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# IMF Executive Board Concludes 2008 Article IV Consultation with Republic of Montenegro

On February 23, 2009, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Republic of Montenegro.[1]

## Background

Montenegro has made significant progress in overhauling its economy, and has been rewarded for this by strong foreign investor interest. As a result, the economy has boomed in recent years, stimulated by large foreign direct investment (FDI) inflows and high credit growth, with GDP growth averaging 7 percent from 2004–08. However, the boom has also generated large macroeconomic imbalances, and the country is highly exposed to the rapidly dimming global environment.

The current account deficit is estimated to have risen to 31 percent of GDP in 2008, driven primarily by very low private sector savings and facilitated by rapid credit expansion. Gross FDI inflows moderated in 2008 as investment opportunities narrowed while the share of private external borrowing, particularly by banks, has risen rapidly. Strong wage growth has also been eroding external competitiveness.

[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.

Financial sector vulnerabilities are substantial. Banks' non-performing loans have been rising strongly, and there is a substantial exposure to the rapidly cooling construction sector. Banking system dependence on foreign financing inflows from parent banks is also high. Public confidence remains fragile, and bank deposits are declining. Private sector credit growth decelerated to 23 percent in 2008 (compared to the record high 173 percent in 2007) reflecting prudential tightening measures, lower risk appetite and declining deposits.

However, the authorities have taken several welcome steps to help strengthen financial sector stability, beefing up banks' capital and liquidity buffers, introducing a blanket deposit guarantee, providing liquidity support and pledging public funds for bank recapitalization. Also, all parent banks have supported their subsidiaries with additional funding thus far, thus partly offsetting the drain on deposits.

On the fiscal side, after substantial improvement during the boom years the surplus is estimated to have declined considerably to 1½ percent of GDP in 2008. While strong demand kept taxes buoyant, the surplus shrank due primarily to cuts to social contribution rates, a 30 percent hike in public sector wages and increased transfers.

Plans for cuts in tax and social contribution rates and increases in capital and social expenditure will substantially increase the deficit in 2009 and beyond, implying a risk of rapidly rising public debt. Moreover, there are substantial contingent liabilities linked to the blanket guarantee of bank deposits, potential recapitalization of banks, the lossmaking aluminum company, and longer term aging pressures.

**Executive Board Assessment**

Executive Directors welcomed the structural reforms implemented over the past few years and financial integration that have helped Montenegro attract substantial foreign direct investment and generate rapid growth with moderate inflation. Fiscal surpluses were achieved in past years, allowing a decline in gross public debt. Directors noted favorably the recent application for EU membership and negotiations to join the WTO.

Directors observed, nevertheless, that global financial deleveraging and the recession in advanced economies will have a substantial adverse impact on economic activity in Montenegro and cause a rise in financial, external, and fiscal vulnerabilities. Against this background, Directors agreed that it will be important to maintain financial sector stability and fiscal sustainability, while continuing the structural reform momentum. With euroization, the burden on fiscal policy—the only available macroeconomic instrument—is greater to strike the proper balance in supporting economic activity, assisting the financial sector, and securing medium-term sustainability.

Most Directors recognized that the already large structural fiscal deficit and the overhang of contingent liabilities related to the financial sector constrain the scope for fiscal stimulus in 2009. Considering fiscal multipliers to be low in a small, open economy, most Directors called for reconsideration of the planned cuts in taxes and contribution rates. Directors welcomed the authorities' intention to reduce current spending to create fiscal space and, if the economic outlook deteriorates further, to scale back lower-priority capital expenditures. Directors generally encouraged the authorities to better anchor medium-term fiscal sustainability by adopting a target for net public debt and by the welcomed intention to create a medium-term expenditure framework.

Directors supported the authorities' actions to bolster financial system stability and reduce vulnerabilities by intensifying supervisory oversight, tightening prudential regulations, and lifting bank capitalization requirements. They welcomed efforts to improve systemic liquidity management and to reach agreements with parent banks and home supervisors related to possible liquidity and solvency problems. Directors recommended strengthening further the enforcement powers of the central bank.

Directors noted the staff's assessment that the real effective exchange rate was broadly aligned with fundamentals. They also underscored the importance of continued structural reform for raising potential growth and increasing the economy's resiliency to shocks. While welcoming the new labor market legislation, Directors encouraged further measures to make the labor market flexible and to encourage job creation and longer-term employment. They supported efforts to reduce red tape at the central government level to improve the business climate, and recommended that similar steps be taken at the municipal level. They endorsed renewed efforts to reform the electricity sector.

Directors encouraged the authorities to continue their efforts to improve the supply and quality of statistical data.

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Montenegro: Selected Economic Indicators, 2004–08

| | 2004 | 2005 | 2006 | 2007 | 2008 |
|---|---|---|---|---|---|
| | | | | Est. | Proj. |
| Real economy | (Percent change; unless otherwise noted) | | | | |
| Nominal GDP (millions of €) | 1,670 | 1,815 | 2,149 | 2,810 | 3,292 |
| Unemployment rate (in percent) | 22.3 | 19.7 | 13.5 | 11.8 | 10.7 |
| Real GDP | 4.4 | 4.2 | 8.6 | 10.7 | 7.5 |
| Tourism | | | | | |
| Arrivals | 17.4 | 16.6 | 16.3 | 18.8 | 4.8 a/ |
| Nights | 14.7 | 14.3 | 13.9 | 22.9 | 6.2 a/ |
| Retail prices (period average) | 3.1 | 3.4 | 2.1 | 3.5 | 9.1 |
| Money and credit (end of period, 12–month) | (Percent change) | | | | |
| Bank credit to private sector | 43.2 | 33.2 | 138.9 | 175.9 | 23.4 |
| Enterprises | 40.6 | 30.2 | 112.2 | 191.0 | 19.0 |
| Households | 49.4 | 39.7 | 193.0 | 153.7 | 31.0 |
| Bank deposits—private sector | 23.0 | 84.2 | 119.5 | 99.5 | -15.2 |
| General government finances (cash) | (Percent of GDP) | | | | |
| Revenue and grants | 37.4 | 36.8 | 41.4 | 45.5 | 44.4 |
| Expenditure (incl. discrepancy) | 40.0 | 38.5 | 39.2 | 39.0 | 42.9 |
| Overall balance | -2.6 | -1.7 | 2.1 | 6.4 | 1.5 |
| Primary balance | -1.1 | -0.6 | 3.3 | 7.4 | 2.1 |
| Gross debt | 45.4 | 40.9 | 34.8 | 27.5 | 32.4 |
| Balance of payments | (Percent of GDP) | | | | |
| Current account balance, excl. grants | -8.4 | -8.9 | -24.1 | -29.3 | -31.3 |
| Foreign direct investments | 3.0 | 21.0 | 21.7 | 18.7 | 16.7 |
| Exchange rate regime | The euro is the legal tender | | | | |
| Exchange rate, U.S./€ (period average) | 1.24 | 1.24 | 1.25 | 1.37 | 1.49 |
| REER (wage-based; annual average change, in percent) (- indicates depreciation) | 6.6 | 7.9 | 7.4 | 3.6 | … |

Sources: Montenegrin authorities; and IMF staff estimates.

a/ As of October 2008.