September 29, 2021
Approval: 10/6/21

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 19/76-2

10:40 a.m., September 6, 2019

2. Montenegro—2019 Article IV Consultation

Documents: SM/19/211 and Correction 1; and Supplement 1

Staff: Seshadri, EUR; Sommer, SPR

Length: 35 minutes

Executive Board Attendance

M. Furusawa, Acting Chair

Executive Directors	Alternate Executive Directors
	B. Jappah (AE), Temporary
	L. Nankunda (AF), Temporary
	J. Corvalan (AG), Temporary
	J. Shin (AP), Temporary
	P. Fachada (BR)
	P. Sun (CC)
	J. Montero (CE), Temporary
	C. Williams (CO), Temporary
	S. Benk (EC)
	P. Rozan (FF)
	K. Merk (GR)
	B. Singh (IN), Temporary
	P. Di Lorenzo (IT), Temporary
	K. Chikada (JA)
	S. Alavi (MD), Temporary
	D. Fadhel (MI), Temporary
	R. Doornbosch (NE)
	M. Bernatavicius (NO)
	A. Tolstikov (RU), Temporary
	R. Alkhareif (SA)
	R. Pandit (ST), Temporary
P. Inderbinen (SZ)	
	D. Andreicut (UK), Temporary
M. Rosen (US)	

H. Al-Atrash, Acting Secretary
E. Tsounta, Summing Up Officer
D. Jiang, Board Operations Officer
L. Nagy-Baker, Verbatim Reporting Officer

Also Present
Communications Department: G. Vilkas. European Central Bank: D. Rakitzis. European Department: J. Decressin, P. Kopyrski, W. Lindquist, T. Lybek, S. Seshadri. Legal Department: C. Blair, A. Hyman Bouchereau, M. Markevych. Strategy, Policy, and Review Department: M. Sommer. World Bank Group: E. Blanco Armas, A. Oguz. Executive Director: L. Levonian (CO). Senior Advisors to Executive Directors: P. Pollard (US), M. Sidi

Bouna (AF). Advisors to Executive Directors: S. Buetzer (GR), X. Cai (CC), J. Hanson (NE), M. Mehmedi (EC), E. Ondo Bile (AF), A. Park (AP), N. Shenai (US), M. Shimada (JA), Y. Pierre (BR).

2. MONTENEGRO—2019 ARTICLE IV CONSULTATION

The staff representative submitted the following statement:

This statement reports on information that has become available since the staff report (SM/19/211) was issued. It does not alter the thrust of the staff appraisal.

Montenegro has notified the Fund of restrictions on the making of payments and transfers for current international transactions maintained for security purposes, pursuant to the procedures of Decision No. 144-(52/51). A notification was circulated to the Executive Board on September 4 (EBD/19/35).

Mr. Doornbosch and Mr. Josic submitted the following statement:

On behalf of the Montenegrin authorities, we would like to thank staff, led by Mr. Seshadri, for their productive engagement during the Article IV mission and express our appreciation for the constructive policy findings and recommendations reflected in their report. The authorities broadly agree with staff's appraisal.

The authorities have continued implementing the fiscal consolidation measures as well as the Medium-Term Debt Management Strategy (MTDMS), which should put the debt on a steady downward path and reduce the refinancing risks, as recognized in the report. The banking system is very liquid, well-capitalized, and adequately profitable, despite the recent challenges associated with two small banks. At the same time, the authorities are progressing with the improvements in the AML/CFT framework, implementation of the remaining 2016 FSAP recommendations as well as following up on recent technical assistance recommendations. In parallel with ensuring long-term macro-financial sustainability, the authorities continued with the implementation of their Economic Reform Program (ERP) for 2019-2021. These combined efforts should warrant stable economic growth after the end of the first phase of the highway project while smoothing the negative effects of a possible global slowdown and worsening of global financial markets conditions.

Recent Economic Development and Outlook

The first results published by Monstat showed that the positive economic developments from 2018 continued during the first quarter of 2019.

