertise to effectively manage performance and the privatization agenda of the sector. They expressed their intention to structure this company along similar lines as Greece's HCAP.

STAFF APPRAISAL

42. The economy is making good strides in recovery, but is still fragile. The human cost of COVID-19 was compounded by a significant decline in economic activity. Government and CBCG support measures to individuals, companies, and the financial sector have provided an important cushion and helped avoid an even deeper downturn. The economy is rebounding, supported by a revival of tourism. Nevertheless, official employment data indicate that many people remain without work, suggesting that continuing with temporary but targeted support to the most vulnerable deserves strong consideration. The nascent recovery is subject to several global risks including the pandemic, persisting inflationary forces, and a tightening of financial conditions.

43. While a phased and sequenced approach to the recent revenue reforms would have helped moderate fiscal risks, the focus should now be on closing wider fiscal gaps. The fiscal deficit is projected to widen in 2022 and remain high in the medium term due to a permanent reduction in revenues and an increase in long-term spending commitments, putting at risk the gains from pre-pandemic consolidation, as well as the efforts to rein in the deficit in 2021. The Authorities should persevere with their efforts to gain parliamentary approval for offsetting measures (e.g., excise tax increases, fuel marking, and a VAT increase for the hospitality industry) at the earliest possible opportunity.

44. A substantial reduction in public debt over the medium term is the overarching fiscal priority. Gross public debt, already high pre-crisis, has further risen in part due to the large fiscal deficit, GDP collapse, and a substantial Eurobond issuance in December 2020. The Authorities' decision to issue the Eurobond was appropriate, as it gave the country needed time and liquidity to recover from the shock of the pandemic, at a very favorable interest rate. These resources need to be carefully conserved given the continued economic uncertainty, and used wisely on items that safeguard the sustainability of public finances. With the widening deficit in 2022 and a structural fiscal loosening, debt is projected to rise further in the medium term if corrective measures are not clearly identified and implemented. The Authorities are advised to target a primary surplus of about 1 percent of GDP through a combination of revenue and expenditure measures, to ensure that public debt is on a steady downward path. As well as enacting the offsetting measures above, additional measures could include raising the general rate of VAT, and closing selected tax exemptions (total revenues forgone could be between 0.8 to 2 percent of GDP). Restricting growth in capital spending to inflation could be supported by stronger prioritization of investment projects as recommended by the PIMA. Measures to reduce growth in spending in public sector compensation, through workforce efficiencies or salary growth, could be identified and implemented through the upcoming Public Administration Reform.

45. Progress on public reforms will support debt reduction.

- The effective completion of the ongoing merger of the revenue administration agencies is important to ensure minimal disruptions to revenue collection.
- To be successful, 'Montenegro Works' would require robust institutional and legal frameworks, legal and financial capacity, political independence, and proper oversight. IMF staff stand ready to help the Authorities on assistance to strengthen SOE oversight, drawing on the lessons learned from international experience.
- A new Public Administration Reform strategy is needed to maximize the value that taxpayers realize from the public sector.
- It is key to adhere to the framework for the selection and appraisal of public investment projects – including PPPs, keeping in mind that they are an integral part of the public sector balance sheet.

46. The financial sector appears to have withstood the shock well. With the economy recovering, it is appropriate that most of these policies are now being phased out. The successful

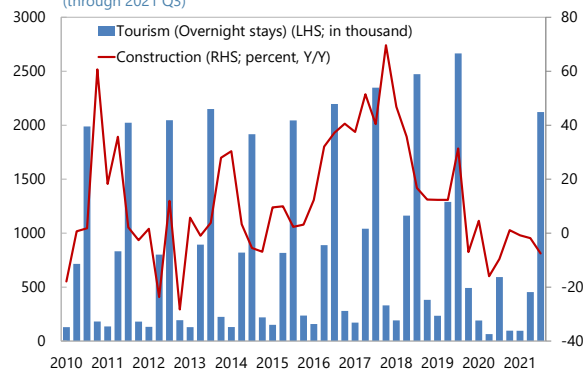
completion of the AQR was an important achievement and provided a reassuring picture of banking system balance sheets as of end-2019. The focus should now be on translating its findings into further strengthening supervision and bank resolution frameworks. Staff welcome the introduction of the new laws on Credit Institutions and on Resolution of Credit Institutions, which are consistent with the FSAP recommendations, and will help align regulation and supervision with current EU frameworks. Staff also encourage the CBCG to continue the work on strengthening contingency planning, ensuring that bank resolution strategies are well-tailored and credible. As the pandemic support measures are phased out, reported NPLs could increase, though expected to remain manageable. Continued vigilant monitoring and supervision during this transition will be important.

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

Figure 1. Real Sector

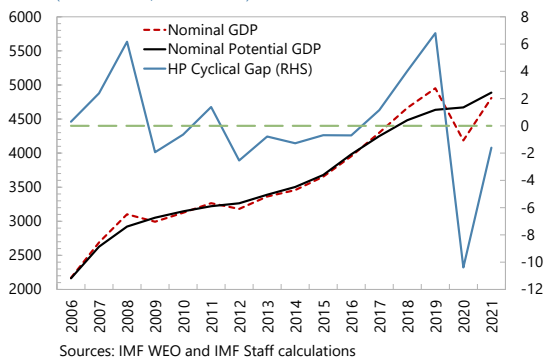
Economic recovery is taking hold in 2021, with a return of tourism...

Indicators of Economic Activity
(through 2021 Q3)



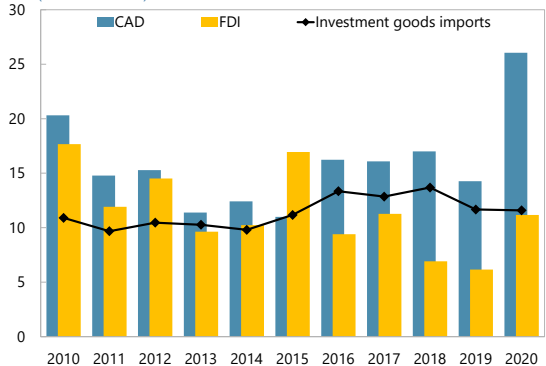
The output gap turned sharply negative in 2020.

Output Gap
(Two sided HP; lambda=6.25)



The current account deficit widened in 2020 from the collapse in tourism, while FDI held strong.

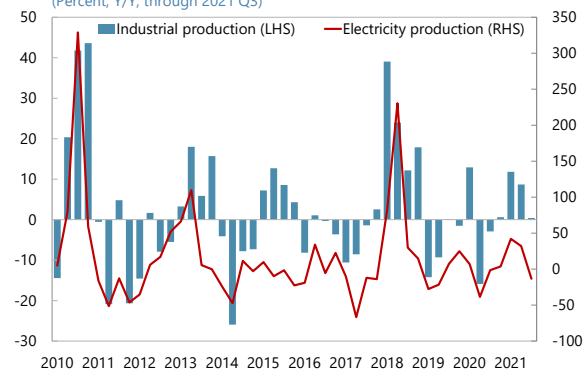
Current Account Deficit and Foreign Direct Investment
(Percent of GDP)



Sources: CBCG, Monstat, and IMF Staff calculations

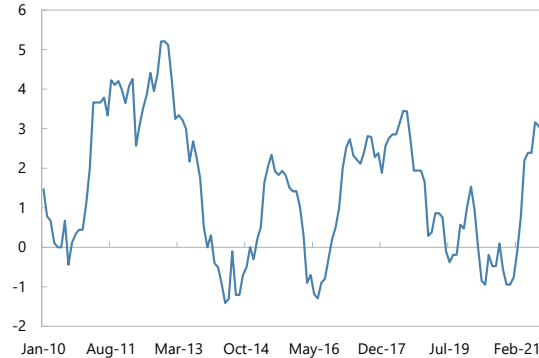
...and growth in industrial production.

Industrial Production
(Percent, Y/Y, through 2021 Q3)



After being negative for much of 2020, CPI picked up in 2021 due to global commodity and food prices.

Headline Consumer Price Inflation
(Percent, Y/Y)



The trade balance continues to improve in 2021 with a decline in imports.

Merchandise Trade
(Percent of GDP)

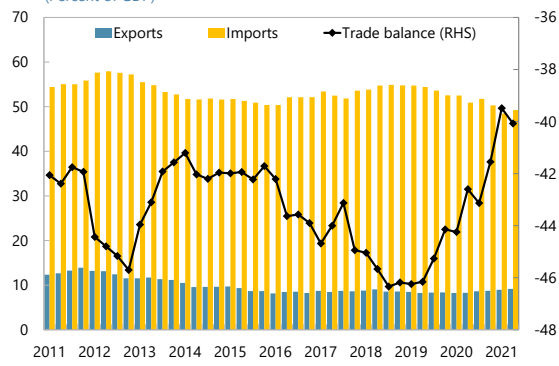
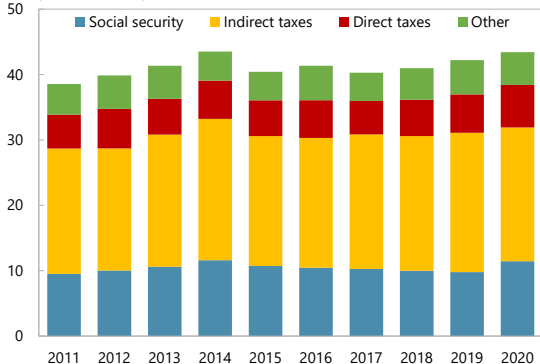


Figure 2. Fiscal Development

Social security as a share of revenues rose due to wage subsidies that were part of the crisis response.

Composition of Government Revenue

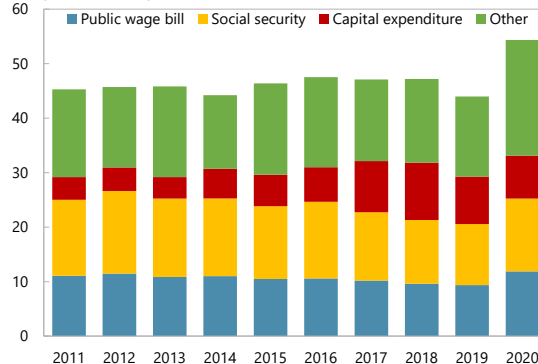
(Percent of GDP)



Expenditures increased to mitigate the impact of the pandemic, as the government extended fiscal support...

Composition of Government Expenditure

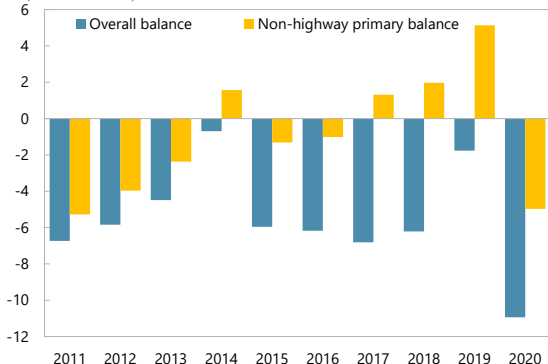
(Percent of GDP)



...widening the fiscal deficit in 2020.

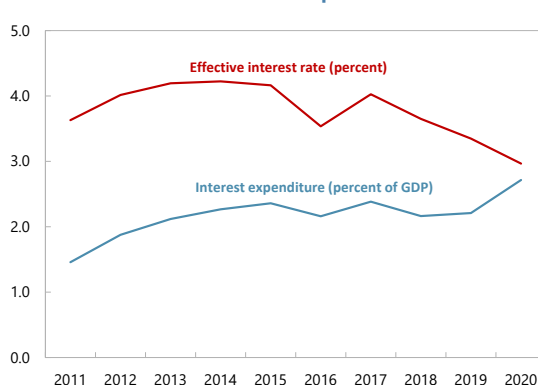
Overall Fiscal Balance and Non-Highway Primary Balance

(Percent of GDP)



While there has been a reduction in the effective interest rate, interest expenditure has risen due to higher debt and a collapse in GDP.

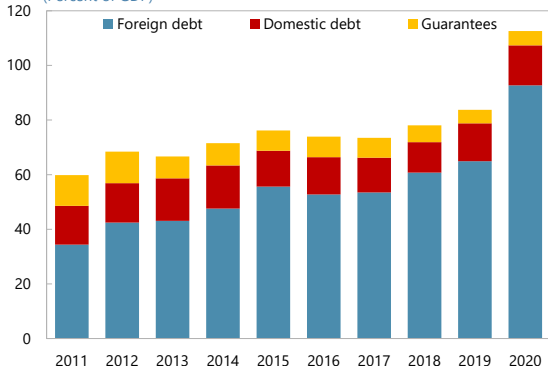
Effective Interest Rate and Expenditure



Government debt surpassed 100 percent of GDP...

General Government Debt Including Guarantees

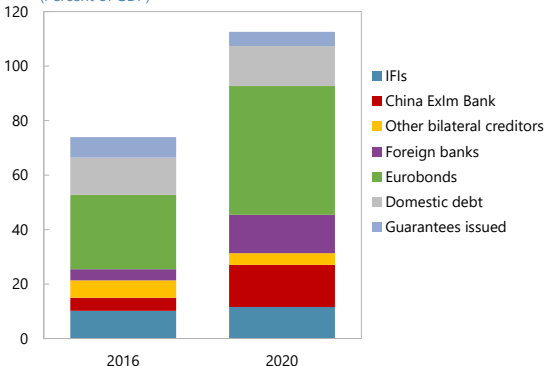
(Percent of GDP)



... in part due to the issuance of a large Eurobond in December 2020.

General Government Debt, by Creditor

(Percent of GDP)



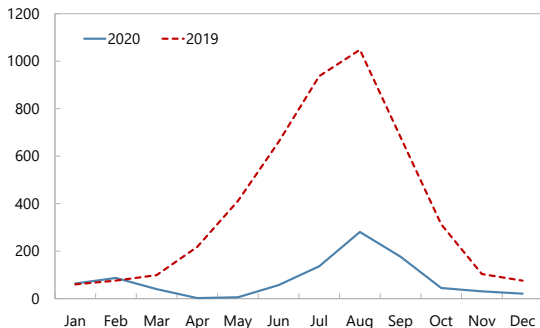
Sources: Ministry of Finance and IMF Staff calculations

Figure 3. Tourism Development

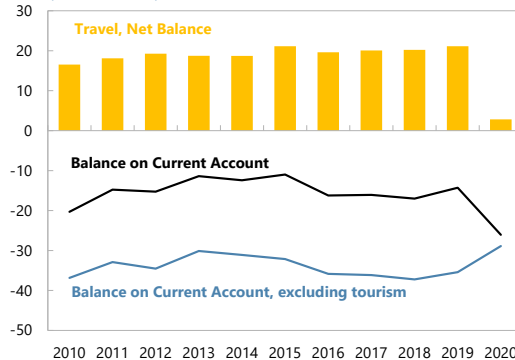
Montenegro suffered a large blow to tourism during the pandemic...

... which caused a deterioration in the current account.

Tourism Overnight Stays
(Thousands)



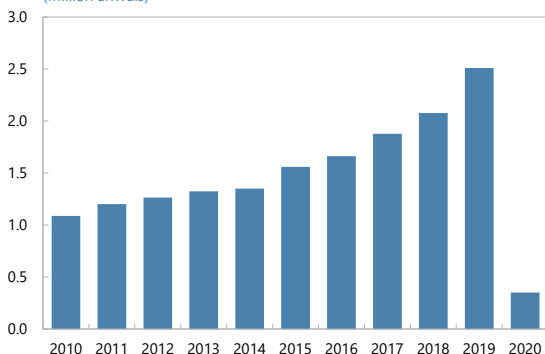
Current Account and Travel Balance
(Percent of GDP)



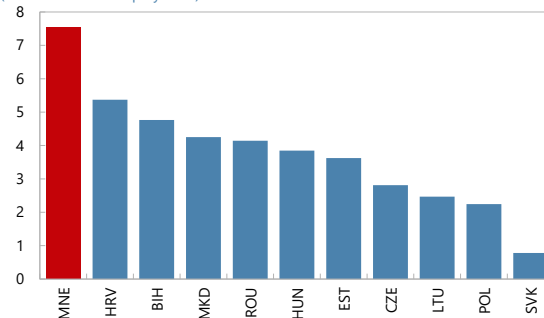
Tourist arrivals fell significantly in 2020 after a sustained increase in the past decade.

Relative to regional peers, employment in tourism-related activities is high.

Tourist Arrivals
(Million arrivals)



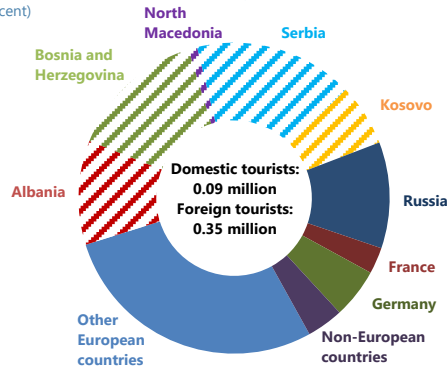
CESEE: Employment in Accommodation and Food Services, 2020
(Percent of total employment)



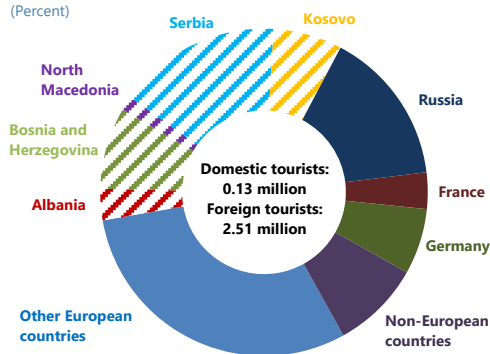
In 2020, a larger share of tourists originated domestically or from neighboring countries...

... compared to 2019 where the bulk of tourists came from outside the region.

