

SM/07/388  
Correction 1

January 22, 2008

To: Members of the Executive Board

From: The Secretary

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

The attached corrections to SM/07/388 (12/17/07) have been provided by the staff:

**Factual Errors Not Affecting the Presentation of Staff's Analysis or Views**

**Page 6, Text Table on gross wages:** figures for 2007 corrected.

**para. 5, bullet 2:** for “Gross wages increased at an annual rate of 26 percent in September”  
read “Gross wages increased at an annual rate of 22 percent in November”

**Page 11, bottom left text chart, label of vertical axis:** for “Z-score 1/”  
read “Change in Z-score 1/”

**Page 27, Table 1:** figure for “Average net wage (12-month)” corrected.

Questions may be referred to Mr. Justice (ext. 38600), Mr. Gagales (ext. 38849), and Mr. Alvesson (ext. 36372) in EUR.

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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.

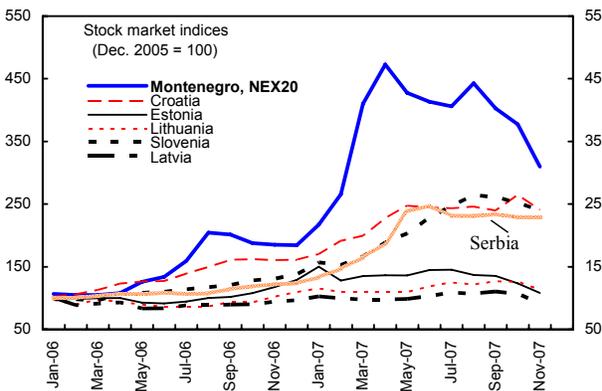
Credit expansion has overtaken FDI in size as demand stimulus (In percent of GDP)			
	2005	2006	2007
FDI	21	24	24
Credit expansion	5	24	58
Source: IMF staff calculations.			

- **Wages have grown rapidly.** Gross wages increased at an annual rate of ~~26~~ **22** percent in ~~September~~, **November**, driven by tourism and construction. Public sector wage policy has been lax, with a 30 percent wage increase in the last quarter of 2007.

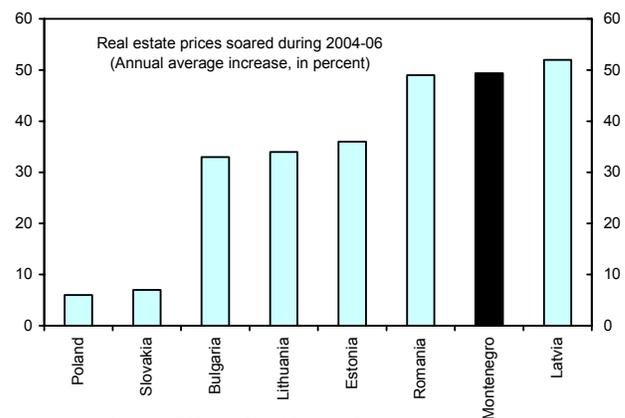
Gross Wage Increases in Selected Sectors (Annual percentage change)			
	2006 1/	QIII-07	XI-2007
Economy wide	15.5	26.4	22.2
Growth sectors			
Construction	30.1	67.6	41.6
Tourism	18.1	50.7	23.1
Financial intermediation	17.0	23.6	46.6
Other sectors			
Electricity	26.3	4.0	4.0
Industry	16.9	44.7	12.3
Public administration	16.8	45.8	15.1
Health care	11.8	10.4	36.5
Education	7.3	8.0	32.1
Source: Statistical Office of Montenegro.			
1/ Annual average based on old official methodology.			

- **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.

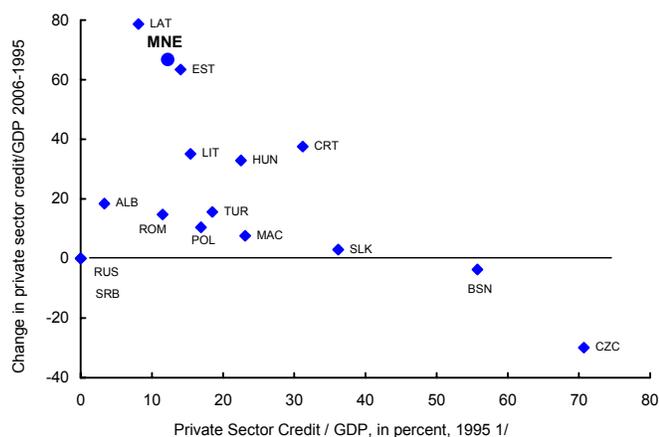


Sources: ECB and Global Property Report.

