

**FOR  
AGENDA**

SM/07/388  
Supplement 1

December 17, 2007

To: Members of the Executive Board

From: The Secretary

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

The attached informational annex is being issued as a supplement to the staff report for the 2007 Article IV consultation with the Republic of Montenegro (SM/07/388, 12/17/07), 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.

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INTERNATIONAL MONETARY FUND

REPUBLIC OF MONTENEGRO

**Staff Report for 2007 Article IV Consultation—Informational Annexes**

Prepared by the European Department

December 14, 2007

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**ANNEX I. MONTENEGRO: FUND RELATIONS<sup>1</sup>**  
(As of October 31, 2007)

**Article IV Consultation.** The discussions were initiated during April 18–May 4, 2007, at which time the possibility of a precautionary Stand-by was discussed. The authorities determined that an arrangement was not needed at this time, and the Article IV consultation discussions were finalized during October 4–17, 2007. The team comprised of Messrs. Justice (head), Alvesson, Gagales (all EUR), Ms. Kim (PDR), Mr. Capuano (MCM), Mr. Norregaard (FAD), Ms. Mantcheva (STA), Mr. Lalonde (LEG), and Mr. Hirschhofer (resident representative). Mr. Christofides and Ms. Cerovic from the Executive Directors’s office participated in the discussions. Mr. Driessen (MCM) joined the mission on April 19–20 to present the conclusions of the FSAP. The mission met with Prime Minister Sturanovic, Deputy Prime Minister Lasovic, Finance Minister Luksic, Economy Minister Gvozdenovic, Labor Minister Radanovic, Tourism and Environment Minister Nenezic, Governor Krgovic of the Central Bank of Montenegro, Minister of Transport Lompar, and other senior officials. A press conference was held at the mission’s end.

Montenegro has accepted the obligations of Article VIII, Sections 2, 3, and 4, and the mission raised the need for a comprehensive examination of Montenegro’s exchange system.

**I. Membership Status:** Joined: 01/18/07; Article VIII

|   |                    |                     |
|---|--------------------|---------------------|
| <b>II. General Resources Account:</b>       | <u>SDR Million</u> | <u>% Quota</u>      |
| Quota                                       | 27.50              | 100.00              |
| Fund Holdings of Currency                   | 20.90              | 76.00               |
| Reserve position in Fund                    | 6.60               | 24.00               |
| <b>III. SDR Department:</b>                 | <u>SDR Million</u> | <u>% Allocation</u> |
| Holdings                                    | 0.07               | N/A                 |
| <b>IV. Outstanding Purchases and Loans:</b> | None               |                     |
| <b>V. Financial Arrangements:</b>           | None               |                     |

<sup>1</sup> Updated information relating to members’ positions in the Fund can be found on the IMF web site (<http://www.imf.org/external/np/fin/tad/exfin1.aspx>).

**VI. Exchange Rate Arrangement:** Exchange arrangement with no separate legal tender. The euro is the legal tender. Montenegro has accepted the obligations of Article VIII, Sections 2, 3, and 4, and awaits a comprehensive examination of the exchange system.

**VII. Article IV Consultation:** Montenegro is proposed to be put on a 12 month cycle. This is the first Article IV consultation.

**VIII. FSAP Participation and ROSCs:** A Financial Sector Assessment Program, initiated in July 2006 jointly with the World Bank, and was concluded during the current Article IV consultation.

**IX. Technical Assistance:**

|         |              |  |
|---------|--------------|--|
| MFD/FAD | July 2005    | Management of Proceeds of Privatization and Review of PFM (Montenegro)               |
| FAD     | April 2006   | Assessment of state-owned enterprises under the World Bank Public Expenditure Review |
| STA     | June 2006    | Monetary and financial statistics  |
| FAD     | January 2007 | Peripatetic advisor on debt management   |
| FAD     | March 2007   | Fiscal risk assessment of Private Public Partnership                                 |
| FAD     | April 2007   | Tax administration   |
| STA     | April 2007   | Real sector statistics   |
| MCM     | October 2007 | Emergency liquidity management   |

**X. Resident Representative:** Mr. Harald Hirschhofer, resident representative to Serbia, was designated resident representative in January 2007. A satellite office has been established in the Central Bank of Montenegro.

