SM/08/3
Correction 1

January 22, 2008

To: Members of the Executive Board

From: The Secretary

Subject: **Republic of Montenegro—Selected Issues**

The attached corrections to SM/08/3 (1/3/08) have been provided by the staff:

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

Page 24, para 31, second bullet, lines 4 and 5: for "which exceeds the average monthly salary by 30 percent." read "which exceeds by far the average monthly salary."

Page 34, lines 8 and 9, for 2001: for "With the adoption of the Law on the Central Bank in March 2001, the deutsche mark becomes the sole legal tender" read "The deutsche mark becomes the sole legal tender on January 1st and the Law on the Central Bank is adopted in March."

Page 36, para. 44, lines 3 and 4: for "The largest group of visitors by country is from Russia, followed by the former Yugoslavia." read "The largest group of visitors by country is from the former Yugoslavia, followed by Russia."

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

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

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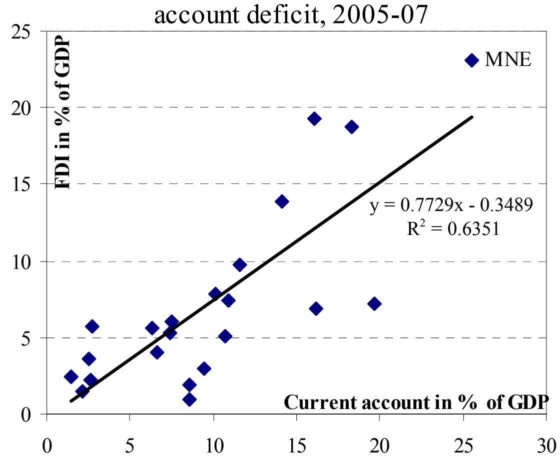
29. **Notably, Montenegro's high current account deficits have not encountered financing problems.** About 70 percent of the deficits in 2005–07 were covered with non-debt creating FDI as assets (real estate and state property) were run down to finance mainly consumption (e.g., automobiles and consumer durables). Private sector external borrowing (mainly banks) is estimated to have increased by 12 percentage points of GDP in 2007. At 30 percent of GDP at end-2007, private debt is not high for a transition economy but the pace of build-up is a concern if it continues unabated.

Correlation between FDI and the current account deficit, 2005-07



Source: WEO.

30. **While in a euroized environment high current account deficits are not problematic in themselves, they could nonetheless be symptomatic of growing imbalances,** mainly overheating, asset overvaluation, and balance sheet fragility.

- **Overheating.** The degree of overheating depends on the extent to which the capital inflows are spent on non-traded goods.[18] Rising wages are part of the macroeconomic adjustment process as they facilitate the transfer of resources to the booming non-traded goods sector. If, however, rapid wage increases during the upswing result in a significant real appreciation, they will render macroeconomic adjustment costly when the capital inflows start unwinding. At that stage, the export sector will not have the torque to pick up the slack released by the downsizing of the non-traded goods sector. And with exchange rate realignment not an option, a real depreciation may necessitate significant wage restraint that could trigger a recession.

- **Asset overvaluation**. To a large extent, the rapid increases in asset prices reflect low starting levels and expectations of rapid growth in the foreseeable future. But unrealistic expectations cannot be ruled out, as evidenced by the 40 percent correction in equity prices during the second half of 2007.

- **Balance sheet fragility**. Increasing reliance on debt instruments for the financing of large current account deficits could impair balance sheets and make the economy vulnerable to large swings in market conditions. In fact, over indebtedness and very

[18] If spent entirely on traded goods, FDI will have no effect on GDP as it will increase equally aggregate demand and imports. It will still expand productive capacity and future income, if spent on imported investment goods.

rapid credit growth are, empirically, early warnings indicators of financial distress, albeit with a low signal to noise ratio.

31. **Large FDI inflows do not come without costs**. Two issues in a small economy like Montenegro are overdevelopment and affordability.

- Overdevelopment without appropriate infrastructure, and without respect for the environment, could generate strong negative externalities, irreversibly change the landscape and undermine further real estate and tourist development. Moreover, a fast pace of development, well above the capacity of the construction sector, will confer limited macroeconomic benefits as it will rely disproportionately on imported inputs, including labor. Zoning regulations, capital gains and transaction taxes to slow down inflows, and taxes to help internalize these externalities, could ameliorate overdevelopment problems.

- Affordability is already a problem for the average household in Montenegro and could create resistance to liberalization. A CBM survey estimates the market value of an average-sized apartment at €100,000. If fully financed at prevailing interest rates, this implies a monthly interest service of €630, which exceeds by far the average monthly salary ~~by 30 percent~~. Under these circumstances, new housing is affordable only to those who can either make a large down payment or borrow with a grace period (in the expectation that they will be able to resell at a capital gain before the expiration of the grace period. The second strategy leaves buyers (and banks) vulnerable to a downward correction in real estate valuations.