The growth of economic activity in the first quarter was broad-based across sectors, particularly supported by a further increase in tourism activities and investments. Real GDP growth in the medium-term is projected to remain robust, although the average annual growth rates will decelerate to 3 percentage points due to the end of the first phase of the highway. However, this is still higher compared to the average growth rate recorded in 2014-2016 period as well as the expected rise in economic activity in most EU countries. At the same time, the authorities expect, similar to the European Commission's Spring Forecast, that the further expansion of tourism and investments in the renewable energy sector and agriculture, supported by the ambitious set of structural reforms will sustain domestic demand and exports.

Fiscal Policy and Debt Management

The authorities remain strongly committed to the fiscal consolidation strategy (FCS) that started in 2017 and will put public finances on a stable footing over the medium term. The fiscal consolidation measures outlined in the 2017–2021 Budget Deficit and Public Debt Recovery Plan, supplemented by the 2017–2020 Fiscal Strategy, have been largely implemented. The main fiscal policy objective in the following medium-term period is to preserve public finance sustainability, defined by maintaining the primary surplus of 2 percent of GDP and reducing the level of public debt, excluding state guarantees close to 60 percent by 2022. In this context, they remain committed to the continuation of fiscal consolidation in the upcoming election year.

Cognizant of development needs, and the fact that Montenegro did not have even one kilometer of highway, the authorities have launched the long-term Bar-Boljare highway project in 2014, envisaged to be built in four phases. The financing of the first and most expensive phase of the project, was secured on an international tender and on the most favorable terms at the time. As envisaged, this large infrastructural project increased public debt, but also significantly boosted economic growth. The authorities are aware that launching the second phase of the project at the current level of public debt would not be in line with the FCS or the MTMDS. Therefore, they will refrain from any new major debt-financed investment project, and to continue with the second phase of the highway only after public debt is put on more sustainable level, and favorable financing conditions are secured, potentially with a grant element.

At the same time, they will continue to work on the preparation of the second phase project, mostly by securing the legal documentation, for which the EU grant funding was secured. Through the grant of the Western Balkan Investment Framework, the EU's program for infrastructure investments in the region, the Ministry of Transport and Maritime Affairs of Montenegro and the Directorate for State Roads will prepare the Preliminary Design and Environmental and Social Impact Assessment for the second phase section of Bar-Boljare highway. In addition, a Cost Benefit Analysis and Feasibility Study for the entire Bar-Boljare project will be prepared with the aim to present the financial viability of the planned infrastructure works and justify the current planning of investments. Furthermore, the authorities would like to emphasize that the EU representatives have identified investments in the project of national, regional and international significance for the Western Balkans, and that once the Bar-Boljare highway is fully operational, it will significantly decrease travel time, reduce emissions and accidents and lower vehicle operating costs, improve trade flows with countries in the region and bring other tangible benefits, such as better living conditions and thus induce a positive impact on the broader economy of Montenegro, its citizens and its neighbors.

On the revenue side, activities will focus on the expansion of the tax base and improvement of tax discipline. In this regard, the Parliament granted the Montenegrin Tax Administration (MTA) as of January 1, 2019 full autonomy, which has already improved their efficiency and significantly reduced tax arrears. At the same time, the MTA has adopted a reform program with the aim of improving the core processes, supported by IMF technical assistance. Furthermore, a system of electronic issuing of fiscal invoices will be introduced as of January 1, 2020. Significant positive effects in generating revenues, primarily through attracting new investments, are also expected from the implementation of the Economic Citizenship Program which implies acquiring Montenegrin citizenship based on the implementation of an investment program that contributes to Montenegro's economic and commercial development. For this purpose, the authorities have signed a contract with three international and reputable agencies that will be responsible for the due diligence to minimize risks. The expected budget impact could be around 30 million EUR in three years from fees, and 500 million EUR in investments with further multiplying effects on budget revenues and economic activity (0.6 and 10.6 percent of GDP respectively). Lastly, a further increase in excise taxes on carbonated water and ethyl alcohol, the introduction of coal excise, the reduction of tax arrears through the implementation of the Law on Rescheduling Tax Receivables, as well as the implementation of the Law on Local Self-Government Financing and legalization of informally constructed buildings is also scheduled for 2019 and 2020.