## **ANNEX II. MONTENEGRO: RELATIONS WITH THE WORLD BANK GROUP**

### **Montenegro's Development Goals**

1. Montenegro declared independence in mid-2006, joining the World Bank and IMF about half a year later in January 2007. Even under the umbrella of the State Union of Serbia and Montenegro, the Bank had effectively established a functional relationship with Montenegro.
2. World Bank support complements Montenegro's development goals, especially its objectives spelt out in the Stabilization and Association process (SAP) with the European Union (EU).<sup>2</sup> Montenegro is in the process of developing and/or updating its development and sectoral strategies and integrating those into the overarching national integration program. These are to update Montenegro's medium-term development strategy, as contained in the 2004 Development and Poverty Reduction Strategy (DPRS)<sup>3</sup> and the Economic Reform Agenda.
3. Following independence, and against the background of accelerating growth rates, largely fueled by a very significant inflow of foreign-direct investments, Montenegro has made substantial progress in advancing its development goals. Euroization has contributed to anchoring macroeconomic stability as a central pillar of economic policymaking, complemented by programs to advance privatization, liberalization, and structural reforms—with the aim of ensuring fiscal consolidation and promoting stronger private sector-led growth. The prolonged debate on the Constitution, the lack of institutional capacity, and the reorientation of policy priorities has delayed the implementation structural reforms in several areas and led to some relaxation of fiscal policies during late 2007. Having completed the immediate state-building tasks and the SAP, the government should overcome quickly the delays in implementing the structural reform agenda.

### **World Bank Group Strategy**

4. A Joint World Bank-IFC Country Partnership Strategy (CPS) for Montenegro, covering FY07–10 and endorsed by the Bank's Board on June 12, 2007, will support the government's key priorities, viz., to (i) enhance sustainable economic growth, through increasing economic freedoms and strengthening the role of the private sector; (ii) build

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<sup>2</sup> The Stabilization and Association Agreement (SAA) with the EU was signed on October 15, 2007, joining Albania, Croatia, and Macedonia as the fourth Southeastern European country to have successfully concluded the SAP.

<sup>3</sup> The Document was presented to the Board as self-standing part of the joint Serbia and Montenegro Poverty Reduction Strategy.

institutions and the rule of law; and (iii) improve the standard of living of citizens, through efficient education, health and social protection systems.

5. Coordination with the IMF has been strong, with cooperation having focused on macroeconomic issues and sectoral ones with a potentially strong macroeconomic impact—more important still after the government’s decision not to request a Fund-supported program and in light of the increased risks to macroeconomic stability. The Bank, through its ongoing and planned operations, as well its complementary economic and sector work, will continue to provide input on issues such as (i) labor market reforms; (ii) energy sector reforms; (iii) public expenditure, pension and health reforms, with a view to streamlining service delivery, and (iv) an appropriate framework to regulate concession arrangements and potential public/private partnerships, with a view to encouraging investment in a way that would ensure that the government does not accumulate significant contingent liabilities.

6. Total outstanding debt of Montenegro towards the various part of the Bank was about US\$401.5 million on November 7, 2007 (US\$56.9 million for IDA and US\$344.6 for IBRD), at the current exchange rate about €275 million. In September 2007, the government prepaid €20 million, with further prepayments foreseen during the fourth quarter of 2007. With these payments, Montenegro has considerably reduced per-capita exposure ratios, which had previously been among the highest for any Bank borrower.

### World Bank Activities

7. The 2007 CPS envisages a total lending envelope of US\$70–90 million. Following the successful completion, in 2006, of the *Second Structural Adjustment Credit (SAC 2)*, the government decided not to request a follow-up development policy credit, largely because of Montenegro’s strengthened fiscal position. Investments aim at fostering private-sector activities and streamlining social services, while maintaining a quality environmental infrastructure that is required for sustainable growth in tourism (a key industry).