A. How Could the FDI and Credit Stimuli Unwind?

32. **The demand stimuli are running their course**. In particular, as the supply of prime land is limited, investment opportunities will gradually diminish, although back of the envelop calculations suggest that real estate related FDI could be sustained for some time if favorable conditions in the international real estate market persist.[19] Significant additional stimulus would be provided by large infrastructure projects (roads, electricity etc). The situation is less clear-cut in the case of the credit shock. Taking EU economies as a benchmark, there is scope for some further increase of the leverage ratio; but banks are likely to attempt to consolidate their portfolios, and probably also their operations, building on

[19] The construction of, say, four high-end resorts and 2,000 secondary residences over the next five years could generate FDI inflows of 12 percent of GDP annually.

Appendix I.1.: Milestones in the History of Montenegro

9 AD	The Romans annex the area of present day Montenegro to the province of Illyricum.
500–700	Slavs colonize the area.
700–1150	Byzantine rule. Montenegro becomes a vassal, known as Duklja or Diokletija.
1150–1389	Period of independence. Known as Principality of Zeta, Montenegro becomes virtually independent from Serbia in 1356 and gains full independence in 1371.
1389–1852	Ottoman rule.
1852	Montenegro becomes an independent principality.
1878	The Berlin Congress recognizes Montenegro as an independent state.
1906	Montenegro issues the *perper* (from the Greek *hyperperos* = refined), equivalent to the French franc as part of the *Latin Monetary Union* (1865-1927). The currency was replaced by the *dinar* in 1918, when the country was annexed to the Kingdom of Serbs, Croats and Slovenes.
1910	Montenegro is proclaimed kingdom.
1912–13	Balkan wars. Montenegro along with Serbia, Bulgaria and Greece reclaim historic territories from the Ottoman Empire.
1918	At the end of WWI borders in the Balkans are redrawn and Croatia and Slovenia are merged with Serbia and Montenegro. A popular uprising in Montenegro fails to reverse its annexation to Serbia and King Nicolas I, who favored independence, is deposed.
1945–91	Socialist era. Centrifugal tendencies in the federation emerge during the 1980s.
1991–92	Yugoslavia is dismembered. The secession Croatia and Slovenia and later of Bosnia-Herzegovina and Macedonia triggers an armed ethnic conflict, prompting UN economic sanctions and an embargo against Serbia and Montenegro.
1998	The international community freezes Serbian and Montenegrin assets abroad in response to deteriorating conditions in Kosovo.

1998	The pro-independence coalition in Montenegro wins the election with a paper-thin majority of 50.4 percent.
1999	More than 30,000 refugees enter Montenegro from Kosovo during the NATO campaign.
1999	The German mark is introduced as parallel currency and rapidly becomes the currency of choice for transactions and as a store of wealth.
2000	The EU lifts sanctions against Serbia and Montenegro.
2001	~~With the adoption of the Law on the Central Bank in March 2001, t~~The deutsche mark becomes the sole legal tender on January 1st and the Law on the Central Bank is adopted in March."~~.~~
2002	With its introduction, the euro replaces the deutsche mark to the euro as sole legal tender.
2003	Under pressure from Montenegro, the Yugoslav parliament votes to transform the federation into a looser federation under the name "State Union Serbia and Montenegro". The new setup gives Montenegro autonomy in setting tariffs and fiscal policy, and responsibility for border control within its territory.
2005	Montenegro takes over full control over security issues.
2006	Following a referendum (and a majority of 55.5 percent), Montenegro reclaims its full independence, almost a century after its annexation to Yugoslavia in 1918.
2007	Signing of SAA with the EU; discussions for WTO membership. The revision of the Constitution dominates the political debate and slows legislative reforms.

II. Tourism in Montenegro[24]

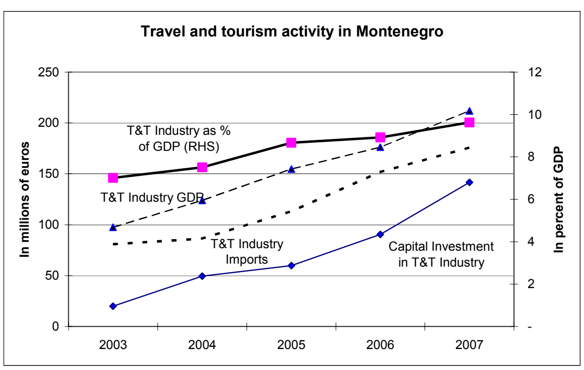
A. Introduction

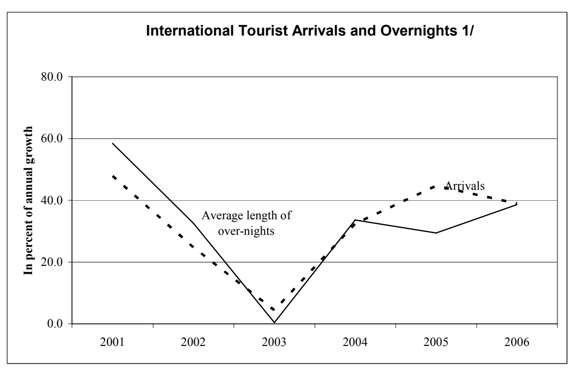
40. **The potential of the tourism sector in Montenegro is impressive.** For the fourth consecutive year, Montenegro has been ranked among the world's top three destinations in terms of growth over the coming decade. However, because Montenegro relies heavily on imports, its tourism industry has high leakage. There are also concerns that, despite rapid growth, tourism has weak linkage with the rest of the economy, and may not lead to significant improvements in any other sectors. By targeting high-end tourists, the industry is in danger of becoming an enclave.

