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IMF Executive Board Concludes 2007 Article IV Consultation with Montenegro

On January 16, 2008, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Montenegro.[1]

Background

Independence and significant tourism potential have generated impressive investor interest in Montenegro and started a recovery with growth expected to reach 7½ percent in 2007. But strong growth, and the exuberance it has generated, has brought its own problems. 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, an expansive fiscal stance, and an asset price boom.

The current account deficit is expected to widen further in 2007 to 37 percent of GDP driven by high investment (spurred by foreign direct investment, which has hovered around 24 percent of GDP in the past few years) and low savings associated with wealth effects and galloping 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

[1] 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.

supervision is relatively strong, but very fast credit expansion tests the capacity of the banks and has been taking its toll on banks' financial indicators.

Fiscal policy is adding to demand pressures. Strong revenue performance has boosted the fiscal surplus, but tax cuts have weakened the impact of automatic stabilizers. A general public sector wage increase of 30 percent, which is implemented in steps starting from October 2007, has added to demand pressures providing an unhelpful fiscal stimulus.

Executive Board Assessment

Executive Directors 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.

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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[c/]
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 (including 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, excluding 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.