**FOR AGENDA**

SM/07/388

December 17, 2007

To: Members of the Executive Board

From: The Secretary

Subject: **Republic of Montenegro—Staff Report for the 2007 Article IV Consultation**

Attached for consideration by the Executive Directors is the staff report for the 2007 Article IV consultation with the Republic of Montenegro, which is tentatively scheduled for discussion on **Wednesday, January 16, 2008**. At the time of circulation of this paper to the Board, the Secretary's Department has not received a communication from the authorities of the Republic of Montenegro indicating whether or not they consent to the Fund's publication of this paper.

Questions may be referred to Mr. Justice (ext. 38600) and Mr. Gagales (ext. 38849) in EUR.

Unless the Documents Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the European Bank for Reconstruction and Development, the European Commission, the European Investment Bank, the Islamic Development Bank, and the Organisation for Economic Cooperation and Development, following its consideration by the Executive Board.

This document, together with a supplement providing an informational annex, will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities. The supplement, which is not being distributed in hard copy, will also be available in the Institutional Repository; a link can be found in the daily list (http://www-int.imf.org/depts/sec/services/eb/dailydocumentsfull.htm) for the issuance date shown above.

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INTERNATIONAL MONETARY FUND

REPUBLIC OF MONTENEGRO

**Staff Report for 2007 Article IV Consultation**

Prepared by the European Department
(In consultation with other departments)

Approved by Juha Kähkönen and Michael Hadjimichael

December 14, 2007


## Executive Summary

**The IMF's most recent member has high economic potential.** The economy is taking off, with strong investor interest in tourism. Driven by strong FDI and accelerating credit, GDP growth is projected to exceed 7 percent in 2007 and remain strong in 2008, unemployment has fallen sharply, and public debt and inflation remain low.

**But strong growth is masking rising vulnerabilities.** The economy is showing clear signs of overheating; the current account deficit at 37 percent of GDP has reached levels that demand vigilance; bank credit has accelerated with an aggressive push for market share, straining the ability of banks to adequately assess loan quality; inflationary pressures are on the rise despite euroization; wages have accelerated as the labor market tightens; and real estate and equity prices have soared.

**Policy options are limited.** Euro adoption precludes an exchange rate adjustment, but rapidly rising private debt raises the possibility of solvency problems related to real estate and asset market exposures, especially if declining competitiveness stunts Montenegro's tourism potential. With few other available policy levers, the procyclical 2008 budget is a concern. Staff stressed the need for a strong fiscal stance, and strengthened banking supervisory powers. The signing of the pre-accession agreement with the EU provides an opportunity to boost structural reforms to remove restrictive labor practices, ease energy bottlenecks, and improve the business climate.

**The authorities are more sanguine about the risks.** They view the widening imbalances as private sector driven, and point to large nation building needs that limit the scope for fiscal policy to contain demand pressures. The Central Bank is taking measures to strengthen supervision and dampen credit growth, but noted that its powers are limited given delays in passing key banking legislation through parliament.

Montenegro has accepted the obligations of Article VIII, Sections 2, 3, and 4, and the Fund staff have not, as yet, undertaken a thorough analysis of Montenegro's exchange system.

Contents Page

**Main Sources of Economic Statistics for the Republic of Montenegro**

Data in the Staff Report reflects information received by October 31, 2007. In most cases, more recent data can be obtained directly from the following sources:

| | |
|---|---|
| Statistical Office of the Republic of Montenegro | http://www.monstat.cg.yu |
| Central Bank of Montenegro | http://www.cb-mn.org |
| Ministry of Finance of the Republic of Montenegro | http://www.vlada.cg.yu/minfin |
| Montenegro Stock Exchange | http://www.montenegroberza.com |
| New Securities Exchange | http://www.nex.cg.yu |
| Institute for Strategic Studies and Prognoses | http://www.isspm.org |
| International Financial Statistics | |

**List of Acronyms**

| | |
|---|---|
| CBM | Central Bank of Montenegro (*Centralna Banka Crne Gore, CGCG)* |
| EPCG | Electric Power Company of Montenegro (*Elektroprivreda Crne Gore*) |
| ISSPM | Institute for Strategic Studies and Prognoses, Montenegro |
| KAP | Aluminum Factory in Podgorica *(Kombinat Aluminijuma u Podgorici*) |
| MONSTAT | Statistical Office of the Republic of Montenegro |
| MTFP | Ministry of Tourism and Environmental Protection |
| WTTC | World Tourism and Travel Council |

## I. Too Much of a Good Thing?

| Montenegro: Main Indicators, 2007 | |
|---|---|
| Population (in thousands) | 625.2 |
| Per capita GDP (in US$) | 5,112 |
| Unemployment rate | 11.8 |
| Inflation (average) | 3.5 |
| Fiscal revenue/GDP | 50.7 |
| Fiscal balance/GDP | 5.4 |
| Government Debt/GDP | 40.5 |
| Trade (GNFS)/GDP | 136.8 |
| FDI/GDP | 24.4 |
| CA deficit/GDP | 37.0 |
| Sources: Authorities; and Fund staff estimates. | |

1. **Independence and huge tourism potential has generated strong investor interest in Montenegro**. The last five years have seen price stability restored through the adoption of the euro as sole legal tender; notable progress in fiscal consolidation; restructuring of the banking sector; progress in privatization; and a favorable resolution of the state liabilities of the former union that left Montenegro with low debt (Figure 1). The authorities' vision is to create a business friendly, open economy with low taxes and minimal state interference.

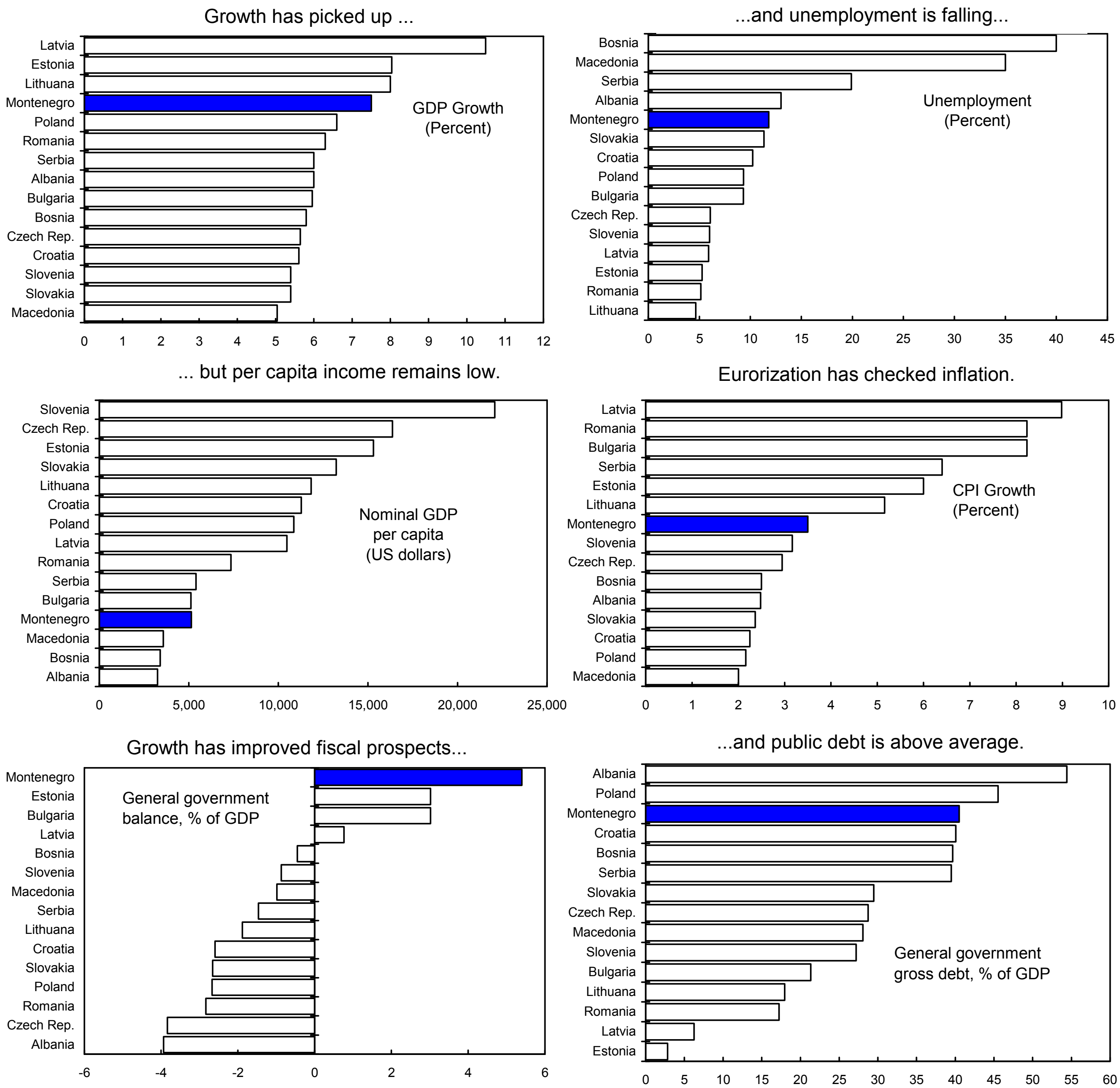
2. **But strong growth, and the exuberance it has generated, has brought its own problems.** Foreign direct investment has snowballed, targeting mainly real estate and the tourism sector. Furthermore, aggressive competition for market share has led to an explosion of bank lending. In response, asset prices have been rising sharply, with the stock index shooting up, and real estate prices rapidly reaching those in wealthier neighboring countries. The resulting wealth effect has fueled pent-up consumer demand, widening external imbalances.

3. **Euroization limits policy options to manage the boom.** Strong import-related revenue growth has generated fiscal surpluses, but the authorities have been reluctant to let the fiscal stabilizers work. Income taxes have been cut sharply, and the 2008 budget is expansionary. With monetary policy discretion curtailed by use of the euro, the Central Bank has moved to tighten prudential regulations, but lacks effective enforcement powers. Structural bottlenecks have also been quick to emerge. Restrictive labor regulations, a decapitalized electricity sector, and a difficult business environment threaten to put a brake on growth if unaddressed. The unofficial economy is large at an estimated 30 percent of GDP.

## II. Background

4. **The economic expansion is proceeding at full strength.** Real growth is expected to be 7½ percent in 2007, up from 6½ percent in 2006. The tourism sector is picking up, with large inflows of FDI generating strong construction activity. However, the manufacturing sector is stalling, partly due to disruption in electricity supply. Domestic credit has progressively replaced FDI as the main driver of demand.

Figure 1. Montenegro: A Good Start to Independence, 2007




Sources: WEO and Fund staff calculations.

5. **Signs of overheating are becoming more pervasive….**

- The labor market has tightened. Unemployment has fallen sharply from 20 percent in 2005 to 12 percent in September 2007 and inflows of temporary workers doubled during the tourist season 2007 compared to the previous year.

Credit expansion has overtaken FDI in size as demand stimulus
(In percent of GDP)

| | 2005 | 2006 | 2007 |
|---|---|---|---|
| FDI | 21 | 24 | 24 |
| Credit expansion | 5 | 24 | 58 |

Source: IMF staff calculations.

- **Wages have grown rapidly.** Gross wages increased at an annual rate of 26 percent in September, driven by tourism and construction. Public sector wage policy has been lax, with a 30 percent wage increase in the last quarter of 2007.

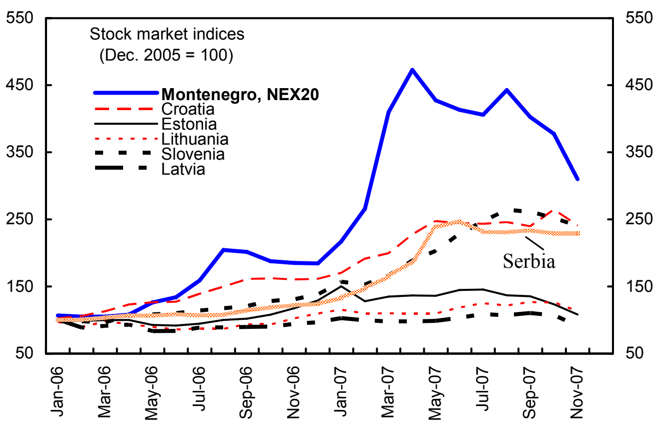
Gross Wage Increases in Selected Sectors
(Annual percentage change)

| | 2006 | QIII-07 |
|---|---|---|
| Economy wide | 15.5 | 26.1 |
| Growth sectors | | |
| Construction | 30.1 | 67.6 |
| Tourism | 18.1 | 50.7 |
| Financial intermediation | 17.0 | 23.6 |
| Other sectors | | |
| Electricity | 26.3 | 4.0 |
| Industry | 16.9 | 44.7 |
| Public administration | 16.8 | 15.8 |
| Health care | 11.8 | 10.4 |
| Education | 7.3 | 8.0 |

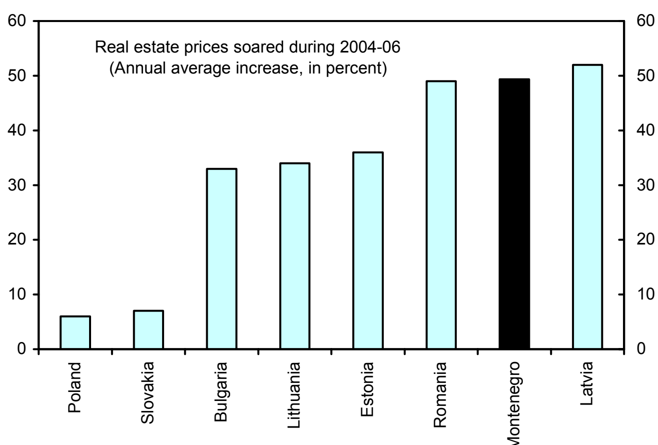
Source: Statistical Office of Montenegro.

- **Inflationary pressures have increased despite euroization.** Retail prices shot up during the summer, partly related to the region-wide drought and hikes in electricity and telecom tariffs, and the end-year inflation rate is expected to reach 5 percent, compared with under 3 percent in 2006.

- **Real estate and stock market prices have soared.** Partial data suggest that land values have already reached levels comparable to those in richer neighboring countries. Meanwhile, notwithstanding a significant correction, stock prices have tripled since end-2005 and market capitalization was 172 percent of GDP at end-November 2007.




Source: Bloomberg.




Sources: ECB and Global Property Report.

6. **…and vulnerabilities have been building up:**

- **External imbalances have widened.** The brunt of the strong demand pressures has been borne by the current account deficit, and Montenegro's competitive edge is eroding fast.

- **Credit growth has accelerated.** Exceptionally rapid credit growth could mask nonperforming loan (NPL) problems, test the capacity of the young banking system to prudently assess and manage credit risks, and weaken private sector balance sheets.

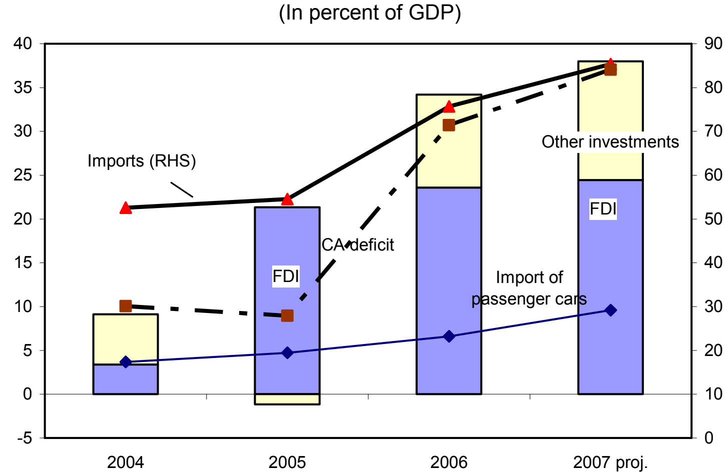
- **Fiscal risks have increased.** Large restitution claims amounting to well over 10 percent of GDP threaten to reverse the impact of the Paris Club debt write-offs at end-2006. Boom-related fiscal surpluses and large privatization receipts have raised the appetite for spending.

- **The asset price boom raises the specter of a correction.** The FSAP raised concerns regarding low disclosure requirements, infrequent reporting, and financial safeguards. A correction of stock market and real estate prices, partly fueled by the rapid credit expansion and possibly amplified by the shallowness of the market, could generate strong balance sheet effects.

