IMF Executive Board Concludes 2013 Article IV Consultation with Montenegro

Press Release No.13/315
August 28, 2013

On July 22, 2013, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Montenegro and considered and endorsed the staff appraisal without a meeting on a lapse-of-time basis.[2]

Montenegro's recovery from the collapse of the lending boom in 2008 has been slowed by the debt overhang that remains in the private sector. Output contracted in 2012 because of unusually severe winter weather early in the year, as well as a sharp decline in aluminum production as the financial position of the troubled aluminum company (KAP) continued to worsen. Activity picked up in early 2013 as more favorable weather conditions resulted in a sharp increase in hydro-based electricity production, but the metals sector has remained a drag on activity.

Public debt has risen sharply in recent years as large structural fiscal deficits at the end of the credit boom have proved difficult to unwind. The authorities undertook sizable fiscal adjustment in 2012, but the level of debt continued to rise, reaching 52 percent by end year. The authorities have taken several significant measures to underpin their ambitious 2013 budget, which targets a further structural adjustment of 1¾ percentage points, including a freeze in pensions and an increase in the standard VAT rate.

The banking system adjustment is at an advanced stage after a massive downsizing following the collapse of the credit bubble, but banks continue to struggle with a large stock of nonperforming loans (NPLs). Banks have aggressively sold off NPLs to factoring companies, but the latter have moved slowly with resolution or restructuring of these problem assets, leaving private balance sheets still impaired. This has contributed to a negative feedback loop whereby sluggish private sector demand is contributing to weak economic activity and a further deterioration of asset quality. As a result, new bank lending remains limited, despite a steady recovery in deposits.

KAP has been downsized but fiscal costs and risks remain. The company has continued to require significant fiscal support, in direct subsidies as well as accumulated electricity bill arrears, and the government had to guarantee its loans in 2009. The authorities have recently launched bankruptcy proceedings in the local commercial court.

Executive Board Assessment

Last year's output contraction was heavily influenced by adverse weather conditions, and a modest rebound is likely this year. Declining output in the struggling aluminum sector will continue to be a drag on activity. Montenegro has significant potential in energy and tourism, but this will require improvements in the business climate to facilitate greater inflows of foreign investment into these sectors, including by strengthening anti-corruption efforts.

A sustained, multi-year fiscal consolidation effort is needed to reduce the public debt burden to an appropriately low level in the medium term. Financing constraints and the risk of a loss of market access, as highlighted by the recent surge in global risk aversion, will continue to be a concern till financing needs dissipate. Aiming to return public debt to its 2008 level (as a share of GDP) in 10 years is appropriate, but it would require sustained fiscal effort in future years.

The authorities' recent fiscal measures are welcome as they would stem the pace of debt accumulation in 2013, but these will need to be extended into 2014 and beyond to put public debt on a declining path. The growing financing gap in the pension fund has cramped the fiscal space, and serious front-loaded reforms are needed in this area to allow savings for 2014 and beyond, including, to meet fiscal contingencies. Efforts to improve the targeting of social spending are welcome, and should be expanded.

Limited progress on NPL resolution has left private sector balance sheets burdened with very high debt, risking a prolonged period of sub-par growth. It is essential to remove structural distortions that hinder the cleanup of private sector balance sheets, including lengthy and ad hoc judicial processes that delay collateral execution. Efforts should also focus on improving the accuracy of appraisals, strengthening the land registry, and advancing auditing standards.

Moving KAP toward liquidation appears to be the least cost option, one that would also improve resource allocation. Prospects for a durable long-term solution that allows the company to operate profitably while paying market prices for electricity appear limited, and it seems inevitable that continuing KAP in its current structure would require further fiscal support—at a time when the authorities are forced to take difficult decisions to raise taxes and curb spending. While liquidation could entail some near term fiscal costs, it would remove the specter of continual subsidies from the budget and release scarce resources that can be employed more productively, including electricity for exports.

Montenegro: Selected Economic Indicators

	2008	2009	2010	2011	2012	2013 Proj.
Output, prices and labor market (percent change, unless otherwise noted)						
Real GDP (percent change)	6.9	-5.7	2.5	3.2	-0.5	1.5
Nominal GDP (in millions of euro)	3,086	2,981	3,104	3,234	3,276	3,411
Industrial production	-2.0	-32.2	17.5	-10.3	-7.1	--
Tourism (Overnight stays)	6.9	-3.1	5.5	10.2	4.3	--
Unemployment rate (in percent) 1/	16.8	19.1	19.7	19.7	19.6	--
Consumer prices (average)	9.0	3.6	0.7	3.1	3.6	3.4
Consumer prices (end of period)	7.2	1.7	0.7	2.8	5.1	3.3
General government finances (percent of GDP) 2/						
Revenue and grants	48.4	42.5	41.3	38.5	38.4	38.9
Expenditure	51.6	47.8	45.9	43.8	42.7	41.2
Fiscal balance	-3.2	-5.4	-4.6	-5.2	-4.3	-2.3
Primary fiscal balance	-2.4	-4.5	-3.6	-3.8	-2.5	-0.1
General government gross debt	29.0	38.2	40.9	46.0	51.9	55.3
Monetary sector (end-period, percent change)						
Bank credit to private sector	25.0	-15.1	-8.9	-13.0	-3.1	0.2
Enterprises	21.3	-18.0	-11.2	-20.3	-4.9	--
Households	31.2	-10.7	-5.7	-3.2	-1.1	--
Private sector deposits	-14.2	-4.1	5.9	1.2	7.2	--
Balance of payments (percent of GDP, unless otherwise noted)						
Current account balance	-49.8	-27.9	-22.9	-17.7	-17.9	-16.9
Exports of goods and services	39.7	34.5	37.3	42.8	42.4	42.4
Imports of goods and services	-93.4	-65.4	-63.2	-64.9	-66.1	-64.7

Foreign direct investment	18.9	35.8	17.8	12.0	14.1	14.6
External debt 3/	90.8	93.5	96.4	101.4	108.4	113.3
REER (CPI-based; average change, in percent;	-3.1	5.2	2.8	-3.2	-0.9	--
+ indicates appreciation)						

Sources: Montenegro authorities; and IMF staff estimates and projections

1/ Labor Force Survey (LFS) data.

1/ Includes extra-budgetary funds and local governments, but not public enterprises.

2/ Staff estimates, as private debt statistics are not officially published.

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[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. The Executive Board takes decisions under its lapse of time procedure when it is agreed by the Board that a proposal can be considered without convening formal discussions.

[2] The Executive Board takes decisions under its lapse-of-time procedure when the Board agrees that a proposal can be considered without convening formal discussions.

IMF COMMUNICATIONS DEPARTMENT

Public Affairs		Media Relations	
E-mail:	publicaffairs@imf.org	E-mail:	media@imf.org
Fax:	202-623-6220	Phone:	202-623-7100