FOR INFORMATION

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To: Members of the Executive Board

From: The Secretary

Subject: **Montenegro—Assessment Letter for the World Bank**

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Questions:	Mr. Seshadri, EUR (ext. 36793) Ms. Mooi, EUR (ext. 39920) Mr. Culiuc, EUR (ext. 38396) Ms. Unigovskaya, ICD (ext. 35641)

***If the authorities consent to the publication of this assessment, it may be published by the World Bank.**

Montenegro – Assessment Letter for the World Bank

May 19, 2020

This letter updates the IMF's assessment of the 2019 Article IV consultation, published on September 10, 2019. Given the pandemic, all projections herein are subject to an unusual degree of uncertainty. Output is currently projected to contract by some 9 percent in 2020 and partially rebound in 2021, although the path of potential GDP is expected to be below pre-pandemic estimates. Debt is expected to rise to 90 percent of GDP this year, and while still sustainable, raises significant risks. When the pandemic subsides, the authorities should resume fiscal consolidation with a view to maintaining strong primary surpluses for the foreseeable future, so that public debt is reduced significantly from its current high levels.

Recent Developments, Outlook, and Risks

1. **The Montenegrin economy is expected to be significantly affected by the COVID-19 crisis, given its heavy dependence on tourism.** The authorities responded swiftly and decisively to contain the outbreak by implementing strict containment measures in March and April, including border closures, significant movement restrictions and the closure of non-essential businesses and activities. Given no new cases since May 4 and a relatively low mortality rate, a phased reopening of the economy has begun on May 4, with further phases contingent on epidemiological conditions.

2. **The economy ended 2019 on a positive note, but the remainder of this year will be very challenging.** In 2019, the country recorded economic growth of 3.6 percent, a fiscal deficit of 3.4 percent of GDP, a current account deficit of 15.1 percent, and adequate international reserves (at 5.1 months of imports). Debt was assessed to be high but sustainable as of the time of the 2019 Article IV Consultation, and the financial sector was adequately capitalized and highly liquid on average. The economy is projected to contract significantly in 2020, by some 9 percent, due to a steep fall in tourism receipts and the accompanying impact on domestic demand. The current account is expected to narrow slightly to 13 percent on account of lower consumption and imports. Under current projections, GDP growth is expected to rebound to around 5 percent in 2021 with output gradually converging to potential in the medium-term.

3. **Montenegro faces significant medium-term risks**, **reflecting uncertainty around the duration of the pandemic.** In particular, the outlook for the resumption of tourism is highly uncertain and will depend significantly on global public health and demand conditions. Current projections envisage a halving of tourism receipts relative to 2019, which could be subject to further downside risk. A more protracted and deeper economic slowdown could cause larger long-term permanent losses of output relative to pre-crisis trends than the 10 percent loss currently envisaged in the baseline. Such a turn of events would hamper the ability to maintain needed strong primary surpluses into the future, lead to larger external financing needs and place the banking system under strain.

Fiscal Measures to Mitigate the Impact of COVID-19

4. **The authorities have announced two economic packages to deal with the fallout of the crisis.** Measures include two-month wage subsidies for employees in sectors affected by the pandemic, income tax and social security contribution deferrals, support for agriculture and fisheries, and financial assistance to the vulnerable. These packages are estimated to cost some 3 percent of GDP.

5. **Falling revenues and higher expenditure are raising financing needs, which the authorities are managing proactively.** The overall fiscal deficit is projected to increase to 10 percent of GDP in 2020 (from 3.4 percent last year). Cognizant of limited fiscal space, the authorities have planned a reduction in current spending, including wage cuts for high-ranking government officials and a partial postponement of some capital expenditures. They have been adept at managing sizable gross financing needs: they successfully pre-financed in 2019 their EUR 321 Eurobond that matured in the first quarter of 2020 and secured a syndicated loan of EUR 250 million backed by the World Bank's Policy Based Guarantee. Additional financing is expected from the EU and other IFIs.