Foreign Tourists in Montenegro, 2020
(Percent)



Foreign Tourists in Montenegro, 2019
(Percent)



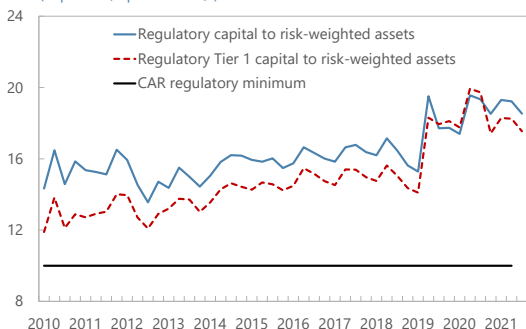
Sources: Monstat, Eurostat, CBCG, Haver Analytics, and IMF Staff calculations

Figure 4. Banking Sector

The overall banking system capital appears adequate...

Bank Capital

(in percent; up to 2021 Q3)

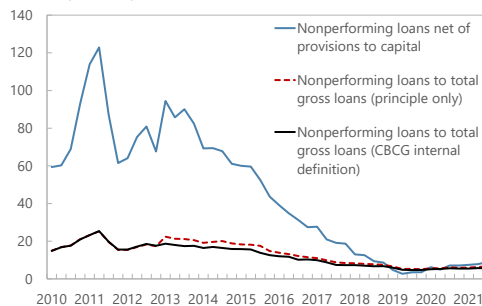


Source: Central Bank of Montenegro

...and NPLs are low, likely in part thanks to crisis support.

Nonperforming Loans

(in percent; up to 2021 Q3)

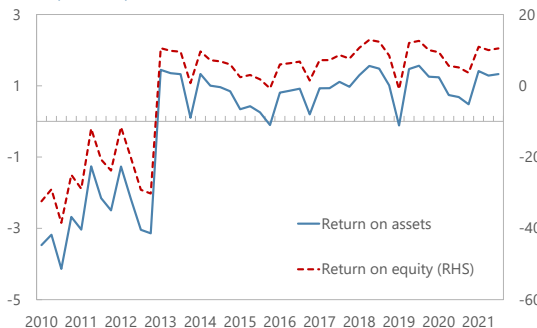


Source: Central Bank of Montenegro

Bank profits increased in 2021 after a modest drop in 2020.

Banking Sector Net Profits

(in percent; up to 2021 Q3)

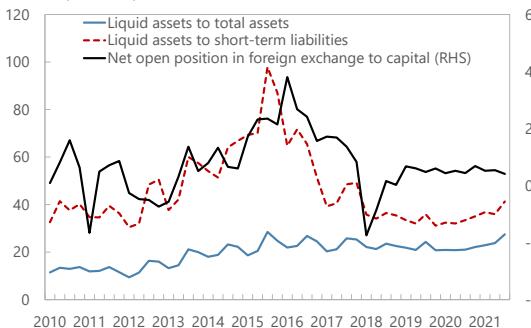


Source: Central Bank of Montenegro

Liquidity has stayed comfortable.

Bank Liquidity and Net Open Position

(in percent; up to 2021 Q3)

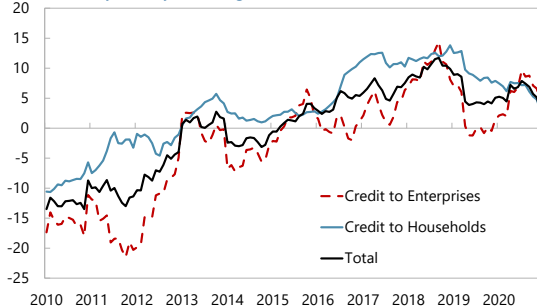


Source: Central Bank of Montenegro

Credit to the private sector grew by 3 percent in 2020 and another 4 percent in the first half of 2021.

Bank Lending by Sector 1/

(Percent, year-on-year, through December 2020)

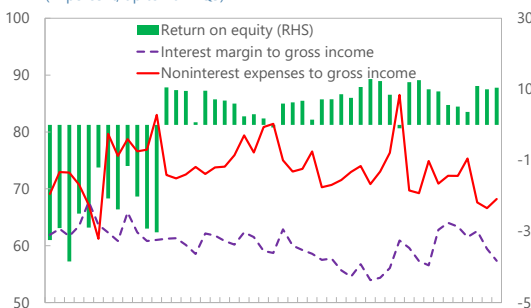


1/ 2019 data distorted by recent Atlas/IBM bankruptcies.

Net interest income remains the main source of income for banks.

Bank Efficiency and Profitability

(in percent; up to 2021 Q3)



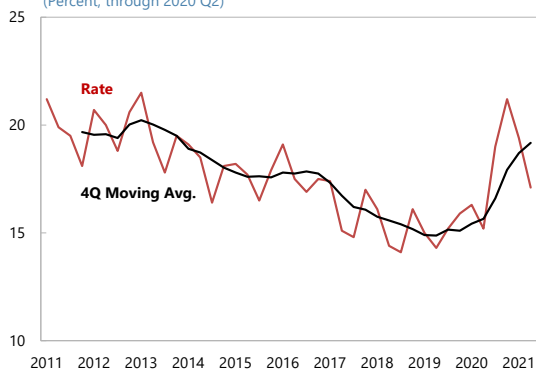
Source: Central Bank of Montenegro

Sources: Central Bank of Montenegro and IMF Staff calculations

Figure 5. Labor Markets

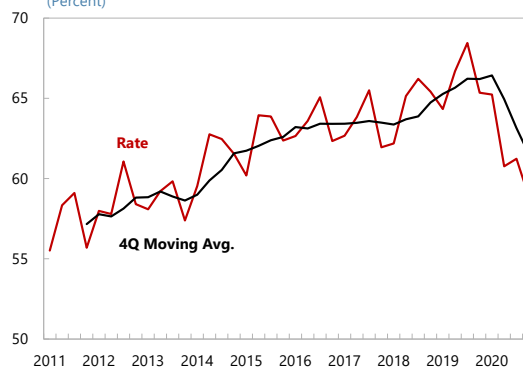
The official unemployment rate increased sharply in 2020 and remains high...

Unemployment Rate
(Percent, through 2020 Q2)



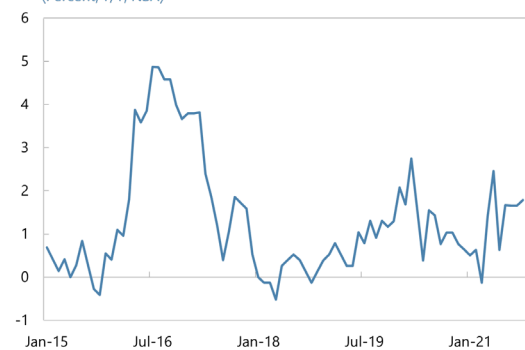
... and labor force participation also dropped significantly

Labor Force Participation Rate
(Percent)



Wage growth remained strong, supported by subsidies...

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



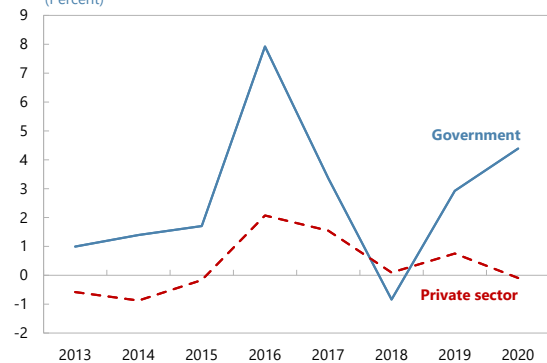
...despite a steep fall in productivity.

Productivity and Gross Wage Growth 1/
(Percent)



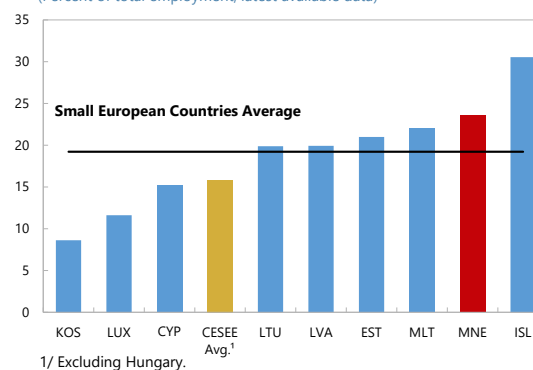
Public sector wage growth has consistently exceeded that in the private sector....

Public and Private Wage Growth
(Percent)



...with public employment also relatively high compared to peers.

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



Sources: Monstat, ILOSTAT, and IMF Staff calculations

Table 4. Montenegro: Selected Economic Indicators, 2016–2026
(Under Current Policies)

	2016	2017	2018	2019	Est. 2020	Projections					
						2021	2022	2023	2024	2025	2026
Real economy											
Nominal GDP (millions of €)	3,954	4,299	4,663	4,951	4,186	4,810	5,308	5,640	5,896	6,165	6,463
Gross national saving (percent of GDP)	9.9	14.1	14.9	17.7	5.0	10.2	11.1	9.8	10.0	10.2	10.1
Gross investment (percent of GDP)	26.1	30.2	31.9	32.0	31.2	25.9	26.2	24.8	25.0	25.2	25.2
Unemployment rate (percent)	17.7	16.1	15.2	15.1	17.9	...	...	...	...	...	...
Real GDP growth	2.9	4.7	5.1	4.1	-15.3	12.0	6.0	2.8	2.5	2.8	3.0
Industrial production growth	-4.4	-4.2	22.4	-6.3	-0.9	...	...	...	...	...	...
Tourism											
Arrivals (growth)	10.2	18.2	12.7	20.1	-79.2	...	...	...	...	...	...
Nights (growth)	8.4	10.5	8.2	11.2	-79.8	...	...	...	...	...	...
Consumer price inflation (period average)	-0.3	2.4	2.6	0.4	-0.2	2.4	4.1	2.7	1.7	1.6	1.6
Consumer price inflation (end of period)	1.0	1.9	1.7	1.1	-0.9	4.7	3.7	1.9	1.6	1.6	1.6
GDP deflator (percent change)	5.1	3.8	3.2	2.0	-0.2	2.6	4.1	3.4	2.0	1.7	1.8
Average net wage growth	4.0	2.3	0.2	0.8	1.7	...	...	...	...	...	...
Money and credit (end of period)											
	(Y-o-y growth)										
Bank credit to private sector	6.3	8.4	11.0	5.0	3.4	5.4	8.1	6.1	5.0	4.5	4.4 ¹
Enterprises	1.5	6.3	7.7	1.5	4.2	...	...	...	...	...	...
Households	11.0	10.3	13.8	7.9	2.9	...	...	...	...	...	...
Private sector deposits	6.0	15.2	6.8	2.0	-2.0	7.4	5.9	4.3	4.1	4.6	4.6
General government finances 1/											
Revenue and grants	41.3	40.3	41.0	42.2	43.4	43.0	38.8	38.8	38.9	38.9	38.9
Expenditure	47.5	47.1	47.2	44.0	54.4	45.0	44.9	44.4	44.8	45.3	45.7
Overall fiscal balance	-6.2	-6.8	-6.2	-1.8	-10.9	-2.0	-6.1	-5.6	-6.0	-6.4	-6.8
Cyclically adjusted overall fiscal balance	-5.8	-7.3	-8.0	-4.8	-5.2	-1.2	-6.7	-6.1	-6.2	-6.5	-6.9
Primary balance	-4.0	-4.4	-4.0	0.4	-8.2	0.5	-4.2	-3.6	-3.6	-3.6	-3.6
General government gross debt	66.4	66.2	71.9	78.8	107.3	88.2	79.4	79.6	82.2	85.0	88.0
General government gross debt (authorities' definition) 2/	64.4	64.3	70.1	77.4	105.5	86.6	77.9	78.2	80.9	83.7	86.8
General government debt, including loan guarantees	73.9	73.5	78.1	83.7	112.6	92.2	83.0	83.0	85.4	88.1	90.9
General government net debt, including guarantees 3/	72.3	71.3	71.6	69.5	89.6	81.0	78.9	79.7	82.1	84.9	87.7
General government net debt, excluding guarantees 4/	64.8	64.0	65.5	64.5	84.3	77.0	75.3	76.3	78.9	81.8	84.8
Balance of payments											
Current account balance	-16.2	-16.1	-17.0	-14.3	-26.0	-15.7	-15.0	-14.9	-14.9	-14.9	-15.0
Foreign direct investment, net	9.4	11.3	6.9	6.2	11.2	7.9	7.5	7.5	7.5	7.5	7.5
External debt (end of period, stock)	162.8	161.0	163.7	169.0	224.1	205.3	190.5	189.5	192.2	194.7	196.8
REER (CPI-based; y-o-y avg. change, in percent) 5/	0.6	0.5	2.7	-1.5	-0.6	...	...	...	...	...	...
Memorandum:											
GDP per capita (USD)	7,032	7,800	8,855	8,911	7,689	...	...	...	...	...	...
Nominal GDP Growth (in percent)	8.2	8.7	8.5	6.2	-15.5	14.9	10.4	6.3	4.5	4.6	4.8
Real output gap (percent of potential GDP)	-0.7	1.2	4.0	6.8	-10.4	-1.6	1.5	1.2	0.5	0.3	0.3
Gross international reserves in millions of USD 6/	794	1,003	1,195	1,519	2,116	1,602	1,252	1,234	1,257	1,273	1,289
In months of imports of goods and services	3.3	3.4	4.0	5.1	8.2	5.5	3.7	3.4	3.3	3.1	3.0

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

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

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

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

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

5/ A negative sign indicates depreciation a REER depreciation.

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

Table 5. Montenegro: Savings and Investment Balances, 2016–2026
(Percent of GDP, unless otherwise noted)

	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026
					Est.	Projections					
Gross national savings	9.9	14.1	14.9	17.7	5.0	10.2	11.1	9.8	10.0	10.2	10.1
Non-government	11.6	13.7	12.6	12.8	10.6	9.1	12.3	11.4	12.3	13.4	14.2
Government	-1.8	0.4	2.3	4.9	-5.6	1.2	-1.2	-1.6	-2.4	-3.3	-4.0
Gross domestic investment	26.1	30.2	31.9	32.0	31.2	25.9	26.2	24.8	25.0	25.2	25.2
Non-government	19.8	20.8	21.4	23.3	23.3	20.5	19.7	19.0	19.1	19.3	19.4
Government	6.3	9.4	10.5	8.7	7.9	5.5	6.5	5.8	5.8	5.8	5.8
Savings - investment balance	-16.2	-16.1	-17.0	-14.3	-26.2	-15.7	-15.1	-15.0	-15.0	-15.0	-15.1
Non-government	-8.1	-7.1	-8.8	-10.5	-12.7	-11.4	-7.4	-7.6	-6.8	-5.9	-5.2
Government	-8.1	-9.0	-8.2	-3.8	-13.5	-4.3	-7.7	-7.5	-8.2	-9.1	-9.8
Current account balance	-16.2	-16.1	-17.0	-14.3	-26.0	-15.7	-15.0	-14.9	-14.9	-14.9	-15.0
Foreign direct investment (net)	9.4	11.3	6.9	6.2	11.2	7.9	7.5	7.5	7.5	7.5	7.5
External debt	162.8	161.0	163.7	169.0	224.1	205.3	190.5	189.5	192.2	194.7	196.8
Consumption	96.4	93.2	91.9	89.2	103.8	98.5	97.8	99.0	98.8	98.5	98.5
Non-government	76.8	74.8	73.4	71.4	81.2	79.5	79.5	81.3	81.1	80.8	80.8
Government	19.6	18.4	18.5	17.8	22.6	19.0	18.3	17.7	17.7	17.7	17.7

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

Table 6. Montenegro: Contribution to Real Gross Domestic Product, 2016–2026
(Contribution to real GDP growth)

	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026
					Est.	Projections					
Gross domestic product	2.9	4.7	5.1	4.1	-15.3	12.0	6.0	2.8	2.5	2.8	3.0
Consumption	5.1	3.4	5.6	3.1	-4.1	4.4	5.1	4.3	4.1	4.0	4.1
Government	0.2	-0.3	1.3	0.2	0.2	-1.3	0.4	0.1	0.5	0.5	0.6
Private	4.9	3.7	4.3	2.9	-4.3	5.7	4.7	4.3	3.5	3.5	3.5
Investment	5.7	4.8	2.5	-0.7	-3.6	-2.6	3.0	1.3	0.1	0.2	0.6
Gross fixed capital formation	9.2	6.0	5.3	-0.7	-4.5	-3.5	2.8	0.6	1.2	1.2	1.2
Government	1.2	4.1	2.0	-1.5	-2.4	-2.4	1.7	-0.3	0.3	0.2	0.3
Private	8.0	1.9	3.4	0.8	-2.1	-1.1	1.1	1.0	1.0	1.0	1.0
Changes in inventories	-3.5	-1.2	-2.9	0.0	0.9	0.9	0.2	0.7	-1.1	-1.0	-0.6
Net Exports	-7.8	-3.5	-3.0	1.7	-7.6	10.2	-2.1	-2.8	-1.6	-1.5	-1.7
Exports	2.0	3.3	5.3	3.8	-24.8	19.5	5.3	3.1	1.8	1.6	1.6
Goods	0.9	0.4	1.4	0.9	-1.4	0.4	0.9	0.7	0.6	0.5	0.5
Services	1.1	2.9	3.9	2.9	-23.4	19.1	4.4	2.4	1.2	1.1	1.1
Imports	-9.8	-6.8	-8.3	-2.1	17.2	-9.3	-7.4	-5.9	-3.4	-3.1	-3.3
Goods	-7.8	-5.6	-5.7	-0.7	12.2	-5.6	-5.2	-2.6	-2.7	-2.5	-2.6
Services	-2.0	-1.2	-2.6	-1.5	5.1	-3.7	-2.2	-3.3	-0.8	-0.6	-0.7

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

Table 7. Montenegro: Consolidated General Government Fiscal Operations, 2016–2026^{1/}
(Millions of euro)