***The widening current account deficit is increasingly debt financed.***

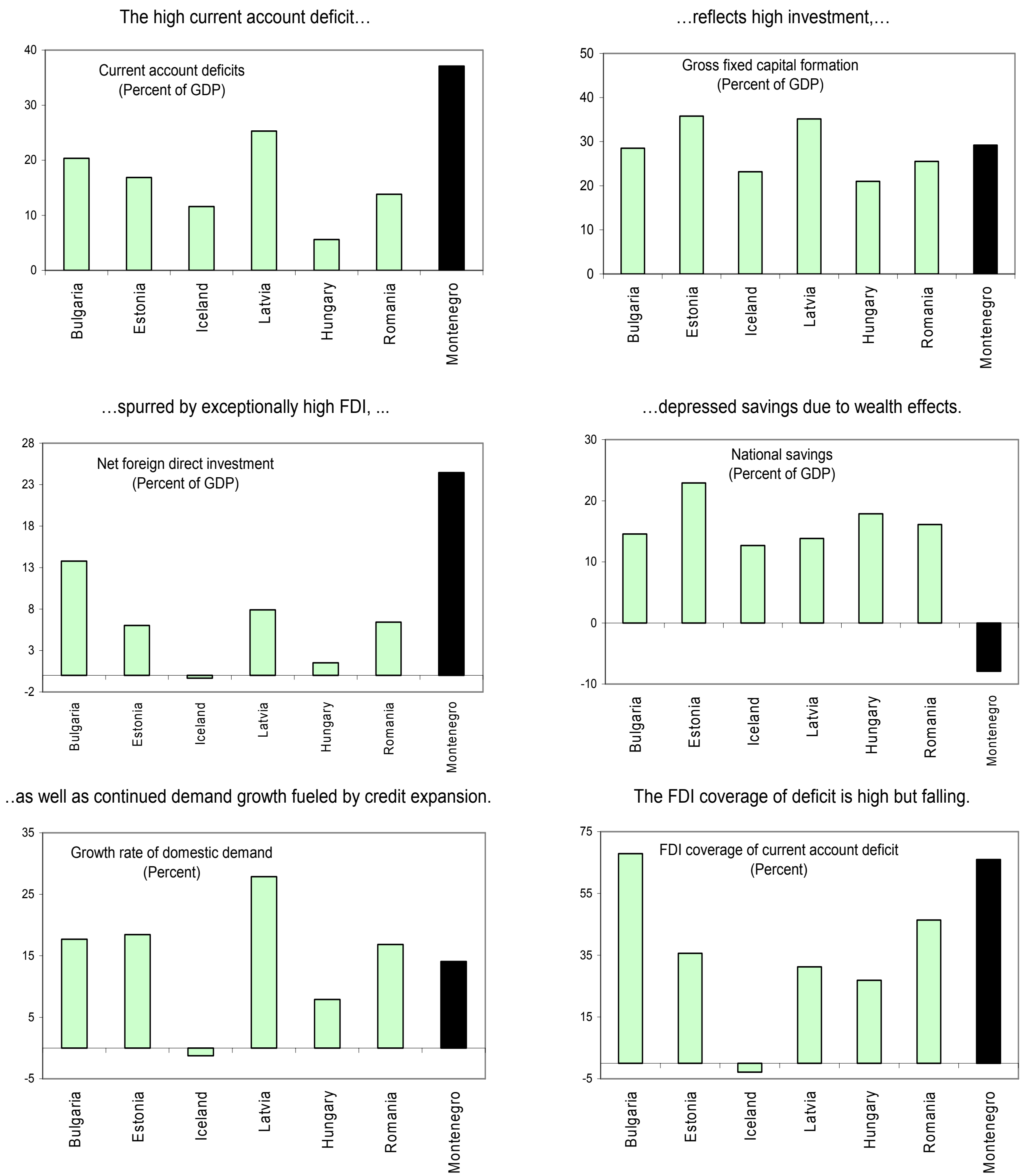
7. **The financing of the current account deficit is shifting.** The current account is estimated to widen to 37 percent of GDP in 2007, from 31 percent in 2006 (Figure 2). Large current account deficits are not uncommon in small states experiencing booms, and the euro peg shelters the economy from currency crises. From a savings-investment perspective, the widening of the deficit initially reflected high investment (spurred by FDI) and very low savings (associated with FDI-driven wealth effects from real estate sales). However, tourism investments have not yet been fully reflected in earnings (Box 1), eroding competitiveness limits diversification of the export base, and increasingly imports are being fueled by pent-up consumer demand. Private external debt is estimated to rise from 19 percent of GDP at end-2006, to 30 percent at end-2007.

External Balance and Its Financing
(In percent of GDP)




Source: Authorities; and Fund staff estimates and projections.

Figure 2. Montenegro: Developments in the External Sector, 2007




Sources: Montenegrin authorities, WEO, and Fund staff estimates.

## Box 1: Montenegro: A Tourism Enclave? [1/]

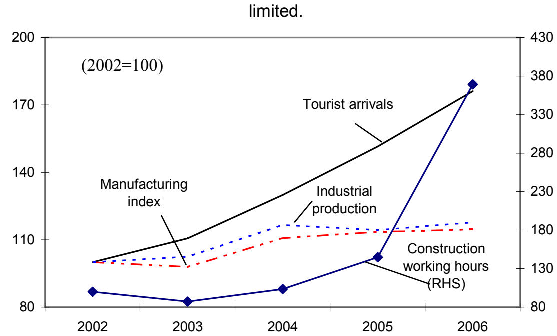
Tourism has fast become the main pillar of Montenegro's economy. The contribution of travel and tourism economy in overall GDP rose from 15 percent in 2004 to 21 percent in just three years. According to World Travel and Tourism Council (2007), Montenegro is a leading emerging tourist destination.

Despite rapid growth, the tourism sector is becoming an enclave in Montenegro. Hotels catering to international visitors rely on imported inputs, including a significant portion of labor. As a result, the tourism sector is characterized by high leakage. Meanwhile, developments in non-tourism related industries have been sluggish, and productivity has not shown any notable improvement, indicating weak linkage of tourism with the rest of the economy.

Available data on tourism suggest some inconsistencies between tourism goals and policies. Montenegro is targeting high-end customers. However, these tend to stay in resort hotels, resulting in high leakage-low retention of tourism earnings.

To achieve its target of tripling the travel and tourism sector by 2017, Montenegro must not only focus on increasing the number of beds and extending the season, but also improving infrastructure, especially roads, electricity and water supply.

Impact of tourism on the rest of the economy appears limited.




Sources: MTEP and WTTC, 2007.

| Travel &Tourism estimates and targets | 2007 | 2017 | % change |
|---|---|---|---|
| T&T Industry employment ('000) (L) | 14.9 | 26.2 | 76% |
| No. of beds ('000) (K) | 35.8 | 86.0 | 141% |
| T&T Industry GDP (mil euro) (Y) | 212.0 | 664.0 | 213% |

To achieve this target, labor will need to rise by 76%, capital by 141%, and the efficiency of labor by 35% 1/.

1/ Based on estimates using CRS production function with capital and labor as inputs.
Source: MTEP and WTTC, 2007

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1/ The role of tourism for Montenegro's development is examined in an accompanying Selected Issues Paper.

***Credit growth has soared***

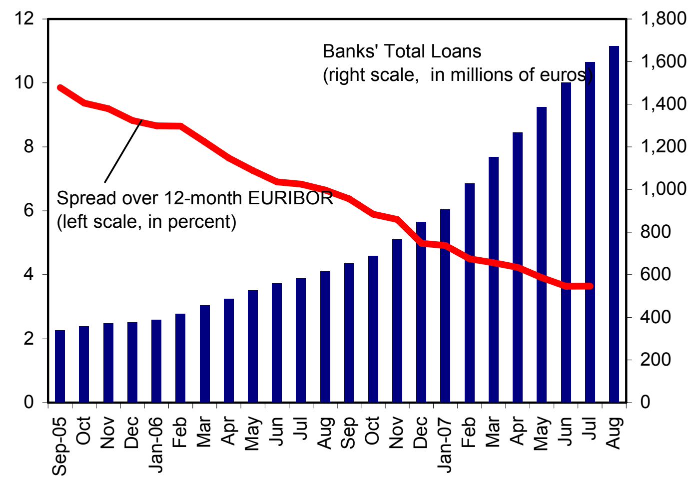
8. **Monetary developments have been dominated by large capital inflows and aggressive bank competition.** Unlike in many other countries in the region, credit expansion was initially financed from domestic sources, especially the proceeds of asset sales (real estate) to nonresidents. Recently, however, foreign credit lines and banks' own funds have had an increasingly large contribution to credit expansion. Declining interest rates due to intensifying competition and expectations of improving economic prospects have also stimulated demand for credit. Aggressive competition among banks for market share has fueled credit supply, with two banks managing to multiply their loan portfolio by tenfold within a year, one partly financed by a shift in public sector deposits to the bank. At 190 percent (y-o-y in September 2007), credit has been expanded notably faster than suggested by historical convergence dynamics (Box 2). Higher effective reserve requirements and stricter prudential requirements have only dented credit expansion at best.

Counterparts of Credit Growth
(Change in percent of GDP)

| | 2004 | 2005 | 2006 | 2007[1/] |
|---|---|---|---|---|
| Private sector credit | 5.4 | 5.2 | 24.3 | 59.1 |
| o/w a. Deposit liabilities | 2.5 | 10.2 | 24.2 | 39.5 |
| b. Net foreign liabilities | 1.9 | -3.4 | 3.7 | 14.3 |
| c. Own funds | 0.1 | 0.9 | 2.1 | 3.9 |
| d. Claims on CBCG | 0.2 | 3.4 | 6.7 | 3.3 |
| Memo item: | | | | |
| Net monetary stimulus (b+c-d) | 1.8 | -5.9 | -0.9 | 14.9 |

Sources: Authorities and Fund staff estimates.
[1/] January-September, annualized.

Spread of Average Interest Rates on Loans to Private Companies over 12-month EURIBOR

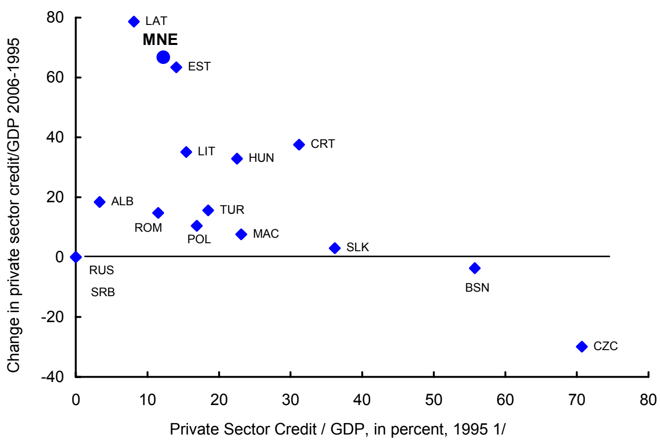



Source: Central Bank of Montenegro.

## Box 2. Rapid Credit Growth [1/]

**The credit-to-GDP ratio has risen rapidly during the past three years.** At 79 percent, the ratio has already reached a level comparable to that in the Baltic countries but the pace of increase has been much faster.

***The financial sector has been rapidly deepening...***




Source: IMF, International Financial Statistics.
1/ MNE 2003-07, and SRB 1998-2007.

***.....and credit/GDP is now at the top among transition economies.***

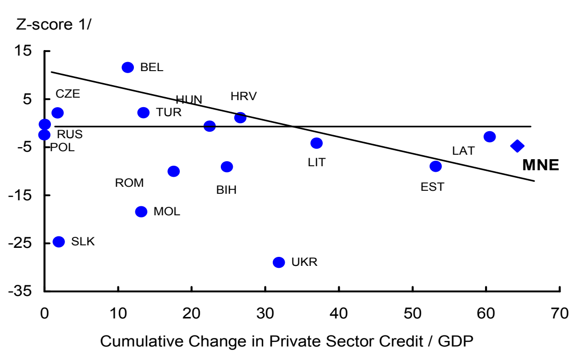
**Credit to Private Sector/GDP in Selected Credit Boom Episodes [1/]**

| Country | Start of Boom | End of Boom | Duration | Credit at Start | Credit at End |
|---|---|---|---|---|---|
| **Crisis Countries** | | | | | |
| Argentina | 1990 | 1995 | 6 | 9.2 | 19.7 |
| Brazil | 1993 | 1995 | 3 | 13.3 | 47.0 |
| Mexico | 1987 | 1994 | 8 | 12.3 | 38.7 |
| Philippines | 1988 | 1998 | 11 | 16.1 | 48.0 |
| Turkey | 1995 | 2000 | 6 | 18.5 | 23.7 |
| Uruguay | 1992 | 2002 | 11 | 25.2 | 65.9 |
| **Non-crisis countries** | | | | | |
| Greece | 1995 | ongoing | 12 | 31.9 | 88.7 |
| Indonesia | 1984 | 1993 | 10 | 14.2 | 44.3 |
| Ireland | 1995 | ongoing | 12 | 61.1 | 182.6 |
| Portugal | 1987 | ongoing | 20 | 61.4 | 157.0 |
| Spain | 1998 | ongoing | 9 | 84.1 | 164.4 |
| **Booms in selected CEE countries** | | | | | |
| Hungary | 1994 | ongoing | 13 | 26.4 | 55.9 |
| Latvia | 1997 | ongoing | 10 | 9.7 | 86.8 |
| Lithuania | 1998 | ongoing | 9 | 11.0 | 43.2 |
| Macedonia | 1999 | ongoing | 8 | 20.9 | 29.7 |
| Ukraine | 1997 | ongoing | 10 | 2.4 | 47.3 |
| **Montenegro** | **2005** | **ongoing** | **2** | **18.2** | **79.0** |

Sources: IFS and IMF staff calculations.
1/ Adapted and updated from Hilbers et al. (2005)

**Is credit growing too rapidly?** Out-of-sample estimation, drawing on historical convergence dynamics, suggests that credit-to-GDP exceeds its equilibrium level for the current stage of development, and the banking sector's distance to default, measured by the Z-score, has declined slightly.

***Distance to default in CEE countries, 2001-06***




Sources: IFS, MCM database on FSIs; and IMF staff calculations.
1/ The Z-score computes the number of standard deviations the return to capital must fall for equity to be depleted. It is measured by Z=(k + m)/s, where k is equity capital as percent of assets, m is average return as percent on assets, and s is the standard deviation of the return on assets. A lower score is associated with a higher probability of insolvency risk.

**Private Sector Credit / GDP in Selected Transition Economies**

| Country | Actual | Predicted 1/ | Deviation | Change 2/ | Predicted 3/ | Excess |
|---|---|---|---|---|---|---|
| Estonia | 77.4 | 80.8 | -3.4 | 12.9 | 7.3 | 5.5 |
| Latvia | 86.8 | 75.3 | 11.4 | 13.6 | 6.9 | 6.6 |
| Romania | 26.3 | 49.6 | -23.3 | 4.0 | 4.8 | -0.8 |
| **Montenegro 4/** | 62.4 | 46.1 | 16.3 | 15.4 | 5.2 | 10.1 |

Source: IFS, WEO. Based on Schadler et al. (2005); IMF staff calculations.
1/ Based on VECM of credit/GDP, log of GDP per capita at PPP and real interest rate
2/ Actual average change in credit/GDP in 2003-06
3/ Average predicted short-run change in 2003-06
4/ 2005-07 data, adjusted for the underground economy and the wealth effect from assets sales.

[1/] Financial convergence in Montenegro is examined in an accompanying Selected Issues Paper.

*Fiscal policies have recently slipped*

9. **The boom has contributed to fiscal surpluses (Figure 3), but the authorities have been reluctant to allow the fiscal stabilizers to work fully.** The general government balance improved to 7 percent of GDP in the first three quarters of 2007, compared with 2½ percent of GDP in 2006. Revenues surged due to VAT on imports, and expenditures were kept under control. However, the cut in the PIT tax to 15 percent in the beginning of the year (with a further cut to 9 percent planned by 2010) added to demand pressures, and weakened the impact of the automatic stabilizers.

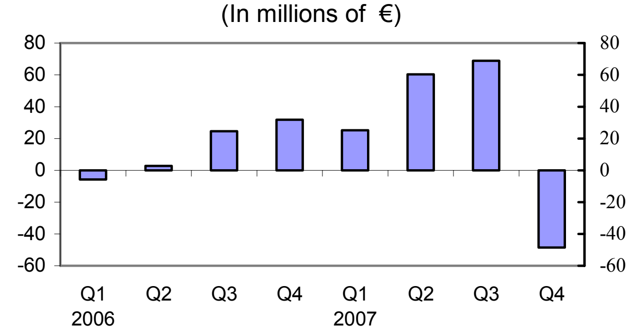
**Consolidated General Government Fiscal Position, 2005-07:QI-III**

| | 2005 | 2006 Prel. | 2007: QI-QIII Prel. 1/ |
|---|---|---|---|
| | (In percent of GDP) | | |
| Republican budget | | | |
| Total revenues and grants | 24.1 | 28.1 | 25.6 |
| Total expenditures and net lending | 25.2 | 24.7 | 17.7 |
| Overall balance | -1.1 | 3.5 | 7.9 |
| Primary balance | 0.0 | 4.6 | 8.8 |
| Social Funds - Overall balance | | | |
| Pension | -0.6 | -0.1 | -0.3 |
| Health | 0.1 | -0.3 | -0.1 |
| Employment | -0.1 | -0.4 | -0.1 |
| Development Fund | ... | -0.9 | ... |
| Restitution Fund | ... | 0.3 | ... |
| Local governments - Overall balance | 0.1 | 0.2 | -0.5 |
| Consolidated | | | |
| Overall balance | -1.8 | 2.4 | 6.9 |
| Primary balance | -0.6 | 3.6 | 7.7 |

Source: Montenegrin authorities; and Fund staff estimates and projections.
1/ In percent of annual GDP.

