FOR INFORMATION

FO/DIS/22/26

February 16, 2022

To: Members of the Executive Board

From: The Secretary

Subject: **Montenegro—Statement by the European Central Bank Representative**

Board Action:	Executive Directors' **information**
Additional Information:	For the Executive Board discussion on Montenegro to be held on Friday, February 18, 2022.

February 16, 2022

Statement by Rasmus Rueffer (ECB Representative) and Sander Tordoir (Advisor) on Montenegro – 2021 Article IV Consultation
(Preliminary)

IMF Executive Board Meeting

18 February 2022

We would like to thank Mr. Dresse and Mr. Voinea for their informative Buff statement and Staff for their Report. We would like to highlight the following issues:

We broadly share Staff's assessment that the Montenegrin economy is recovering well whilst still being subject to substantial risks. The ongoing recovery benefited from the authorities' forceful and timely policy support during the COVID-19 crisis, particularly in protecting jobs, businesses and the financial sector, with increased targeting over time. The economy rebounded sharply from a severe recession, as evidenced by the shift from a GDP drop of 15% in 2020, to growth of 12% in 2021 and projected growth of 6% in 2022. We note that inflation accelerated to 4.5% year-over-year in December 2021. Whilst this was mainly driven by food prices, the economy's closing output gap would likely add to inflationary pressures, which should be reflected in policy considerations, taking into account that monetary policy is not available as a tool in Montenegro given its monetary framework of official euroization with no own legal tender. Several major risks remain for the tourism-dependent economy, including uncertain pandemic developments, global food and commodity prices, elevated geopolitical risks, and tightening global financial conditions. As a small open economy, Montenegro is highly vulnerable to external shocks, while high public debt and the country's monetary framework severely limit the policy space to address these. These risk factors underscore the importance for medium-term policies to rebuild policy buffers against future shocks**.**

We strongly echo Staff's call to authorities to achieve a credible and substantial reduction in public debt over the medium term. In the short term, given the uncertain pandemic evolution, fiscal policy should still preserve the flexibility to address contingencies with increased targeting to protect the most vulnerable groups and raise the efficiency of spending. Public debt, including guarantees, was estimated at 92% of GDP in 2021, the highest in the Western Balkan region. In the medium term, given the significant risks, concrete and credible measures, particularly on the revenue side, should be identified to ensure durable consolidation and bring down the debt trajectory, which is essential for fiscal and external sustainability. Moreover, we concur with Staff that any large capital spending should be considered only when there is adequate fiscal space and accompanied by robust professional appraisal and fiscal risk management. The elevated risks in the external environment, including the significant upside risks on inflation, provide an even higher premium to enhanced fiscal discipline in view of Montenegro's monetary policy framework and its inherent limits for supporting adjustment.

We concur with Staff that while the banking system remains stable, intensified efforts are needed to monitor risks and implement new financial sector legislations. The completion of the Asset Quality Review provides a strong basis for updating supervisory data and ensuring a timely follow-up to the findings. In addition, new financial sector laws and regulations, including the Law on Credit Institutions, the Law on Resolution of Credit Institutions, and the associated regulations should help the authorities align regulation and supervision with the current EU frameworks. In this respect, a concrete and timely implementation is of great importance. Furthermore, while the overall banking system appears to be well-capitalized and liquid, delayed adverse effects on asset quality can materialize as support measures are being phased out. As such, it is important to strengthen a more forward-looking monitoring of bank's asset quality, particularly in the category of watch loans (or stage 2 loans under IFRS9) that could become non-performing, and to ensure adequate provisioning. Finally, the rapid rise in residential real estate prices could point to potential asset price overvaluations and warrant consideration of selective tightening of measures when implementing the authorities' macroprudential policy framework. This would also help rebuild financial sector buffers and enhance stability.