	2016	2017	2018	2019	Est.		Projections				
					2020	2021	2022	2023	2024	2025	2026
Total revenues and grants	1,635	1,732	1,911	2,090	1,817	2,067	2,060	2,187	2,291	2,398	2,516
Total revenues	1,617	1,701	1,881	2,046	1,752	2,019	2,009	2,136	2,239	2,346	2,464
Current revenues	1,613	1,695	1,870	2,038	1,744	2,011	1,999	2,126	2,229	2,335	2,453
Taxes	1,013	1,104	1,220	1,345	1,128	1,322	1,417	1,522	1,593	1,666	1,746
Personal income tax	160	146	163	180	168	183	187	194	202	211	220
Corporate income tax	45	49	68	73	78	75	83	108	114	120	127
Taxes on turnover of real estate	13	15	18	25	16	19	19	20	21	22	23
Value added tax	501	549	617	696	530	682	734	780	815	852	894
Excises	183	225	221	236	205	237	263	281	295	308	323
Taxes on international trade	24	25	27	29	23	26	29	31	32	33	35
Local government taxes	77	86	96	95	99	89	91	97	102	106	111
Other taxes	9	9	9	13	10	10	11	12	13	13	14
Social security contributions	414	441	466	485	480	501	401	420	443	467	494
Nontax revenues	186	149	184	208	136	188	181	183	193	202	213
Duties	19	20	23	21	13	17	18	19	20	21	22
Fees	120	80	76	93	75	105	111	109	114	120	126
Other revenues	47	49	86	94	49	66	52	56	59	61	65
Loan repayment receipts	4	7	11	8	7	9	9	10	10	11	11
Grants	17	30	30	43	65	48	52	52	52	52	52
Total expenditures and net lending	1,879	2,025	2,200	2,177	2,275	2,163	2,382	2,503	2,642	2,792	2,954
Total expenditures	1,875	2,017	2,194	2,171	2,270	2,159	2,377	2,498	2,637	2,787	2,949
Current expenditures	1,624	1,614	1,704	1,740	1,940	1,896	2,032	2,170	2,294	2,428	2,573
Gross salaries	419	438	449	463	497	530	547	584	613	643	677
Other personal income	15	14	17	20	17	15	18	19	19	20	21
Goods and services	161	146	161	130	150	133	139	147	153	159	166
Current maintenance	26	26	26	28	31	26	32	34	36	38	39
Interest payments	85	103	101	109	114	118	96	113	139	173	207
Rent	10	10	11	12	12	12	12	13	13	14	15
Subsidies to enterprises	28	29	32	36	38	49	65	62	64	67	71
Other outflows 2/	41	44	50	46	48	42	55	58	60	63	66
Social security transfers	556	539	545	555	559	568	653	734	772	809	850
Other transfers	263	243	285	275	355	328	346	356	370	386	403
Repayment of guarantees	0	0	0	39	0	0	0	0	0	0	0
Reserves	21	22	27	27	119	74	71	50	53	55	58
Capital expenditures	251	403	490	431	330	263	345	329	343	359	377
Net lending	4	7	6	6	5	4	5	5	5	5	5
Overall Balance	-244	-293	-290	-88	-458	-96	-321	-316	-351	-394	-438
Financing	205	215	293	30	457	96	321	316	351	394	438
Domestic financing	91	-12	-171	-276	-337	367	357	75	-62	-7	75
Central bank financing (- deposit increase)	10	-25	-207	-386	-256	421	328	29	-8	-4	-6
Commercial bank financing	133	37	41	66	-83	-46	-5	1	-51	-59	65
Change in deposits (- increase)	4	-23	-44	-22	-10	0	0	0	-1	-1	1
Bank loans, net	18	67	28	39	41	-46	-45	-48	-50	-58	-6
Bank purchases of securities, net	111	-7	57	50	-114	0	40	50	0	0	70
Non-bank financing	-52	-23	-5	44	2	-8	34	45	-3	57	17
Foreign financing	103	217	510	346	775	-278	-42	241	413	401	363
Disbursements	325	353	913	658	1,193	117	204	487	757	1,337	914
Amortization	-310	-136	-464	-331	-425	-352	-246	-246	-344	-936	-551
Change in foreign accounts receivable 3/	87	-1	60	20	8	-44	0	0	0	0	0
Privatization receipts	11	9	-45	-40	19	7	7	0	0	0	0
Memorandum items:											
Primary balance	-159	-190	-189	22	-344	22	-225	-202	-212	-221	-231
Current balance	-11	81	166	298	-196	115	-33	-44	-65	-93	-120

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

1/ Includes central government budget and local governments.

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

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

Table 8. Montenegro: Consolidated General Government Fiscal Operations, 2016–2026 ^{1/}
(Percent of GDP)

					Est.		Projections				
	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026
Total revenues and grants	41.3	40.3	41.0	42.2	43.4	43.0	38.8	38.8	38.9	38.9	38.9
Total revenues	40.9	39.6	40.3	41.3	41.8	42.0	37.8	37.9	38.0	38.1	38.1
Current revenues	40.8	39.4	40.1	41.2	41.7	41.8	37.7	37.7	37.8	37.9	38.0
Taxes	25.6	25.7	26.2	27.2	27.0	27.5	26.7	27.0	27.0	27.0	27.0
Personal income tax	4.0	3.4	3.5	3.6	4.0	3.8	3.5	3.4	3.4	3.4	3.4
Corporate income tax	1.1	1.1	1.5	1.5	1.9	1.6	1.6	1.9	1.9	1.9	2.0
Taxes on turnover of real estate	0.3	0.4	0.4	0.5	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Value added tax	12.7	12.8	13.2	14.1	12.7	14.2	13.8	13.8	13.8	13.8	13.8
Excises	4.6	5.2	4.7	4.8	4.9	4.9	5.0	5.0	5.0	5.0	5.0
Taxes on international trade	0.6	0.6	0.6	0.6	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Local government taxes	2.0	2.0	2.1	1.9	2.4	1.9	1.7	1.7	1.7	1.7	1.7
Other taxes	0.2	0.2	0.2	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Social security contributions	10.5	10.3	10.0	9.8	11.5	10.4	7.6	7.5	7.5	7.6	7.6
Nontax revenues	4.7	3.5	4.0	4.2	3.3	3.9	3.4	3.3	3.3	3.3	3.3
Duties	0.5	0.5	0.5	0.4	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Fees	3.0	1.9	1.6	1.9	1.8	2.2	2.1	1.9	1.9	1.9	2.0
Other revenues	1.2	1.1	1.8	1.9	1.2	1.4	1.0	1.0	1.0	1.0	1.0
Loan repayment receipts	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Grants	0.4	0.7	0.6	0.9	1.6	1.0	1.0	0.9	0.9	0.8	0.8
Total expenditures and net lending	47.5	47.1	47.2	44.0	54.4	45.0	44.9	44.4	44.8	45.3	45.7
Total expenditures	47.4	46.9	47.1	43.9	54.2	44.9	44.8	44.3	44.7	45.2	45.6
Current expenditures	41.1	37.5	36.5	35.2	46.4	39.4	38.3	38.5	38.9	39.4	39.8
Gross salaries	10.6	10.2	9.6	9.4	11.9	11.0	10.3	10.4	10.4	10.4	10.5
Other personal income	0.4	0.3	0.4	0.4	0.4	0.3	0.3	0.3	0.3	0.3	0.3
Goods and services	4.1	3.4	3.5	2.6	3.6	2.8	2.6	2.6	2.6	2.6	2.6
Current maintenance	0.7	0.6	0.6	0.6	0.7	0.5	0.6	0.6	0.6	0.6	0.6
Interest payments	2.2	2.4	2.2	2.2	2.7	2.4	1.8	2.0	2.4	2.8	3.2
Rent	0.3	0.2	0.2	0.2	0.3	0.3	0.2	0.2	0.2	0.2	0.2
Subsidies to enterprises	0.7	0.7	0.7	0.7	0.9	1.0	1.2	1.1	1.1	1.1	1.1
Other outflows 2/	1.0	1.0	1.1	0.9	1.2	0.9	1.0	1.0	1.0	1.0	1.0
Social security transfers	14.1	12.5	11.7	11.2	13.4	11.8	12.3	13.0	13.1	13.1	13.2
Other transfers	6.6	5.7	6.1	5.6	8.5	6.8	6.5	6.3	6.3	6.3	6.2
Repayment of guarantees	0.0	0.0	0.0	0.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Reserves	0.5	0.5	0.6	0.6	2.8	1.5	1.3	0.9	0.9	0.9	0.9
Capital expenditures	6.3	9.4	10.5	8.7	7.9	5.5	6.5	5.8	5.8	5.8	5.8
Net lending	0.1	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Overall Balance	-6.2	-6.8	-6.2	-1.8	-10.9	-2.0	-6.1	-5.6	-6.0	-6.4	-6.8
Financing	5.2	5.0	6.3	0.6	10.9	2.0	6.1	5.6	6.0	6.4	6.8
Domestic financing	2.3	-0.3	-3.7	-5.6	-8.1	7.6	6.7	1.3	-1.1	-0.1	1.2
Central bank financing (- deposit increase)	0.3	-0.6	-4.4	-7.8	-6.1	8.8	6.2	0.5	-0.1	-0.1	-0.1
Commercial bank financing	3.4	0.8	0.9	1.3	-2.0	-1.0	-0.1	0.0	-0.9	-1.0	1.0
Change in deposits (- increase)	0.1	-0.5	-0.9	-0.4	-0.2	0.0	0.0	0.0	0.0	0.0	0.0
Bank loans, net	0.5	1.6	0.6	0.8	1.0	-1.0	-0.8	-0.9	-0.9	-0.9	-0.1
Bank purchases of securities, net	2.8	-0.2	1.2	1.0	-2.7	0.0	0.8	0.9	0.0	0.0	1.1
Non-bank financing	-1.3	-0.5	-0.1	0.9	0.1	-0.2	0.6	0.8	-0.1	0.9	0.3
Foreign financing	2.6	5.1	10.9	7.0	18.5	-5.8	-0.8	4.3	7.0	6.5	5.6
Disbursements	8.2	8.2	19.6	13.3	28.5	2.4	3.8	8.6	12.8	21.7	14.1
Amortization	-7.8	-3.2	-9.9	-6.7	-10.1	-7.3	-4.6	-4.4	-5.8	-15.2	-8.5
Change in foreign accounts receivable 3/	2.2	0.0	1.3	0.4	0.2						
Privatization receipts	0.3	0.2	-1.0	-0.8	0.5	0.1	0.1	0.0	0.0	0.0	0.0
Memorandum items:											
Primary balance	-4.0	-4.4	-4.0	0.4	-8.2	0.5	-4.2	-3.6	-3.6	-3.6	-3.6
Current balance	-0.3	1.9	3.6	6.0	-4.7	2.4	-0.6	-0.8	-1.1	-1.5	-1.9
General government debt (gross)	66.4	66.2	71.9	78.8	107.3	88.2	79.4	79.6	82.2	85.0	88.0
Gen. govt debt, including guarantees	73.9	73.5	78.1	83.7	112.6	92.2	83.0	83.0	85.4	88.1	90.9

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

1/ Includes central government and local governments.

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

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

Table 9. Montenegro: Summary of Accounts of the Financial System, 2016–2026
(Percent of GDP)

	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026
					Est.	Projections					
I. Central Bank											
Net foreign assets	720	816	1019	1335	1637	1216	888	859	868	872	878
Assets 1/	753	847	1050	1367	1738	1388	1059	1031	1038	1043	1049
Liabilities	33	31	31	32	101	172	171	171	171	171	171
Net domestic assets	-590	-673	-890	-1217	-1501	-1071	-729	-690	-691	-687	-684
Net credit to the nonfinancial public sector	30	2	-205	-537	-845	-424	-96	-67	-76	-80	-86
Of which: general government	30	2	-205	-537	-845	-424	-96	-67	-76	-80	-86
Net credit to the banking system	-654	-708	-669	-705	-689	-727	-682	-672	-664	-656	-647
Required reserves	-226	-234	-252	-260	-179	-193	-204	-213	-222	-232	-242
Giro account	-427	-474	-416	-444	-509	-534	-478	-460	-443	-425	-405
Claims on depository institutions	-1	-1	0	-1	-1	1	1	1	1	1	1
Other assets net	34	34	-17	24	32	79	49	49	49	49	49
Deposits included in broad money	65	78	59	44	56	64	71	76	79	83	87
Equity	64	66	69	74	80	80	88	94	98	102	107
II. Banking System											
Net foreign assets	-290	-246	-317	-504	-560	-978	-1,014	-1,052	-1,092	-1,134	-1,177
Assets	527	616	649	593	608	318	318	318	318	318	318
Liabilities	818	861	966	1,097	1,169	1,297	1,333	1,371	1,411	1,452	1,496
Net domestic assets	2,623	2,858	3,182	3,418	3,461	3,856	4,292	4,816	5,225	5,699	6,212
Net assets held in the central bank	653	708	668	695	685	727	682	672	665	657	648
Net credit to nonfinancial public sector	-5	17	143	264	254	208	203	205	153	94	159
Of which: general government	275	316	353	423	376	330	325	327	275	216	281
Credit to the private sector	1,922	2,083	2,312	2,428	2,511	2,647	2,861	3,035	3,187	3,330	3,477
Other domestic assets	53	50	59	32	11	9	9	9	9	9	9
Liabilities	2,333	2,612	2,820	2,890	2,893	3,045	3,346	3,818	4,161	4,572	13,988
Private sector deposits	1,812	2,086	2,219	2,259	2,211	2,375	2,514	2,621	2,730	2,854	2,986
Other items, net	520	526	601	631	682	729	753	784	806	832	861
o/w capital	496	529	513	598	589	646	712	795	853	924	1,001
III. Consolidated System											
Net foreign assets 1/	430	571	702	831	1,077	237	-126	-193	-225	-262	-299
Net domestic assets	2,033	2,185	2,291	2,201	1,960	2,520	3,027	3,231	3,323	3,403	3,608
Net credit to the nonfinancial public sector	25	19	-62	-273	-591	-215	107	137	78	14	73
Of which: general government	305	318	148	-113	-469	-93	229	259	200	136	195
Credit to the private sector	1,922	2,083	2,312	2,428	2,511	2,647	2,861	3,035	3,187	3,330	3,477
Other net domestic assets	86	83	41	46	40	88	58	58	58	58	58
Liabilities	2,398	2,690	2,880	2,934	2,949	2,677	2,813	2,944	3,001	3,039	3,202
Equity capital of the central bank	64	66	69	74	80	80	88	94	98	102	107
IV. Ratios											
Net assets held in CBCG/Deposits	36.0	33.9	30.1	30.8	31.0	30.6	27.1	25.7	24.3	23.0	21.7
Effective required reserves ratio	12.5	11.2	11.4	11.5	8.1	8.1	8.1	8.1	8.1	8.1	8.1
Credit to private sector / GDP	48.6	48.5	49.6	49.0	60.0	55.0	53.9	53.8	54.1	54.0	53.8
Banks' capital / credit to private sector	25.8	25.4	22.2	24.6	23.5	20.1	19.5	19.2	18.6	18.0	18.2
CBCG reserves / bank deposits 1/	41.5	40.6	47.3	60.5	78.6	58.4	42.1	39.3	38.0	36.5	35.1
Banks' foreign liabilities / credit to private sector	42.5	41.3	41.8	45.2	46.5	49.0	46.6	45.2	44.3	43.6	43.0
Memo item:											
Broad money	2,240.5	2,546.8	2,625.0	2,581.2	2,484.4	2,710.3	2,856.0	2,967.4	3,079.6	3,207.9	3,343.9
BM growth	9.5	13.7	3.1	-1.7	-3.7	9.1	5.4	3.9	3.8	4.2	4.2

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

Table 10. Montenegro: Balance of Payments, 2016–2026
(Millions of euro, unless otherwise noted; BPM6)

	2016	2017	2018	2019	Est.			Projections			
					2020	2021	2022	2023	2024	2025	2026
	(Millions of euros)										
Current account balance	-642	-691	-793	-706	-1,090	-753	-798	-843	-880	-920	-971
Trade balance	-1,658	-1,860	-2,049	-2,066	-1,642	-1,968	-2,185	-2,255	-2,350	-2,454	-2,573
Exports	351	382	436	466	409	461	510	538	566	593	622
Imports	2,008	2,243	2,485	2,531	2,051	2,429	2,694	2,793	2,916	3,047	3,194
Services account	769	852	937	1,020	182	795	917	914	953	998	1,044
Receipts	1,255	1,382	1,563	1,698	674	1,416	1,630	1,766	1,851	1,936	2,028
Expenditures	486	531	627	678	492	621	713	852	898	939	984
Primary Income	35	88	55	55	61	87	104	113	117	120	125
Compensation of employees, net	224	234	216	216	216	255	281	299	313	327	343
Investment income, net	-190	-146	-162	-161	-155	-168	-177	-186	-196	-207	-218
Secondary Income	212	228	265	284	308	332	365	385	400	416	434
Government, net	24	21	33	49	51	33	36	35	34	33	32
Other sectors, net	188	208	232	236	258	299	330	350	366	383	401
Capital account	1	0	0	0	0	0	0	0	0	0	0
Financial account	-690	-774	-886	-1,175	-1,368	-332	-470	-814	-888	-924	-977
Foreign direct investment, net	-372	-484	-322	-305	-468	-382	-398	-420	-440	-462	-485
Portfolio investment, net	4	-26	-135	-337	-394	346	35	38	39	41	43
General government, net change in liabilities	89	0	137	319	424	-227	0	0	0	0	0
Eurobond	120	0	129	331	429	-227	0	0	0	0	0
Disbursements (increase in liabilities)	300	0	491	500	750	0	0	0	0	500	0
Amortization (reduction in liabilities)	-180	0	-362	-169	-321	-227	0	0	0	-500	0
Derivatives, net	34	34	78	64	71	68	19	83	100	109	121
Other investment, net	-323	-263	-429	-534	-507	-296	-108	-432	-487	-504	-535
General government	24	-256	-422	9	-322	51	42	-241	-413	-401	-363
Commercial banks	-151	56	-66	-222	-69	162	-36	-38	-40	-42	-44
Other sectors	-196	-63	59	-320	-116	-509	-114	-153	-34	-61	-129
Errors and omissions	80	15	108	-153							
Change in official reserves (+ denotes increase) 1/	129	97	202	316	374	-351	-328	-29	8	4	6
Memorandum items	(Percent of GDP)										
Current account balance	-16.2	-16.1	-17.0	-14.3	-26.0	-15.7	-15.0	-14.9	-14.9	-14.9	-15.0
Trade balance	-41.9	-43.3	-43.9	-41.7	-39.2	-40.9	-41.2	-40.0	-39.9	-39.8	-39.8
Exports	8.9	8.9	9.4	9.4	9.8	9.6	9.6	9.5	9.6	9.6	9.6
Imports	50.8	52.2	53.3	51.1	49.0	50.5	50.8	49.5	49.5	49.4	49.4
Services account	19.4	19.8	20.1	20.6	4.4	16.5	17.3	16.2	16.2	16.2	16.2
Receipts	31.7	32.2	33.5	34.3	16.1	29.4	30.7	31.3	31.4	31.4	31.4
Payments	12.3	12.3	13.4	13.7	11.7	12.9	13.4	15.1	15.2	15.2	15.2
Income account	0.9	2.1	1.2	1.1	1.5	1.8	2.0	2.0	2.0	2.0	1.9
Current transfers, net	5.4	5.3	5.7	5.7	7.4	6.9	6.9	6.8	6.8	6.7	6.7
Foreign direct investment, net	-9.4	-11.3	-6.9	-6.2	-11.2	-7.9	-7.5	-7.5	-7.5	-7.5	-7.5
Portfolio investment, net	0.1	-0.6	-2.9	-6.8	-9.4	7.2	0.7	0.7	0.7	0.7	0.7
Other investment, net	-8.2	-6.1	-9.2	-10.8	-12.1	-6.2	-2.0	-7.7	-8.3	-8.2	-8.3
General government	0.6	-6.0	-9.1	0.2	-7.7	1.1	0.8	-4.3	-7.0	-6.5	-5.6
Other sectors	-5.0	-1.5	1.3	-6.5	-2.8	-10.6	-2.1	-2.7	-0.6	-1.0	-2.0
Errors and omissions	2.0	0.3	2.3	-3.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross external debt	162.8	161.0	163.7	169.0	224.1	205.3	190.5	189.5	192.2	194.7	196.8
of which: Government	53.8	54.3	59.2	63.2	91.6	76.6	68.3	68.4	72.3	75.6	77.7
Real goods import growth	12.5	8.4	8.2	1.0	-17.5	8.3	8.0	3.9	3.9	3.6	3.8
Real goods export growth	6.7	3.7	11.9	7.3	-11.4	3.0	7.6	5.4	4.9	4.2	3.7
Real service export growth	3.1	8.5	11.1	7.3	-60.4	105.6	13.2	6.8	3.2	3.0	3.0