10. **The revised 2007 budget, adopted in October, would reduce the surplus to 4½ percent of GDP.** The rectification raises spending substantially on both goods and services and capital investment. In addition, a general public sector wage increase of 30 percent has been announced, which will be implemented in steps starting from October 1, 2007. However, staff estimate that capacity constraints are likely to contain expenditures and improve overall fiscal performance to 5½ percent of GDP (Table 3).

Fiscal balance with revised 2007 budget
(In millions of €)

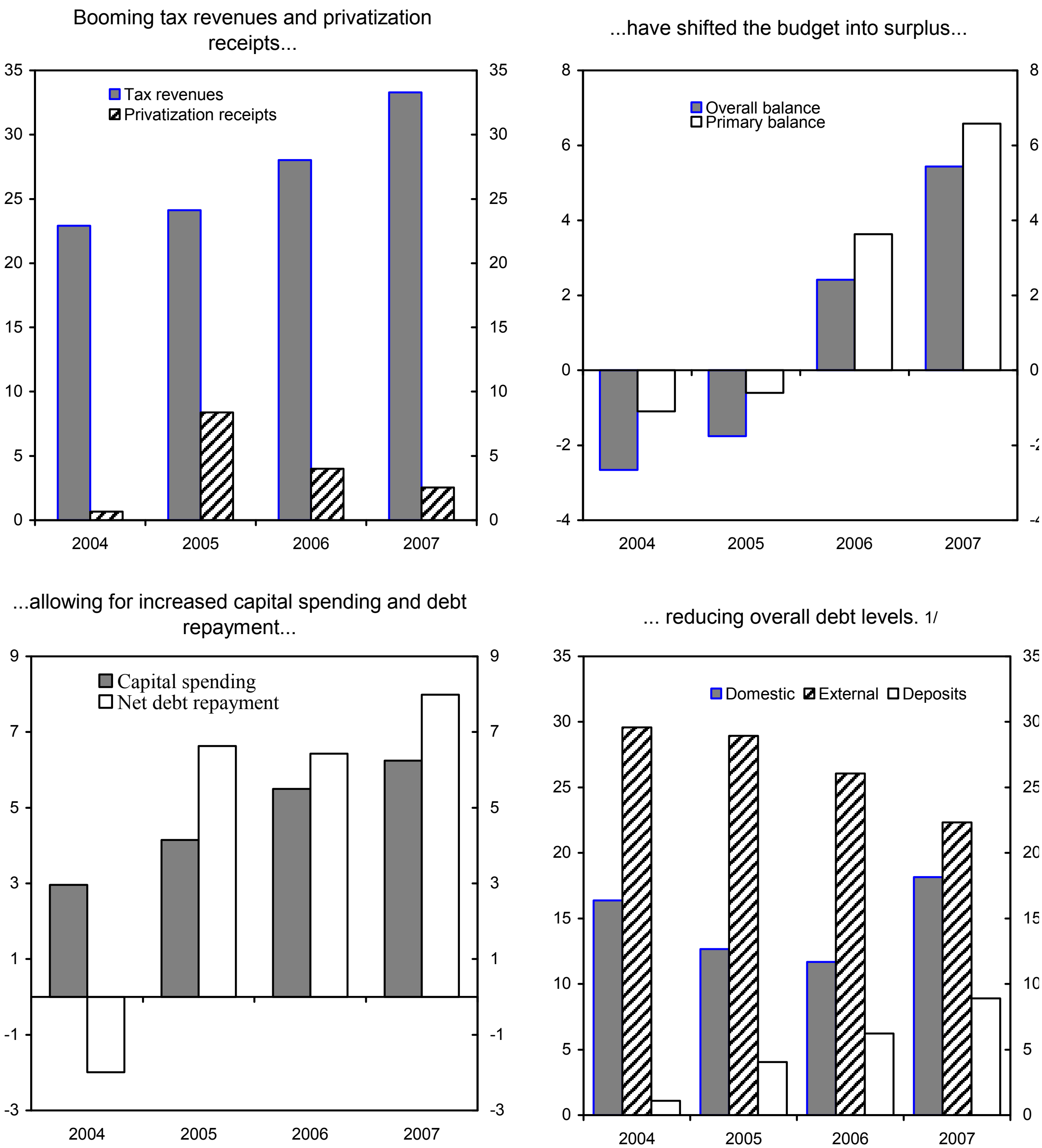



Source: Montenegrin authorities and staff estimates.

11. **The level of public debt is set to increase.** Public debt is projected to increase to 40 percent of GDP in 2007 mainly due to large restitution claims and additional compensation for foreign currency deposits seized during the Milosevic regime (Appendix I).

12. **Performance could be further undermined by weak controls in the wider public sector, despite improvements in central budget implementation.** The 2008 organic budget law will, for the first time, include the social funds, which will fall under the spending authorization of the central government. However, spending by municipal governments is unconstrained due to substantial privatization revenues; and the state-owned enterprise sector is loss making after taking into account the quasi-fiscal operations of the electricity company, amounting to an estimated 2 percent of GDP in 2006.

Figure 3. Montenegro: Consolidated Fiscal Developments, 2004–07
(Percent of GDP)

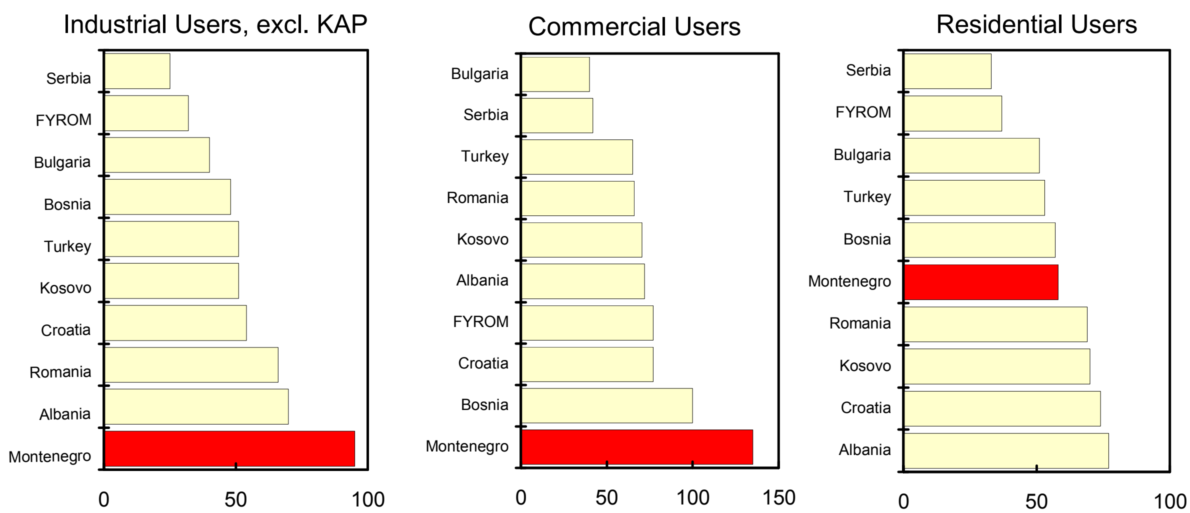



Sources: Montenegrin authorities and Fund staff estimates.
1/ Includes Paris Club debt reductions and assumption of restititution liabilities.

***Structural barriers to growth are pervasive:***

13. **Electricity shortages pose a serious threat to growth.** Electricity demand is growing fast while production is hampered by dilapidated production and distribution facilities, and chronic operating losses in the state-owned electricity company (EPCG) that have precluded investment in the sector. The situation is complicated by a distorted tariff structure that overcharges commercial consumers (to offset implicit subsidies worth 2 percent of GDP to the private aluminum complex (KAP), governed by a long-term contract). Household charges are not particularly low by regional standards, but are well below costs, contributing to EPCG losses. The increase of electricity tariffs in July 2007 has not been sufficient to bring EPCG to profit.

Electricity tariffs are high in Montenegro, especially for commercial users
(Electricity tariffs in euro per MWh, in 2006)




Source: USAID.

14. **Restrictive labor legislation, too, is a drag on the local economy**. Excessive employment protection, a fairly high tax wedge, and low wage flexibility are major deterrents to labor market participation, especially in the formal economy, and encourage the employment of temporary foreign workers, especially in tourism and construction.

15. **The business climate remains weak**. The reduction of corporate taxation, the speeding up of licensing and the adoption of a *laissez fare* attitude have bolstered the attractiveness of Montenegro as a business location. However, interference by municipalities remains pervasive, incomplete zoning regulations raise the effective cost of investment, and public administration is weak.

## III. Policy Discussions

16. **Against this background, the discussions focused on policies to manage the upswing and prevent a hard landing, complete the transition to a market economy, and reduce vulnerabilities.**

- **The potential growth outlook is strong, but staff expressed concerns about the impact of overheating and eroding competitiveness on external sustainability.** Staff and the authorities concurred that near-term prospects are positive, with strong tourism potential, but differed on the assessment of risks.

- **The CBM shared staff concerns regarding the extremely fast credit growth**. There was agreement that the enforcement powers of the CBM need to be strengthened, and prudential supervision tightened further.

- **There was less agreement on the use of fiscal policy to counter the boom.** Staff emphasized the importance of a countercyclical fiscal stance, but the authorities pointed to high nation-building needs. Staff stressed the importance of a comprehensive medium-term expenditure framework to create space for public investments.[1]

- **Discussions on policies to promote growth were mixed.** There was agreement on the need to strengthen labor and business legislation to increase the flexibility of the economy and reduce grey market activity, but less agreement on energy policies and privatization.

- **The authorities were more sanguine about the need for measures to offset vulnerabilities**. Nevertheless, progress has been made on limiting restitution compensation, which is the main source of contingent fiscal liabilities, and strengthening financial markets

[1] The fiscal framework is discussed in an accompanying Selected Issues Paper.

## A. Medium-Term Framework

17. **Growth potential is high, but with risks**. The good prospects for tourism, as demonstrated by WTTC projections and phenomenally high FDI, provide a firm basis for strong growth over the medium term. However, current macroeconomic policies are adding to overheating pressures and increasing downside risks and, together with the slowing of reforms, are denting growth potential and impeding economic diversification by eroding competitiveness.

**Medium-term Macroeconomic Framework, 2005-15**

| | 2005 | 2006 | 2007 | 2008 | 2009 | 2012 | 2015 |
|---|---|---|---|---|---|---|---|
| | Prel. | Est. | | | Proj. | | |
| Growth rates | | | | | | | |
| GDP (real) | 4.0 | 6.5 | 7.5 | 7.2 | 5.5 | 4.7 | 4.5 |
| Inflation (ave) | 3.4 | 2.1 | 3.5 | 4.7 | 4.1 | 3.0 | 3.0 |
| Exports (euro) | 12.6 | 25.6 | 25.6 | 21.6 | 9.9 | 9.1 | 7.7 |
| In percent of GDP | | | | | | | |
| Fixed investments | 16.0 | 29.4 | 29.2 | 27.7 | 25.7 | 20.2 | 19.7 |
| Domestic savings | -1.8 | -7.1 | -10.7 | -8.4 | -7.1 | -3.2 | 5.7 |
| Fiscal balance | -1.8 | 2.4 | 5.4 | 2.3 | 1.3 | -2.1 | -2.8 |
| Privatization receipts | 8.4 | 4.0 | 2.6 | 2.1 | 2.1 | 1.4 | 0.0 |
| Gross public debt (end of period, stock) | 41.6 | 37.7 | 40.5 | 38.6 | 35.9 | 29.3 | 29.9 |
| Current account (before grants) | -8.9 | -30.7 | -37.0 | -33.0 | -29.5 | -21.3 | -12.4 |

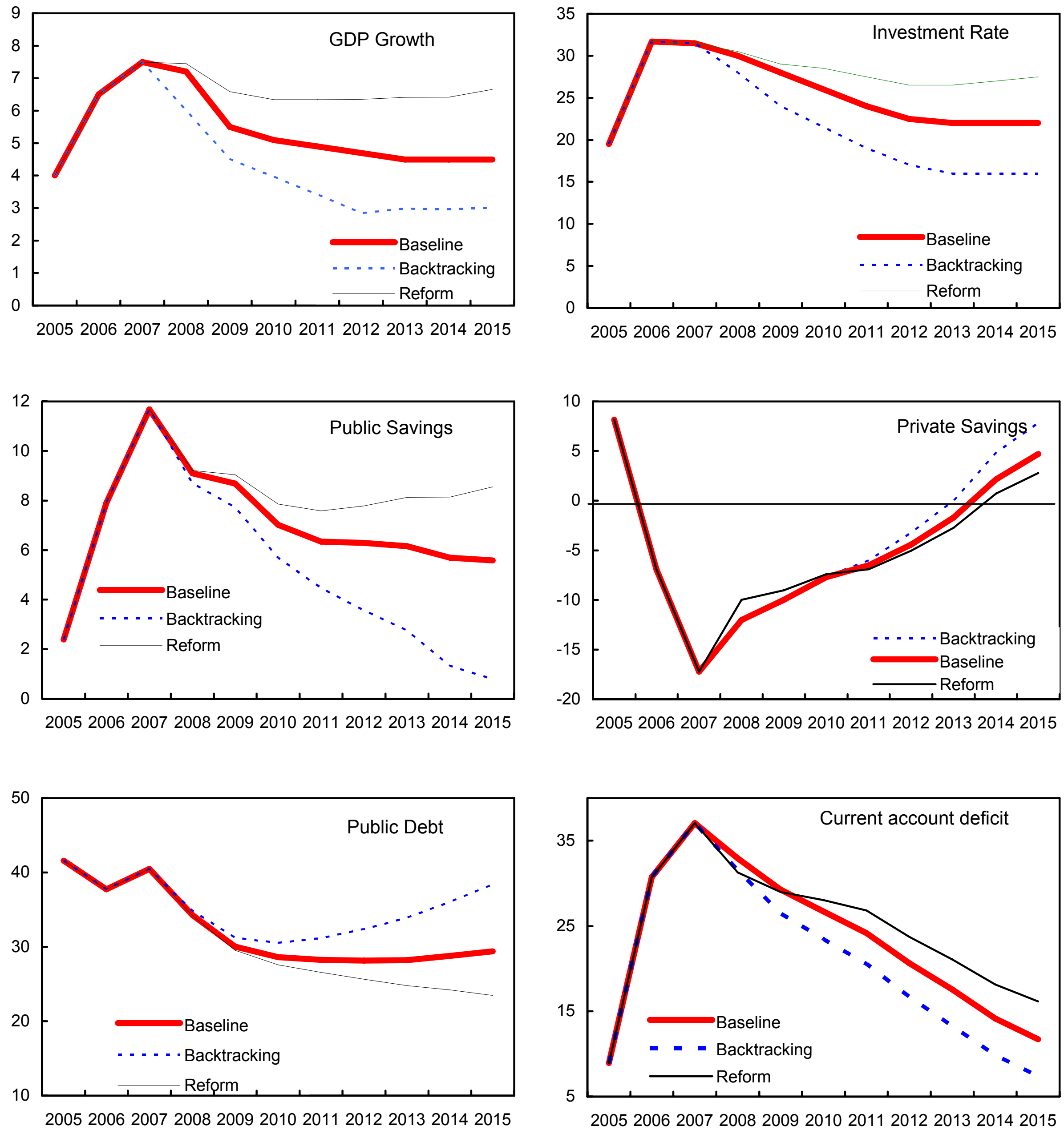
Sources: Ministry of Finance; and Fund staff estimates and projections.

18. **Short-term growth prospects remain positive, despite overheating**. Staff projections are close to those of the authorities with growth of about 7 percent in 2008, as tourism picks up, and demand continues to be buoyed by strong FDI and credit growth (although less than in 2007). Both expected inflation to inch up in the face of wage pressures. The current account deficit is projected to narrow to 33 percent of GDP in 2008, due to a pick-up in tourism earnings, and less strong demand due to weakening wealth effects and policies to rein on credit growth.

19. **The boom is expected to slow over the medium term (Figure 4).** Medium-term growth prospects are where the authorities and staff differ. The staff see competitiveness erosion and the slow pace of structural reforms moderating potentially higher growth rates from strong tourism expansion (Box 3) to levels lower than expected for the current stage of transition. Both agree that the current account would narrow as the demand shock peters out, as credit markets are quickly saturated given the already high credit-to-GDP ratio (Box 2), and narrowing investment opportunities lead to the unwinding of FDI inflows. But staff stressed that labor costs have been rising very rapidly compared with the experience of other transition countries; and that wage moderation and reforms facilitating broader-based growth were indispensable for a soft landing.[1] The current account would become increasingly debt financed, with private external indebtedness doubling from 30 percent of GDP at end 2007 to 59 percent by 2012 (Appendix II).