On the expenditures side, the strategic commitment is to further rationalize the current expenditures, which is in line with staff's recommendations. The focus will be on the further implementation of the 2018–2020 Public Administration Optimization Plan and a freeze on employment in the public sector. This will facilitate a reduction in the number of employees in the public sector and a further reduction in the aggregate gross wage bill. The authorities agree with staff on the limited progress so far. However, they would like to emphasize that in a small state and a country in transition, it takes more time for such important reforms to make visible progress. In addition, implementation of the new concept of "consolidated public procurement" will create the conditions for rationalization of the "common" costs of the state authorities.

The authorities share staff's concerns that robust investment management and Public-Private-Partnership (PPP) frameworks are important. As a small state with high development needs, Montenegro needs to strike a proper balance between the availability of fiscal space and the development needs. Cognizant of development needs, the authorities are currently preparing a strong legislative and institutional PPP framework that could help them achieve these goals. Bearing in mind the risks that PPP projects could bring, the draft version of the law on PPP was prepared and agreed upon with the European Commission to ensure integrated regulation of this area. The authorities are also working jointly with the IFC, the IMF and several bilateral partner countries in preparing an appropriate law. It is paramount for the authorities to include the strong role of the Ministry of Finance in the process of approving the PPP projects as well as their supervision, both at the national and local level. This also includes putting limits on the number of projects as well their value, at all levels of the government. In this regard, the Ministry of finance has requested PFRAM support by FAD to proactively engage in further staff capacity development on this matter.

Regarding the strengthening of oversight of the implementation of fiscal policy, options are being considered for the identification of the most adequate model for establishing a Fiscal Council, and expert assistance has been sought from the European Union for this purpose. In addition, three-year budgeting will be formally introduced in the budget system as of 2020, where the first year will be mandatory, and the following two will be indicative.

Financial system and policies

The banking system is very liquid, well-capitalized, and adequately profitable, despite the recent challenges associated with the resolution of two small banks. Interventions in two non-systemic banks had no spillovers effects to the broader banking sector and financial stability. Key performance indicators (KPIs) of the banking system for 13 banks (without Atlas bank and Invest bank Montenegro), improved by end-2018 and their positive trend continued in 2019, with assets, loans, deposits and capital recording growth compared to December 2018 (4.2 percent, 7.6 percent, 1.3 percent and 14.3 percent respectively).

The level of non-performing loans (NPLs) also recorded further improvement. The authorities' efforts aimed at addressing NPLs in the last two years have been effective, and the systemic level of NPLs decreased to 4.8 percent at end-June 2019, compared to 8.2 percent in July 2017. At the same time, NPLs are adequately provisioned, with the provision coverage ratio standing at 83.2 percent at end-June 2019 and the coverage with regulatory reserves at 94.7 percent. However, they recognize that although the level of NPLs is not a systemic risk, it is still a challenge for some small banks. In this context, they will remain vigilant about the developments in these banks and stand ready to act appropriately. Lastly, the authorities announced the amendments to the Decision on Minimum Standards for Credit Risk Management in Banks, introducing a strict non-performing loans definition that does not exclude impaired assets that are deemed to have adequate or prime collateral.

The authorities agree that strong banking supervision is of utmost importance. In this context, they have already established a Supervisory Committee to better support decisions made by senior management as well as to allow another layer of oversight. At the same time, staffing of off-site supervision is ongoing, which will enable the implementation of the risk-based approach to supervisory assignments. The Supervision Department also underwent organizational improvements, with the establishment of a separate unit for off-site banking supervision, and thus, contributing to further improvement and strengthening of the risk-based supervision approach. An additional separate organizational unit was established which will be responsible for issuing and monitoring measures, compliance issues, and penalties. Lastly, the authorities are actively preparing for AQR that should be executed by end-2020. In order to assure the quality and transparency of the process, the AQR will be carried out by reputable international assessors. In addition, the CBM will hire a reputable international provider to assist the institution in assuring robustness of the process.