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

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

Table 11. Montenegro: Financial Soundness Indicators of the Banking Sector, 2014–2021

	2014	2015	2016	2017	2018	2019	2020	2021
	Dec	Dec	Dec	Dec	Dec	Dec	Dec	Sep
Capital adequacy								
Regulatory capital as percent of risk-weighted assets	16.2	15.5	16.0	16.4	15.6	17.7	18.5	18.5
Regulatory tier 1 capital as percent of risk-weighted assets	14.4	14.2	14.7	15.0	14.4	18.1	17.4	17.5
Asset composition and quality								
Nonperforming loans in percent of gross loans	15.9	12.6	10.3	7.3	6.7	4.7	5.5	5.6
Nonperforming loans net of provisions in percent of capital	61.1	43.7	27.4	18.7	8.6	3.5	7.1	9.0
Earnings and profitability								
Return on assets	0.8	-0.1	0.2	1.0	1.0	1.3	0.5	1.3
Return on equity	6.0	-0.7	1.5	7.6	8.5	10.0	3.6	10.5
Interest margin to gross income	60.2	58.7	58.6	54.5	56.1	56.6	61.5	57.3
Noninterest expenses to gross income	75.9	81.4	76.6	73.0	76.3	74.9	75.3	68.2
Liquidity								
Liquid assets to total assets	22.2	24.8	24.5	25.3	22.6	20.8	22.2	27.5
Liquid assets to short-term liabilities	66.8	87.0	51.4	49.2	35.4	31.1	35.1	41.3
Net open position in foreign exchange to capital	0.6	2.1	1.6	0.8	0.0	0.6	0.7	0.4
Efficiency of operations								
Personnel expenses to noninterest expenses	37.3	37.0	36.8	36.0	34.9	35.9	35.9	34.8
Spread between reference lending and deposit rates (basis points)	561	555	552	546	544	540	541	537
Customer deposits to total (noninterbank) loans	116.1	110.3	104.5	105.2	108.3	109.7	114.4	126.3

Source: Central Bank of Montenegro.

Annex I. Risk Assessment Matrix¹

(Scale – High, medium, or low)

Source of Risks	Relative Likelihood	Impact if Realized	Policy Response
<p>Uncontrolled COVID-19 local outbreaks and subpar/volatile growth in affected countries.</p> <p>Montenegro can become one of the countries to experience a local outbreak as the vaccination rate is still relatively low.</p>	High	High. The economic impact would be high primarily because of loss of the tourism market to competitors with better epidemiological conditions.	Appropriate measures, including speeding up vaccination may lessen the probability of a local outbreak. If realized, fiscal and financial support measures may need to be recalibrated, without increasing macro stability risks.
<p>Global resurgence of the COVID-19 pandemic.</p> <p>Local outbreaks may lead to a global resurgence of the pandemic (possibly due to vaccine-resistant variants), which may require costly containment efforts and prompts persistent behavioral changes rendering many activities unviable.</p>	Medium	High, due to the high dependency on tourism.	Fiscal and financial support measures may need to be recalibrated, without increasing macro stability risks.
<p>Disorderly transformations.</p> <p>COVID-19 may trigger structural transformations, but the reallocation of resources may be impeded by labor market rigidities, debt overhangs, and inadequate bankruptcy resolution frameworks. This, coupled with a withdrawal of COVID-19-related policy support, may undermine growth prospects and increases unemployment, with adverse social/political consequences.</p>	Medium	High. The baseline already assumes significant economic scarring in Montenegro. It can be exacerbated if the reallocation of resources is impeded further, for example due to labor market rigidities.	Strengthen active labor market policies, boost labor force participation (particularly of women), and improve the quality of education. Ensure that the banking sector intermediates effectively to support the reallocation of resources.
<p>De-anchoring of inflation expectations in the U.S. leads to rising core yields and risk premia.</p>	Medium	Medium. Montenegro is vulnerable because of high dependence on external financing.	Fiscal consolidation needs to resume to put debt on a declining path. A more aggressive tightening may

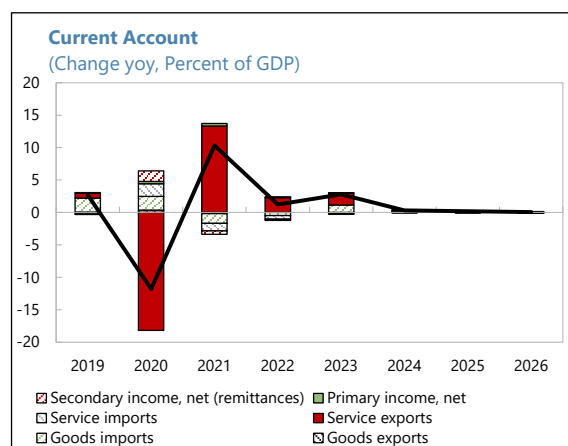
¹ The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate 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
A fast recovery in demand (supported by excess private savings and stimulus policies), combined with COVID-19-related supply constraints, leads to sustained above-target inflation readings and a de-anchoring of expectations. The Fed reacts by signaling a need to tighten earlier than expected. The resulting repositioning by market participants leads to a front-loaded tightening of financial conditions and higher risk premia, including for credit, equities, and emerging and frontier market currencies.		However, fiscal financing needs are largely covered in the near term.	be required if financing costs increase substantially. To gradually reduce reliance on external financing, the domestic bond market should be developed.
Political/social instability. Prolonged policy uncertainty could hamper investment or delay budget approval.	Medium	Medium. The economic impact will depend on the scale of disruptions but can potentially be significant.	The integrity and credibility of economic institutions should be safeguarded.
Stalling of fiscal consolidation efforts. Revenue measures in the 'Europe Now' package may not yield the expected gains and durability. Moreover, there may be new political pressures to increase or introduce new permanent spending measures. There is also a risk of new large-scale infrastructure projects without careful cost-benefit analysis.	High	High. Given high public debt, lack of fiscal discipline could increase future financing costs and result in debt sustainability problems.	Commit to a credible medium-term plan to put debt on a downward path. Ensure strict adherence to the public investment management framework.
The economy may respond dynamically to 'Europe Now' reforms. The lower labor tax wedge may encourage investment and the higher minimum wage may lead to formalization of 'envelope payments', and not to higher unemployment and informality.	Medium	High. Growth could be higher than in the baseline in the medium term. There would also be positive fiscal effects, through higher revenues and lower debt relative to GDP.	To facilitate the realization of this upside risk, the authorities should focus on reducing the informal economy and boosting labor force participation.
Asset quality may be worse than indicators currently suggest. As the financial support measures are fully withdrawn, AQR results are reflected in financial reporting, and new more stringent asset classification standards become effective in 2022, the NPL ratio may increase.	Medium	Medium. Deterioration of the asset portfolio may become a burden, especially for local banks, preventing them from effectively supporting the recovery.	The supervisor needs to continue vigilant monitoring of asset quality. Contingency planning would need to be accelerated, ensuring that bank resolution strategies are well-tailored and credible.

Annex II. External Sector Assessment

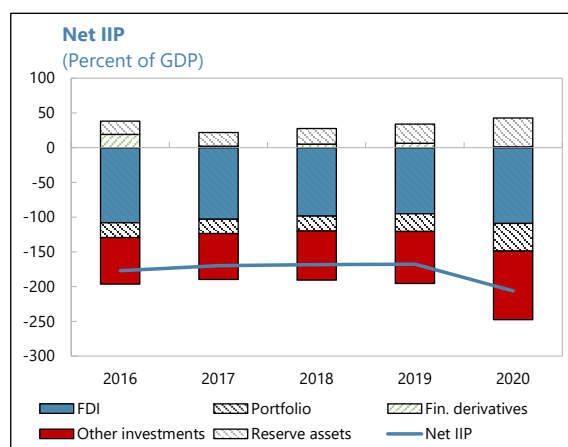
Montenegro's external position in 2021 is assessed to be moderately weaker than levels implied by fundamentals and desirable policies. The current account balance is expected to return to close to its pre-pandemic average as the recovery in tourism is offset by fiscal loosening,

1. After a steep jump in 2020, the current account deficit is projected to return to pre-pandemic levels. In 2020, the current account deficit increased to 26 percent of GDP as a result of the collapse of tourism and a fall in goods exports. As well as some import compression, remittance inflows held up well and provided an important economic buffer. Data up to Q3 2021 suggests that the current account deficit will narrow significantly to around 16 percent due to the partial recovery of tourism, strong growth of goods exports, and moderate import growth. In 2022, a recovery in tourism will be largely offset by the fiscal loosening, with only a modest strengthening of the current account expected. Over the medium term the current account is projected to return to around pre-pandemic levels.



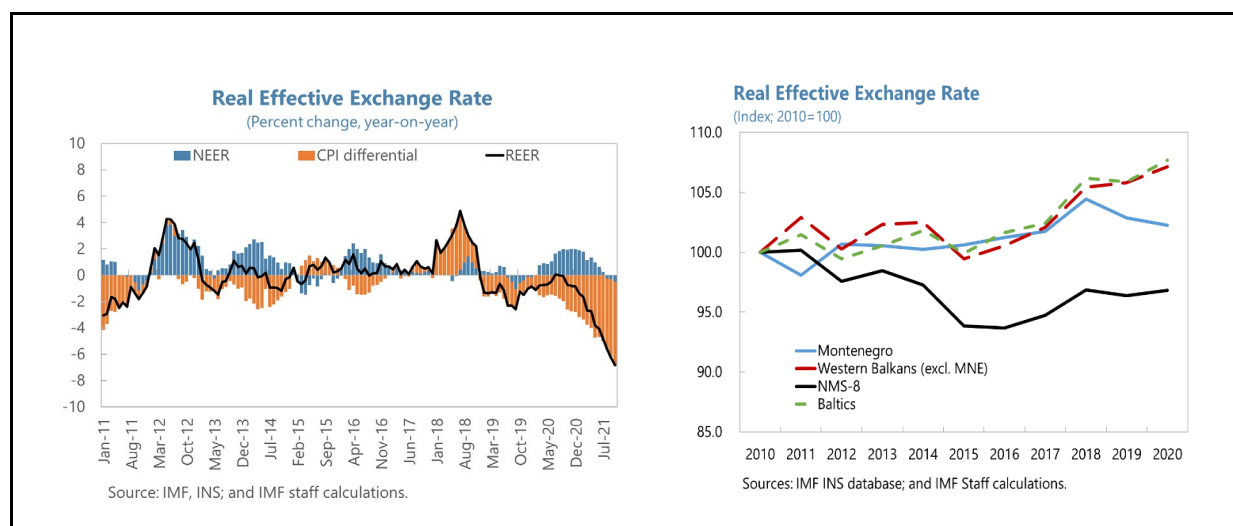
2. The capital and financial account in 2020 was supported by a Eurobond issuance, emergency financing from IFIs, as well as robust FDI inflows. In recent years, the current account deficit was largely financed by FDI inflows and government borrowing. In 2020, FDI inflows were also strong, especially through debt instruments, as parent companies supported their subsidiaries. In 2021, FDI fell back to pre-pandemic levels, and is assumed to remain steady over the medium term. Large-scale international financial institution (IFI) support provided finance in the middle of 2020, but by the end of the year, the large Eurobond issuance supported a significant jump in reserves. These reserves were drawn down at the start of 2021, and will likely continue to fall in 2022.

3. The net international investment position (IIP) is highly negative. As of end-2020 the net IIP was -206 percent of GDP, driven by the high level of foreign FDI in Montenegro, government external debt and the denominator



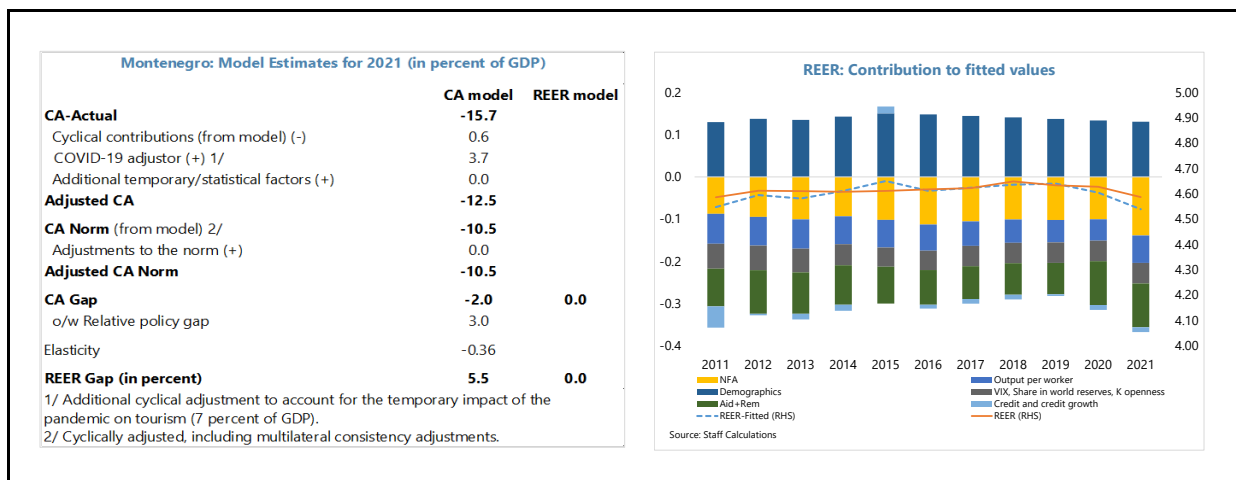
effect from the fall in nominal GDP.¹ External debt in 2021 is estimated to be 200 percent of GDP, driven by both large-scale public and private borrowing (Annex III).

4. The real effective exchange rate (REER) has depreciated back to its medium-term average. Inflation below trading partner peers has put downward pressure on the REER in the last two years. This has pushed the REER back to close to its medium-term average, and somewhat below the average other Western Balkan countries.

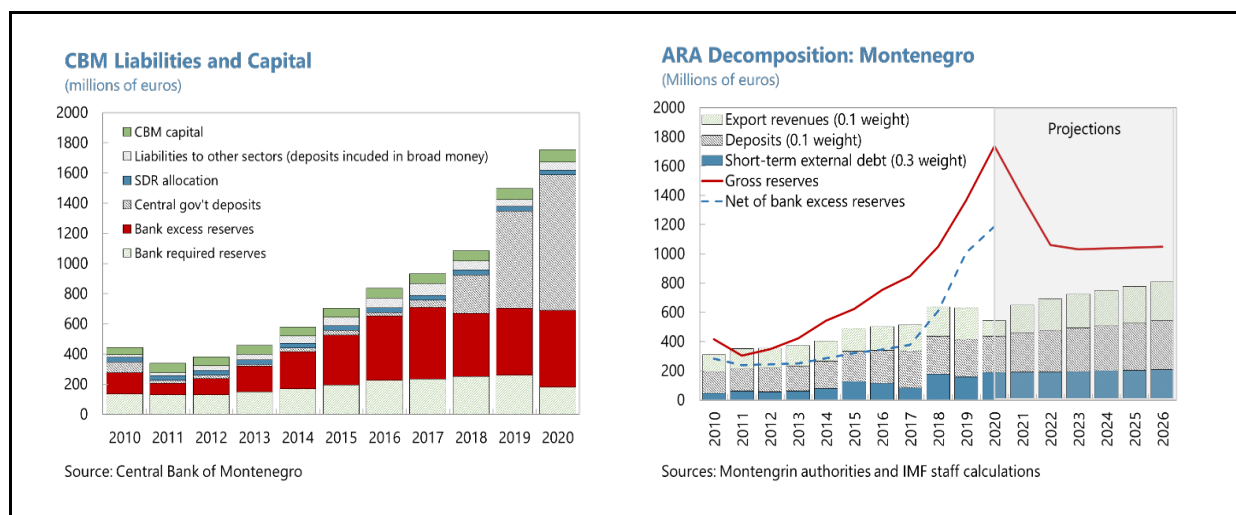


5. The current account is moderately weaker than the norm determined by fundamentals and desirable policies. The current account model includes an adjuster for Montenegro's significant reliance on tourism, which remains significantly below 2019 levels. This 'adjusted current account' (-12.5 percent of GDP) is moderately weaker than the level implied by fundamentals and desirable policies (10.5 percent of GDP). The 'relative policy gap' of 3.0 percent of GDP is attributed to fiscal policy, whereby Montenegro has a tighter stance than the average of its trading partners. The REER model suggests that the exchange rate is also close to its equilibrium level. The deterioration in the net foreign asset position suggests that a more depreciated REER is required to achieve external balance.