8. Streamlining social services is a particular challenge given the relatively large cost of social services as a proportion of GDP, even when compared to neighboring countries with similar income levels. The *Montenegro Education Reform Project* aims at strengthening the capacity of the education system to make continuous improvements, especially in the quality of teaching and learning in schools and in the efficient use of budgetary resources. There is a high degree of government ownership and no problems in project implementation.

Montenegro: World Bank Lending Envelope, FY07-FY10

|                                       |    |
|---------------------------------------|----|
| Lending envelope FY07-FY10            | 89 |
| Fiscal year 2007                      | 19 |
| Energy <sup>1</sup>                   | 9  |
| Sustainable tourism <sup>1</sup>      | 10 |
| Fiscal year 2008                      | 15 |
| Sustainable tourism                   | 5  |
| Land administration                   | 10 |
| Fiscal year 2009                      | 25 |
| Energy efficiency                     | 10 |
| Rural and regional development        | 15 |
| Fiscal year 2010                      | 30 |
| Improved social services              | 10 |
| Transport infrastructure <sup>2</sup> | 20 |

<sup>1</sup> On IDA terms; IBRD terms otherwise.

<sup>2</sup> In high-case lending scenario.

Source: World Bank, 2007, *Country Partnership Strategy for the Republic of Montenegro*, Report No. 39800-ME.

9. The *Healthcare System Improvement Project* seeks to put in place first steps toward a reformed healthcare system to increase the capacity for policy, planning, and regulation, stabilize healthcare financing, and improve primary healthcare service delivery. The implementation is proceeding well, and government ownership is strong. The Health Ministry has succeeded in securing CIDA grant funds to co-finance the project.

10. The *Energy Community of South East Europe-APL3 Montenegro Project* is awaiting effectiveness. Procurement activities for the projects have started. The General Procurement Notice is prepared and about to be published, while EPCG is finalizing the technical specifications for the projects and is planning to issue tender documents of some of these projects by end-December 2007. In addition, Bank teams have discussed an *Energy Efficiency Project*, planned for FY09, to support financing related projects in the public sector, especially in the education and health sectors. The Bank team has agreed with government representatives on next steps for further assessment of prospects and scope of energy efficiency investments in public sector buildings.

11. The *Montenegro Sustainable Tourism Development Project* is to help Montenegro to better design and implement an integrated coastal zone management approach. With this, coastal degradation is to be reduced and environmentally sound tourism development fostered by supporting activities aimed at (i) enhancing spatial development, the use of natural resources, regulatory policy, institutional capacity and governance of the coastal zone, and (ii) initiating priority investments to improve environmental conditions and foster development of high-quality tourism. These objectives will be achieved through (i) improvements in land-use planning and protection to guard against uncontrolled construction and development; and (ii) investments for the Continental and Southern part of the Regional Water Supply Scheme with the capacity to provide water from Lake Skadar/Shkodër to the municipalities of Bar and Ulcinj/Ulqin and the tourist areas of Valdanos and Velika Plaža. This phase of the MSTDP will only finance the investments from Lake Skadar/Shkodër to Bar.

12. The *Montenegro Environmentally Sensitive Tourist Areas Project* is to create ecological and commercially sustainable solid waste collection and disposal services in Montenegro coastal municipalities, needed to maintain a clean, environmentally attractive coastal area. This is to be achieved through the (i) development of the sector's institutional, policy and regulatory framework; (ii) rehabilitation of municipal disposal sites to function as properly designed regional sanitary landfills; (iii) closing existing disposal sites in an environmentally acceptable manner; (iv) provision of modern collection equipment; (v) initiating a pilot recycling campaign; and (vi) strengthening multi-municipal joint companies (MJC) that will be created to operate the two regional solid waste disposal systems.