The authorities share staff's recommendation on the need for further improvements in the supervision of AML/CFT risks. In this context, significant changes were made in the organization and staffing of the CBM's Unit for Supervision of prevention of money laundering and terrorist financing in the period from September 2018 to August 2019. In February 2019, a separate Directorate for supervision in the field of money laundering (ML) and terrorist financing (TF) and a sub-unit for protection of users of financial services were established. A highly qualified Director has already been appointed and with the almost finalized procedure of employing a higher examiner, the leadership and expertise of the Directorate will be significantly strengthened. In addition, the Service for the Protection of Financial Services Users, which is part of the Directorate, also hired a new employee. It is planned to fill all the vacancies of the Directorate with highly qualified personnel. Immediately after the establishment of the Directorate, an act of the "Guidelines for developing risk analysis and risk factors for the purposes of the prevention of ML and TF by reporting entities under the supervision of the Central Bank of Montenegro", was drafted and adopted by the Council of the Central Bank. Guidelines were sent to the Fund Mission team for comments and suggestions. Lastly, the process of developing an AML/CFT manual is underway as part of a twining project, within which it is planned to develop a risk-based approach for control of reporting entities, that would guide the capacity of the Directorate in right direction with good allocation of resources.

Structural reforms and Competitiveness

Montenegro's strategic development objective, defined in the ERP, is sustainable and inclusive economic growth will contribute to reducing the country's development gap relative to the EU average and increase the quality of life of all its citizens. The authorities are aware that high growth rates needed to achieve this can be sustained in the medium term only by pushing forward a wide set of structural reforms, of which some of them are also emphasized by staff. They agree that migration and labor shortages in the key industrial sectors, are the two single biggest challenges the Montenegrin economy faces today. To mitigate this, the authorities have already passed a decision on decreasing employers' health insurance contributions by 2 percentage points. This will decrease the already high tax wedge and lower labor costs for employers. At the same time, they have submitted the draft version of the new labor law in coordination with the European Commission which will ease the currently rigid labor protection.

One of the goals set out by the Vocational Education Development Strategy to 2020 is to ensure that vocational education is relevant to the labor market. To achieve this goal and eliminate the structural mismatch between the supply and demand of the labor force, the authorities are already developing qualifications, based on learning outcomes, that match the labor market needs and, in line with them, design modular curricula. The authorities plan to fully implement new curricula in the next two years.

The authorities would like to emphasize that the implementation of the reform measures from the ERP is monitored through regular reports by the Competitiveness Council, established by the Government in 2017 and in accordance with the recommendations of the European Commission.

Mr. Obiora and Mr. Jappah submitted the following statement:

We broadly agree with the thrust of the staff assessment and policy recommendations. Montenegro has continued to experience robust economic growth, buoyed by huge investment in transportation infrastructure and a surge in tourism activity. Nevertheless, growth is expected to moderate over the medium term as the public investment impetus slows down. Moreover, heavy reliance on debt to finance these large investment projects rightly undertaken to close infrastructure gaps and improve connectivity, have put considerable stress on public finances, raising fiscal and debt sustainability concerns. Tackling these challenges would require fiscal discipline, a further strengthening of the banking sector, and continued implementation of structural reforms.

The authorities' resolute implementation of the 2017 medium-term fiscal adjustment strategy is commendable but more needs to be done. We are encouraged that these actions have helped improve the sustainability of Montenegro's public finances. But further efforts are required to durably reduce debt levels, including a consideration to contain expenditures on public wages, reform the pension system, strengthen revenue administration and rationalize tax exemptions. Given current financing requirements for the commencement of phases 2-4 of the Bar-Boljare highway project, we welcome the authorities' intent to pursue other non-debt creating financing options but emphasize the need for appropriate contingencies to minimize fiscal risks. In line with the country's Medium-Term Debt Management Strategy and Fiscal Consolidation Strategy, we are delighted with reassurances highlighted in the buff Statement by Messrs. Doornbosch and Josic that the authorities would refrain from investing in any new major debt-financed project. Within the context of strengthening Montenegro's PPP frameworks, we support staff's recommendation for a PIMA assessment. Could staff indicate and explain the authorities' views on this recommendation?

Although the financial sector is solvent and well-capitalized, we are concerned that the banking sector balance sheet is still subject to credit and liquidity risks. To this end, we urge the authorities to act with urgency in establishing much better regulatory and supervisory frameworks for these risks, as recommended in the 2015 FSAP Report. On the remaining pockets of vulnerabilities, we are encouraged that the CBM is introducing effective macroprudential measures to contain them. Similarly, we support their efforts to strengthen oversight and adopt risk-based supervision following the establishment of a supervisory committee, and welcome key steps taken to align banking supervision and crises management tools with EU practices, consistent with earlier recommendations. We applaud the authorities' commitment to conduct an Asset Quality Review (AQR) by end 2020 and look forward to the report.