¹ The Authorities are working on improving the periodicity and timeliness of IIP statistics by implementing the recommendations of a 2017 technical assistance mission to construct annual and quarterly IIP statistics.



6. Montenegro’s gross international reserves are estimated to be adequate. At end-2020 reserves reached a peak of €1.7 billion or 42 percent of GDP. The increase of reserves by about 9 percent of GDP over 2020, despite the massive current account deficit, was due to the Eurobond issuance as well as emergency support from various IFIs. Reserves were €1.6 billion at end-September 2021 and over the medium term are projected to decline, stabilizing at about 16 percent of GDP. End-2020 reserves were at 319 percent of the IMF metric for reserve adequacy and are expected to stay at about 130 percent over the medium term. Having adopted the euro as its currency, while not having access to the Euro-system, international reserve adequacy in the Montenegrin context should take into account considerations such as buffers for fiscal financing and bank emergency liquidity assistance (ELA). In this respect, the Government’s deposits at the central bank have historically been mostly below a benchmark of one month of expenditure, with the exception of 2018-20. Regarding ELA, in 2020 the Central Bank expanded its buffers with the Eurosystem repo facility of €250 million² and doubled its existing BIS liquidity line to €100 million.



² The facility was introduced in June 2020 for one year as precautionary backstop to address pandemic-related euro liquidity needs outside the Euro Area and was subsequently extended through March 2022.

Annex III. External Debt Sustainability Analysis

External debt jumped to 239 percent of GDP in 2020 from 168 percent of GDP in 2019. Massive public borrowing, the sharp fall of GDP and depreciation of the euro against the dollar contributed to this dramatic rise in the debt-to-GDP ratio. Under the baseline, external debt is projected to decline from its peak in 2020 but stay elevated at 197 percent of GDP in 2026. The debt trajectory is sensitive to a variety of shocks, including growth and the non-interest current account balance as well as to a sharp depreciation of the euro against the dollar.

1. External debt is projected to remain high at around 197 percent of GDP over the medium term. External debt had increased from 142 to 168 percent of GDP in the decade preceding the pandemic, driven by public debt, especially since the start of the Bar-Boljare project. External gross financing needs have also been elevated and are expected to remain on average just below 40 percent of GDP over the medium term, of which a significant share is driven by public sector debt servicing (Annex IV). In 2020, the issuance of the Eurobond as well as emergency lending from IFIs accounted for most of the public borrowing and the share of public external debt in total increased to 41 percent. The structure of non-bank private sector debt, which is about 46 percent of total debt, has remained stable, with long-term intercompany debt accounting for about half. The share of private sector short term debt has stayed relatively low at about 10 percent of total external debt.

Shocks and Stress Tests

2. External debt is very sensitive to a variety of shocks. This was best illustrated by the experience of 2020 when the current account deficit widened to 26 percent of GDP due to the collapse of tourism and GDP contraction of 15.3 percent. The extreme nature of the 2020 crisis also affects the calibration of the standard shocks below, making the shock scenarios more dramatic than in previous exercises.

Standard stress tests

- **Growth shock.** Under this scenario, baseline real GDP growth is permanently reduced by one-half standard deviation calculated over the recent 10-year period ending in 2020. This corresponds to an average growth rate during 2022-26 of 0.3 percent, compared with baseline average growth of 3.4 percent. Under this scenario, the external debt ratio increases by 24 percentage points compared to the baseline to 221.6 percent of GDP in 2026.
- **Interest rate shock.** This scenario assumes an increase in the nominal interest rate on new debt relative to baseline by one-half standard deviation during 2022-26. Since the variation of interest rates has been low over the past decade, this scenario implies an average increase in interest rates of only 20 basis points. Consequently, this shock increases external debt to GDP ratio only by 1.8 percentage points compared to baseline in 2026.

- **Non-interest current account shock.** This scenario permanently increases the non-interest current account by one-half standard deviation in 2022-26. Given the high volatility of the current account in Montenegro, including the exceptionally high deficit in 2020, this scenario assumes non-interest current account balances about 2 percent of GDP lower than in the baseline and results in external debt that is about 9.4 percent of GDP higher than in the baseline in 2026.
- **Combined macro shock.** This scenario assumes a permanent $\frac{1}{4}$ standard deviation shock to the growth rate, the interest rate and the current account deficit in 2022-26 and results in an external debt ratio that in 2026 is 17 percent of GDP higher than in the baseline.
- **Real exchange rate shock.** This scenario assumes a one-time 30 percent real depreciation in the exchange rate to the US dollar in 2022. The shock is applied to the estimated stock of external debt denominated in currencies other than the euro. For the public sector, the main non-euro denominated debt is related to the highway project, however, after the arrangement reached in 2021, we assume that about 85 percent of the exchange rate risk is hedged, effectively reducing the ratio of the non-euro denominated debt. There is no data on the currency breakdown of private sector debt, but we assume that it is denominated in euro. Notwithstanding the low share of foreign currency denominated debt, the exchange rate shock has a large impact on external debt, increasing it by 30 percent of GDP compared to baseline. This is largely driven by much higher current account to GDP ratios in this scenario due to the denominator effect.

Annex III Table 1. Montenegro: External Debt Sustainability Framework, 2016–2026
(in percent of GDP, unless otherwise indicated)

	Actual					Projections						Debt-stabilizing non-interest 6/ -16.5	
	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026		
Baseline: External debt	155.1	168.7	157.7	167.8	239.0	199.8	192.0	190.5	193.1	195.4	197.4		
Change in external debt	-9.6	13.6	-11.1	10.1	71.2	-39.2	-7.8	-1.5	2.6	2.3	2.0		
Identified external debt-creating flows (4+8+9)	-2.4	-4.6	-2.3	1.9	52.0	-13.5	-1.1	4.9	5.3	4.7	4.4		
Current account deficit, excluding interest payments	18.7	18.4	19.6	16.8	29.1	18.4	17.6	17.4	17.3	17.3	17.3		
Deficit in balance of goods and services	22.5	23.5	23.9	21.1	34.9	24.4	23.9	23.8	23.7	23.6	23.7		
Exports	40.6	41.1	42.9	43.7	25.9	39.0	40.3	40.9	41.0	41.0	41.0		
Imports	63.1	64.5	66.7	64.8	60.7	63.4	64.2	64.6	64.7	64.6	64.7		
Net non-debt creating capital inflows (negative)	-6.1	-8.0	-5.5	-4.0	-4.4	-5.2	-5.1	-5.1	-5.1	-5.1	-5.1		
Automatic debt dynamics 1/	-15.0	-15.0	-16.4	-10.9	27.3	-26.7	-13.5	-7.4	-6.9	-7.5	-7.8		
Contribution from nominal interest rate	-2.5	-2.3	-2.6	-2.5	-3.1	-2.7	-2.5	-2.4	-2.4	-2.3	-2.3		
Contribution from real GDP growth	-4.5	-6.6	-7.6	-6.4	29.8	-24.0	-11.0	-5.0	-4.5	-5.1	-5.5		
Contribution from price and exchange rate changes 2/	-8.0	-6.0	-6.2	-2.0	0.5	...	...	...	...	...	...
Residual, incl. change in gross foreign assets (2-3) 3/	-7.2	18.2	-8.8	8.2	19.2	-25.6	-6.8	-6.3	-2.8	-2.4	-2.4		
External debt-to-exports ratio (in percent)	382.0	411.0	367.7	384.0	923.8	512.0	476.2	466.3	471.1	476.4	481.5		
Gross external financing need (in billions of US dollars) 4/	1.7	1.3	2.2	1.9	2.6	2.2	2.2	2.3	2.5	3.4	3.1		
in percent of GDP	39.4	27.5	39.1	33.8	54.8	39.2	34.6	33.8	35.4	45.0	38.6		
						10-Year	10-Year						
Scenario with key variables at their historical averages 5/						199.8	202.3	208.9	215.5	221.6	227.3	-14.2	
Key Macroeconomic Assumptions Underlying Baseline													
						Historical	Standard						
						Average	Deviation						
Nominal GDP (US dollars)	4.4	4.9	5.5	5.5	4.8			5.7	6.2	6.7	7.1	7.5	7.9
Real GDP growth (in percent)	2.9	4.7	5.1	4.1	-15.3	1.1	6.2	12.0	6.0	2.8	2.5	2.8	3.0
GDP deflator in US dollars (change in percent)	4.8	6.0	8.0	-3.3	1.7	0.8	7.2	6.6	3.0	5.0	3.1	2.7	2.6
Nominal external interest rate (in percent)	-1.6	-1.7	-1.8	-1.6	-1.6	-2.0	0.4	-1.4	-1.4	-1.4	-1.3	-1.3	-1.2
Growth of exports (US dollar terms, in percent)	3.7	12.2	18.5	2.5	-49.0	0.4	20.5	80.2	12.7	9.4	6.0	5.6	5.6
Growth of imports (US dollar terms, in percent)	12.1	13.5	17.4	-2.3	-19.2	1.9	12.0	24.7	10.5	8.7	5.8	5.5	5.7
Current account balance, excluding interest payments	-18.7	-18.4	-19.6	-16.8	-29.1	-18.4	4.2	-18.4	-17.6	-17.4	-17.3	-17.3	-17.3
Net non-debt creating capital inflows	6.1	8.0	5.5	4.0	4.4	7.4	2.9	5.2	5.1	5.1	5.1	5.1	5.1

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

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

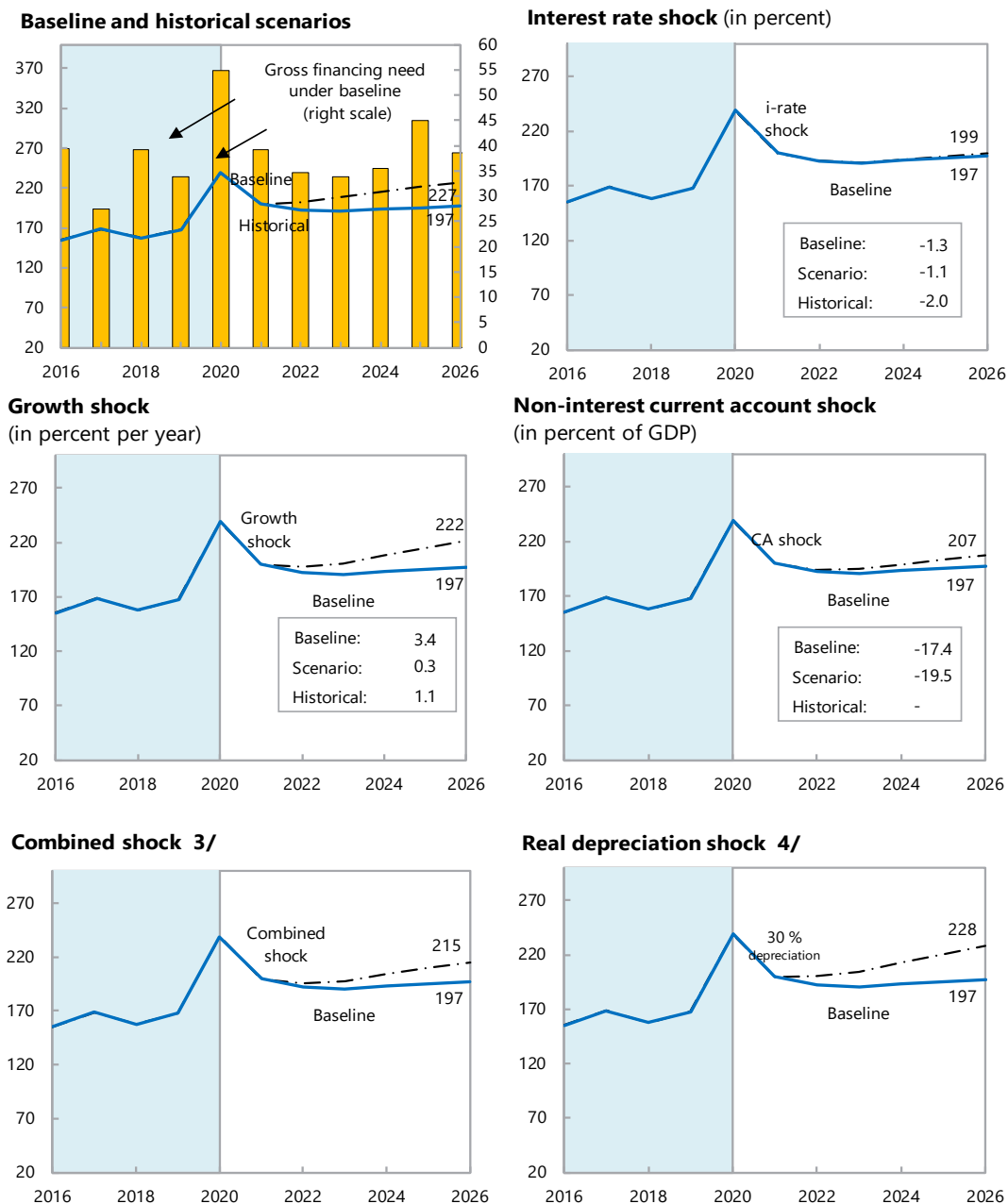
3/ For projection, line includes the impact of price and exchange rate changes.

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

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Annex III Figure 1. Montenegro: External Debt Sustainability: Bound Tests ^{1/ 2/}
(External Debt in Percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks.

Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.

3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

4/ One-time real depreciation of 30 percent occurs in 2022.

Annex IV. Public Debt Sustainability Analysis

Debt falls under the baseline from its 2021 levels but is on a gradually increasing trajectory by the end of the projection horizon. Montenegro's deep economic contraction due to the pandemic caused public debt to rise sharply to a peak of 107 percent of GDP in 2020. Debt is projected to fall back to 89 percent of GDP in 2021, driven by the strong bounce-back in economic activity and fiscal consolidation. Debt further falls to 81 percent of GDP in 2022 due to the continued economic recovery, but then moves onto a gradual upward trajectory from 2023-2026 due to the fiscal impact of the reform package 'Europe Now', which staff estimate to lead to permanently lower revenues. Under currently specified and legislated policies, staff project the medium-term fiscal deficit to remain above 6 percent of GDP and debt to move back towards 90 percent of GDP by 2026. Gross financing needs remain high, and in some years rise above 20 percent of GDP due to amortizations of Eurobonds. Authorities have demonstrated a record of proactive debt management, including through a recent €750 million Eurobond issuance on favorable terms, and the hedging of the Chinese Ex-Im bank loan to reduce currency risk.

Baseline and Realism of Projections

1. **Background.** Montenegro's public debt has been on an increasing trajectory since 2017, with gross debt rising sharply by 28.4 percentage points to a peak of 107.2 percent of GDP in 2020 as a result of the pandemic. This was primarily driven by a sharp contraction in GDP of 15.2 percent in 2020, and a widening fiscal deficit resulting from falling revenues and increased expenditures to fund a number of fiscal stimulus packages. The 2020 fiscal deficit created additional near-term financing needs. In addition, pressures on financing needs arose due to bond amortizations including two large Eurobond redemptions in 2020 and early 2021, totaling €548 million. Several important sources of finances were successfully issued in 2020 to ensure that financing needs could be met, including the purchase under the IMF's RFI of €74 million, a policy-based guaranteed (PBG) syndicated loan of €250 million, and a Eurobond issuance of €750 million. These issuances not only covered immediate financing redemptions, but also built up government deposits to about 10 percent of GDP in 2021, which can support additional financing needs should the short-term economic environment worsen. While there are SOE guaranteed loans which represent contingent liabilities, these largely relate to long-term loans for well-performing infrastructure projects, and are assessed as low risk.¹
2. **Macroeconomic assumptions.** Following the sharp contraction in 2020, real GDP growth is projected to rebound to 12 percent in 2021 and continues to recover over the projection period, although does not reach pre-crisis trend by the end of the projection period in 2026.
3. **Fiscal Scenario.** Staff projections are for the fiscal deficit to widen to around 6 percent of GDP in 2022 due to the 'Europe Now' reform which entails a permanent fiscal loosening. Overall, the

¹ Total liabilities for the SOE sector are estimated at about 20 percent of GDP, with explicit guarantees amounting to about 3 percent of GDP.

primary deficit is projected rise from 0.5 percent of GDP in 2021 to 4.2 percent in 2022, before remaining between 3.3 to 3.6 percent of GDP between 2023 and 2026.

4. Realism of baseline assumptions. The median forecast errors for real GDP growth (actual minus projection) in 2011-2019 are modest relative to those for other Market Access Countries (MACs), although they show on average a slightly pessimistic bias in staff's past projections particularly in more recent years. The median forecast errors for the primary balance are also modest relative to those for other MACs, but suggests that staff projections have been somewhat pessimistic on average over this period. While the three-year adjustment in the cyclically-adjusted primary balance is very large (in the 4th percentile of observations for advanced and emerging economies over 1990 to 2011), part of the adjustment comes from the reduction in highway spending, which will occur automatically after the completion of the first phase in 2021. However, given the unprecedented circumstance of the pandemic, and as noted above, there are significant uncertainties and risks to the DSA projection. The path of the economic recovery remains highly uncertain which will impact on the automatic stabilizers and the need for additional – or faster withdrawal of – fiscal stimulus measures.