[1] The macroeconomic adjustment to the large FDI inflows is discussed in more detail in the accompanying Selected Issues Paper.

Figure 4. Montenegro: Macroeconomic Framework, 2005-15
(Percent of GDP)




Sources: Montenegrin authorities; and Fund staff estimates and projections.
The slow reform scenario is driven by lower FDI, weaker private investment, and smaller gains in labor force participation and unemployment reduction.

## Box 3. Montenegro's Competitiveness and External Sustainability

Montenegro's high current account deficit largely reflects transitory demand pressures, as confirmed by macroeconomic balance analysis, which implies a correction as the demand shocks unwind. Competitiveness indicators do not provide clear evidence of overvaluation but rapidly rising labor costs point to the need for productivity enhancing structural reforms to preserve competitiveness.

### I. Price and cost competitiveness

Competitiveness indicators give mixed signals. The RPI-based REER shows little movement compared to other countries in the region, but the statistics are distorted by price repression. The average net wage is currently at middle range compared to other neighboring countries; however, it has been rising rapidly, and the wage-based REER suggests erosion of competitiveness. The internal terms of trade rose in 2004 but have stabilized since.

### II. Tourism prospects: do costs matter?

Surveys have shown that tourism is not particularly sensitive to local costs, especially the type of enclave tourism resorts being established in Montenegro, which depend heavily on imported inputs and labor. Tourism receipts more than doubled from 2003 to 2006. According to the World Travel and Tourism Council, Montenegro ranks 3rd in speed of growth of tourism in 2007. This suggests that the importance of competitiveness is more to foster broad-based growth, and ensure that the local economy benefits from tourism-related activities.

### III. Macro-balance approach

The macroeconomic balance approach suggests that the large current account deficit will decline as FDI moderates, which is not unusual for transition economies. The underlying balance, which adjusts for transitory factors, is roughly equal to its equilibrium level but a gap is expected to emerge reflecting eroding cost competitiveness due to rapid wage increases and slow productivity growth. The equilibrium current account balance is based on economic fundamentals such as fiscal balance, old-age dependency ratio, population growth, relative income, and ratio of NFA to GDP.

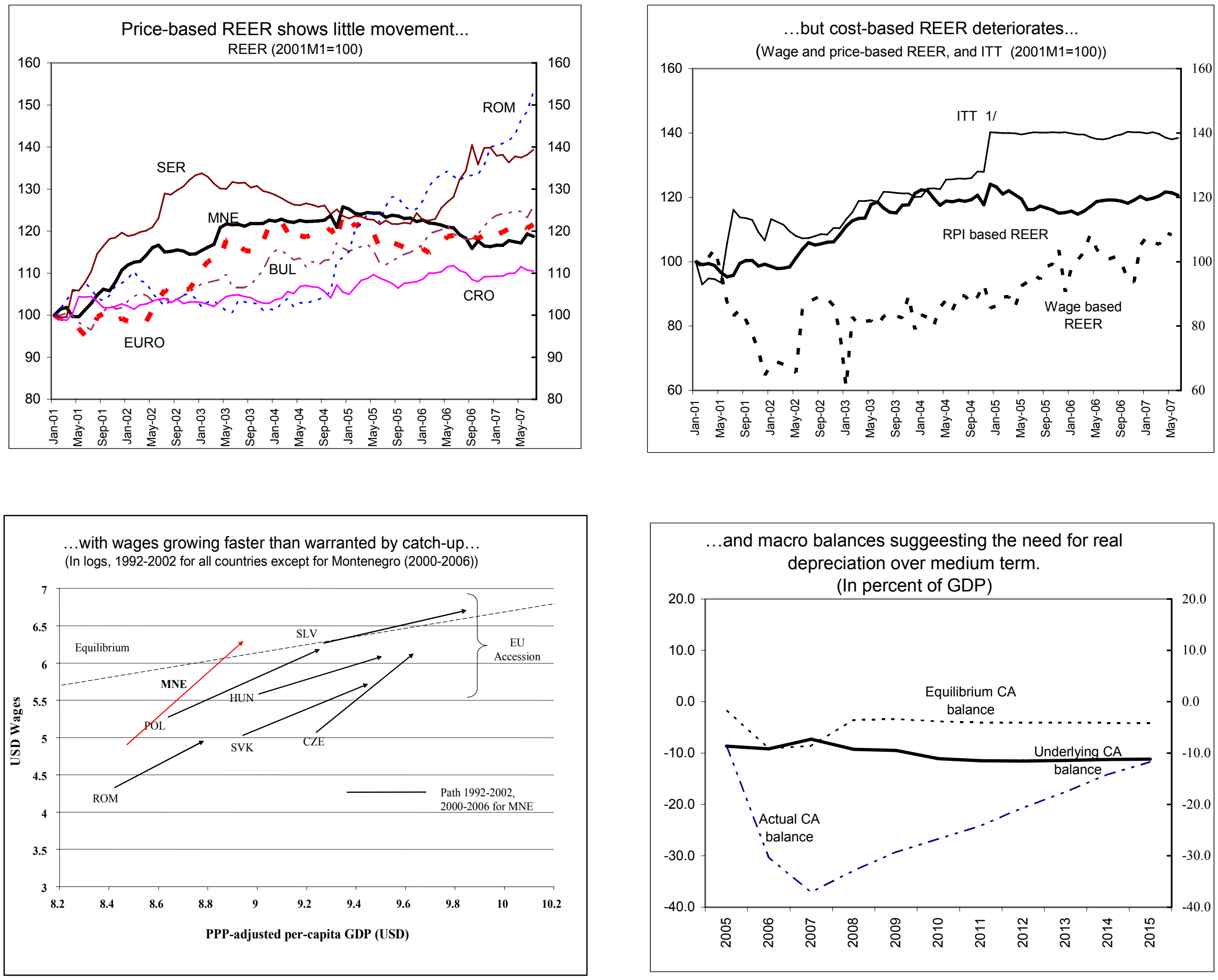
**Assessment of business climate**

| 2007 CPI 1/ by Transparency Intl. | | 2008 Doing Business by IFC | | 2007-08 GCI by 2/ World Economic Forum | |
|---|---|---|---|---|---|
| Countries | rank | Countries | rank | Countries | rank |
| Slovenia | 27 | Slovakia | 32 | Estonia | 27 |
| Malta | 33 | Namibia | 43 | Czech Rep. | 33 |
| Dubai/UAE | 34 | Bulgaria | 46 | Slovenia | 39 |
| Botswana | 38 | Botswana | 51 | Slovak Rep. | 41 |
| Cyprus | 39 | Slovenia | 55 | Latvia | 41 |
| Slovakia | 49 | Turkey | 57 | Poland | 51 |
| Greece | 56 | Belize | 59 | Turkey | 53 |
| Namibia | 57 | Trinidad & Tobago | 67 | Croatia | 57 |
| Turkey | 64 | **Montenegro** | **81** | Greece | 65 |
| Bulgaria | 64 | Vietnam | 91 | Ukraine | 72 |
| Croatia | 64 | Croatia | 97 | Romania | 74 |
| Trinidad & Tobago | 79 | Greece | 100 | Botswana | 76 |
| **Montenegro** | **84** | Dubai/UAE | ... | **Montenegro** | **82** |
| Belize | 99 | Malta | ... | Serbia | 91 |
| Vietnam | 123 | Cyprus | ... | Macedonia | 94 |

Source: Transparency International, World Bank, World Economic Forum
1/ Corruption Perception Index
2/ Global Competitiveness Index

### IV. Institutional indicators

Various indicators of the business climate rank Montenegro consistently at the middle of the group. Montenegro ranked 84 out of 179 in the Transparency International's Corruption Perception Index, and 81 out of 177 in World Bank's Doing Business Index. The 2007 Freedom House report shows deterioration, in large part due to the lack of transparency in privatization.




1/ Ratio price of nontradeables to tradebles using RPI.
Source: Central Bank of Montenegro, WEO and staff estimates and projections.

20. **Staff cautioned that a harsher landing is clearly possible**. Disillusion with current policies or diminished expectations could trigger a more abrupt private sector adjustment choking off private investment and discouraging FDI. Euroization rules out a currency crisis, but reliance on wage correction would be painful, especially if rigidities in labor markets are not addressed. The authorities acknowledged that overheating could result in a "hard landing," but remained relatively sanguine about the risks of a disorderly adjustment and expected that after the adoption of the constitution the reform effort would regain momentum. Staff emphasized the downside risks including excessive restitution claims, potential volatility of the large FDI inflows, wage increases in excess of productivity growth, and an abrupt weakening of private sector balance sheets due to a shift in expectations. Public debt is not a source of vulnerability as confirmed by sustainability analysis (Appendix I).

**Box 4. FSAP Recommendations and Follow-up**

The Central Bank of Montenegro is in the process of implementing an action plan to follow-up the FSAP, as described in the FSSA. The main findings of the FSAP were:

- Rapid credit growth has strained banks' capacity to underwrite loans prudently, and eroded capital adequacy and profitability.

- Banking supervision is robust, but the legal framework needs to be strengthened through adoption of the banking law, and enhanced enforcement powers.

- The buoyant stock market is poorly supervised and may pose a reputational risk.

While the CBM has moved quickly to restructure supervisory practices and address specific vulnerabilities by tightening capital requirements, approval of the banking law has dragged.

**Central Bank of Montenegro: Action Plan 1/**

| Measure in Action Plan | Status of Implementation |
|---|---|
| Change the organizational structure of CBM:<br>Increased specialization<br>Integration of on-site and off-site supervision<br>Development of portfolio management | Adopted by the CBM council in March 2007 |
| Thematic controls of banking sector:<br>Credit risk<br>Liquidity risk<br>FX risk<br>Operational risks | Included in Work Plan for 2007, currently underway |
| Supervisory Development Plan for 2007–10 | To be finalized by end-2007 |
| Consolidated Supervision | Started for a number of banks. |
| Banking Law and Central Bank Law | Pending parliamentary discussion |
| Measures to address bank-specific vulnerability | Several banks were required to strengthen their capital. |
| Credit Registry:<br>Broaden access to information by banks<br>Include additional information in line with Basel II<br>Charge a fee to access information | Data exchange with banks has yet to start. Expected to be fully operative by end-2007 |

1/ As of October 31, 2007.

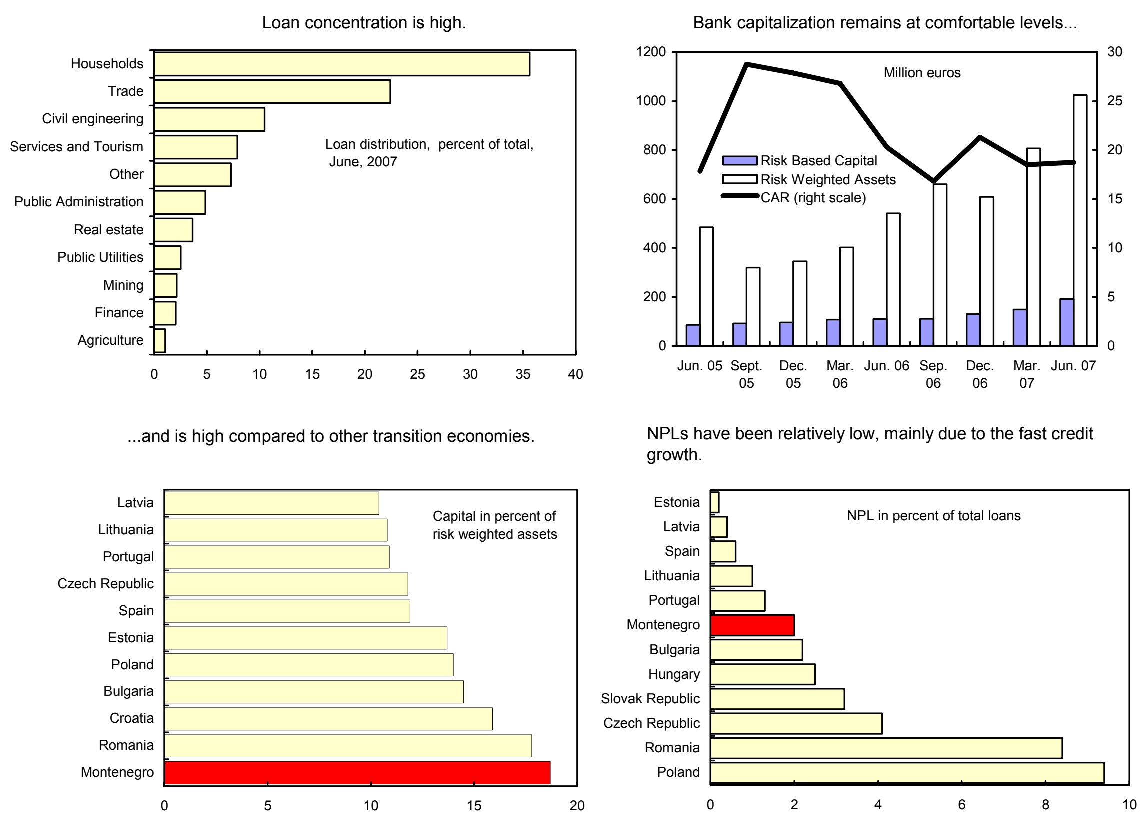
## B. Safeguarding Financial Sector Stability

21. **The central bank has moved to tighten credit, but lacks sufficient enforcement powers.** The absence of a lender of last resort arrangement in Montenegro suggests the need for higher liquidity ratios. The authorities noted that they recently had raised effective reserve requirements to 14 percent (on average), which is high by international standards. They had also instructed some banks to strengthen their capital, and the average capital adequacy ratio at 18.7 percent appears to be at a comfortable level. CBM representatives noted that the turmoil in international financial markets had not been felt in Montenegro. The CBM has been following up on FSAP recommendations (Box 4), has been monitoring banks very closely, and has prepared regulations refining (effectively tightening) loan classification rules, but lacks effective enforcement powers. Staff agreed that the banking system is reasonably well supervised but noted that its resilience has not been tested in a downturn and

the rapid credit growth has been taking its toll on banks' financial indicators, especially regarding liquidity (Table 5).

22. **Staff noted that euroization still leaves some limited room for maneuver in controlling credit growth.** Staff noted that expanding the base of calculation of reserve requirements to include all non-capital liabilities would discourage banks' recourse to foreign financing and reduce moral hazard. Moreover, relatively high concentration of risks, and the inexperience of some banks, argued for above average solvency rates. The CBM argued that the pending refinements in loan classification obviated at this stage the need for higher minimum solvency ratios. Direct credit controls were also discussed but rejected by the CBM on efficiency and enforceability grounds.

23. **There was agreement on a number of structural measures to check credit growth and strengthen the financial system.** These included acceleration of the approval of the laws on the central bank and banks to provide, among other things, CBM supervisors with effective enforcement powers and immunity in the discharge of their duties; and to facilitate strengthened supervision, a tightening of loan-to-income and loan-to-value ratios, and the development of early warning systems for systemic macro risks, particularly for bank exposure to the stock market and real estate sector. Improved access to the Credit Registry would also enhance risk management practices at banks.




Sources: Central Bank of Montenegro, and Global Stability Report, IMF.

24. **Exuberance on the stock market is a concern.** The authorities have requested Fund technical assistance to help strengthen governance.

## C. Fiscal Framework: Balancing Growth and Stability

***Medium-term fiscal framework.***

25. **Staff and authorities agreed that implementation of two key elements of the medium-term fiscal framework would bolster policy credibility:**

- **Fiscal policy should be anchored on a medium-term target.** The target to reduce gross debt to below 30 percent of GDP by 2012 can be achieved with, on average, a small primary surplus over the medium-term (Appendix I).

- **Downsizing of the public sector.** The authorities plan to reduce current spending to make room for further tax cuts, and higher public investments. They have yet, however, to formulate concrete public sector reforms that would lend credibility to these plans. Staff recommended the development of a medium-term fiscal framework to reconcile spending needs.

***Fiscal policy in 2007–08: leaning against the wind***

26. **Staff argued for a countercyclical fiscal stance.** Notwithstanding their medium-term objective of downsizing the public sector, the authorities' immediate plans were predicated by nation building expenditure and prior commitments to reduce tax rates. As a result, the revised budget for 2007 and preliminary 2008 budget would add additional fiscal stimuli to the domestic economy. Reductions of social contribution rates, large public wage increases, and increases in spending are estimated to add 3½ percent of GDP to demand in 2008. Staff recommended a re-assessment of the policy package to aim for an unchanged primary balance. But apart from scaling back a proposed abolition of municipal surtaxes and doubling the real estate turn-over tax, the authorities felt bound by political considerations and already announced policy changes.