6. **The adverse fiscal shock from COVID will further raise debt to 90 percent of GDP this year, which while still sustainable, raises significant risks.** The Bar-Boljare highway project had already strained public finances (2019 Article IV). This prompted a comprehensive fiscal consolidation strategy starting in 2017, which has resulted in an improvement in the non-highway primary balance of 4 percentage points of GDP in three years. With the widening fiscal deficit and lower GDP, however, general government debt (excluding guarantees) is expected to peak at around 90 percent of GDP this year. The authorities should resume fiscal consolidation starting in 2021, and maintain strong primary surpluses for the foreseeable future to bring debt down to safe levels and reduce large external financing needs. The authorities will also have to remain very cautious about large capital expenditures for several years to come, and speed up fiscal and administrative reforms to instill greater confidence.

Financial Sector Policies

7. **The banking sector has entered the crisis from a position of strength.** The sector is well-capitalized and liquid, but its resilience will be tested should the effects of the pandemic last longer than currently foreseen. In particular, the share of non-resident deposits, at 23 percent of the total, could become a source of added risk. The central bank has taken steps in recent years to improve banking supervision and regulation, such as by increasing off-site monitoring of banks, improving the reporting of banks, and harmonizing banking laws and regulations with the EU While temporarily halted by the crisis, preparations for a systemwide AQR are already well underway, and should resume when conditions stabilize.

8. In response to the crisis, the central bank has announced several measures. These include: (i) a 90-day moratorium on loan repayments, granted on the basis of the borrower's request; (ii) a temporary ban on payment of dividends to shareholders; (iii) a temporary halving in the fees that banks are required to pay for withdrawing reserve requirement liquidity; and (iv) a reduction in the reserve requirement rate. Any supervisory measures taken to address the impact of the COVID-19 shock should be well-targeted, temporary, and transparent, and loan classification and provisioning standards should not be lowered. Already announced permissions to exceed exposure limits to single or related parties during the period of heightened financial stress should be based on thorough and objective assessments, constantly monitored and reversed once the situation returns to normal.

Fund Relations

9. Montenegro is on the standard 12-month Article IV consultation cycle. The 2019 Article IV consultation mission took place during June 17 to 28, 2019. Montenegro has been a member of the IMF since January 18, 2007. Recent IMF technical assistance covered national accounts statistics, tax policy and administration, bank supervision, and debt management.

Table 1. Montenegro: Selected Economic Indicators, 2015-25

(Under current policies)