Heatmap and debt profile vulnerabilities

5. Staff project public debt to fall sharply by 19 percentage points to 88 percent of GDP in 2021, and further to 79 percent of GDP in 2022. This is largely driven by the recovery in GDP growth and a contraction of the fiscal deficit relative to 2020 due to recovering revenues, withdrawal of stimulus measures, and fiscal consolidation efforts in the budget. It also reflects a reduction in gross debt due to the use of the large government deposits accumulated due to the €750 million Eurobond issuance in 2020.

6. Debt reduction is projected to stall in 2023 before turning to a gradually increasing trajectory. This is due to the permanent increase in the fiscal deficit over the medium term resulting from 'Europe Now', leading to the primary deficit stabilizing around 3.6 percent of GDP. This is above the debt-stabilizing primary balance, and debt begins to rise as growth returns to potential over the medium term.

7. More decisive policy action is needed to keep debt on a firm downward trajectory in the medium term. Debt is projected at 88 percent of GDP by 2026, which is only marginally lower than the level in 2021. Policy action would be required to reduce the fiscal deficit to return debt onto a downward trajectory. Targeting a primary surplus of 1 percent of GDP by 2026 would likely be sufficient to bring debt onto a strong downward and sustainable path.

8. Financing needs. Gross Financing Needs climb from 14 percent of GDP in 2022 and 2023 to over 25 percent of GDP in 2025, which reflects maturing of Eurobonds. Projected financing over the projection period amounts to approximately €5 billion, representing about 20 percent more than was issued in the previous 6 years in nominal terms (2016-2021). Financing needs are therefore significant and need to be managed carefully through responsible fiscal policy, management of fiscal risks, and active debt management. The Authorities have demonstrated a record of proactive

debt management as evidenced by their accessing of private funds through the PBG loan and €750 million Eurobond issuance on favorable terms, and the hedging of the Chinese Ex-Im bank loan to reduce currency risk. However, it will be important for the Authorities to manage financing needs by enacting concrete measures to reduce fiscal deficits, while continuing to exploit market conditions when favorable for debt issuance.

9. Debt markets. Interest rates are projected to remain low reflecting prevailing global monetary conditions, an increasing share of multilateral debt, and Montenegro's recent record of accessing private financing on favorable terms even during times of turbulence. However, given the size of the financing needs going forward, and potential downside risks to interest rates and market conditions, it will be important that authorities continue addressing risks to the debt profile by lengthening debt maturities, smoothing debt repayments, and using exchange rate hedging to the extent market conditions permit.

Alternative scenarios

10. The similarity of the baseline projection to the historical scenario suggests a return to the weak fiscal outcomes of the past decade. The historical scenario in which projections are based on the average level of the primary balance over the last ten years, a primary deficit of 3.4 percent of GDP over 2021-26 provides a similar trajectory for public debt to the baseline. This reflects the weak fiscal outcomes in the in the baseline projections. If the primary deficit were to stay at the projected 2021 level of 0.4 percent of GDP, rather than the project fiscal loosening under the baseline, debt would continue to fall to 67 percent of GDP.

Shocks and stress tests

11. Debt and gross financing needs rise to even further elevated levels under standard stress tests. Stress tests indicate that growth shocks and contingent liability 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

12. Highway Phases 2-4. In this scenario, the authorities decide to proceed with the debt-financed construction of the remainder of the Bar-Boljare highway, which staff assumes would cost €1.2 billion, equally spent over 2023-25. In this scenario, the primary balance declines in line with highway spending, and the public debt ratio increases to 113 percent of GDP by 2026; a sustained upward trajectory over the projection period. Gross financing needs would peak at 35 percent of GDP in 2025, 10 percentage points higher than in the baseline. This scenario demonstrates that the Authorities cannot afford to take on new debt to complete the remainder of the highway over the medium term.

Standard stress tests

13. Growth shock. Under this scenario, real output growth rates are lowered during 2022 and 2023 by one standard deviation (6.2 percentage points), also lowering inflation and raising interest rates. The public debt ratio rises sharply to 102 percent of GDP in 2023 and continues on an upward path to 111 percent of GDP by 2026, while the gross financing needs ratio in 2023 increases around 10 percentage points of GDP relative to the baseline.

14. Interest rate shock. This scenario examines the implications of an increase in interest rates on new debt by 375 basis points (the difference between the maximum past effective interest rate and the average interest rate in the projection period) in 2022–26. Debt increases by 4 percentage points in 2026 in this scenario relative to the baseline, while financing needs increase by 2 percentage point of GDP in 2026.

15. Combined macro shock. This scenario comprises a recession in 2022 and 2023, a 375 basis-point increase in interest rates, a real exchange rate shock, and a sharp rise in expenditures in 2022–23. It pushes the debt-to-GDP ratio up to 106 percent of GDP in 2023, rising further to 117 percent of GDP by 2026, with gross financing needs rising by about 10 percentage points in 2023 relative to the baseline.

16. Financial contingent liability shock. Expenditures increase in 2022 equivalent to 10 percent of the size of the banking sector, combined with a shock to GDP and interest rates. The shock results in a sharp increase in the debt ratio to 99 percent of GDP in 2023. Meanwhile, gross financing needs would rise by 8 percent of GDP in 2022 and stay well above the baseline over the medium term.

17. Primary balance shock. This scenario assumes an expenditure shock and a rise in interest rates leading to a 1.5 p.p. deterioration in the primary balance over 2022–23. The combined shocks lead to deterioration in the debt ratio by about 5 percent of GDP by 2026, while the impact on gross financing needs peaks at 3 percentage points of GDP in 2023.

18. Real exchange rate shock. The scenario assumes a 13 percent depreciation of the real exchange rate in 2022, which reflects the maximum depreciation experienced in Montenegro over 2011–20. The debt ratio would fall only marginally from the baseline, because the impact from a larger GDP deflator on total debt outweighs the increase in the relatively modest foreign currency debt. This depends critically on the assumption of an exchange rate pass-through to inflation of 25 percent.

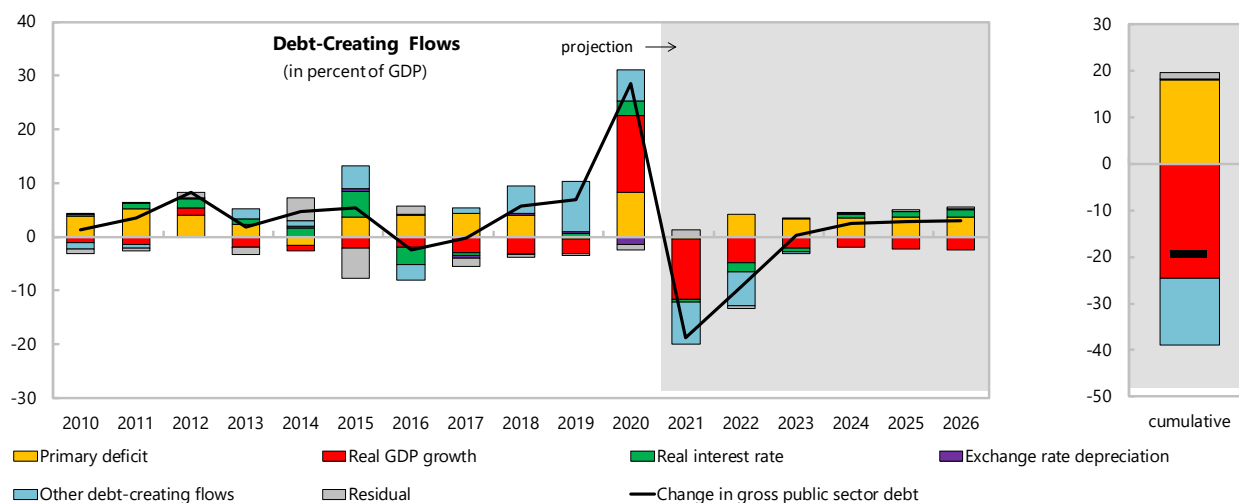
Annex IV. Figure 1. Montenegro: Public Sector Debt Sustainability Analysis (DSA) Baseline Scenario (In percent of GDP, unless otherwise indicated)

Debt, Economic and Market Indicators ^{1/}

	Actual			Projections						As of August 11, 2021		
	2010-2018 ^{2/}	2019	2020	2021	2022	2023	2024	2025	2026	Sovereign Spreads		
Nominal gross public debt	60.6	78.8	107.3	88.6	79.4	79.7	82.2	85.0	88.0	EMBIG (bp) 3/		
Public gross financing needs	13.3	11.7	26.9	13.4	14.3	13.4	16.7	25.8	19.0	5Y CDS (bp)		
Net public debt	59.2	65.8	85.9	78.6	76.6	77.3	79.8	82.7	85.7	Ratings		
Real GDP growth (in percent)	2.7	4.1	-15.3	12.0	6.0	2.8	2.5	2.8	3.0	Moody's	Foreign	Local
Inflation (GDP deflator, in percent)	2.3	2.0	-0.2	2.6	4.1	3.4	2.0	1.7	1.8	S&Ps	B	B
Nominal GDP growth (in percent)	5.1	6.2	-15.5	14.9	10.4	6.3	4.5	4.6	4.8	Fitch	n.a.	n.a.
Effective interest rate (in percent) ^{4/}	3.6	3.3	2.9	2.5	2.3	2.5	2.8	3.1	3.6			

Contribution to Changes in Public Debt

	Actual			Projections						cumulative	debt-stabilizing primary balance ^{10/}
	2010-2018	2019	2020	2021	2022	2023	2024	2025	2026		
Change in gross public sector debt	3.1	6.9	28.6	-18.8	-9.2	0.3	2.5	2.8	3.0	-19.3	
Identified debt-creating flows	3.5	7.2	29.6	-20.1	-8.6	0.3	2.4	2.5	2.7	-20.8	
Primary deficit	3.3	-0.4	8.2	-0.5	4.2	3.3	3.6	3.6	3.6	17.9	-0.9
Primary (noninterest) rev. and grants	40.9	42.2	43.4	43.0	38.8	38.8	38.8	38.7	38.7	236.8	
Primary (noninterest) expenditure	44.2	41.8	51.6	42.5	43.1	42.1	42.3	42.4	42.4	254.7	
Automatic debt dynamics ^{5/}	-0.7	-1.8	15.7	-11.6	-6.5	-2.8	-1.3	-1.2	-1.0	-24.4	
Interest rate/growth differential ^{6/}	-0.8	-2.1	17.1	-11.6	-6.5	-2.8	-1.3	-1.2	-1.0	-24.4	
Of which: real interest rate	0.7	0.6	2.9	-0.4	-1.6	-0.7	0.6	1.0	1.4	0.3	
Of which: real GDP growth	-1.6	-2.8	14.3	-11.2	-4.8	-2.1	-1.9	-2.2	-2.4	-24.7	
Exchange rate depreciation ^{7/}	0.1	0.3	-1.5	...	...	...	...	...	...	...
Other identified debt-creating flows	0.9	9.4	5.7	-8.0	-6.3	-0.3	0.2	0.0	0.1	-14.3	
Privatization and deposits (negative)	8/ 0.3	9.1	5.9	-8.9	-6.3	-0.3	0.2	0.0	0.1	-15.2	
Contingent liabilities	0.6	0.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Use of foreign account receivable	0.0	-0.4	-0.2	0.9	0.0	0.0	0.0	0.0	0.0	-1.0	
Residual, including asset changes ^{9/}	-0.4	-0.2	-1.0	1.3	-0.6	0.1	0.1	0.3	0.3	1.5	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Long-term bond spread over German bonds.

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

5/ Derived as $[(r - \pi(1+g) - g + ae(1+r))/(1+g+\pi+g\pi)]$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate;

a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the numerator in footnote 5 as $r - \pi(1+g)$ 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/ In 2021 and 2022, the reduction in deposits is driven by a drawdown of a 750m eurobond issued in 2020, and amortization of a 227m eurobond in March 2021.

9/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

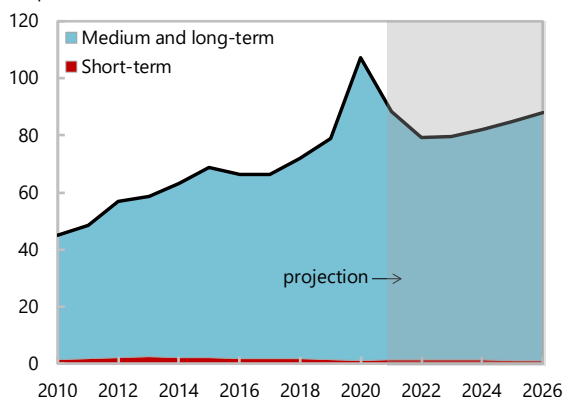
10/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Annex IV. Figure 2. Montenegro: Public DSA—Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

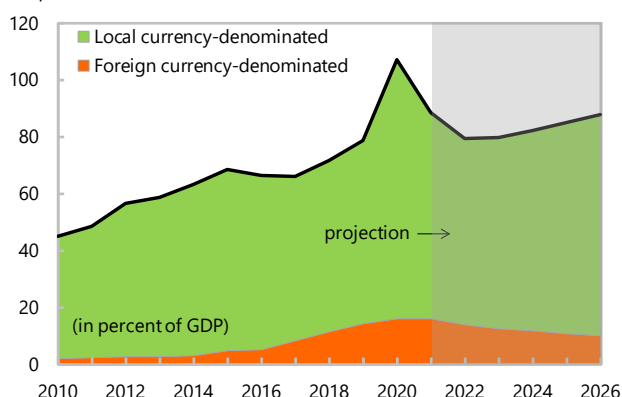
By Maturity

(in percent of GDP)



By Currency

(in percent of GDP)

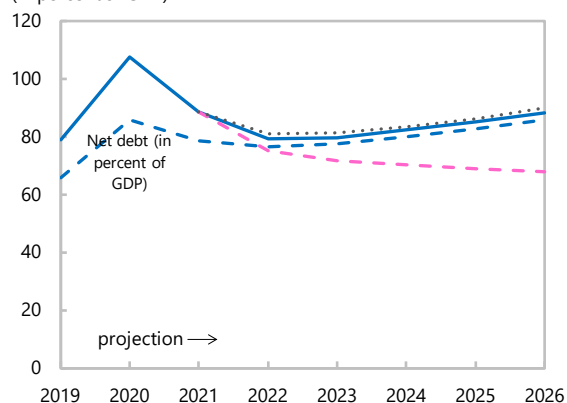


Alternative Scenarios

— Baseline Historical - - - Constant Primary Balance

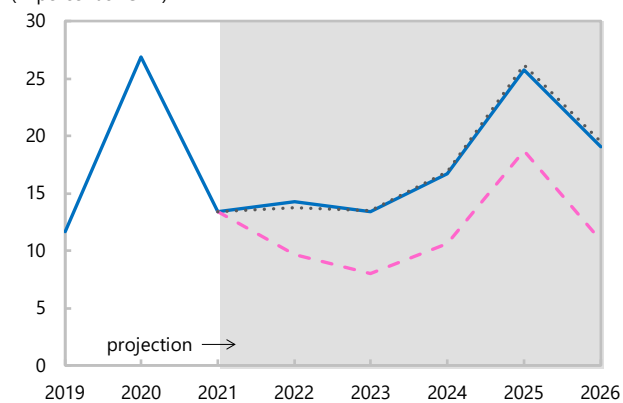
Gross Nominal Public Debt

(in percent of GDP)



Public Gross Financing Needs

(in percent of GDP)



Underlying Assumptions

(in percent)

Baseline Scenario	2021	2022	2023	2024	2025	2026
Real GDP growth	12.0	6.0	2.8	2.5	2.8	3.0
Inflation	2.6	4.1	3.4	2.0	1.7	1.8
Primary Balance	0.5	-4.2	-3.3	-3.6	-3.6	-3.6
Effective interest rate	2.5	2.3	2.5	2.8	3.1	3.6
Constant Primary Balance Scenario						
Real GDP growth	12.0	6.0	2.8	2.5	2.8	3.0
Inflation	2.6	4.1	3.4	2.0	1.7	1.8
Primary Balance	0.4	0.4	0.4	0.4	0.4	0.4
Effective interest rate	2.5	2.3	2.4	2.6	2.9	3.3

Historical Scenario	2021	2022	2023	2024	2025	2026
Real GDP growth	12.0	2.9	2.9	2.9	2.9	2.9
Inflation	2.6	4.1	3.4	2.0	1.7	1.8
Primary Balance	0.4	-3.4	-3.4	-3.4	-3.4	-3.4
Effective interest rate	2.5	2.3	2.6	3.1	3.6	4.3

Source: IMF staff.