**Structural balance (in percent of GDP)**

| | 2006 | 2007 | 2008 |
|---|---|---|---|
| | Prel. | Proj. | |
| Overall balance | 2.4 | 5.4 | 2.3 |
| Primary balance | 3.6 | 6.6 | 3.3 |
| Revenues | 44.9 | 50.7 | 48.9 |
| Expenditures | 42.7 | 45.2 | 46.6 |
| Cyclical adjustment | 5.5 | 7.4 | 7.7 |
| Primary balance (structural) | -1.9 | -0.4 | -4.0 |
| Fiscal impulse | 0.4 | -1.5 | 3.6 |

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

27. **Staff suggested that strong fiscal performance should be used to implement difficult but essential public sector reforms.** Staff noted that tax reductions and wage increases will be difficult to claw back when the economy slows, and fiscal space will be needed when large infrastructure projects are ready to be executed. Staff proposed the following:

- **Public administration reforms should accompany the announced wage increases.** Montenegro is not alone in the region in facing the challenge of keeping qualified staff in the public sector as private sector wages increase. The answer is a reform of pay scales and streamlining of the public sector to allow pay to better match skills. The public expenditure review conducted by the World Bank provides useful recommendations for public sector reform.

- **Reassessing tax reforms.** With tax rates already low by international standards, further reform should be undertaken with care and aim at strengthening the revenue base, and preventing distortions by eliminating exemptions and preferences.

- **Increased control of the broader public sector.** Staff recommended that the government more actively exercise its ownership rights in public enterprises and strengthen control of local government spending decisions. In addition, staff proposed to transfer public sector deposits to the central bank to avoid fueling bank credit.

28. **The authorities concurred with the importance of enhancing the monitoring and reduction of fiscal risks.** The government is currently considering the possibility of financing large infrastructure projects through Private-Public Partnerships (PPP), in particular, regional highways. Staff pointed out that while PPPs could be an attractive means of financing they could also generate substantial fiscal risks; and stressed the need to introduce a sound legal and institutional framework, as suggested in earlier technical assistance. The government is contemplating prepayment of restitution claims, and while the discount could be sizeable, staff strongly advised against this due to the potentially sizeable negative impact on domestic demand and risk of unequal treatment of claimants.

### D. Boosting Structural Reforms

29. **The authorities stressed their commitment to structural reform but indicated that forging the necessary consensus is not easy**. They noted that they had made considerable progress in privatization and establishing the legal basis for a business friendly environment.

30. **Staff emphasized the importance of energy reforms to prevent shortages.** Staff stressed that adjustment of electricity tariffs toward market levels was critical for reducing quasi-fiscal losses of about 2½ percent of GDP, and attracting much needed private investment into the sector. The authorities were less convinced of the importance of tariff reform and privatization. However, World Bank staff consulted were concerned that the electricity company had neither the resources nor the know-how to undertake the large investments needed. In addition, the tariff increase of July 2007 was barely sufficient to cover operating costs and regulators explained that it included no allowance for return on capital. More positively, the authorities have completed the financial unbundling of EPCG's

operations into generation, transmission and distribution and were expecting to open up the market in early 2008.

31. **The authorities were in the process of a comprehensive reform of labor legislation.** They explained that the new draft law incorporated key provisions from international conventions. Staff stressed the need for flexibility in collective bargaining (especially allowing separate agreements for individual sectors and opt out clauses), facilitating job mobility, and reducing non-wage costs, which were among the highest in the region.

32. **The authorities confirmed their commitment to improving the business environment.** Staff acknowledged that significant progress had been achieved in improving the business environment but stressed the need for further progress, especially in improving predictability and limiting discretion, setting timely limits in processing applications, upgrading the judiciary, and completing zoning regulations at the municipal level. Staff emphasized the importance of strengthening corporate governance, especially regarding the timely release of financial statements for listed companies, and noted that failure to do so could risk the reputation of the young stock exchange.

33. **The authorities were committed to combating money laundering and the financing of terrorism.** They explained that the framework for AML/CFT was being upgraded and a new law would be submitted to parliament in early 2008.

34. **Economic policy was hampered by deficiencies in macroeconomic statistics.** The weakest area was the real sector, where the implementation of statistical standards has barely kept pace with the increasing data demand. The authorities noted that progress was being made in developing data sources, implementing international standards in statistics methodology, and developing expertise.

## IV. Staff Appraisal

35. **Much is going well.** The economy is booming. Euro adoption has delivered low inflation and anchored expectation, and the discovery of Montenegro as an international tourist destination has drawn massive FDI inflows.

36. **But strong growth is hiding growing vulnerabilities.** The economy is overheating. Rapid credit growth is overstretching banks, and has contributed to ballooning asset prices.

37. **Eroding competitiveness is a concern**. Euro adoption precludes an exchange rate adjustment, but rapidly rising private debt raises the possibility of solvency problems related to asset markets, especially if competitiveness problems stunt Montenegro's tourism potential.

38. **Policy levers are few, but need to be used.** The authorities need to make more active use of those policy instruments available to address demand pressures, reduce vulnerabilities, and ensure a soft landing.

39. **Management of the boom falls on fiscal policy.** However, the preliminary 2008 budget would be expansionary unless revised. The 30 percent public sector wage increase and tax cuts would provide an unhelpful boost to an already overheated economy.

40. **Tax cuts have been procyclical and potentially destabilizing**. Corporate tax cuts, combined with absence of capital gains taxation, only provide investors with a windfall in a country with the enormous potential of Montenegro. Strong import-driven VAT growth should not be seen as providing scope for further tax cuts, as these revenues will eventually fall as import growth slows. The authorities should review ongoing tax reforms to strengthen the tax base and fiscal stabilizers.

41. **Fiscal risks need to be contained.** Paris Club debt reductions have lowered public debt, but the central government should resist assuming large restitution liabilities. Recent efforts to tighten criteria and ensure that property is returned to owners rather than compensated through government bonds are welcome. The authorities also need to guard against the assumption of guarantees and contingent liabilities, including PPPs, to solve their large infrastructure needs.

42. **Better budgetary control is crucial.** Control over local government should be strengthened, and state enterprise quasi-fiscal operations brought on budget.

43. **Absent monetary policy, the main focus of credit policy should be to strengthen banking sector supervision.** Passage of the banking law is the single most important measure to allow for enhanced supervisory practices to be enforced. Attention needs to be given to the monitoring of systemic risks, including real estate prices, and private external debt. Urgent attention is needed to limit risks associated with the highly capitalized stock market.

44. **Completing the transition to market economy should be kept at the top of the policy agenda.** Progress has been made, but energy and labor reforms, two areas critical for ensuring sustained growth, have been patchy at best. Privatization momentum, especially in the electricity sector, needs to be reinvigorated, and more weight given to market-based policies. Labor flexibility is crucial to ensure competitiveness given euroization. The authorities' plans to reform the labor legislation are welcome, but need to address restrictive practices and ensure sufficient weight is given to both private sector and social partners in the planned consultative process.

45. **The authorities need to address the poor state of the statistics**. Important deficiencies and gaps in the national accounts, fiscal, price, and balance of payments

statistics undermine informed policy decisions. Reorganization of the statistical agency is essential if further technical assistance is to be effective.

46. It is recommended that the next Article IV consultation with Montenegro be held on the standard 12-month cycle.

Table 1. Montenegro: Selected Economic Indicators, 2003–09

| | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 |
|---|---|---|---|---|---|---|---|
| | | | Prel. | Est. | | Proj. | |
| Real economy | | | | | | | |
| Nominal GDP (millions of €) 1/ | 1,392 | 1,651 | 1,785 | 1,979 | 2,204 | 2,453 | 2,711 |
| Gross national saving (percent of GDP) | 7.8 | 8.9 | 7.3 | -1.0 | -7.8 | -5.0 | -3.4 |
| Gross investment (percent of GDP) | 15.1 | 16.2 | 16.0 | 29.4 | 29.2 | 27.7 | 25.7 |
| Unemployment rate (in percent) | 22.9 | 22.3 | 19.7 | 13.5 | 11.8 a/ | ... | ... |
| | | | (Annual percentage change) | | | | |
| Real GDP | 2.4 | 4.2 | 4.0 | 6.5 | 7.5 | 7.2 | 5.5 |
| Industrial production | 2.4 | 13.8 | -1.9 | 1.0 | ... | ... | ... |
| Tourism | | | | | | | |
| Arrivals | 10.7 | 17.4 | 16.6 | 16.3 | 19.0 b/ | ... | ... |
| Nights | 7.8 | 14.7 | 14.3 | 13.9 | 22.4 b/ | ... | ... |
| Retail prices (period average) | 7.5 | 3.1 | 3.4 | 2.1 | 3.5 | 4.7 | 4.1 |
| Retail prices (end of period) | 6.2 | 4.2 | 1.8 | 2.0 | 5.0 | 4.5 | 4.0 |
| GDP deflator | ... | ... | 4.0 | 4.1 | 3.6 | 3.8 | 4.7 |
| Average net wage (12-month) | 22.3 | 12.3 | 9.1 | 15.3 | 31.0 a/ | | |
| Money and credit (end of period, 12-month) | | | | | | | |
| Bank credit to private sector | ... | 43.2 | 33.2 | 138.9 | 191.3 a/ | ... | ... |
| Enterprises | ... | 40.6 | 30.2 | 112.2 | 198.4 | ... | ... |
| Households | ... | 49.4 | 39.7 | 193.0 | 180.7 | ... | ... |
| Bank deposits - private sector | ... | 23.0 | 84.2 | 119.5 | 129.4 a/ | ... | ... |
| | | | (In percent of GDP; unless otherwise noted) | | | | |
| General government finances (cash) 2/ | | | | | | | |
| Revenue and grants | 41.8 | 37.8 | 37.4 | 44.9 | 50.7 | 48.9 | 47.7 |
| Expenditure (incl. discrepancy) | 46.6 | 40.5 | 39.1 | 42.5 | 45.2 | 46.6 | 46.4 |
| Overall balance | -4.8 | -2.7 | -1.8 | 2.4 | 5.4 | 2.3 | 1.3 |
| Primary balance | -3.7 | -1.1 | -0.6 | 3.6 | 6.6 | 3.3 | 2.2 |
| Privatization receipts | 2.4 | 0.7 | 8.4 | 4.0 | 2.6 | 2.1 | 2.1 |
| Central government deposits (end-of-period) | 1.6 | 1.1 | 4.1 | 6.2 | 8.9 | 10.7 | 12.7 |
| Net debt (end-of-period) 3/ | 50.3 | 44.8 | 37.5 | 31.5 | 31.6 | 27.9 | 23.1 |
| General government gross debt (end of period, stock) | 51.8 | 45.9 | 41.6 | 37.7 | 40.5 | 38.6 | 35.9 |
| External debt | 33.2 | 29.6 | 28.9 | 26.1 | 22.3 | 21.4 | 20.0 |
| Domestic debt | 18.7 | 16.4 | 12.7 | 11.7 | 18.1 | 17.2 | 15.9 |
| Balance of payments | | | | | | | |
| Current account balance, excl. grants | -11.1 | -10.1 | -8.9 | -30.7 | -37.0 | -33.0 | -29.5 |
| Foreign direct investments | 2.8 | 3.4 | 21.4 | 23.6 | 24.4 | 21.3 | 18.7 |
| External debt (end of period, stock) | 41.2 | 40.4 | 44.6 | 44.9 | 52.8 | 59.4 | 63.3 |
| *Of which:* Private sector | 8.0 | 10.9 | 15.7 | 18.8 | 30.4 | 38.0 | 43.3 |
| REER (wage-based; annual average change, in percent) ( - indicates depreciation) | 4.4 | 6.6 | 7.9 | 7.4 | 3.6 c/ | ... | ... |
| Memorandum: | | | | | | | |
| Aluminum price (€ per tonne) | 1,267 | 1,382 | 1,526 | 2,049 | 1,963 | 1,747 | 1,595 |

Sources: Ministry of Finance, Central Bank of Montenegro, Statistical Office of Montenegro, Employment Agency of Montenegro; and Fund staff estimates and projections.

1/ There is a break in the GDP series in 2005.

2/ Includes extra-budgetary funds and, from 2006, local governments, but not public enterprises.

3/ Gross debt minus deposits; projected path dependent on privatization receipts.

a/ As of September 2007.

b/ As of August 2007.

c/ As of June 2007.

Table 2. Montenegro: Macroeconomic Framework, 2005-12

| | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|---|---|---|---|
| | | Est. | Prel. | | | Proj. | | |
| Real GDP | 4.0 | 6.5 | 7.5 | 7.2 | 5.5 | 5.1 | 4.9 | 4.7 |
| Retail prices (end-period) | 1.8 | 2.0 | 5.0 | 4.5 | 4.0 | 3.5 | 3.0 | 3.0 |
| Gross domestic savings | -1.8 | -7.1 | -10.7 | -8.4 | -7.1 | -6.1 | -5.2 | -3.2 |
| Non-government | -4.1 | -14.8 | -22.2 | -17.3 | -15.4 | -12.8 | -11.2 | -9.2 |
| Government | 2.2 | 7.7 | 11.6 | 8.9 | 8.3 | 6.7 | 6.0 | 5.9 |
| Net factor receipts and transfers from abroad | 9.2 | 6.1 | 2.8 | 3.5 | 3.6 | 3.0 | 2.5 | 2.2 |
| Non-government | 9.0 | 5.9 | 2.7 | 3.2 | 3.3 | 2.7 | 2.1 | 1.8 |
| Government | 0.2 | 0.2 | 0.1 | 0.3 | 0.4 | 0.4 | 0.4 | 0.4 |
| Gross national savings | 7.3 | -1.0 | -7.8 | -5.0 | -3.4 | -3.1 | -2.7 | -1.1 |
| Non-government | 5.0 | -8.9 | -19.5 | -14.1 | -12.2 | -10.2 | -9.0 | -7.4 |
| Government | 2.4 | 7.9 | 11.7 | 9.1 | 8.7 | 7.1 | 6.4 | 6.3 |
| Gross domestic investment | 16.0 | 29.4 | 29.2 | 27.7 | 25.7 | 23.7 | 21.7 | 20.2 |
| Non-government | 11.8 | 23.9 | 23.0 | 20.8 | 18.3 | 15.8 | 13.5 | 11.8 |
| Government | 4.1 | 5.5 | 6.2 | 6.9 | 7.4 | 7.9 | 8.2 | 8.4 |
| Non-government national savings minus investment | -6.9 | -32.8 | -42.5 | -34.9 | -30.5 | -25.9 | -22.6 | -19.2 |
| Savings - investment balance | -8.6 | -30.4 | -37.0 | -32.7 | -29.1 | -26.8 | -24.4 | -21.3 |
| Non-government | -6.9 | -32.8 | -42.5 | -34.9 | -30.5 | -25.9 | -22.6 | -19.2 |
| Government | -1.8 | 2.4 | 5.4 | 2.3 | 1.3 | -0.9 | -1.8 | -2.1 |
| Foreign savings | 8.6 | 30.4 | 37.0 | 32.7 | 29.1 | 26.8 | 24.4 | 21.3 |
| Foreign savings, excluding official grants | 8.9 | 30.7 | 37.0 | 33.0 | 29.5 | 27.2 | 24.8 | 21.3 |
| Memorandum items: | | | | | | | | |
| Net export of goods and services | -17.8 | -36.5 | -39.9 | -36.1 | -32.8 | -29.8 | -26.9 | -23.4 |
| Nominal GDP (millions of €) | 1,785 | 1,979 | 2,204 | 2,453 | 2,711 | 2,968 | 3,222 | 3,495 |