13. Current Bank involvement is restricted to policy dialogue and an application to the *Public-Private Infrastructure Advisory Facility* trust fund, which is currently awaiting approval. The government wishes to improve competitiveness and has major development



plans for two main road corridors (Bar to the Serbian Border, and Adriatic – Ionian Corridor). The government has commissioned a study to investigate the feasibility, and implementation schedule, of constructing motorways on both these axis, and political pressure is high and increasing. The estimated costs are significant, exceeding current GDP and, consequently, available resources. The government has therefore sought the support of PPIAF and the Bank to investigate this option.

14. Over the last year, the performance of projects in Montenegro has increased considerably. As of October 5, 2007, the portfolio consisted of six projects under implementation, with a total commitment of US\$43 million, of which US\$17 million have been disbursed during the FY 2007. The disbursement rate, for the same period, has been 33 percent. Performance rating is *Satisfactory* (S) for 2 projects (education and sustainable tourism development), *Moderately Satisfactory* (MS) for 2 (health and pension), and *Unsatisfactory* for one (MESTAP); one project has not been rated yet (energy). The average age of the portfolio is 2.2 years. Two new projects—in sustainable tourism and energy sector development over a total amount of US\$19 million—have been approved during the third quarter of 2007. With respect to non-lending operations, a public expenditure and institutional review (PEIR) is planned for the FY08.

15. In support of the implementation of the project portfolio, the Bank is also administering 2 Trust Funds financed by single and/or multi donors. Two projects financed by Global Environmental Facility (GEF), the *Tara and Lim River Basins Watershed Management Project* and the *Lake Skadar/Shkodër Integrated Ecosystem Management Project*, both under preparation, should help boost tourism in the poorer northern part of the country and around Lake Skadar/Shkodër.

16. The Bank's assistance has been supported by a standard package of analytical and advisory activities. A *CPAR* and a *CFAA* were delivered in 2002, followed by a *PEIR* and a *Poverty Assessment* in 2003. A *Montenegro Economic Memorandum* was completed in 2005 and focused on macroeconomic issues (particularly public expenditure), labor market reform, the business climate and also synthesized findings of supporting studies of energy. A *PEIR update* and *Debt Sustainability Analysis* were recently completed, while a *Poverty Assessment Update* and an *FSAP* and *ROSC* are ongoing.

17. **FIAS** assisted the self-assessment of administrative procedures for doing business which identified several major areas of concern: complex procedures for registration of enterprises, along with the lack of funds as well as shortcomings in the legal framework for competition and management of public and private enterprises.

18. **MIGA**, with EAR support, is implementing a capacity building project in support of the new Montenegrin Investment Promotion Agency. MIGA's TA activities are feeding into a new, regional FDI outreach and marketing initiative for the Western Balkans launched in summer 2004 (the European Investor Outreach Program for the Western Balkans).

19. **IFC** has also provided \$5.2 million through Opportunity Bank Montenegro to expand micro- and small-business enterprise loan portfolio. In addition, IFC has provided support through its Southeast European Enterprise Development (SEED) facility, later transformed into Private Enterprise Partnership of Southeast Europe (PEPSE) and assisted in introduction of Financial Leasing Law through its *Leasing Project*.

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|---|
| Prepared by World Bank staff. Questions may be addressed to Jan-Peter Olters. |
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### ANNEX III. MONTENEGRO: STATISTICAL ISSUES