Annex IV. Figure 3. Montenegro: Public DSA – Realism of Baseline Assumptions

Forecast Track Record, versus all countries

Real GDP Growth

(in percent, actual-projection)

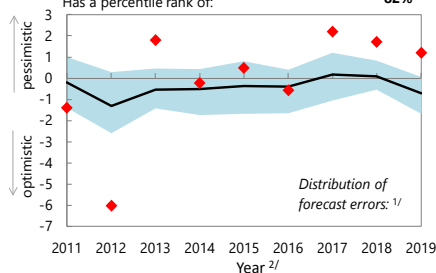
Montenegro, Rep. of median forecast error,

0.48

2011-2019:

Has a percentile rank of:

82%



Primary Balance

(in percent of GDP, actual-projection)

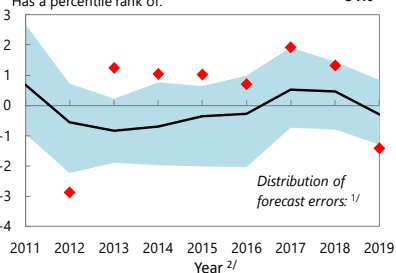
Montenegro, Rep. of median forecast error,

1.03

2011-2019:

Has a percentile rank of:

84%



Inflation (Deflator)

(in percent, actual-projection)

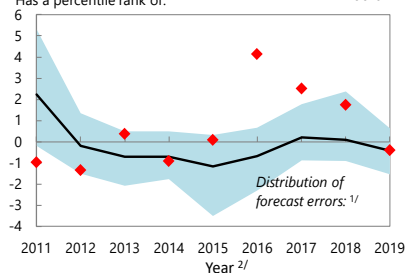
Montenegro, Rep. of median forecast error,

0.10

2011-2019:

Has a percentile rank of:

66%

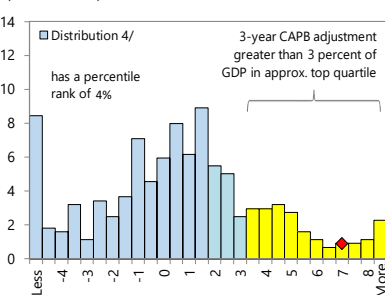


Assessing the Realism of Projected Fiscal Adjustment

3-Year Adjustment in Cyclically-Adjusted

Primary Balance (CAPB)

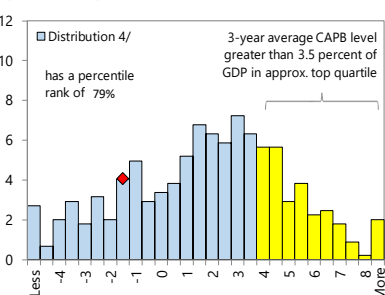
(Percent of GDP)



3-Year Average Level of Cyclically-Adjusted

Primary Balance (CAPB)

(Percent of GDP)

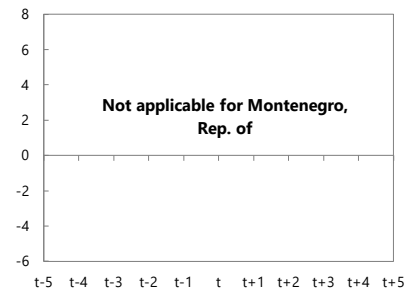


Boom-Bust Analysis^{3/}

Real GDP growth

(in percent)

— Monte...



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.

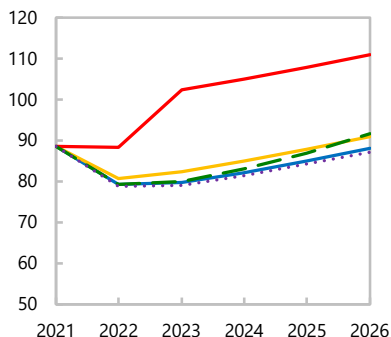
4/ Data cover annual observations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Annex IV. Figure 4. Montenegro: Public DSA – Stress Tests

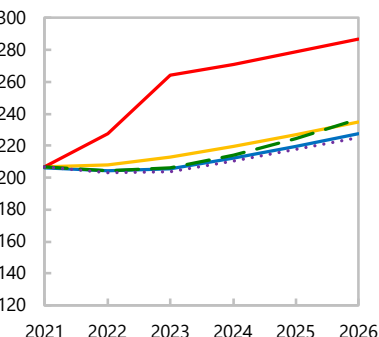
Macro-Fiscal Stress Tests

— Baseline
— Real GDP Growth Shock
— Primary Balance Shock
- - - Real Exchange Rate Shock
— Real Interest Rate Shock

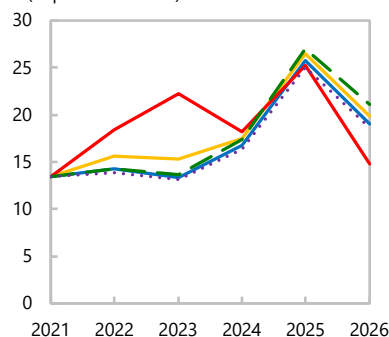
Gross Nominal Public Debt
(in percent of GDP)



Gross Nominal Public Debt
(in percent of Revenue)



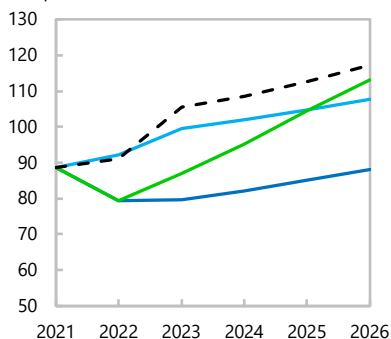
Public Gross Financing Needs
(in percent of GDP)



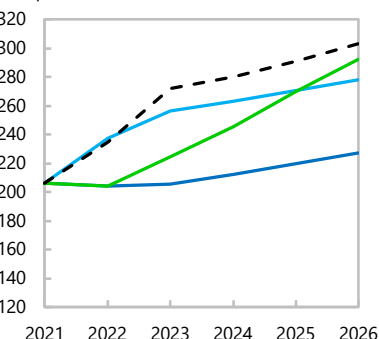
Additional Stress Tests

— Baseline
— Highway Phase 2-4
- - - Combined Macro-Fiscal Shock
— Contingent Liability Shock

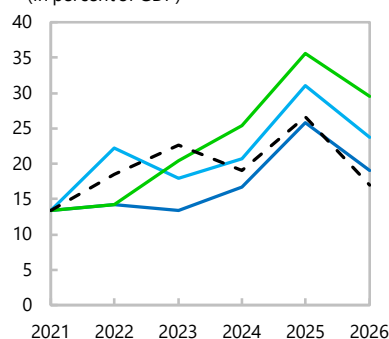
Gross Nominal Public Debt
(in percent of GDP)



Gross Nominal Public Debt
(in percent of Revenue)



Public Gross Financing Needs
(in percent of GDP)



Underlying Assumptions (in percent)

	2021	2022	2023	2024	2025	2026		2021	2022	2023	2024	2025	2026
Primary Balance Shock							Real GDP Growth Shock						
Real GDP growth	12.0	6.0	2.8	2.5	2.8	3.0	Real GDP growth	12.0	-0.2	-3.4	2.5	2.8	3.0
Inflation	2.6	4.1	3.4	2.0	1.7	1.8	Inflation	2.6	2.6	1.8	2.0	1.7	1.8
Primary balance	0.4	-5.6	-4.7	-3.6	-3.6	-3.6	Primary balance	0.4	-7.6	-10.2	-3.6	-3.6	-3.6
Effective interest rate	2.5	2.3	2.6	2.9	3.2	3.6	Effective interest rate	2.5	2.3	2.6	3.4	3.6	3.9
Real Interest Rate Shock							Real Exchange Rate Shock						
Real GDP growth	12.0	6.0	2.8	2.5	2.8	3.0	Real GDP growth	12.0	6.0	2.8	2.5	2.8	3.0
Inflation	2.6	4.1	3.4	2.0	1.7	1.8	Inflation	2.6	8.6	3.4	2.0	1.7	1.8
Primary balance	0.4	-4.2	-3.3	-3.6	-3.6	-3.6	Primary balance	0.4	-4.2	0.8	1.0	1.1	1.2
Effective interest rate	2.5	2.3	2.8	3.6	4.4	5.5	Effective interest rate	2.5	2.3	2.4	2.7	3.0	3.5
Combined Shock							Contingent Liability Shock						
Real GDP growth	12.0	-0.2	-3.4	2.5	2.8	3.0	Real GDP growth	12.0	-0.2	-3.4	2.5	2.8	3.0
Inflation	2.6	2.6	1.8	2.0	1.7	1.8	Inflation	2.6	2.6	1.8	2.0	1.7	1.8
Primary balance	0.4	-7.6	-10.2	-3.6	-3.6	-3.6	Primary balance	0.4	-11.2	-3.3	-3.6	-3.6	-3.6
Effective interest rate	2.5	2.3	2.9	3.9	4.6	5.6	Effective interest rate	2.5	2.4	2.9	3.1	3.3	3.7

Source: IMF Staff

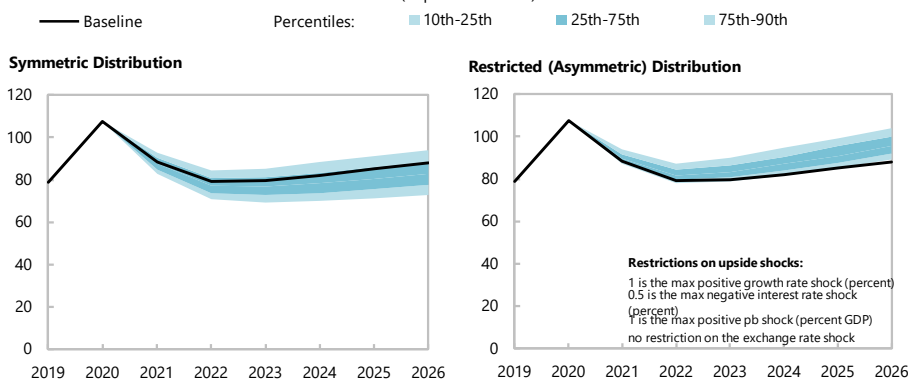
Annex IV. Figure 5. Montenegro: Public DSA Risk Assessment

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

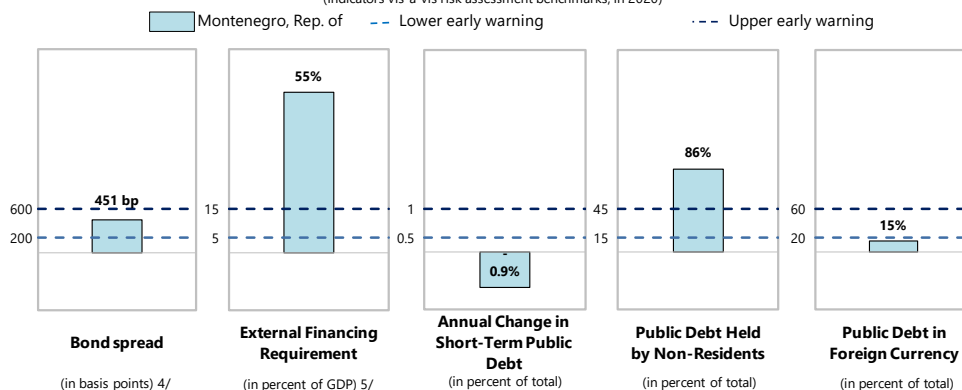
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2020)



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:

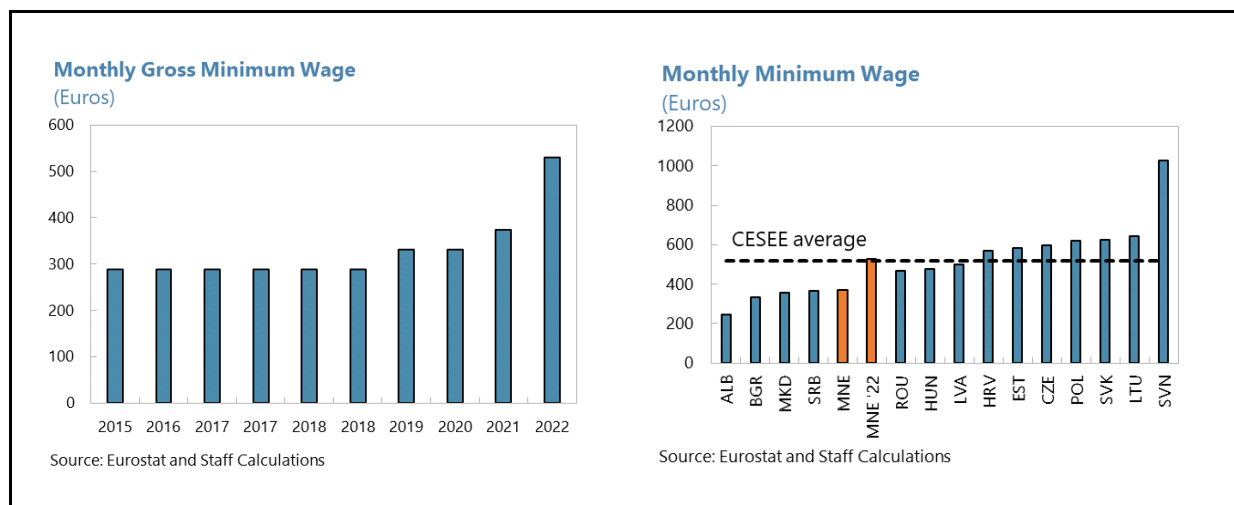
200 and 600 basis points for bond spreads; 5 and 15 percent of GDP for external financing requirement; 0.5 and 1 percent for change in the share of short-term debt; 15 and 45 percent for the public debt held by non-residents; and 20 and 60 percent for the share of foreign-currency denominated debt.

4/ Long-term bond spread over German bonds, an average over the last 3 months, 13-May-21 through 11-Aug-21.

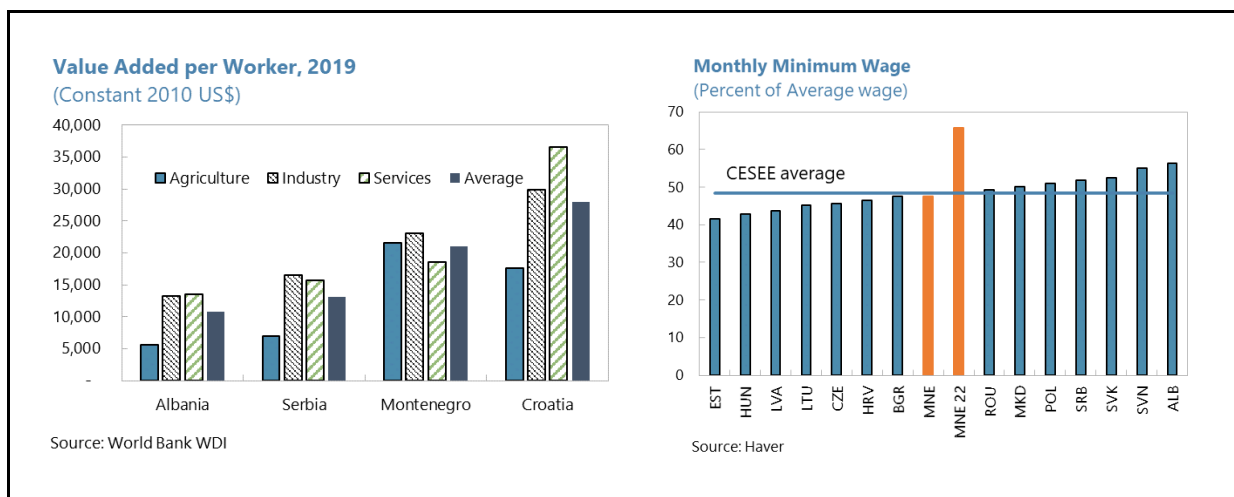
5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

Annex V. Minimum Wage in Montenegro

1. The 2022 increase in the minimum wage is substantial. After several years of stagnation, the minimum wage increased moderately in 2019 and 2021. Given the relatively small size of these increases, and the significant impact on labor markets from the pandemic, an assessment of these hikes is difficult. But the increase in 2022 as part of 'Europe Now' is much more substantial: an increase in gross terms from €370 to €530 per month. In nominal terms, this would bring Montenegro close to the CESEE average.



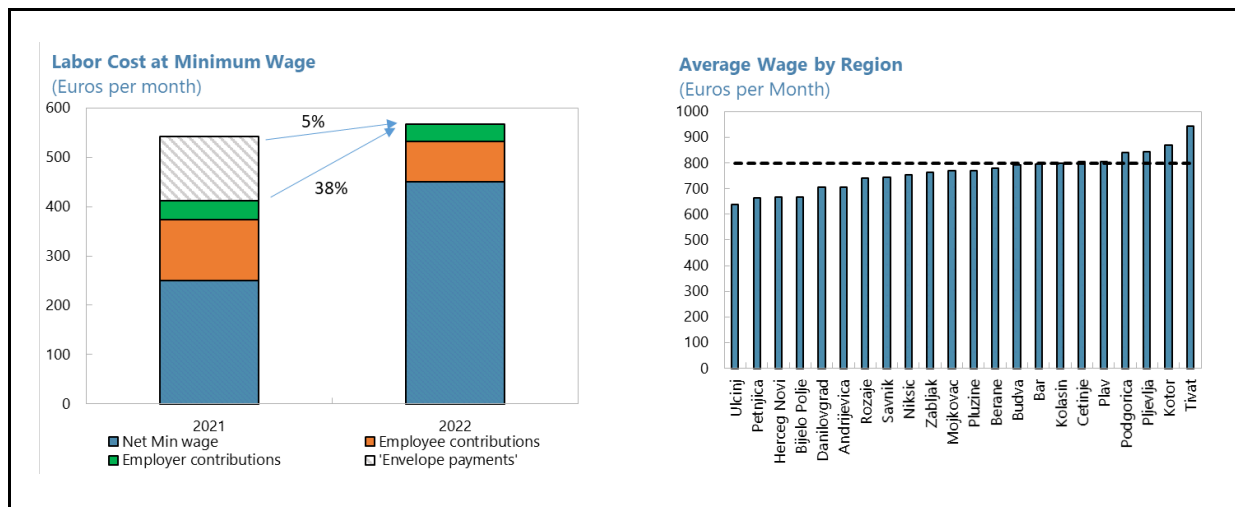
2. Relative to the average wage, this hike makes Montenegro's minimum wage the highest in the region. While the new minimum wage is similar to that of Croatia, average value added per worker is around 25 percent lower in Montenegro. Indeed, the increase pushes the minimum-to-average-wage ratio to 66 percent, which is the highest in the CESEE region.¹



¹ The distribution of average wages could be distorted by the presence of unreported 'envelope payments'. However, even when looking at the minimum wage as a ratio to GDP per capita (which will not be distorted by such unreported payments), Montenegro is an outlier with this hike.

3. The presence of ‘envelope payments’ and a reduced tax wedge could partially cushion the rise in firms’ labor costs.

The decline in the tax wedge on low-wage earners from 42 to 22 percent of the gross wage will ‘absorb’ a sizeable share of proposed minimum wage increase. It is also likely that employers will formalize at least some part of the informal ‘envelope payments’ paid, which the authorities estimate to be at least €130 per month. While there is evidence that these payments exist, no formal surveys or studies have been undertaken to provide system-wide estimates. In addition to differences across sectors, it is likely that envelope payments may be much smaller in some regions of the country.