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

Table 3. Montenegro: Consolidated General Government Fiscal Operations, 2004-09 1/
(in percent of GDP)

| | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 |
|---|---|---|---|---|---|---|
| | | Est. | | | Proj. | |
| Total revenues and grants | 37.8 | 37.4 | 44.9 | 50.7 | 48.9 | 47.7 |
| Total revenues | 37.4 | 37.2 | 44.7 | 50.6 | 48.6 | 47.3 |
| Current revenues | 37.2 | 37.0 | 44.2 | 49.9 | 48.5 | 47.2 |
| Taxes | 22.9 | 24.1 | 28.0 | 33.3 | 32.8 | 32.2 |
| Personal income tax | 4.8 | 4.6 | 4.7 | 4.3 | 4.2 | 3.4 |
| Corporate income tax | 1.0 | 1.2 | 0.6 | 1.8 | 1.8 | 1.8 |
| Taxes on property | 0.2 | 0.3 | 1.3 | 2.0 | 1.9 | 2.1 |
| Value added tax | 9.6 | 10.8 | 13.8 | 16.9 | 16.8 | 16.8 |
| Excises | 3.7 | 3.7 | 3.7 | 4.1 | 4.1 | 4.1 |
| Taxes on international trade | 2.2 | 2.3 | 2.9 | 3.1 | 3.0 | 3.0 |
| Local government taxes | 1.2 | 1.1 | 0.9 | 0.9 | 0.8 | 0.8 |
| Other republic taxes | 0.1 | 0.2 | 0.2 | 0.3 | 0.3 | 0.3 |
| Social security contributions | 9.9 | 9.4 | 10.1 | 10.1 | 9.3 | 8.6 |
| Nontax revenues | 4.4 | 3.5 | 6.2 | 6.5 | 6.4 | 6.4 |
| Capital revenues | 0.2 | 0.3 | 0.5 | 0.7 | 0.1 | 0.1 |
| Grants | 0.4 | 0.2 | 0.2 | 0.1 | 0.3 | 0.4 |
| Total expenditures and net lending | 40.3 | 38.8 | 42.7 | 45.2 | 46.6 | 46.4 |
| Total expenditures | 39.5 | 38.2 | 42.2 | 44.9 | 46.5 | 46.3 |
| Current expenditures | 20.2 | 18.3 | 20.3 | 21.8 | 22.6 | 22.0 |
| Gross salaries | 11.4 | 10.6 | 10.4 | 10.5 | 11.4 | 11.1 |
| Other personal income | 1.4 | 1.1 | 1.4 | 1.4 | 1.4 | 1.4 |
| Goods and services | 4.4 | 4.3 | 6.6 | 7.5 | 7.6 | 7.5 |
| Interest payments | 1.6 | 1.2 | 1.2 | 1.1 | 1.0 | 0.9 |
| Rent | 0.1 | 0.3 | 0.2 | 0.3 | 0.3 | 0.3 |
| Subsidies | 0.8 | 0.6 | 0.3 | 0.6 | 0.6 | 0.5 |
| Other outflows | 0.6 | 0.3 | 0.2 | 0.4 | 0.4 | 0.4 |
| Social security transfers | 13.8 | 13.2 | 11.9 | 12.1 | 12.1 | 12.0 |
| Other transfers | 1.5 | 1.6 | 3.7 | 4.1 | 4.2 | 4.2 |
| Capital expenditure | 3.0 | 4.1 | 5.5 | 6.2 | 6.9 | 7.4 |
| Reserves | 1.0 | 1.0 | 0.8 | 0.7 | 0.7 | 0.7 |
| Net lending | 0.8 | 0.7 | 0.4 | 0.3 | 0.1 | 0.1 |
| Discrepancy (+ expenditure) | 0.2 | 0.3 | -0.1 | 0.0 | 0.0 | 0.0 |
| Overall balance | -2.7 | -1.8 | 2.4 | 5.4 | 2.3 | 1.3 |
| Financing | 2.7 | 1.8 | -2.4 | -5.4 | -2.3 | -1.3 |
| Domestic financing | 0.1 | -7.7 | -7.0 | -6.4 | -5.0 | -3.8 |
| Banking system | 0.0 | -2.9 | -3.7 | -4.2 | -3.2 | -3.0 |
| Nonbank | 0.8 | -2.4 | -1.0 | -0.8 | -0.9 | -0.9 |
| T-bills | 1.0 | -1.6 | -0.2 | -0.1 | 0.0 | 0.0 |
| Frozen foreign currency deposits (FFCD) | -0.3 | -0.8 | -0.6 | -0.5 | -0.5 | -0.4 |
| Restitution | 0.0 | 0.0 | -0.2 | -0.2 | -0.4 | -0.5 |
| Domestic arrears | -0.6 | -2.0 | -1.9 | -1.3 | -0.9 | -0.4 |
| Foreign financing | 1.9 | 1.0 | 0.5 | -1.6 | 0.6 | 0.4 |
| Borrowing | 2.0 | 1.3 | 1.3 | 1.3 | 1.3 | 1.0 |
| Repayment | -0.1 | -0.3 | -0.7 | -2.9 | -0.7 | -0.7 |
| Privatization receipts | 0.7 | 8.4 | 4.0 | 2.6 | 2.1 | 2.1 |
| Memorandum items: | | | | | | |
| Overall balance (incl. FFCD and restitution) | -2.9 | -2.5 | 1.7 | 4.7 | 1.3 | 0.5 |
| Primary balance | -1.1 | -0.6 | 3.6 | 6.6 | 3.3 | 2.2 |
| Wage costs (net salaries and other personal income) | 9.0 | 8.2 | 8.3 | 8.4 | 9.2 | 9.2 |
| Gross Domestic Product (millions of euro) | 1,651 | 1,785 | 1,979 | 2,204 | 2,453 | 2,711 |

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

1/ Includes republican budget and extra-budgetary funds; and, from 2006, local governments.

Table 4. Montenegro: Summary of Accounts of the Financial System, 2003–September 2007
(In millions of euros)

| | 2003 | 2004 | 2005 | 2006 | Mar-07 | Jun-07 | Sep-07 |
|---|---|---|---|---|---|---|---|
| | | | I. Central Bank | | | | |
| Net foreign assets | 50.4 | 60.1 | 172.9 | 310.3 | 343.5 | 431.2 | 517.3 |
| Net domestic assets | -49.7 | -59.9 | -171.6 | -307.7 | -340.3 | -427.4 | -512.5 |
| Net credit to the nonfinancial public sector | 2.4 | 2.2 | -39.2 | -57.0 | -89.0 | -137.4 | -191.4 |
| Net credit to the banking system | -30.4 | -39.9 | -99.2 | -233.3 | -232.4 | -266.1 | -291.7 |
| Other assets net | -21.7 | -22.1 | -33.2 | -17.4 | -18.8 | -23.8 | -29.4 |
| Central bank fully backed liabilities | 0.7 | 0.2 | 1.3 | 2.6 | 3.2 | 3.9 | 4.7 |
| | | | II. Banking system | | | | |
| Net foreign assets | 13.4 | -18.7 | 42.2 | -30.8 | -97.4 | -174.1 | -279.7 |
| Net domestic assets | 231.7 | 319.4 | 454.7 | 1,048.7 | 1,314.9 | 1,689.4 | 2,051.3 |
| Net assets held in the central bank | 36.1 | 40.2 | 100.3 | 233.1 | 232.4 | 267.2 | 287.2 |
| Net credit to nonfinancial public sector | 23.8 | 28.5 | 26.0 | 23.7 | 13.6 | -16.3 | 7.6 |
| Credit to the private sector | 170.4 | 244.1 | 325.6 | 779.6 | 1,057.7 | 1,412.9 | 1,722.0 |
| Other domestic assets | 1.4 | 6.7 | 2.8 | 12.2 | 11.2 | 25.6 | 34.5 |
| Liabilities to the private sector | 245.1 | 300.8 | 496.9 | 1,017.9 | 1,217.6 | 1,515.3 | 1,769.8 |
| Deposits | 176.6 | 217.3 | 400.2 | 878.3 | 1,038.3 | 1,292.5 | 1,521.4 |
| Other | 68.5 | 83.5 | 96.7 | 139.6 | 179.3 | 222.8 | 248.4 |
| | | | III. Consolidated System | | | | |
| Net foreign assets | 63.8 | 41.4 | 215.2 | 279.5 | 246.2 | 257.2 | 237.5 |
| Net domestic assets | 181.9 | 259.6 | 283.0 | 741.0 | 974.6 | 1,262.0 | 1,538.8 |
| Net credit to the nonfinancial public sector | 26.2 | 30.7 | -13.3 | -33.3 | -75.4 | -153.7 | -183.8 |
| Credit to the private sector | 170.4 | 244.1 | 325.6 | 779.6 | 1,057.7 | 1,412.9 | 1,722.0 |
| Other net domestic assets | -14.6 | -15.2 | -29.3 | -5.3 | -7.7 | 2.8 | 0.7 |
| Liabilities to the private sector | 245.8 | 301.0 | 498.2 | 1,020.5 | 1,220.8 | 1,519.2 | 1,774.5 |

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

Table 5. Montenegro: Financial Soundness Indicators of the Banking Sector, 2004–June 2007

| | 2004 | 2005 | | 2006 | | | 2007 | |
|---|---|---|---|---|---|---|---|---|
| | Dec. | Jun. | Dec. | Jun. | Sep. | Dec. | Mar. | Jun. |
| Capital adequacy | | | | | | | | |
| Regulatory capital as percent of risk-weighted assets | 31.3 | 28.3 | 27.8 | 20.3 | 16.8 | 21.3 | 18.5 | 18.7 |
| Capital as percent of assets | 20.4 | 17.8 | 15.3 | 14.3 | 12.0 | 10.4 | 10.4 | 9.5 |
| Asset composition and quality | (In percent of total credit) | | | | | | | |
| Distribution of bank credit by borrower | | | | | | | | |
| Central government, local government, government agencies | ... | 4.5 | 7.0 | 5.8 | 5.2 | 4.2 | 3.2 | 2.4 |
| Funds | ... | 5.9 | 3.1 | 2.3 | 3.4 | 2.1 | 1.8 | 1.4 |
| State-owned companies | ... | 4.4 | 5.2 | 4.9 | 2.8 | 2.7 | 2.6 | 1.4 |
| Private companies, entrepreneurs | ... | 58.2 | 56.5 | 53.5 | 51.5 | 52.7 | 54.4 | 56.6 |
| Banks | ... | 0.0 | 0.0 | 0.2 | 0.0 | 0.1 | 1.3 | 1.0 |
| Financial Institutions | ... | 0.6 | 0.0 | 0.7 | 0.6 | 0.7 | 0.3 | 0.5 |
| Citizens | ... | 25.7 | 27.5 | 31.1 | 35.2 | 36.3 | 35.1 | 35.3 |
| Credit Cards | ... | 0.5 | 0.3 | 0.3 | 0.3 | 0.4 | 0.5 | 0.7 |
| Other | ... | 0.3 | 0.3 | 1.3 | 1.0 | 0.9 | 0.7 | 0.8 |
| | (In percent of total credit) | | | | | | | |
| Distribution of bank credit by sectoral economic activity | | | | | | | | |
| Agriculture, Hunting, Fishing | 1.7 | 1.3 | 1.9 | 1.1 | 1.3 | 1.0 | 1.5 | 1.1 |
| Mining and Energy | 2.2 | 3.0 | 2.7 | 2.9 | 1.3 | 1.7 | 2.4 | 2.4 |
| Civil engineering | 5.1 | 5.0 | 5.0 | 5.6 | 8.0 | 7.3 | 9.6 | 10.5 |
| Trade | 41.5 | 28.7 | 34.4 | 36.4 | 29.0 | 31.3 | 23.3 | 22.4 |
| Services, tourism | 6.0 | 9.5 | 7.7 | 4.8 | 8.3 | 7.8 | 7.8 | 7.9 |
| Transport, Warehousing, Communications | 2.1 | 2.9 | 4.4 | 1.5 | 2.6 | 1.5 | 2.4 | 2.5 |
| Finance | 3.4 | 0.8 | 3.0 | 2.2 | 2.9 | 1.1 | 2.3 | 2.1 |
| Real estate trading | 0.3 | 0.4 | 2.9 | 2.4 | 0.9 | 0.8 | 3.5 | 3.6 |
| Administration, other public services | 4.6 | 8.1 | 5.3 | 5.2 | 3.5 | 4.5 | 6.9 | 4.9 |
| Consumer loans | 26.2 | 24.9 | 26.3 | 31.0 | 35.3 | 36.6 | 35.4 | 35.6 |
| Other | 6.8 | 15.5 | 6.6 | 6.8 | 7.0 | 6.6 | 5.0 | 7.0 |
| Asset quality | | | | | | | | |
| Non-performing loans (NPL), in percent of gross loans | 5.2 | 7.0 | 5.3 | 7.0 | 3.6 | 2.9 | 2.0 | 2.0 |
| Provisions, in percent of NPL | 77.3 | 54.5 | 67.4 | 67.4 | 73.3 | 78.8 | 99.0 | 104.1 |
| Provisions, in percent of total loans | 4.0 | 3.8 | 3.6 | 2.7 | 2.6 | 2.2 | 2.0 | 2.0 |
| NPL net of provisions, in percent of capital | 3.6 | 11.3 | 6.1 | 5.9 | 4.7 | 3.5 | 0.1 | -0.6 |
| Earnings and profitability | | | | | | | | |
| Gross profits, in percent of average assets (ROAA) | -0.3 | 2.5 | 0.8 | 0.6 | 1.1 | 1.1 | 1.5 | 1.4 |
| Gross profits, in percent of average equity capital (ROAE) | -1.4 | 13.8 | 5.3 | 4.6 | 6.8 | 6.8 | 12.5 | 11.6 |
| Net interest margin 1/ | 6.9 | 3.4 | 5.4 | 2.6 | 3.1 | 3.5 | 4.0 | 1.8 |
| Gross income, in percent of average assets | 12.3 | 10.3 | 11.1 | 9.5 | 9.2 | 8.9 | 7.6 | 3.9 |
| Net interest income, in percent of gross income | 49.8 | 41.6 | 48.3 | 50.8 | 50.0 | 50.6 | 53.5 | 53.6 |
| Non-interest income, in percent of gross income | 50.2 | 58.4 | 51.7 | 49.2 | 50.0 | 49.4 | 46.5 | 46.4 |
| Net fee income, in percent of net interest income | 84.3 | 66.7 | 75.8 | 71.1 | 77.4 | 75.6 | 63.0 | 62.0 |
| Trading income, in percent of gross income | 8.3 | 30.6 | 15.0 | 13.1 | 11.3 | 11.1 | 12.8 | 13.3 |
| Aggregate overhead expenses, in percent of gross income | 69.3 | 57.2 | 70.0 | 75.2 | 70.4 | 71.9 | 61.1 | 56.1 |
| Liquidity | | | | | | | | |
| Liquid assets, in percent of total assets | 24.2 | 28.7 | 38.4 | 28.8 | 34.8 | 35.8 | 29.1 | 25.4 |
| Liquid assets, in percent of short-term liabilities | 41.0 | 47.3 | 58.7 | 43.0 | 58.0 | 63.0 | 48.7 | 43.0 |
| Deposits, in percent of assets | 61.5 | 65.6 | 70.1 | 73.0 | 73.4 | 75.2 | 75.0 | 74.5 |
| Loans, in percent of deposits | 103.0 | 95.8 | 77.1 | 88.1 | 80.7 | 78.8 | 88.6 | 95.0 |
| Sensitivity to market risk | | | | | | | | |
| Original maturity of assets (in percent of total) | | | | | | | | |
| Less than 3 months | ... | 48.9 | 56.8 | 49.3 | 46.2 | 45.3 | 37.3 | 34.3 |
| 3 months to 1 year | ... | 25.4 | 17.4 | 22.4 | 23.8 | 18.1 | 18.9 | 19.9 |
| 1 to 5 years | ... | 22.9 | 22.0 | 21.3 | 21.9 | 25.6 | 34.1 | 31.5 |
| Over 5 years | ... | 2.8 | 3.8 | 7.0 | 8.1 | 11.0 | 9.8 | 14.4 |
| Original maturity of liabilities (in percent of total) | | | | | | | | |
| Less than 3 months | ... | 52.2 | 60.4 | 54.4 | 43.9 | 46.4 | 39.9 | 41.8 |
| 3 months to 1 year | ... | 24.3 | 16.0 | 24.4 | 25.0 | 22.5 | 27.7 | 24.6 |
| 1 to 5 years | ... | 22.3 | 19.1 | 16.8 | 22.1 | 24.6 | 25.0 | 25.4 |
| Over 5 years | ... | 1.3 | 2.9 | 4.5 | 9.0 | 6.5 | 7.4 | 8.3 |