Strong institutional and legal frameworks are warranted to support the country's investment-led growth strategy. Against this premise, we welcome the drafting of a new PPP legislation, which is expected to become law later this year. This notwithstanding, we note that the draft framework in its current form needs strengthening to align with best practices for mitigating fiscal risks. In line with this, we welcome staff 's comment on the authorities' willingness to address the gaps in the draft law before submission to parliament. Further, we welcome the authorities request to FAD to help build the analytical and reporting capabilities of personnel working on PPP arrangements. We encourage the authorities to continue to implement further measures to boost private sector development, improve competitiveness, expand domestic production and re-structure critical State-owned Enterprises (SOEs). In this context, we welcome the draft law that seeks to address labor market weaknesses, including correcting mismatches between educational outcomes and skills requirements for the labor market.

Mr. Merk and Mr. Buetzer submitted the following statement:

We thank staff for its well-written report and Mr. Doornbosch and Mr. Josic for their helpful buff statement. While growth in Montenegro has increased strongly in recent years, the medium-term outlook is somewhat clouded as highway construction ends. The country continues to face external as well as domestic challenges: On the external side, risks regarding the elevated current account deficit persist. Domestically, weak financial sector oversight and vulnerabilities to corruption weigh on Montenegro's economic development. In addition, fiscal sustainability is at risk, not least due to the highway construction project and in light of parliamentary elections in 2020. We therefore echo staff's call for continued progress in fiscal adjustment.

As we broadly concur with staff's appraisal we would just like to offer the following comments for emphasis:

High public debt and the country's mixed track record in sustaining fiscal discipline limit Montenegro's room to implement countercyclical fiscal measures and long-term growth enhancing investment projects. With regard to the highway project, we take note that the first phase has exhausted Montenegro's fiscal space, crowding out other productive spending. The risks to fiscal sustainability increased further by not hedging the loan contract, which has already resulted in substantially higher costs according to staff. Particularly worrisome is that the economic return of the overall project is estimated to be low and that, apart from highway investment, other public investment and social security expenditures are relatively low. We do take note that the net benefits of Phase 2 of the project are considered to be more favorable and that better connectivity and infrastructure could boost tourism and trade, thereby potentially supporting Montenegro's weak external position. Given the risks to fiscal sustainability, however, we agree with staff that the net benefits of constructing the remaining parts of the highway should be carefully assessed before any decision is made on going ahead with Phase 2. We take positive note of the authorities' assurances in this regard and their desire to seek more favorable financing conditions as expressed in the buff statement.

In this context we would have appreciated a more in-depth analysis of the highway project's potential positive long-term effects on productivity and tourism in the current staff report. Staff comments would be welcome.

Moreover, staff states that an element of grant financing would be needed in order for the continuation of the construction project to be feasible (para. 22). Could staff provide further information on the terms and conditions of project financing so far?

Regarding financial oversight and financial stability, we welcome the CBM's steps taken so far to harmonize banking laws with EU directives.

Nonetheless, further efforts with respect to risk-based tools for supervision are needed. Given Montenegro's relatively high number of banks, we concur with staff that it is important to thoroughly apply prudential regulation. The recent bankruptcies of two domestic banks underline the need for improved banking supervision. Furthermore, we would like to strongly emphasize the potential risks for financial integrity in connection with the investor citizenship program. Strengthening the AML/CFT framework is therefore all the more important and we very much support the TA provided by MCM in this context.

Mr. Tan and Ms. Pandit submitted the following statement:

We thank staff for the insightful report and Mr. Doornbosch and Mr. Josic for the informative buff statement. The Montenegrin economy has enjoyed strong economic growth in recent years. Nevertheless, challenges remained in safeguarding fiscal sustainability and financial stability, as well as improving labor market outcomes over the medium-term. We also note that risks to the outlook are accentuated by external vulnerabilities including a tightening in global financial conditions and an economic slowdown in Europe. Against this backdrop, we agree with the broad thrust of the staff appraisal and offer the following comments for emphasis.