	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
					Est.			Projections			
Real economy											
Nominal GDP (millions of €)	3,655	3,954	4,299	4,663	4,911	4,443	4,762	5,039	5,286	5,553	5,841
Gross national saving (percent of GDP)	9.1	9.9	14.1	14.9	14.8	11.1	15.2	14.8	14.3	14.9	14.9
Gross investment (percent of GDP)	20.1	26.1	30.2	31.9	30.0	24.2	25.1	24.2	23.9	24.3	24.4
Unemployment rate (percent)	17.6	17.7	16.1	15.2	...	...	...	...	...	...	...
					(percent change)						
Real GDP growth	3.4	2.9	4.7	5.1	3.6	-8.6	5.1	4.2	3.2	3.2	3.3
Industrial production growth	8.2	-2.9	-4.4	22.5	...	...	...	...	...	...	...
Tourism											
Arrivals (growth)	8.5	10.2	18.2	12.7	...	...	...	...	...	...	...
Nights (growth)	5.3	8.4	10.5	8.2	...	...	...	...	...	...	...
Consumer price inflation (period average)	1.5	-0.3	2.4	2.6	0.4	0.7	0.9	1.4	1.6	1.7	1.8
Consumer price inflation (end of period)	1.4	1.0	1.9	1.7	1.1	0.4	1.2	1.6	1.7	1.8	1.8
GDP deflator (percent change)	2.2	5.1	3.8	3.2	1.6	-1.0	2.0	1.5	1.7	1.8	1.9
Average net wage growth	0.7	4.0	2.3	0.1	...	...	...	...	...	...	...
Money and credit (end of period)					(Y-o-y growth)						
Bank credit to private sector	2.4	6.3	8.4	9.1	4.5	-18.5	13.4	7.2	6.0	8.8	10.3
Enterprises	2.0	1.5	6.3	5.2	...	...	...	...	...	...	...
Households	2.8	11.0	10.3	12.5	...	...	...	...	...	...	...
Private sector deposits	9.0	6.0	15.2	6.0	...	...	...	...	...	...	...
General government finances 1/						(in percent of GDP)					
Revenue and grants	40.4	41.3	40.3	41.0	42.6	39.2	41.7	40.9	41.3	41.5	41.5
Expenditure	46.4	47.5	47.2	47.2	46.0	49.2	45.4	42.2	41.9	41.8	41.4
Overall fiscal balance	-6.0	-6.2	-6.9	-6.2	-3.4	-10.0	-3.6	-1.3	-0.6	-0.2	0.1
Cyclically adjusted overall fiscal balance	-5.8	-5.8	-6.9	-6.8	-3.9	-5.4	-0.4	0.7	0.7	0.4	0.1
Primary balance	-3.6	-4.0	-4.5	-4.1	-1.2	-7.3	-1.5	0.8	1.6	2.1	2.4
Non-highway primary balance	-1.3	-1.0	1.2	2.0	2.7	-4.7	0.9	0.8	1.6	2.1	2.4
General government gross debt	69.0	66.6	66.3	71.9	79.4	90.2	86.8	81.4	78.7	73.0	70.1
General government gross debt (authorities' definition) 2/	66.3	64.6	64.4	70.1	77.7	88.3	85.1	79.7	77.1	71.5	68.6
General government debt, including loan guarantees	76.4	74.1	73.6	78.1	84.3	95.7	91.9	86.2	83.3	77.4	74.2
General government net debt, including guarantees 3/	74.3	72.5	71.3	71.6	71.9	88.1	85.1	81.6	80.1	74.8	71.0
General government net debt, excluding guarantees 4/	66.9	65.0	64.1	65.4	67.0	82.6	79.9	76.7	75.4	70.4	66.8
Balance of payments											
Current account balance	-11.0	-16.2	-16.1	-17.0	-15.1	-13.0	-9.9	-9.5	-9.6	-9.4	-9.5
Foreign direct investment, net	16.9	9.4	11.3	6.9	7.0	4.3	6.4	6.7	6.7	6.7	6.7
External debt (end of period, stock)	168.0	162.6	160.6	164.7	170.4	191.1	183.0	177.7	174.5	171.6	170.1
REER (CPI-based; y-o-y avg. change, in percent) 5/	0.4	0.6	0.5	2.7	-1.2	...	...	...	...	...	...
Memorandum:											
GDP per capita (USD)	6,389	6,699	8,176	8,532	8,767	...	...	...	...	...	...
Nominal GDP Growth (in percent)	5.7	8.2	8.7	8.5	5.3	-9.5	7.2	5.8	4.9	5.0	5.2
Real output gap (percent of potential GDP)	-0.4	-0.9	0.0	1.1	1.1	-8.3	-4.9	-2.6	-1.6	-0.7	0.0
Gross international reserves in millions of USD 6/	679	794	1,003	1,195	1,518	1,207	1,209	1,109	1,036	1,012	1,061
In months of imports of goods and services	3.1	3.3	3.4	4.0	5.1	5.5	4.7	3.9	3.5	3.2	3.2

Sources: Ministry of Finance; Central Bank of Montenegro; Statistical Office of Montenegro; and IMF staff estimates and projections.

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

2/ The authorities do not include the arrears of local governments in their definition of general government gross debt.

3/ General government debt, including guarantees, net of central and local government deposits

4/ General government debt, excluding guarantees, net of central and local government deposits

5/ A negative sign indicates depreciation a REER depreciation.

6/ CBM's international reserves have been revised to exclude CBM's holdings of Montenegrin government securities and reclassify SDRs for 2015-17.