Source: Central Bank of Montenegro

1/ Net interest income in percent of interest bearing assets

Table 6. Montenegro: Balance of Payments, 2004–12 1/
(In millions of euros)

| | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|---|---|---|---|---|
| | Est. | Est. | Est. | | | Proj. 2/ | | | |
| Current account balance (incl. grants) | -120 | -154 | -601 | -816 | -802 | -790 | -795 | -785 | -743 |
| Trade balance | -416 | -514 | -938 | -1,303 | -1,487 | -1,556 | -1,613 | -1,663 | -1,712 |
| Exports f.o.b. | 452 | 461 | 559 | 577 | 617 | 664 | 708 | 754 | 805 |
| *Of which:* Aluminum | 184 | 186 | 215 | 235 | 241 | 224 | 214 | 203 | 207 |
| Imports c.i.f. | -869 | -974 | -1,498 | -1,880 | -2,104 | -2,220 | -2,321 | -2,416 | -2,517 |
| Services Balance (non-factor services, net) | 148 | 196 | 216 | 425 | 600 | 667 | 727 | 797 | 893 |
| Receipts | 250 | 330 | 434 | 670 | 899 | 1,002 | 1,112 | 1,237 | 1,368 |
| *Of which:* Tourism | 172 | 222 | 288 | 518 | 735 | 837 | 945 | 1,061 | 1,178 |
| Expenditure | -101 | -134 | -217 | -245 | -299 | -335 | -385 | -441 | -474 |
| Net factor income | -40 | -44 | -26 | -47 | -61 | -67 | -73 | -80 | -86 |
| Unrequited transfers, net | 188 | 208 | 147 | 108 | 145 | 166 | 164 | 161 | 162 |
| Current account balance (excl. grants) | -166 | -160 | -608 | -816 | -808 | -801 | -807 | -798 | -743 |
| Capital and Financial account balance | 68 | 366 | 645 | 843 | 796 | 763 | 749 | 727 | 689 |
| Financial account | 68 | 366 | 659 | 843 | 796 | 763 | 749 | 727 | 689 |
| Foreign direct investment, net | 56 | 381 | 467 | 539 | 523 | 508 | 453 | 414 | 367 |
| Portfolio investment , net | 6 | 5 | -4 | 6 | 12 | 15 | 19 | 25 | 26 |
| Other investments | 95 | -20 | 210 | 298 | 262 | 241 | 277 | 288 | 295 |
| Errors and omissions | 61 | -99 | 93 | 46 | 0 | 0 | 0 | 0 | 0 |
| Overall balance | 10 | 113 | 137 | 72 | 106 | 128 | 106 | 87 | 76 |
| Financing | -10 | -113 | -137 | -72 | -106 | -128 | -106 | -87 | -76 |
| Net foreign assets (increase, -) | -10 | -113 | -137 | -72 | -106 | -128 | -106 | -87 | -76 |
| Arrears (reduction, -) | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Memorandum items: | | | | | | | | | |
| | | | | | In percent of GDP | | | | |
| Current account balance | -7.2 | -8.6 | -30.4 | -37.0 | -32.7 | -29.1 | -26.8 | -24.4 | -21.3 |
| Excluding official grants | -10.1 | -8.9 | -30.7 | -37.0 | -33.0 | -29.5 | -27.2 | -24.8 | -21.3 |
| Trade balance | -25.2 | -28.8 | -47.4 | -59.1 | -60.6 | -57.4 | -54.3 | -51.6 | -49.0 |
| Service balance | 9.0 | 11.0 | 10.9 | 19.3 | 24.5 | 24.6 | 24.5 | 24.7 | 25.6 |
| | | | | | 12-month growth rates (value) | | | | |
| Export | 67.1 | 1.9 | 21.4 | 3.2 | 6.9 | 7.6 | 6.7 | 6.4 | 6.8 |
| Import | 37.9 | 12.2 | 53.7 | 25.5 | 11.9 | 5.5 | 4.6 | 4.1 | 4.2 |
| Tourism revenues | 26.4 | 29.4 | 29.8 | 79.7 | 41.9 | 13.9 | 13.0 | 12.2 | 11.1 |

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

1/ BOP compilation methods have been changed in 2006, including the recording system for trade data and treatment of income transfer of foreign workers. Therefore direct comparison with 2005 may not be feasible.

Table 7. Montenegro: Indicators of External and Financial Vulnerability
(In percent of GDP; unless otherwise indicated)

| | 2004 | 2005 | 2006<br>Est. | 2007<br>Proj. |
|---|---|---|---|---|
| Financial indicators | | | | |
| General government debt | 45.9 | 41.6 | 37.7 | 40.5 |
| Deposit money (percent change, 12-month basis) 1/ | -71.4 | 532.4 | 106.5 | 129.6 |
| Private sector credit (percent change, 12-month basis) 1/ | 43.3 | 33.4 | 139.4 | 174.5 |
| 91 day T-bill yield 1/ | 10.4 | 5.8 | 1.2 | 0.7 |
| External indicators | | | | |
| Exports (percent change, 12-month basis) | 67.1 | 1.9 | 21.4 | 3.2 |
| Imports (percent change, 12-month basis) | 37.9 | 12.2 | 53.7 | 25.5 |
| Current account balance | -7.2 | -8.6 | -30.4 | -37.0 |
| Capital and financial account balance | 4.1 | 20.5 | 32.6 | 38.2 |
| *Of which:* Foreign direct investment | 3.4 | 21.4 | 23.6 | 24.4 |
| Gross official reserves (in euros) | 60.1 | 172.9 | 310.3 | 432.3 |
| Central Bank short-term foreign liabilities (in US$) | 0.0 | 0.0 | 0.0 | 0.0 |
| Official reserves in months of imports GS | 0.8 | 2.1 | 2.7 | 3.4 |
| Total external debt | 40.4 | 44.6 | 44.9 | 52.8 |
| *Of which:* General government | 29.6 | 28.9 | 26.1 | 22.3 |
| Exchange rate (US$ per euro, period average) 2/ | 1.2 | 1.2 | 1.3 | 1.4 |
| REER appreciation (-) (RPI based, 12 month basis) 2/ | 3.5 | -2.8 | -5.3 | -4.9 |
| Financial market indicators | | | | |
| Stock market index | 115.1 | 463.1 | 918.9 | 2351.1 |
| Spread of benchmark bonds (basis points, end of period) | … | … | … | … |

Sources: Central Bank of Montenegro, Ministry of Finance; and Fund staff estimates and projections.

1/ End-September 2007.

2/ End-July 2007.

## Appendix I: Montenegro—General Government Debt Sustainability Analysis

1. The monitoring of general government debt has improved significantly, with the debt management department of the Ministry of Finance taking a leading role in clarifying and making public the debt situation.

2. This debt sustainability analysis includes gross public debt that is recognized by the authorities and covers the general government.[1] Estimates of the liabilities from the restitution process are included. Parliament has limited the overall liabilities stemming from restitution to a maximum of 10 percent of GDP through amendments to the restitution law. For 2007, ca. €150 million is added to government liabilities. Debt of municipal governments has been revised upwards on account of recognition of domestic payment arrears (ca. €20 million). The discussions between Serbia and Montenegro on the division of external debt are not yet final, and under the current scenario, debt equivalent to €20 million is added in 2007 on account of assumed debt from the former State Union.[2] The government has also decided to compensate confiscated foreign savings of Montenegrin citizens in banks outside Montenegro[3] and, possibly, for losses incurred in the pyramid-schemes (additional €18 and €10 million are included in the current scenario). There is still uncertainty regarding debt of public enterprises from before the reconstitution of the Union between Serbia and Montenegro that ultimately could become a liability of the government. Montenegro has also decided to pre-pay World Bank debt. In September, a payment of €19 million was made, and the current scenario assumes that an additional early re-payment of €38 million will be effected before the end of 2007.

3. Under the baseline scenario, Montenegro's debt-to-GDP ratio would decline to below 30 percent of GDP in 2012 (Table 1). The primary balance is projected to improve with the current upswing in the economy. However, a weakening of the automatic stabilizers through tax rate reductions and expansion of the public sector will slow the pace of debt reduction. Nominal interest rates, while low due to the high share of relatively cheap domestic and foreign debt, are projected to reach 3½ percent on account of the government taking on a higher proportion of debt on non-IDA terms, and robust real economic growth will strengthen the automatic debt dynamics. Privatization revenues are expected to decrease following the windfall in 2005–08.

4. The standard stress tests were performed using the methodology adopted in July 2005 (Information Note on Modifications to the Fund's Debt sustainability Assessment Framework for market access Countries-http://www-imf.org/external/np/pp/eng/205/070105.htm), but with modifications due to data constraints. Relevant economic information for Montenegro prior

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[1] The central government, social funds (pension, health and employment) and local governments. Debt of state-owned enterprises is included only as so far it is explicitly recognized as a liability of the government.

[2] Debt expected to be assumed by the Republic of Montenegro is toward Kuwait, Libya, Czech Republic, and Slovakia.

[3] This goes beyond the previous compensation that applied only to foreign savings confiscated by banks in Montenegro, and, in principle, the Montenegro government will have a claim on the countries in which these banks reside.

to 2002 does not exist, and estimates for 2002–06 are used for historical averages and standard deviations.

5. The standard stress tests result in a slower reduction of debt in the medium-term, but not a reversal (Figure 1), and the debt path is robust to most adverse scenarios. Montenegro, however, is facing large risks due to external concentration in trade and uncertainties in real debt levels; and euroization limits the economy's flexibility to respond to a shock. To test the limits of the debt dynamics the standard shocks applied to real interest rate, growth rate and primary balance was doubled, and 20 percent of GDP was added to the debt stock in 2008, reflecting possible hidden debt or addition of new liabilities (Figure 2). In this scenario, debt sustainability is particularly sensitive to growth and fiscal shocks, while less sensitive to interest and exchange rate shocks (due to the relatively low interest rates on existing debt stock and a small share of debt denominated in non-euro currencies). Thus, the relatively high sensitivity to changes in growth and fiscal policy reinforces the importance of continued structural reforms and a prudent fiscal stance.

Table A1. Montenegro: General Government Debt Sustainability Framework, 2003-2012
(Percent of GDP, unless otherwise indicated)

| | Actual | | | | Projections | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | Debt-stabilizing primary balance 9/ |
| Baseline: Public sector debt 1/ | 51.8 | 45.9 | 41.6 | 37.7 | 40.5 | 38.6 | 35.9 | 32.8 | 30.0 | 29.3 | -2.2 |
| *Of which:* foreign-currency denominated | 5.2 | 4.6 | 4.2 | 3.8 | 4.0 | 3.9 | 3.6 | 3.3 | 3.0 | 2.9 | |
| | | | | | | | | | | | |
| Change in public sector debt | -37.6 | -5.9 | -4.4 | -3.8 | 2.7 | -1.9 | -2.7 | -3.1 | -2.8 | -0.7 | |
| Identified debt-creating flows (4+7+12) | -35.1 | -0.5 | -9.4 | -9.7 | -2.0 | -6.3 | -5.8 | -2.5 | -1.0 | -0.7 | |
| Primary deficit | 3.7 | 1.1 | 0.6 | -3.6 | -6.6 | -3.3 | -2.2 | 0.1 | 1.1 | 1.4 | |
| Revenue and grants | 41.8 | 37.8 | 37.4 | 44.9 | 50.7 | 48.9 | 47.7 | 45.4 | 44.5 | 44.3 | |
| Primary (noninterest) expenditure | 45.6 | 38.9 | 38.0 | 41.3 | 44.1 | 45.6 | 45.5 | 45.5 | 45.6 | 45.7 | |
| Automatic debt dynamics 2/ | -4.7 | -0.9 | -1.6 | -3.4 | -2.7 | -2.8 | -2.4 | -2.0 | -1.5 | -1.4 | |
| Contribution from interest rate/growth differential 3/ | -3.1 | -0.3 | -2.3 | -2.9 | -2.7 | -2.8 | -2.4 | -2.0 | -1.5 | -1.4 | |
| *Of which:* contribution from real interest rate | -1.0 | 1.8 | -0.6 | -0.4 | -0.2 | -0.2 | -0.5 | -0.3 | -0.1 | -0.1 | |
| *Of which:* contribution from real GDP growth | -2.0 | -2.1 | -1.7 | -2.4 | -2.5 | -2.6 | -1.9 | -1.7 | -1.5 | -1.3 | |
| Contribution from exchange rate depreciation 4/ | -1.6 | -0.6 | 0.7 | -0.5 | ... | ... | ... | ... | ... | ... | |
| Other identified debt-creating flows | -34.1 | -0.7 | -8.4 | -2.7 | 7.3 | -0.2 | -1.2 | -0.6 | -0.6 | -0.8 | |
| Privatization receipts (negative) | -2.4 | -0.7 | -8.4 | -4.0 | -2.6 | -2.1 | -2.1 | -1.5 | -1.4 | -1.4 | |
| Recognition of implicit or contingent liabilities | 0.0 | 0.0 | 0.0 | 2.6 | 9.8 | 1.9 | 0.9 | 0.9 | 0.8 | 0.5 | |
| Other (Paris Club rescheduling 2003 and 2006) | -31.7 | 0.0 | 0.0 | -1.3 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | |
| Residual, including asset changes (2-3) 5/ | -2.5 | -5.4 | 5.0 | 5.8 | 4.7 | 4.5 | 3.1 | -0.6 | -1.8 | 0.1 | |
| | | | | | | | | | | | |
| Public sector debt-to-revenue ratio 1/ | 123.8 | 121.5 | 111.2 | 84.0 | 79.9 | 79.0 | 75.2 | 72.2 | 67.3 | 66.2 | |
| | | | | | | | | | | | |
| Gross financing need 6/ | 4.8 | 2.6 | 1.4 | -3.1 | -8.3 | -3.0 | -2.0 | 0.2 | 1.1 | 1.4 | |
| In billions of U.S. dollars | 74.8 | 52.4 | 32.2 | -77.9 | -246.6 | -99.8 | -75.4 | 9.0 | 50.5 | 69.6 | |
| | | | | | | | | | | | |
| Scenario with key variables at their historical averages 7/ | | | | | 40.5 | 43.9 | 44.8 | 42.4 | 38.8 | 37.1 | -2.3 |
| Scenario with no policy change (constant primary balance) in 2007-2012 | | | | | 40.5 | 43.9 | 40.3 | 32.8 | 24.7 | 18.7 | 0.8 |
| | | | | | | | | | | | |
| Key macroeconomic and fiscal assumptions underlying baseline | | | | 0.0 | | | | | | | |
| | | | | | | | | | | | |
| Real GDP growth (in percent) | 2.4 | 4.2 | 4.0 | 6.5 | 7.5 | 7.2 | 5.5 | 5.1 | 4.9 | 4.7 | |
| Average nominal interest rate on public debt (in percent) 8/ | 1.3 | 3.6 | 2.7 | 3.2 | 3.4 | 3.5 | 3.5 | 3.5 | 3.5 | 3.5 | |
| Average real interest rate (nominal rate minus change in GDP deflator, in percent) | -1.1 | 3.6 | -1.2 | -0.8 | -0.2 | -0.4 | -1.3 | -0.7 | 0.0 | -0.1 | |
| Nominal appreciation (increase in US dollar value of local currency, in percent) | 20.7 | 9.1 | -11.6 | 11.4 | ... | ... | ... | ... | ... | ... | |
| Inflation rate (GDP deflator, in percent) | 2.4 | 0.0 | 4.0 | 4.1 | 3.6 | 3.8 | 4.7 | 4.2 | 3.5 | 3.6 | |
| Growth of real primary spending (deflated by GDP deflator, in percent) | 25.6 | 1.3 | 1.5 | 15.8 | 14.7 | 10.9 | 5.2 | 5.2 | 5.1 | 4.9 | |
| Primary deficit | 3.7 | 1.1 | 0.6 | -3.6 | -6.6 | -3.3 | -2.2 | 0.1 | 1.1 | 1.4 | |

1/ Gross debt, including central government, social funds and local governments

2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; $\pi$ = growth rate of GDP deflator; g = real GDP growth rate; $\alpha$ = share of foreign-currency denominated debt; and $\varepsilon$ = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as -g.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.

5/ For projections, this line includes exchange rate changes.

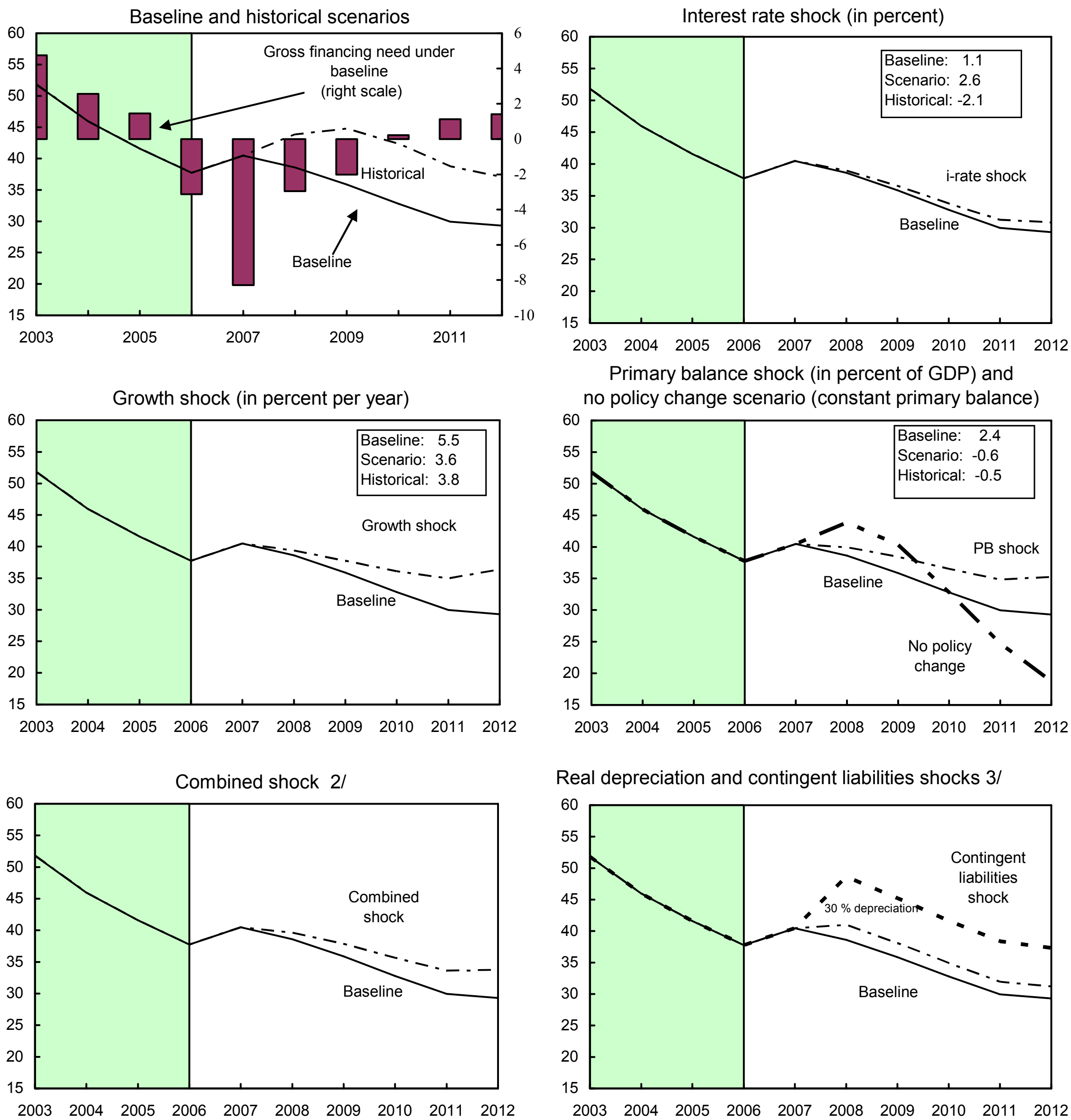
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

8/ Derived as nominal interest expenditure divided by previous period debt stock.