41. **The paper looks at these trends and how developments in the tourism industry have contributed to the shaping of the economy.** Section B covers the growth of the sector over the last 5 years, and how it is influencing real sector activities in Montenegro. Section C discusses the structural factors that undermine the contribution of the tourism sector to overall economic growth, namely high leakage, low linkage with the rest of the economy, and tourism as an enclave. Section D looks at determinants of competitiveness of Montenegro's tourism sector and Section E concludes with a discussion of the way forward, including an analysis of the productivity gains needed to meet the goals adopted by the Ministry of Tourism and Environmental Protection (MTEP).

B. Growth in Tourism Sector

42. **Tourism has been the pillar of Montenegro's real economic growth.** After a complete halt during the 1990s due to the Balkan conflict, the sector expanded by over 7 percent per annum, ranking 9th position in the world in terms of annual real growth.





Sources: Ministry of Tourism and Environmental Protection (MTEP); and World Travel and Tourism Council (WTTC).
1/ Slowdown in 2003 was due to the introduction of VAT which discouraged tourist operators, and the electricity and water shortages in the previous year which had discouraged foreign visitors.

24 Prepared by Jung Kim.

43. **Growth has been one of the most impressive in the region, and Montenegro's tourism potential has been widely recognized in the world.** According to the World Travel and Tourism Council (WTTC), the baseline forecasts for Montenegro's Travel & Tourism (T&T) are extremely positive. In 2007, the T&T economy[25] is expected to contribute 21 percent of Montenegro's GDP (11 percent for T&T industry)—as against 10.9 percent for T&T economy in the European Union. The T&T economy accounts for 28,900 jobs representing 19 percent of total employment (12 percent in the EU), about 34 percent of total exports of goods and services, and about 26 percent of capital investment. Over the next ten years, Travel & Tourism in Montenegro is forecast to achieve annualized real growth of 7 percent, in terms of GDP, compared with only 3 percent in the EU.

T&T Economy (% of Total GDP)

Rank	2004	% GDP	Rank	2007	% GDP
19	Malta	28.5	23	Malta	23.7
21	Cyprus	27.6	25	Cyprus	21.5
27	Croatia	24.2	***27***	***Montenegro***	***20.7***
38	Bulgaria	16.8	33	Croatia	19.0
46	***Montenegro***	***14.8***	43	Greece	16.5
50	Greece	14.3	50	Slovakia	14.9
52	Slovenia	14.1	54	Bulgaria	14.5
68	Slovakia	11.5	57	Slovenia	14.2
83	Turkey	10	70	Turkey	9.1

Source: WTTC

Expected Growth in T&T Economy (%)

Rank	2008-2017	10-yr avg real growth
1	Croatia	8.9
9	***Montenegro***	***7.1***
32	Slovakia	5.5
70	Bulgaria	4.5
103	Greece	4
105	Turkey	3.9
107	Slovenia	3.9
108	Cyprus	4.6
172	Italy	1.3

Source: WTTC

44. **In terms of origin of tourists,** the EU accounts for about 50 percent of all arrivals, and visitors from former Yugoslavia represent about 20 percent, followed by Russia and CIS countries (18 percent). The largest group of visitors by country is from the former Yugoslavia, followed by Russia.~~, followed by the former Yugoslavia.~~ Tourists from other western European countries are also rising rapidly, including Italy (up 55 percent a year since 2000), France (up 57 percent) and UK (up 67 percent).

45. **Montenegro's tourism is characterized by high seasonality of demand in the coastal region.** The five months from May through September account for about 90 percent of total overnights and over 80 percent of arrivals. Just two months, July and August, generate over 50 percent of arrivals and overnights. These tourists mostly favor coastal areas, with about 60 percent of arrivals and 65 percent of overnights concentrated in the popular destinations of Budva and Herceg Novi. About 95 percent of hotel bed capacity is concentrated in the coastal region of Montenegro, only 1 percent in the mountains despite their potential, and 3 percent in the capital and central region.

[25] T&T economy includes direct and indirect impact of visitor activities, capital investment, exports and government services. A narrower concept is T&T industry, which is limited to direct impact of visitor activity such as transportation, accommodation, food and beverage, recreation, entertainment and travel services.