## Box 2. Rapid Credit Growth <sup>1/</sup>

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.

<sup>1/</sup> 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 <sup>1/</sup>

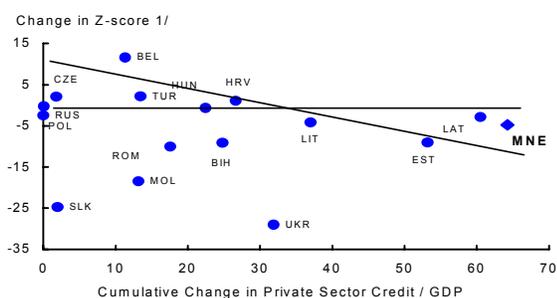
Country	Start of Boom	End of Boom	Duration	Credit at Start	Credit at End
<b>Crisis Countries</b>					
Argentina	1990	1995	6	9.2	19.7
Brazil	1993	1995	3	13.3	47.0
Mexico	1987	1994	8	12.3	38.7
Philippines	1988	1998	11	16.1	48.0
Turkey	1995	2000	6	18.5	23.7
Uruguay	1992	2002	11	25.2	65.9
<b>Non-crisis countries</b>					
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
<b>Booms in selected CEE countries</b>					
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
<b>Montenegro</b>	<b>2005</b>	<b>ongoing</b>	<b>2</b>	<b>18.2</b>	<b>79.0</b>

Sources: IFS and IMF staff calculations.

<sup>1/</sup> 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, 2001-07



Sources: IFS, MCM database on FSIs; and IMF staff calculations.

<sup>1/</sup> 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 <sup>1/</sup>	Deviation	Change <sup>2/</sup>	Predicted <sup>3/</sup>	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
<b>Montenegro <sup>4/</sup></b>	<b>62.4</b>	<b>46.1</b>	<b>16.3</b>	<b>15.4</b>	<b>5.2</b>	<b>10.1</b>

Source: IFS, WEO. Based on Schadler et al. (2005); IMF staff calculations.

<sup>1/</sup> Based on VECM of credit/GDP, log of GDP per capita at PPP and real interest rate

<sup>2/</sup> Actual average change in credit/GDP in 2003-06

<sup>3/</sup> Average predicted short-run change in 2003-06

<sup>4/</sup> 2005-07 data, adjusted for the underground economy and the wealth effect from assets sales.

<sup>1/</sup> Financial convergence in Montenegro is examined in an accompanying Selected Issues Paper.

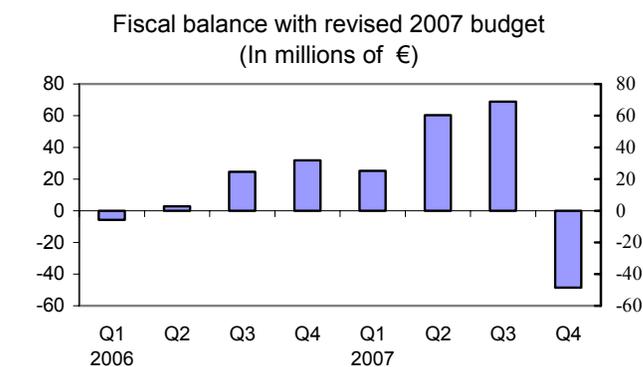
### *Fiscal policies have recently slipped*

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:Q1-III			
	2005	2006	2007: Q1-QIII
		Prel.	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).



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.

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

	2003	2004	2005	2006	2007	2008	2009
			Prel.	Est.	Proj.		
<b>Real economy</b>							
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	...	...	...
<b>Tourism</b>							
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	3.4	4.8	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/	...	...
<b>Money and credit (end of period, 12-month)</b>							
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)						
<b>General government finances (cash) 2/</b>							
Revenue and grants	41.8	37.8	37.4	44.9	52.6	50.0	48.8
Expenditure (incl. discrepancy)	46.6	40.5	39.1	42.5	45.7	49.7	49.5
Overall balance	-4.8	-2.7	-1.8	2.4	6.9	0.4	-0.7
Primary balance	-3.7	-1.1	-0.6	3.6	8.1	1.4	0.2
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	4.2	4.6	5.2
Net debt (end-of-period) 3/	50.3	44.8	37.5	31.5	36.3	34.0	30.7
<b>General government gross debt (end of period, stock)</b>							
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
<b>Balance of payments</b>							
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/	...	...
<b>Memorandum:</b>							
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.