1. While data are broadly adequate for surveillance, weaknesses hamper economic analysis and policy making. Following the creation of the State Union between Serbia and Montenegro in 2003, statistical institutions were split and Montenegro, being the smaller partner and with a capital located far from Yugoslav institutions, lacked sufficient resources and qualified personnel, and lost institutional memory and know-how. The quality and timeliness of reporting vary across sectors. For monetary and balance of payments statistics, international reporting standards have been adopted, while the adaptation of national account data has been slower. Reporting of fiscal data has recently improved but coverage is limited. A page for Montenegro in *International Financial Statistics* (IFS) was introduced with the March 2007 issue.
2. The authorities have created a statistical council to coordinate efforts to improve data quality and requested technical assistance from foreign partners. In response, the Fund has provided a series of technical assistance missions to improve the quality of macroeconomic statistics and support policy formulation, often jointly with TA provided to Serbia. Over the period 2001–04, STA conducted six missions to the State Union, including a mission on monetary and financial statistics, separate balance of payments statistics missions to Serbia and to Montenegro, and a multi-topic mission covering national accounts statistics. The status of the statistical base, as reflected in these missions, can be summarized as follows: (i) there is a critical need to improve the quality of existing macroeconomic statistics by developing comprehensive data sources and improving statistical methodologies; (ii) informal activities are inadequately recorded in the national accounts, especially in the expanding service sector; and (iii) the principles for compiling monetary statistics are broadly consistent with MFSM 2000. A 2006 monetary statistics mission and a 2007 real sector statistics mission were undertaken to assist the authorities in improving the quality of the compiled data.

#### A. Real Sector

3. Real sector data are compiled by the Statistical Office of Montenegro (MONSTAT). MONSTAT has started to adopt the *1993 System of National Accounts* as a framework for compiling national accounts estimates. However, the scope of the accounts is limited to compiling annual production account in current prices, and only aggregate GDP in previous year prices. The accuracy of the data sources needs to be improved. The business statistics are still following the material system product concepts, collecting data mainly on quantities produced. The national accounts estimates depend solely on bookkeeping data. There is no business register to be used for statistical surveying, although work has started with Statistics Sweden. On the expenditure side, there are no data on changes in inventories, and the quality of investment and merchandise trade data is unsatisfactory. The exhaustiveness of the national accounts data is seriously undermined by the lack of sound techniques to incorporate unobserved activities. Some work has been done on ad-hoc basis, but the estimates produced

are not included in the regular compilation practice. The techniques for deriving volume measures of GDP are constrained by the lack of suitable price and volume indices.

4. MONSTAT compiles and disseminates retail price indices (RPI), and cost of living indices, and producer price indices. A proper consumer price index is planned to be introduced in 2008. In all price indices, the “carry-forward” technique for treatment of seasonal goods, new goods, and missing items are not following international standards. The quality of the labor and wage indicators is good.

## **B. Balance of Payments**

5. Balance of payments statistics are compiled by MONSTAT (current account) and the Central Bank of Montenegro (capital and financial accounts). Significant improvement is needed in data compilation, in particular in external trade, where MONSTAT uses the special trade system for imports but general trade system for exports. This inconsistency may have resulted in the overestimation of imports. In addition, the classification used by MONSTAT is the Harmonized System (HS), but data are disseminated according to the Nomenclature générale des Activités économiques dans les Communautés Européennes (NACE), on highly aggregated groups, and with a significant time lag. Some components are likely under-recorded, since a significant proportion of foreign exchange transactions occur through informal channels.

6. Data on private external debt are weak. While the Central Bank of Montenegro (CBM) has continuously maintained a record of flows of private external debt in recent years, there is no data on stock of external debt. The authorities’ program includes strengthening the monitoring of private external debt by CBM and MONSTAT.

7. A June/July 2004 mission to the CBM assisted with adoption of compilation methodologies consistent with the fifth edition of the *Balance of Payments Manual (BPM5)* and provided recommendations to improve international trade and external debt statistics, as well as Montenegro’s international transactions reporting system (ITRS). The authorities have implemented many of the recommendations of the 2004 mission. Following the authorities’ request for further assistance, a mission visited Montenegro in September – October 2007. Although it noted substantial progress, inadequate data sources continue to constrain progress in improving balance of payments data.

## **C. Government Finance**

8. Fiscal data are compiled by the Ministry of Finance (MOF) based on a new GFS institutional classification, and since early 2006, include data for the social security funds and local governments. The chart of accounts introduced in 2001 has been implemented at the local level from mid-2005. Fiscal data reporting suffers from frequent re-classifications, especially, at the level of local governments and social funds. The MOF has recently created a unit responsible for data collection for state-owned enterprises (SOE), but a satisfactory

compilation of the public sector fiscal balance requires significant further efforts. Data on stock of local government arrears need to be strengthened.