Continued efforts are essential to reduce debt vulnerabilities and enhance fiscal stability and sustainability. We are encouraged by the successful debt management operations by the authorities. That said, given the weak economic growth and fragile financial conditions globally, we also note with concern that general government debt reached 79 percent of GDP in 2018 and might increase to 89 percent in 2019. In this context, continued efforts to maintain adequate fiscal space is paramount to safeguard fiscal stability and sustainability, and keep the debt trajectory on a downward path. We see merit in staff's suggestion of maintaining minimum 2 percent of primary fiscal balance of GDP over the medium-term and are glad that the authorities recognize the importance of maintaining primary surpluses to reduce debt. Could staff elaborate on the reasons behind the lower projection for the primary fiscal balance from 4.5 percent of GDP to 2.7 percent? The additional desirable reforms that would create space for a more growth-friendly budget are also welcomed. To implement these initiatives timely and effectively, we call on the authorities to work toward a comprehensive medium-term budget framework and the necessary legislative changes in line with the Fund TA's recommendations. Could staff comment on the prospects of effecting the pension reforms in the near/medium-term?

We welcome the authorities' commitment to continue the Bar-Boljare highway project only after ensuring that public debt is put on a more sustainable level and securing favorable financing conditions. Staff has provided a clear case for carefully considering the costs and benefits of the highway project against alternative uses of scarce public resources, and the project's potential risks to fiscal sustainability. This is a matter of significant implications for Montenegro and we are pleased that there was agreement on completing the new feasibility study in 2020 and analyzing the possible financing models for phase 2. In this regard, we also underline staff's recommendation for more robust investment management and PPP frameworks, and we encourage the authorities to duly consider a PIMA TA from the Fund.

Further progress is required to strengthen banking supervision. We are pleased that there was no immediate spillover effect from the bank closures in 2018. However, we would ask the authorities not to be complacent and to continue to lay the foundation for financial stability. To this end, we concur with staff that the CBM should enhance its supervisory structure and the effective implementation of risk-based supervision. This would include actions to strengthen AML/CFT supervision in particular. Significant efforts are needed on the part of the authorities and we support the Fund TA efforts on this front. We welcome the CBM's efforts to improve the regulatory framework and harmonize banking laws with EU directives. However, we note that the asset quality review (AQR) is a pending recommendation from the 2015 FSAP and we encourage the authorities to carry out the AQR expediently. Staff's comments are welcome whether there are any new banking licenses in the pipeline and the scope for consolidation in the banking system.

The authorities should continue with the labor market reforms in addressing barriers to formal sector employment and inclusive growth. We commend the authorities' plan to enhance labor market conditions through the reduction of the labor tax wedge, the proposed labor law to reduce the gap in employment protection and the consideration to increase the minimum wage. We concur with staff's view that these proposed initiatives are well-intentioned to improve labor market outcomes. With respect to the minimum wage, we also draw attention to staff's emphasis on the need to strike a balance by assessing the impact of prior increases and considering a broad set of labor market indicators.

With these comments, we wish the authorities further success in their future endeavors.

Mr. Benk and Mr. Mehmedi submitted the following statement:

We thank staff for the comprehensive reports, and Mr. Doornbosch and Mr. Josic for their candid and in-depth buff statement. We welcome Montenegro's strong economic growth momentum, driven by a sharp increase in tourism arrivals. We note however, that the need for fiscal and structural reforms is amplified by the downside risks stemming from the high public debt and fiscal deficit, and the heavy reliance on external financing. Going forward, the macroeconomic policy mix should be focused at rebuilding policy buffers through the implementation of a growth-friendly fiscal consolidation and faster implementation of the structural reform agenda to lift the constraints to growth, investment, and employment. These efforts would ultimately speed up the process of income and institutional convergence with the European Union. In view of the general election scheduled for next year, which could increase fiscal pressures, the authorities' utmost commitment to fiscal discipline will be critical. We broadly share staff's assessment and policy recommendations, and provide the following comments for emphasis.

