SM/07/388
Correction 2

January 30, 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 27, Table 1, footnote 3: for "privatization receipts." read "privatization receipts and restitution compensations. Gross debt includes also extra-budgetary funds; these are not included in official debt statistics."

Page 34, footnote 1, line 2: "liability of the government." read "liability of the government. Official debt figures do not include extra-budgetary funds."

Typographical Errors

Page 3, List of Acronyms, line 1: for "CGCG" read "CBCG"

Page 28, Table 2: added units of accounts

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.

Att: (4)

Other Distribution:
Department Heads

Main Sources of Economic Statistics for the Republic of Montenegro

Data in the Staff Report reflects information received by October 31, 2007. In most cases, more recent data can be obtained directly from the following sources:

Statistical Office of the Republic of Montenegro	http://www.monstat.cg.yu
Central Bank of Montenegro	http://www.cb-mn.org
Ministry of Finance of the Republic of Montenegro	http://www.vlada.cg.yu/minfin
Montenegro Stock Exchange	http://www.montenegroberza.com
New Securities Exchange	http://www.nex.cg.yu
Institute for Strategic Studies and Prognoses	http://www.isspm.org
International Financial Statistics	

List of Acronyms

CBM	Central Bank of Montenegro (*Centralna Banka Crne Gore, C~~G~~BCG)*
EPCG	Electric Power Company of Montenegro (*Elektroprivreda Crne Gore*)
ISSPM	Institute for Strategic Studies and Prognoses, Montenegro
KAP	Aluminum Factory in Podgorica *(Kombinat Aluminijuma u Podgorici*)
MONSTAT	Statistical Office of the Republic of Montenegro
MTFP	Ministry of Tourism and Environmental Protection
WTTC	World Tourism and Travel Council

I. TOO MUCH OF A GOOD THING?

Montenegro: Main Indicators, 2007	
Population (in thousands)	625.2
Per capita GDP (in US$)	5,112
Unemployment rate	11.8
Inflation (average)	3.5
Fiscal revenue/GDP	50.7
Fiscal balance/GDP	5.4
Government Debt/GDP	40.5
Trade (GNFS)/GDP	136.8
FDI/GDP	24.4
CA deficit/GDP	37.0

Sources: Authorities; and Fund staff estimates.

1. **Independence and huge tourism potential has generated strong investor interest in Montenegro**. The last five years have seen price stability restored through the adoption of the euro as sole legal tender; notable progress in fiscal consolidation; restructuring of the banking sector; progress in privatization; and a favorable resolution of the state liabilities of the former union that left Montenegro with low debt (Figure 1). The authorities' vision is to create a business friendly, open economy with low taxes and minimal state interference.

2. **But strong growth, and the exuberance it has generated, has brought its own problems.** Foreign direct investment has snowballed, targeting mainly real estate and the tourism sector. Furthermore, aggressive competition for market share has led to an explosion of bank lending. In response, asset prices have been rising sharply, with the stock index shooting up, and real estate prices rapidly reaching those in wealthier neighboring countries. The resulting wealth effect has fueled pent-up consumer demand, widening external imbalances.

3. **Euroization limits policy options to manage the boom.** Strong import-related revenue growth has generated fiscal surpluses, but the authorities have been reluctant to let the fiscal stabilizers work. Income taxes have been cut sharply, and the 2008 budget is expansionary. With monetary policy discretion curtailed by use of the euro, the Central Bank has moved to tighten prudential regulations, but lacks effective enforcement powers. Structural bottlenecks have also been quick to emerge. Restrictive labor regulations, a decapitalized electricity sector, and a difficult business environment threaten to put a brake on growth if unaddressed. The unofficial economy is large at an estimated 30 percent of GDP.

II. BACKGROUND

The economic expansion is proceeding at full strength. Real growth is expected to be 7½ percent in 2007, up from 6½ percent in 2006. The tourism sector is picking up, with large inflows of FDI generating strong construction activity. However, the manufacturing sector is stalling, partly due to disruption in electricity supply. Domestic credit has progressively replaced FDI as the main driver of demand.