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

Figure A1. Montenegro: General Government Debt Sustainability: Bound Tests 1/
(Public debt, percent of GDP)



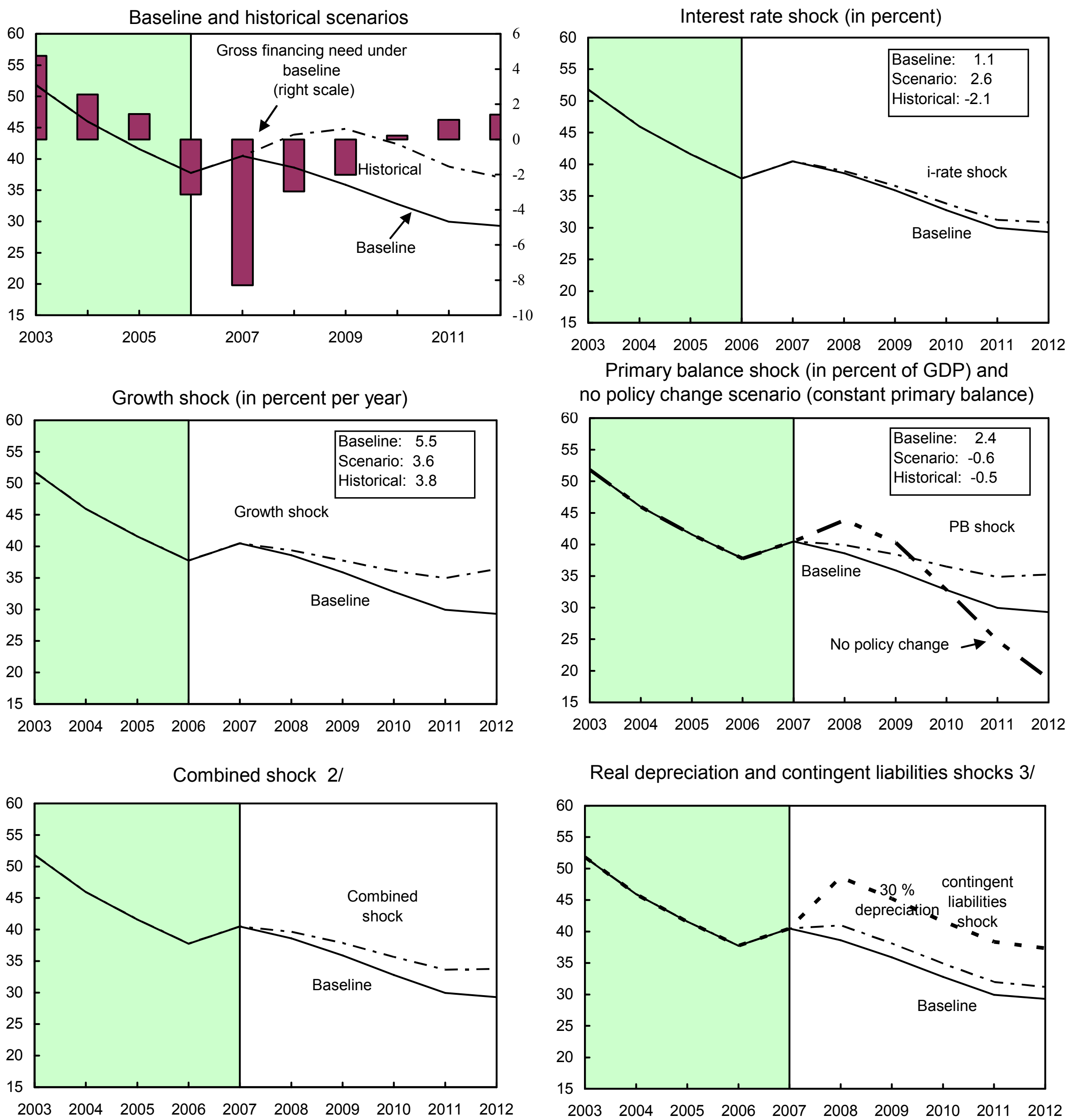

Sources: International Monetary Fund, country desk data, and staff estimates.

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

3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2008, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Figure A2. Montenegro: General Government Debt Sustainability: Bound Tests 1/
(Public debt, percent of GDP)




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

1/ Shaded areas represent actual data. Individual shocks are permanent one 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/ Permanent 1/2 standard deviation shocks applied to real interest rate, growth rate, and primary balance.

3/ One-time real depreciation of 30 percent and 20 percent of GDP shock to contingent liabilities occur in 2008, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

## Appendix II. Montenegro—External Debt Sustainability

1. Montenegro's external public debt is low. Since the debt restructuring by Paris Club and bilateral donors in 2003, which almost halved external public debt to around 33 percent of GDP, the public external debt has continued to decline. Montenegro also benefited from another debt write-off by Paris Club creditors in 2006, which contributed to total external public debt falling to about 26 percent of GDP.

2. The data on private external debt is weak; however, staff and the authorities' estimates indicate that external private debt has been increasing rapidly since 2006 which warrants cautious monitoring. Based on available data so far, private external debt is expected to jump from 19 percent of GDP in 2006 to 30 percent in 2007. Commercial bank debt accounted for just under half of the increase, with financial institutions taking advantage of improved access to international capital markets and foreign bank branches in Montenegro borrowing from headquarters abroad. The remainder of the increase may partly reflect hidden FDI, with the debt later converted to equity. The mission has stressed the need to maintain record of private debt stock.

3. The macroeconomic framework projects real growth to slow down gradually, while the current account situation improves with a fall in FDI related imports, and strong tourism earnings. Under the baseline scenario, the debt-to-GDP ratio increases from about 53 percent in 2007 to 59 percent in 2008 and continues to grow to reach 74 percent by 2012. During this period, the external *public* debt declines from 22 percent to 16 percent. Meanwhile, the private sector is expected to replace the role of FDI and pushing up the *private* external debt to 38 percent by 2008 and continue upwards to reach 58 percent by 2012. An alternative scenario with key variables at their historical average shows an *improvement* in external debt because of exceptionally high FDI. Scenarios with higher interest and a worsening current account indicate less favorable debt path, especially for the latter shock. A large real depreciation would boost exports, and lead to a significant improvement in the debt position.

Table A1. Montenegro: External Debt Sustainability Framework, 2004-2012
(In percent of GDP, unless otherwise indicated)

| | Actual | | | Projections | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | **Debt-stabilizing** |
| **Baseline: External debt** | 40.4 | 44.6 | 44.9 | **52.8** | **59.4** | **63.3** | **66.9** | **70.2** | **74.1** | **-15.5** |
| Change in external debt | -0.7 | 4.2 | 0.3 | 7.9 | 6.7 | 3.9 | 3.6 | 3.3 | 3.9 | |
| Identified external debt-creating flows (4+8+9) | -1.2 | -20.3 | -14.4 | 7.0 | 5.8 | 5.3 | 7.1 | 7.1 | 7.0 | |
| Current account deficit, excluding interest payments | 5.3 | 9.1 | 27.3 | 35.1 | 31.5 | 28.0 | 25.7 | 23.3 | 19.2 | |
| Deficit in balance of goods and services | 15.1 | 18.7 | 34.7 | 39.2 | 36.1 | 32.7 | 29.7 | 26.8 | 23.3 | |
| Exports | 39.4 | 46.5 | 47.7 | 55.7 | 61.7 | 61.3 | 61.1 | 61.5 | 61.9 | |
| Imports | 54.5 | 65.2 | 82.3 | 94.9 | 97.7 | 94.0 | 90.8 | 88.3 | 85.2 | |
| Net non-debt creating capital inflows (negative) | -3.2 | -31.2 | -34.8 | -26.6 | -23.4 | -20.8 | -16.7 | -14.2 | -11.2 | |
| Automatic debt dynamics 1/ | -3.4 | 1.9 | -6.9 | -1.6 | -2.2 | -1.9 | -1.9 | -2.0 | -1.0 | |
| Contribution from nominal interest rate | 1.6 | 0.0 | 1.6 | 1.3 | 1.2 | 1.1 | 1.0 | 1.0 | 2.0 | |
| Contribution from real GDP growth | -1.5 | -1.7 | -2.3 | -2.9 | -3.4 | -2.9 | -2.9 | -3.0 | -3.0 | |
| Contribution from price and exchange rate changes 2/ | -3.4 | 3.5 | -6.1 | ... | ... | ... | ... | ... | ... | |
| Residual, incl. change in gross foreign assets (2-3) 3/ | 0.5 | 24.5 | 14.7 | 0.9 | 0.9 | -1.5 | -3.5 | -3.8 | -3.0 | |
| External debt-to-exports ratio (in percent) | 102.6 | 95.8 | 94.2 | 94.8 | 96.4 | 103.3 | 109.5 | 114.1 | 119.7 | |
| **Gross external financing need (in billions of US dollars) 4/** | 0.2 | 0.3 | 0.7 | 1.0 | 1.1 | 1.0 | 1.1 | 1.1 | 1.0 | |
| in percent of GDP | 9.5 | 11.9 | 25.0 | 32.4 | 31.4 | 27.8 | 25.7 | 23.3 | 20.1 | |
| **Scenario with key variables at their historical averages 5/** | | | | **52.8** | **40.5** | **28.2** | **15.5** | **3.8** | **0.0** | **-22.4** |
| **Key Macroeconomic Assumptions Underlying Baseline** | | | | | | | | | | |
| Real GDP growth (in percent) | 4.2 | 4.0 | 6.5 | 7.5 | 7.2 | 5.5 | 5.1 | 4.9 | 4.7 | |
| GDP deflator in US dollars (change in percent) | 9.1 | -8.1 | 16.0 | 7.5 | 4.2 | 5.3 | 5.0 | 4.4 | 4.6 | |
| Nominal external interest rate (in percent) | 4.4 | 0.0 | 4.4 | 3.4 | 2.5 | 2.0 | 1.8 | 1.6 | 3.1 | |
| Growth of exports (US dollar terms, in percent) | 67.1 | 12.9 | 26.6 | 35.0 | 23.7 | 10.4 | 10.0 | 10.4 | 10.1 | |
| Growth of imports (US dollar terms, in percent) | 50.3 | 14.5 | 55.9 | 33.2 | 15.0 | 6.8 | 6.6 | 6.5 | 5.7 | |
| Current account balance, excluding interest payments | -5.3 | -9.1 | -27.3 | -35.1 | -31.5 | -28.0 | -25.7 | -23.3 | -19.2 | |
| Net non-debt creating capital inflows | 3.2 | 31.2 | 34.8 | 26.6 | 23.4 | 20.8 | 16.7 | 14.2 | 11.2 | |

1/ Derived as [r - g - ρ(1+g) + εα(1+r)]/(1+g+ρ+gρ) times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, γ = ρεαλ ΓΔΠ γροωτη ρατε, ε = nominal appreciation (increase in dollar value of domestic currency), and α = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as [-ρ(1+g) + εα(1+r)]/(1+g+ρ+gρ) times previous period debt stock. ρ increases with an appreciating domestic currency (ε > 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.

Appendix III

INTERNATIONAL MONETARY FUND

***Public Information Notice***

EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 08/XXX
FOR IMMEDIATE RELEASE
January XX, 2008

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

## IMF Executive Board Concludes 2007 Article IV Consultation with Republic of Montenegro

On January 16, 2008, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Republic of Montenegro.[6]

### Background

Independence and huge tourism potential have generated impressive investor interest in Montenegro and kick started a recovery with growth expected to reach 7½ percent in 2007. Much of this can be attributed to fiscal consolidation and structural reforms over the last few years.

But strong growth, and the exuberance it has generated, has brought its own challenges. There are signs of overheating, with inflation and wages picking up, and the current account deficit soaring. Vulnerabilities are also building up with rapid credit growth weakening private sector balance sheets, and an asset price boom.

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[6] 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. 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.

The current account deficit is expected to widen further in 2007 to 37 percent of GDP driven by high investment (spurred by FDI, which has hovered around 24 percent of GDP in the past few years) and low savings associated with wealth effects and credit expansion. The share of foreign credits in the financing of the current account deficit has risen. Rising labor costs have been eroding competitiveness.

Rapid credit growth is testing the capacity of the young banking system to prudently assess and manage credit risks. Capital injections have kept the capital adequacy ratio at 18.7 percent of risk weighted assets, which is high by international standards. Banking regulation and supervision is relatively strong. The Central Bank has moved quickly to strengthen prudential regulations, but crucial bank laws have been delayed.

Strong revenue performance and fiscal consolidation have boosted the fiscal surplus, but tax cuts have weakened the impact of automatic stabilizers. The public sector wage increase of 30 percent to be implemented in steps starting from October 2007 will provide an additional fiscal stimulus if not offset.

**Executive Board Assessment**

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***Public Information Notices (PINs)*** form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

## Montenegro: Selected Economic Indicators, 2003–07

| | 2003 | 2004 | 2005 | 2006 Est. | 2007 Proj. |
|---|---|---|---|---|---|
| Real economy | (Percent change; unless otherwise noted) | | | | |
| Nominal GDP (millions of €) | 1,392 | 1,651 | 1,785 | 1,979 | 2,204 |
| Unemployment rate (in percent) | 22.9 | 22.3 | 19.7 | 13.5 | 11.8 a/ |
| Real GDP | 2.4 | 4.2 | 4.0 | 6.5 | 7.5 |
| Tourism | | | | | |
| Arrivals | 10.7 | 17.4 | 16.6 | 16.3 | 19.0 b/ |
| Nights | 7.8 | 14.7 | 14.3 | 13.9 | 22.4 b/ |
| Retail prices (period average) | 7.5 | 3.1 | 3.4 | 2.1 | 3.5 |
| Money and credit (end of period, 12-month) | (Percent change) | | | | |
| Bank credit to private sector | ... | 43.2 | 33.2 | 138.9 | 191.3 a/ |
| Enterprises | ... | 40.6 | 30.2 | 112.2 | 198.4 |
| Households | ... | 49.4 | 39.7 | 193.0 | 180.7 |
| Bank deposits - private sector | ... | 23.0 | 84.2 | 119.5 | 129.4 a/ |
| General government finances (cash) | (In percent of GDP) | | | | |
| Revenue and grants | 41.8 | 37.8 | 37.4 | 44.9 | 50.7 |
| Expenditure (incl. discrepancy) | 46.6 | 40.5 | 39.1 | 42.5 | 45.2 |
| Overall balance | -4.8 | -2.7 | -1.8 | 2.4 | 5.4 |
| Primary balance | -3.7 | -1.1 | -0.6 | 3.6 | 6.6 |
| Gross debt | 51.8 | 45.9 | 41.6 | 37.7 | 40.5 |
| Balance of payments | (In percent of GDP) | | | | |
| Current account balance, excl. grants | -11.1 | -10.1 | -8.9 | -30.7 | -37.0 |
| Foreign direct investments | 2.8 | 3.4 | 21.4 | 23.6 | 24.4 |
| Exchange rate regime | The euro is the legal tender | | | | |
| Exchange rate, U.S.$/€ (period average) | 1.13 | 1.24 | 1.25 | 1.26 | ... |
| REER (wage-based; annual average change, in percent) ( - indicates depreciation) | 4.4 | 6.6 | 7.9 | 7.4 | 3.6 c/ |

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

a/ As of September 2007.
b/ As of August 2007.
c/ As of June 2007.