Annex VI. State-Owned Enterprises (SOEs)

1. **Public information on Montenegrin SOEs is limited.** There are around 40 SOEs in Montenegro, with the largest SOEs concentrated in the energy, transport and tourism sector. Fixed assets of the sector are estimated at around 70 to 100 percent of GDP.
2. **Their economic performance varies widely.** About half are loss-making (notably some in the railway and maritime transport sectors) though there are profitable ones such as the state utility company, Montenegro Electric Enterprise. At the end of 2020, the only airline company Montenegro Airlines was shut down when the government declined to finance requests for capital injections, following years of financial losses. In its place, a new state airline 'To Montenegro' was established – it operated its first flight in June, to Belgrade. It is also operating flights to Frankfurt, Istanbul, and Ljubljana.

Strengthening the oversight of SOEs could yield significant fiscal and economic benefits

3. **The overall SOE oversight framework is weak.** There is limited central oversight and review of the investment plans of SOEs and the financial performance of SOEs. Few contingent liabilities are reported to the Central Government, and capital projects undertaken by SOEs are not shown in the budget. Key areas of concern include the need to manage fiscal risks from the sector, strengthening oversight, and improving governance arrangements for overseeing SOEs as well as within individual SOEs. Strengthening arrangements can improve returns on governments assets, reduce budgetary risks, and support economic growth.
4. **Without adequate oversight and management, SOE sectors can generally pose significant risks, such as:**
 - Inefficient or poorly managed public corporations can impose substantial economic and fiscal costs. Loss-making SOEs can be a persistent drag on public finances and be a source of fiscal risks in the form of government guarantees, subsidies, loans, or capital injections;
 - SOEs can be pressured or mandated to fulfill political objectives and engage in quasi-fiscal activities that negatively impact their financial position and for which the companies are not compensated from the budget; and
 - Public corporations can be used as a mechanism for circumventing traditional fiscal controls.
5. **In Montenegro, SOEs are predominantly overseen by the Ministry of Capital Investment and line ministries.** The Ministry of Capital Investments compiles an annual report on the SOEs for which it is responsible. The Directorate of Local Self-Government and State-Owned Companies at the Ministry of Finance receives information on investment plans and the financial performance of SOEs but does not consolidate nor produce a report on this information. Information is mostly available for projects that receive government support through on-lending or

guarantees. SOEs prepare business plans that include investment initiatives that are not approved by SOE supervisory bodies.

6. **SOEs undertake capital investments in some key sectors of the economy (concentrated in energy, water and transportation).** However, there is a lack of information in the budget on public sector investment being undertaken by SOEs. Despite the lack of information on SOE public investments, the government has provided loan guarantees to SOEs, with an outstanding guaranteed debt stock of €218.8 million (or about 5 percent of GDP) as at end-2020.

Ongoing developments

7. **In August 2021, the Government of Montenegro adopted the Decision to establish a Limited Liability Company.** ‘Montenegro Works’ LLC is expected to monitor and analyze the financial situation in SOEs and provide expert support in implementing reforms, with the goal of more efficient management and increasing the transparency of SOE operations.

8. **The precise roles of Montenegro Works in oversight, policy making, and as a shareholder are yet to be set out.** It is important that the respective objectives, powers, and responsibilities of the company, the Ministry of Finance, and any line ministries involved are clearly articulated in statute. Furthermore, the new company should take action to harmonize reporting standards, and support the mapping of assets across the SOE sector. Strong attention to such pre-requisites is essential to the goal of improving oversight and performance of SOEs.

9. **Models of SOE oversight and supervision vary across countries.** There are three main archetypes: a centralized model, a decentralized model, and a dual model, as well as many hybrids. There is no single recognized best practice, but the most appropriate arrangement for a given context is dependent on country-specific factors such as the nature of the SOE sector and the institutional expertise across government agencies.

10. **In centralized models, the shareholder functions are centralized under a single entity.** Frequently, the shareholder and financial oversight functions may be centralized under the Ministry of Finance (such as Brazil and Sweden). In countries following more decentralized approaches, the line ministries typically fulfill the shareholder role. This model is more common in countries with a diverse portfolio of SOEs, such as in South Africa and Mexico – and is the practice most closely followed currently within Montenegro.

11. **Still, in some other countries, the shares of SOEs are held in an autonomous agency or investment company (such as Australia or Spain).** This can have the advantage of professional asset managers with relevant skills to actively manage the portfolio of SOEs, and can also insulate SOEs from political interference. However, there are important pre-requisites for this model to work, including the appropriate legal frameworks regarding ownership and oversight. Moreover, this model does not diminish the need for expertise and capacity of the Ministry of Finance to assess and manage fiscal risks of the holding company. The experience of the Greek SOE holding company

demonstrates the importance of having the appropriate mix of professional skills, and highlights the challenges of transferring assets to a central agency.

12. **The Authorities need to ensure a clearly defined ownership policy backed by strong legal and institutional arrangements.** These requirements, and sufficient professional expertise are necessary to ensure that the new arrangements succeed in making meaningful changes to the management and oversight of the sector. If lines of responsibilities are blurred, accountability and governance weakened, transparency requirements decreased, or technical capacities diluted, current weaknesses in the sector may not be adequately addressed.

13. **Improved reporting and transparency SOE investment plans would also strengthen oversight of the sector.** As noted in the recent Public Investment Management Assessment (PIMA), SOEs' investment plans should be submitted to the MoF once a year during the budget preparation process, and SOEs' investment plans should be published alongside the state budget documentation.

Annex VII. Implementation of Past IMF Recommendations

In the 2019 Article IV consultation, Directors stressed the importance of continued fiscal adjustment, further efforts to strengthen banking supervision, and fiscal and structural reforms to support inclusive growth over the medium term.

Key recommendations	Implemented Policies
Fiscal Policies	
Maintain a primary fiscal surplus of at least 2 percent of GDP over the medium term.	With the COVID-19 crisis, the fiscal position in 2020 deteriorated substantially. The Authorities' Medium-Term Fiscal Strategy (which includes the 'Europe Now' reforms) envisages a primary surplus in 2024 (0.8 percent of GDP). Staff project the baseline primary balance to be negative in the medium-term under 'Europe Now'.
Strengthen fiscal institutions, including fiscal rules and budgetary processes.	The Authorities have started taking steps to introduce program-based budgeting. Under an EU-funded project, options are being considered for the development of a Fiscal Council.
Highway planning should be paused until a new and credible feasibility study is completed.	Feasibility studies on building future phases of the highway are being explored.
Establish more robust investment management and PPP frameworks.	A new PPP law was passed in December 2019. The Montenegro Investment Agency was set up in March 2020, and has a role in promoting, setting up, and monitoring PPPs across the public sector. In June 2021, the Authorities completed the PIMA with the Fiscal Affairs Department.
Reform public sector employment and the pension system. Review tax expenditures.	A new Public Administration Reform Strategy is being planned, to replace the previous one which had limited progress (2016-2020). In July 2020, the Parliament adopted new pension legislation that introduced changes to the pensionable age, the basis of pension calculations, and formula for indexation. Plans for further pension reforms are being discussed with the World Bank.

Financial Sector Policies	
Enhance the supervisory structure of the CBCG.	A staff-level supervisory committee to support decisions by senior management has been established. In addition, an independent Directorate for Supervision in charge of MML/CFT issues has been established, comprising of staff with significant experience in the field.
Conduct a thorough Asset Quality Review to provide a full diagnostic of banking sector health.	The AQR was completed in 2021 based on 2019 data.
Continue to address banking sector vulnerabilities.	The CBCG has been proactive in addressing the vulnerabilities identified by the AQR in one bank.
Pre-empt the build-up of systemic risk due to rapid growth of uncollateralized consumer lending.	The macroprudential measure to curb uncollateralized consumer lending deployed by the CBCG has been effective.
Improve the regulatory framework for the financial system and harmonize banking laws with EU directives.	The legislative package comprising of the Law on Credit Institutions and the Law on Resolution of Credit Institutions as well as their supporting regulations will become effective in January 2022. The implementation was delayed due to the pandemic and priority given to the AQR. These laws and regulations will help harmonize financial sector supervision with EU directives.
Further strengthen the AML/CFT regime	Progress in the implementation of the AML/CFT framework is supported by the upcoming MONEYVAL AML/CFT assessment (expected to take place in 2023). An action plan of mitigating measures was developed in 2020.
Structural Policies	
Reduce the labor tax wedge.	The proposed policies in the 'Europe Now' package would substantially reduce the labor tax wedge.

Annex VIII. Implementation of 2015 FSAP Recommendations¹

Recommendations	Timing ¹	Progress
Prepare and implement time-bound supervisory action plans for vulnerable banks (CBCG).	I	Done. Supervisory action plans for vulnerable banks were adopted, and the banks were under intensified supervision by the CBCG. Since 2019 the remaining vulnerable bank is required to maintain a capital adequacy ratio 2 percentage points higher than the regulatory minimum. On-site and off-site examinations are conducted periodically. The operations of the vulnerable bank are monitored monthly and quarterly, while all inflows and outflows, the structure and the level of liquid assets, as well as the balance of total and state deposits are monitored daily.
Conduct an Asset Quality Review (AQR) for all banks to determine adequacy of provisions (CBCG).	I	Done. The AQR exercise was successfully completed in September 2021. The AQR covers the banking sector data as of end-2019. The review was conducted by reputable international experts.
Introduce a macroprudential mandate taking into account the institutional setup and establish pertinent policies and a toolkit consistent with EU/ESRB framework (MOF/CBCG/FSC).	MT	Done. The macroprudential mandate for CBCG was introduced in 2018. The legislative package, consisting of the Law on Credit Institutions and Law on Resolution of Credit Institutions, was adopted at the end of 2019 and will become effective January 2022. It is aligned with Basel III standards and will facilitate effective macroprudential policy implementation. In 2020 the CBCG adopted all implementing regulations arising from these two laws (24 regulations from the area of supervision of credit institutions and 14 regulations from the area of resolution of credit institutions).
Introduce effective consolidated supervision (CBCG). Improve the regulatory and supervisory framework for liquidity and credit risks (CBCG).	NT, I	Done. The Law on Credit Institutions (to become effective January 2022) includes the solutions transposed from the current EU regulations, which relate to the enhancement the supervision on consolidated basis. The Law sets up basic principles for risk management while details are given in the implementing regulations that were adopted at the end of 2020 (Decision on Minimum Standards for Risk Management in Credit Institutions and the Decision on Liquidity Risk Management in Credit Institutions).

¹ Updates since the 2019 Article IV consultation Staff Report.

Recommendations	Timing ¹	Progress
Tighten prudential norms for identification, classification, and reclassification of nonperforming assets (CBCG).	NT	Done. The Decision on Minimum Standards for Risk Management in Credit Institutions with the Guidelines for managing non-performing and forborne exposures was adopted at the end of 2020. These standards are fully aligned with the current EU regulations. The Decision on the Criteria and the Manner of Classification of Assets and Calculation of Provisions for Potential Loan Losses of a Credit Institution was also adopted, and the implementation of both decisions will start on the effectiveness date of the Law on Credit Institutions.
Adopt risk-based supervision (ISA).	I	In progress. Since 2016 ISA has been implementing a risk assessment framework for the purpose of the annual supervisory review. After the adoption of the new Insurance Law (currently in development) further steps in risk-based supervision will be taken.
Incrementally implement Solvency II (ISA).	NT	In progress. Through an EU-funded project, the development of a new information system for supervisory reporting has been completed, thus providing technical platform for future transition to risk-based reporting in line with EU regulatory frameworks. Since June 1, 2021, digitalization of supervisory reporting to ISA is in place. A more comprehensive implementation of Solvency II will be achieved after adoption of the new Insurance Law, aligned with Solvency II framework.
Implement risk mitigation measures to minimize liquidity risks in the RTGS system and to eliminate the possibility of partial unwinding in the DNS system (CBCG).	I	In progress. The CBCG emergency liquidity facility was adopted in 2017. An in-house solution for linkage to central securities depository is being considered. This solution implies pledging of additional eligible securities toward the end of opening hours. Implementation is delayed until availability of IT resources and some legal issues are resolved.
Finalize national risk assessment and ensuing action plan and ensure that high money laundering/terrorist financing risks are adequately mitigated (CBCG).	NT	Done. The new national risk assessment was adopted at the end of 2020 along with the ensuing Action plan. It was used in procedures for making examination plans for 2021.
Set strict and objective criteria for determining the systemic importance of banks to determine eligibility for capital support (CBCG/MOF).	NT	Done. At the end of December 2020, the Decision on Identifying Other Systemically Important Credit Institutions was adopted. Its implementation will start on the effectiveness date of the Law on Credit Institutions, which defines the basic principles of identifying globally systemically important and other systemically important credit institutions. Both

Recommendations	Timing ¹	Progress
		regulations are fully aligned with the current EU regulations.
Strengthen resolution-funding options (MOF).	NT	Done. The Law on Deposit Protection Fund was adopted in December 2019 and is effective as of January 3, 2020. The new laws on Credit Institutions and the on Resolution of Credit Institutions also address this issue.
Organize a dedicated resolution unit within the CBM, and initiate bank-specific resolution planning, prioritizing the weakest CAMEL-rated banks (CBCG).	I	Done, in progress. In 2020, the CBCG established a Directorate for resolution, which is independent from supervision. Resolution plans for all banks (including systemic banks) will be prepared within six months from the date of effectiveness of the Law on Resolution of Credit Institutions (January 2022). The CBCG has already adopted internal procedures for drafting resolution plans and has begun work on resolution plans for individual banks, starting with the systemic ones.
Implement risk-based contributions and shorten the pay-out term for DPF (DPF/MOF).	NT	Done. The Law on the Deposit Protection Fund, effective since 2020, envisages shortening of the pay-out term. The methodology for the calculation of risk-based premiums has been adopted and has been implemented quarterly since 1 January 2021.
¹ I-Immediate" is within one year; "NT-near-term" is 1–3 years; "MT-medium-term" is 3–5 years.		



Appendix I. Draft Press Release

IMF Executive Board Concludes 2021 Article IV Consultation with Montenegro

FOR IMMEDIATE RELEASE

Washington, DC – February [xx], 2022: On February 18, 2022, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Montenegro.¹

The Montenegrin economy was hit hard by COVID-19, but a strong recovery is underway. The pandemic caused significant human and economic costs, the latter intensified by strong tourism dependence, constrained fiscal space, and labor market rigidities. The Authorities provided support through a variety of measures that helped to contain the economic effects of the pandemic. These included wage subsidies, tax deferrals, financial assistance to the vulnerable, and loan moratoria.

The financial sector appears to have withstood the COVID-19 shock well. Headline banking system metrics indicate resilience. Still, it is possible that there may be some hidden deterioration in asset quality that is masked by forbearance measures. Most of the crisis support measures introduced by the Central Bank in 2020 have been withdrawn over the past months. The Central Bank also successfully completed an independent asset quality review using data as of end-2019, which indicates that the banking sector was generally in a solid position, at the onset of the pandemic.

A growth rebound is expected in 2021 and 2022, of 12 percent and 6 percent respectively, driven primarily by the normalization of tourism. This will support a reversion of the current account to the pre-pandemic average. Over the medium term, growth is currently projected to ease to around 3 percent. Public debt was elevated prior to the pandemic in part due to the Bar-Boljare highway project. The pandemic caused a further increase in public debt levels. The Authorities have passed a landmark reform program, 'Europe Now', beginning in 2022. It aims to arrest outward migration through a series of measures: the near doubling of the net minimum wage; a substantial reduction in the labor tax wedge; and the introduction of a progressive tax code. Absent effective offsetting measures, the reductions in

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.

revenue from the removal of healthcare contributions in ‘Europe Now’ and increases in some long-term spending commitments are currently projected to keep the fiscal deficit and public debt elevated.

Uncertainty is exceptionally high. On the upside, medium-term growth could be higher than projected, if labor and capital are reallocated to viable firms and sectors promptly, and the reduction in the labor tax wedge attracts significant new investment. On the downside, negative surprises from the pandemic could stymie the recovery of tourism, and the economy. Geopolitical tensions could place sustained upward pressure on energy prices and risk premia. The reforms related to ‘Europe Now’ are expected to provide a short-term boost to growth. However, their effects on inflation and formal employment are uncertain as they depend significantly on the extent to which higher formal wages are absorbed by a commensurate fall in ‘grey wages’, which are likely to be variable across regions and sectors of the economy.

Executive Board Assessment²

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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>

Selected Economic Indicators 2017–2022						
	2017	2018	2019	2020	2021	2022
				Est.	Proj.	
Output						
Real GDP growth (%)	4.7	5.1	4.1	-15.3	12.0	6.0
Employment						
Unemployment (%)	17.0	15.2	15.1	17.9	--	--
Prices						
Inflation (average, %)	2.4	2.6	0.4	-0.2	2.4	4.1
General government finances						
Revenue (% GDP)	40.3	41.0	42.2	43.4	43.0	38.8
Expenditure (% GDP)	47.1	47.2	44.0	54.4	45.0	44.9
Overall fiscal balance (% GDP)	-6.8	-6.2	-1.8	-10.9	-2.0	-6.1
Primary fiscal balance (% GDP)	-4.4	-4.0	0.4	-8.2	0.5	-4.2
General government debt (% GDP)	66.2	71.9	78.8	107.3	88.2	79.4
Gen. govt. debt including guarantees (% GDP)	73.5	78.1	83.7	112.6	92.2	83.0
Money and credit						
Credit to the private sector (% change)	8.4	11.0	5.0	3.4	5.4	8.1
Non-performing loans (% of total loans)	7.3	6.7	4.7	5.5	--	--
Balance of payments						
Current account (% GDP)	-16.1	-17.0	-14.3	-26.0	-15.7	-15.0
Foreign direct investment (% GDP)	11.3	6.9	6.2	11.2	7.9	7.5
Reserves (months of imports)	3.4	4.0	5.1	8.2	5.5	3.7
Exchange rate						
REER (% change)	0.5	2.7	-1.5	-0.6	--	--

Sources: Ministry of Finance and Social Welfare, Central Bank, Statistical Office of Montenegro, and IMF staff estimates