SUR/08/2

January 17, 2008

The Acting Chair's Summing Up
Republic of Montenegro—2007 Article IV Consultation
Executive Board Meeting 08/4
January 16, 2008

Executive Directors agreed with the thrust of the staff appraisal. They welcomed the bright prospects for the Montenegrin economy, and praised the authorities for their sound macroeconomic management and bold structural reforms over the past few years. These efforts have helped Montenegro attract substantial foreign direct investment. At the same time, the increased confidence related to independence and the fast growth of tourism and real estate-related investments is generating strong demand pressures, and raising vulnerabilities.

Directors considered that the economy may now be operating above capacity, with inflation picking up and large wage increases weakening competitiveness. Rapid credit growth is overstretching banks' risk assessment capabilities, and has contributed to ballooning asset prices. The quickly increasing level of private debt could lead to solvency problems, especially if eroding competitiveness dampens the potential for the further development of tourism.

Against this background, Directors observed that the key policy challenge will be to prevent overheating and ensure that the current boom unwinds smoothly. Given the limits on using monetary policy with the adoption of the euro, fiscal policy will need to play a prominent role in this regard. Directors recommended a combination of measures aimed at withdrawing fiscal stimulus, reining in credit growth, and bolstering structural reforms to boost competitiveness and improve the economy's resilience to shocks.

While recognizing the need to allocate resources to strengthen infrastructure and the institutional foundations of a new state, Directors counseled that, at a minimum, fiscal policy should avoid adding to private sector demand pressures at the current juncture. The temporary surge in tax revenues should not be seen as providing scope for tax cuts and higher current spending. Directors underscored the need to contain fiscal risks from large restitution claims and the assumption of contingent liabilities, including from private-public partnerships. They recommended the development of a strong medium-term fiscal framework.

Directors commended the Central Bank of Montenegro for recent steps to stem the very rapid growth of credit, including the broadening of reserve requirements and tightening of prudential regulations. They encouraged early passage of the Banking Law to provide for stronger supervisory powers for the banking sector regulatory authorities. Directors welcomed the authorities' commitment to combat money laundering and the financing of terrorism, and their intention to upgrade the current AML/CFT framework.

Directors encouraged the authorities to persist in implementing key structural reforms. They welcomed the authorities' efforts to reform labor legislation to improve economic flexibility and facilitate job mobility. At the same time, wage discipline should be strengthened, and a better link established between job performance and compensation. Directors called for further efforts to improve the business environment, especially by limiting the scope for discretion on the part of officials and regulators, completing zoning regulations, and strengthening corporate governance. They noted the importance of reforms in the energy sector, in particular to ensure adequate electricity supplies for the growing economy. They looked forward to the opening up of the electricity sector to private investment and the phasing out of subsidies.

Directors noted that economic statistics need to be improved considerably in order to lay a sound basis for economic analysis. They encouraged the authorities to strengthen the organization of the statistical agency.

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