A credible and well-paced fiscal consolidation underpinned by the rationalization of tax expenditures, and the careful implementation of the Bar-Boljare Highway project is essential to further reduce public debt and build fiscal buffers. While the 2017 fiscal adjustment has continued, we regret that some of the adjustment measures were reversed last year. With public debt reaching 79 percent of GDP and the overall fiscal balance reaching 6.3 percent of GDP last year, preserving fiscal adjustment and putting debt on a sustainable downward path will require the implementation of sound fiscal measures to preserve a primary fiscal surplus of at least 2 percent of GDP over the medium term. In this vein, rationalizing tax expenditures, and improving the tax administration will be essential components of this strategy. With the government wage bill exceeding its peers, the authorities should focus on rationalizing public employment and containing the public wage dynamics and consider introducing a public sector wage rule which would complement the implementation of the authorities' ongoing public administration reform. At the same time, while we recognize the importance of the Bar-Boljare Highway for enhancing the interconnectivity and making Montenegro part of the regional road network, we concur with staff that rushing to complete the highway should not jeopardize fiscal sustainability. We encourage the authorities to move cautiously with future phases of the highway construction and only after a new and credible feasibility study is completed and the cost and benefits are judiciously evaluated. Staff's comments on the main components of the recently launched investor citizenship program and how the authorities will address potential reputational and integrity risks are welcome.

Vulnerabilities in the financial sector related to weak domestic banks and the supervisory framework should be urgently addressed. The CBM intervened in 2018 with the appointment of an interim administration in two non-systemic domestic banks, within months placed them into bankruptcy. This further underscores the need for a stronger banking supervisory framework, including better risk-based supervision, and the prompt completion of the delayed independent asset quality review for banks. Concurrently, the authorities should advance the implementation of the outstanding key policy recommendations from the 2015 FSAP, including measures to enhance emergency liquidity assistance. Furthermore, time-bound measures are needed to strengthen the AML/CFT framework by improving AML/CFT supervisory procedures and developing an institutional risk assessment model. Staff's comments on whether the update to the national Risk Assessment has been finalized and the main findings are welcome.

Strengthening the rule of law, improving governance, and enhancing the business environment are essential components for boosting growth and productivity. While the authorities have made important strides in improving the business environment and investment climate, competitiveness continues to be hampered by high labor costs, an overvalued real exchange rate, and an inflexible labor market. Against this backdrop, the structural reform agenda should be focused on policies aimed at lowering the labor costs through aligning them with productivity dynamics and reducing the high tax wedge, minimizing the regulatory burden, increasing labor market flexibility, and implementing vocational training programs to reduce the skills mismatch, particularly among the youth. Considering the authorities' plans to increase the minimum wage by 15 percent, which exceeds both accumulated inflation and average wage gains of 6 percent since the last increase in 2013, we are wondering how the increase would impact the labor market and employment and whether it could trigger increases in social schemes.

Mr. Chikada and Mr. Shimada submitted the following statement:

We thank staff for their informative report and Mr. Doornbosch and Mr. Josic for their helpful statement. We welcome that the Montenegrin economy has grown strongly since 2015, bolstered by large investments and tourism. However, we also take note that the growth-driver highway project has significantly increased government debt, and thus for the sake of fiscal sustainability as well as for the balanced economic growth, due caution is warranted regarding further expansion of the project. As we broadly concur with the staff's opinion, we will limit our comments on following points for emphasis.

Rigorous cost and benefit analysis on infrastructure investments as well as due consideration to "opportunity costs" are essential to safeguard fiscal sustainability and the balanced economic growth. In this regard, we commend the authorities' prudent stance that they would not proceed with phase 2 of the Bar-Boljare Highway Project unless questions about feasibility and financing are resolved although the highway project has symbolic importance for Montenegro. Also, considering Montenegro's limited fiscal space and high development needs in infrastructure in a broader sense, it is important for the authorities to examine economic returns and opportunity costs of various ongoing and potential investment projects and prioritize them accordingly.

We concur with staff's recommendation that an asset quality review (AQR) should be completed promptly. While we welcome the authorities' recent measures to strengthen banking supervision and refining the definition of non-performing loans, risk-based supervision cannot work without information about quality of banks' assets and a full diagnostic analysis of banking sector health. As staff points out, recent two banks failures highlight the necessity of AQR. Also, we encourage the authorities to strengthen their AML/CTF supervision, based on the recommendation of 2016 FSAP and recent technical assistance.