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

	2003	2004	2005	2006	2007	2008	2009
			Prel.	Est.		Proj.	
Real economy							
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	...	...	...
Tourism							
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	3.5	4.7	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	...		
Money and credit (end of period, 12-month)							
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)				
General government finances (cash) 2/							
Revenue and grants	41.8	37.8	37.4	44.9	50.7	48.9	47.7
Expenditure (incl. discrepancy)	46.6	40.5	39.1	42.5	45.2	46.6	46.4
Overall balance	-4.8	-2.7	-1.8	2.4	5.4	2.3	1.3
Primary balance	-3.7	-1.1	-0.6	3.6	6.6	3.3	2.2
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	8.9	10.7	12.7
Net debt (end-of-period) 3/	50.3	44.8	37.5	31.5	31.6	27.9	23.1
General government gross debt (end of period, stock)	51.8	45.9	41.6	37.7	40.5	38.6	35.9
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
Balance of payments							
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/	...	...
Memorandum:							
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 and restitution compensations. Gross debt includes also extra-budgetary funds; these are not included in official debt statistics.

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.		
				(Percent change)				
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
				(In percent of GDP; unless otherwise indicated)				
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 investmer	-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.

Appendix I: Montenegro—General Government Debt Sustainability Analysis

1. The monitoring of general government debt has improved significantly, with the debt management department of the Ministry of Finance taking a leading role in clarifying and making public the debt situation.

2. This debt sustainability analysis includes gross public debt that is recognized by the authorities and covers the general government.[1] Estimates of the liabilities from the restitution process are included. Parliament has limited the overall liabilities stemming from restitution to a maximum of 10 percent of GDP through amendments to the restitution law. For 2007, ca. €150 million is added to government liabilities. Debt of municipal governments has been revised upwards on account of recognition of domestic payment arrears (ca. €20 million). The discussions between Serbia and Montenegro on the division of external debt are not yet final, and under the current scenario, debt equivalent to €20 million is added in 2007 on account of assumed debt from the former State Union.[2] The government has also decided to compensate confiscated foreign savings of Montenegrin citizens in banks outside Montenegro[3] and, possibly, for losses incurred in the pyramid-schemes (additional €18 and €10 million are included in the current scenario). There is still uncertainty regarding debt of public enterprises from before the reconstitution of the Union between Serbia and Montenegro that ultimately could become a liability of the government. Montenegro has also decided to pre-pay World Bank debt. In September, a payment of €19 million was made, and the current scenario assumes that an additional early re-payment of €38 million will be effected before the end of 2007.

3. Under the baseline scenario, Montenegro's debt-to-GDP ratio would decline to below 30 percent of GDP in 2012 (Table 1). The primary balance is projected to improve with the current upswing in the economy. However, a weakening of the automatic stabilizers through tax rate reductions and expansion of the public sector will slow the pace of debt reduction. Nominal interest rates, while low due to the high share of relatively cheap domestic and foreign debt, are projected to reach 3½ percent on account of the government taking on a higher proportion of debt on non-IDA terms, and robust real economic growth will strengthen the automatic debt dynamics. Privatization revenues are expected to decrease following the windfall in 2005–08.

4. The standard stress tests were performed using the methodology adopted in July 2005 (Information Note on Modifications to the Fund's Debt sustainability Assessment Framework for

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[1] The central government, social funds (pension, health and employment) and local governments. Debt of state-owned enterprises is included only as so far it is explicitly recognized as a liability of the government. Official debt figures do not include extra-budgetary funds.

[2] Debt expected to be assumed by the Republic of Montenegro is toward Kuwait, Libya, Czech Republic, and Slovakia.

[3] This goes beyond the previous compensation that applied only to foreign savings confiscated by banks in Montenegro, and, in principle, the Montenegro government will have a claim on the countries in which these banks reside.

market access Countries-http://www-imf.org/external/np/pp/eng/205/070105.htm), but with modifications due to data constraints. Relevant economic information for Montenegro prior to 2002 does not exist, and estimates for 2002–06 are used for historical averages and standard deviations.

5. The standard stress tests result in a slower reduction of debt in the medium-term, but not a reversal (Figure 1), and the debt path is robust to most adverse scenarios. Montenegro, however, is facing large risks due to external concentration in trade and uncertainties in real debt levels; and euroization limits the economy's flexibility to respond to a shock. To test the limits of the debt dynamics the standard shocks applied to real interest rate, growth rate and primary balance was doubled, and 20 percent of GDP was added to the debt stock in 2008, reflecting possible hidden debt or addition of new liabilities (Figure 2). In this scenario, debt sustainability is particularly sensitive to growth and fiscal shocks, while less sensitive to interest and exchange rate shocks (due to the relatively low interest rates on existing debt stock and a small share of debt denominated in non-euro currencies). Thus, the relatively high sensitivity to changes in growth and fiscal policy reinforces the importance of continued structural reforms and a prudent fiscal stance.