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Statement by Mr. Bakker and Mr. Tomic on Montenegro
Executive Board Meeting
April 29, 2011

1. The authorities of Montenegro would like to thank staff for the focused report and the high quality of advice extended since the previous Article IV consultations. The report correctly puts in a perspective the causes of the crisis and the challenges the economy of Montenegro is facing in the post-crisis period. More importantly, the report indicates the necessary path of action required to utilize the enormous growth potential. There is a high degree of agreement between staff and the authorities on policy actions necessary for sustainable growth.

2. Although the economic developments in 2010 surprised on the upside – a positive real GDP growth of 1.1 percent was realized against negative projections of -1.7 percent, matched with low inflation (the end year CPI was at 0.5 percent) and a sizeable current account adjustment - the authorities are fully aware of the need to step up structural reform efforts in order to further boost the recovery and put the economy on a higher growth path in the medium term. In order to avoid severe internal devaluation that could further limit policy space, the fiscal deficit was financed by tapping into international capital markets. After the initial issue in September 2010, the recent second issue was better priced (by 62.5 basis points), signaling the market's recognition of the appropriate policy efforts. A sizeable headline fiscal adjustment was booked and is projected to continue, in line with the government's determination to return into surplus territory as soon as feasible.

3. The authorities are fully aware of the impact of borrowing on public debt, and, therefore, enacted several measures to contain public finances in a structural manner, the most important being pension reform. The pension law has extended the retirement age and puts the entitlements on a more solid footing from a fiscal sustainability perspective. Staff is right in claiming that implementation of the key pension reform parameter changes should be sooner rather than later. The enacted solution reflects, however, the maximum social compromise that could have been reached within the existing political economy constraints. In addition, to remedy high spending on wages in the public sector, the government introduced a rule where for every new hire in public administration two positions have to be closed.

4. Although there are encouraging signs of stabilization, such as deposit growth and

recent small credit increase, recovery of the banking system is not taken for granted. Despite relatively tight prudential regulations, severe damage to the banking system was not avoided, exemplified through the deposit run, collapse of credit, increase in NPLs and decreasing profitability. With hindsight, an even more conservative approach to implementation of banking sector regulation would have been appropriate - a lesson learned the hard way that will shape the future supervisory and regulatory actions. The authorities' swift response to support domestic banks, accompanied by adequate reaction from the foreign parent banks to their subsidiaries, succeeded in preserving overall confidence in the system. Although the NPLs remain high, a reduction and cleaning of balance sheets of major banks is underway. With technical support from the WB and the IMF, several important laws (including a law on commercial banks, a law on bankruptcy, and a law on the central bank) have been adopted in 2010. The Central Bank, under the new mandate, has stepped up on-site inspection and is carefully monitoring developments in the financial system.

5. The authorities recognize that setting the financial system on a solid footing is a precondition for continued macroeconomic stability. With a limited role for the 'lender-of-last–resort' function of the Central Bank, the authorities are aware of the buffers on public finance needed to maintain the necessary confidence. Although in theory there may be short-run macroeconomic benefits from a faster credit recovery, the authorities value full recovery of the financial system as a more important goal and will refrain from any action that could water down prudency in credit approval. Further improvements in the financial sector are continuously discussed with both the Fund and the WB staff, and the authorities stand ready to implement best international practice.

6. The specificities of a small and open economy help explain the large and volatile current account. Any of several big projects in the pipeline, requiring import of goods not locally produced, may further add to this but should not be seen exclusively from the negative side of the savings-investment imbalance. With the highest per capita FDI in Europe and a very diversified origin of FDI, Montenegro has relied and will continue to rely on FDI as a major source of growth.

7. In light of the macroeconomic framework, the authorities recognize the need to have a flexible labor market, not only in the tourism industry, which relies also on labor import, but also in other sectors. Staff recommendation to introduce opt-out clauses from collective bargaining agreements to allow for a more efficient restructuring is well received. Similarly, recommendations to increase labor supply through earned income tax credits are worth considering. The work on removing administrative barriers is underway, and this should, together with the labor law reforms, secure positive developments in competitiveness.

8. Political stability is expected to continue in the future. Furthermore, as firm EU and NATO integration processes are progressing, the country is expected to increase its attractiveness to foreign investors. The authorities continue to consider these processes, apart from the political perspective, as business development opportunities

and will fine-tune their policies so that that full economic potential from integration processes can be realized.