#### **D. Monetary Accounts**

9. Monetary and financial statistics are compiled by the CBM, broadly following the institutional coverage, classification, and valuation methodology set forth in the *Monetary and Financial Statistics Manual*, 2000. Dissemination practices meet GDDS recommendations with respect to the periodicity and timeliness for financial sector data. Beginning in early 2006, the CBM publishes detailed monetary statistics in its monthly *Statistical Bulletin*, which includes tables on monetary statistics, balance sheets and surveys for the CBM and the commercial banks.

10. Significant progress notwithstanding, there is need for further improvement. The 2006 monetary and financial statistics mission made recommendations to the CBM on methodological issues concerning: (i) the exclusion of two banks in bankruptcy from financial reporting (the mission proposed that if these institutions are excluded from the coverage of the monetary survey, a separate table on their monetary accounts could be included in the CBM's *Statistical Bulletin*); and (ii) treatment of interest accrued but not yet due (which is maintained in aggregate on separate accounts rather than incorporated in the outstanding amount of the financial asset or liability).

11. The CBM does not yet report monetary data in the format of Standardized Report Forms (SRFs). To avoid duplication of effort, the CBM will need to decide whether to adopt the European Central Bank's framework for collecting, compiling and reporting monetary data or the STA-developed SRFs, either of which will provide monetary data that accord with international standard.

# MONTENEGRO: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE

AS OF NOVEMBER 15, 2007

|   | Date of Latest Observation | Date Received | Frequency of Data <sup>6</sup> | Frequency of Reporting <sup>6</sup> | Frequency of Publication <sup>6</sup> |
|---|----------------------------|---------------|--------------------------------|-------------------------------------|---------------------------------------|
| International reserve assets and reserve liabilities of the monetary authorities <sup>1</sup>             | Oct.2007                   | Nov.2007      | M                              | M                                   | M                                     |
| Reserve/base money  | Oct.2007                   | Nov.2007      | M                              | M                                   | M                                     |
| Central bank balance sheet  | Oct.2007                   | Nov.2007      | M                              | M                                   | M                                     |
| Consolidated balance sheet of the banking system  | Oct.2007                   | Nov.2007      | M                              | M                                   | M                                     |
| Interest rates <sup>2</sup>   | Aug.2007                   | Oct.2007      | M                              | M                                   | M                                     |
| Consumer price index  | Sep.2007                   | Oct.2007      | M                              | M                                   | M                                     |
| Revenue, expenditure, balance and composition of financing <sup>3</sup> – general government <sup>4</sup> | Sep.2007                   | Oct.2007      | Q                              | Q                                   | Q                                     |
| Revenue, expenditure, balance and composition of financing <sup>3</sup> – central government              | Sep.2007                   | Oct.2007      | M                              | M                                   | M                                     |
| Stocks of central government and central government-guaranteed debt <sup>5</sup>                          | Sep.2007                   | Oct.2007      | Q                              | Q                                   | Q                                     |
| External current account balance  | Jun.2007                   | Sep.2007      | Q                              | Q                                   | Q                                     |
| Exports and imports of goods and services   | Jun.2007                   | Sep.2007      | Q                              | Q                                   | Q                                     |
| GDP/GNP   | 2005                       | Apr.2007      | A                              | I                                   | A                                     |
| Gross external debt   | Jun.2007                   | Sep.2007      | Q                              | Q                                   | Q                                     |

<sup>1</sup>Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

<sup>2</sup>Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

<sup>3</sup>Foreign, domestic bank, and domestic non-bank financing.

<sup>4</sup>The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments. General government reporting is incomplete; local government expenditure data are available only after a six-month lag.

<sup>5</sup>Including currency and maturity composition.

<sup>6</sup>Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Semi-annually (SA), Annually (A), Irregular (I); or Not Available (NA).