Mr. Sigurgeirsson and Mr. Bernatavicius submitted the following statement:

We thank staff for a comprehensive report and Mr. Doornbosch and Mr. Josic for their helpful buff statement. We broadly share staff's appraisal and offer the following comments on fiscal policy, the Bar-Boljare highway project, and external sector issues for emphasis.

We take positive note of the significant fiscal adjustment implemented over 2017-19. As risks to debt sustainability remain significant, we support staff's recommendation to maintain a primary fiscal surplus of at least 2 percent of GDP over the medium term. We strongly encourage the authorities to refrain from further postponing urgently needed reforms in the pension system and rationalization of public employment. Stronger fiscal institutions and a credible medium-term budget framework are needed to maintain fiscal discipline.

The key driver for the increase in public debt since 2014 has been related to the construction of the first phase of the Bar-Boljare highway project. According to staff's analysis, a decision to fund the remaining phases of the highway with debt could have a major impact on fiscal sustainability. The completion of the highway could cost an additional 25 percent of GDP, and public debt could remain over 80 percent of GDP for most of the coming decade. In this context, we strongly support staff's recommendation to place further highway construction on hold until a new and credible feasibility study is fully completed.

External imbalances remain elevated amid weak performance in goods exports and low labor productivity. Recently implemented structural reforms and wage restraint would help to alleviate imbalances, but more needs to be done. Despite relatively high economic growth in recent years, the unemployment rate is still high at 15 percent and the share of temporary contracts remains the highest in Europe.

Recent closures of two small banks highlight the need for stronger banking supervision. We welcome the authorities' decision to carry out an asset quality review by the end of 2020, which was a key recommendation pending since the 2015 FSAP. The AML/CFT supervisory regime should also be strengthened in line with recommendations provided in Annex IX.

Mr. Psalidopoulos and Mr. Di Lorenzo submitted the following statement:

We thank staff for their insightful paper and Mr. Doornbosch and Mr. Josic for their informative buff statement. We agree with the thrust of staff appraisal and would like to make some points for emphasis. These concern the need for thorough reforms in the areas of the framework for capital expenditure, the labor market, and banking supervision.

While appropriate fiscal measures to preserve debt sustainability have been adopted, the framework regulating public investment should be immediately strengthened to allow for effective projects prioritization. We commend the authorities for the adoption of the quality compensatory measures that have contributed to contain the sharp rise in public debt following the construction of the Bar-Boljare highway. We agree that the primary surplus of 2 percent currently projected at the end of the construction period needs to be maintained going forward in order to attain a steadfast reduction in public debt and welcome the authorities' commitment in this regard. Moreover, debt sustainability is supported by the sizeable liquidity buffers accumulated to pre-finance next Eurobond redemptions. Montenegro's experience well highlights the importance, especially for countries with a low capital stock, of having in place a thorough legal and institutional framework to prioritize projects, efficiently allocate funds and transparently monitoring the implementation of the public investment, while keeping fiscal risks in check. At this end, we strongly encourage the authorities to request a PIMA TA and to make sure that the new PPPs law will incorporate Fund and WB's staff recommendations. We welcome that the authorities have secured a grant from the EU for the second phase of the project, but it is vital that the feasibility study and the cost benefit analysis for this and potential future phases are conducted with the collaboration of some IFIs. Has staff any information about the preparation of those studies?

Employment in the formal sector needs to be encouraged. Given the high rate of official unemployment and the sizeable informal sector, we encourage the authorities to move forward with their plan to reform the labor market. Reducing the cost of hiring by cutting the tax wedge and making open ended contracts more attractive to employers should help in promoting high-quality jobs. At the same time, if employment protections are reduced, it is important that an appropriate safety net is put in place. Staff's views on the possibility that the minimum wage increase would force greater payment of salaries through formal means, as argued by the authorities, are welcome.

While the banking system is overall stable, enhancing supervisory action is needed to strengthen its resilience. The serious irregular activities by a few banks that went undetected for some time point to a series of weaknesses of the supervision system. We welcome that the depositors were promptly paid back, thus avoiding a generalized loss of confidence in the system. We welcome the steps made for the incoming launch of the asset quality review and for the harmonization of the banking laws with the EU framework. The establishment of a risk-based approach for banking and AML supervision would ensure that the limited resources for onsite inspections are effectively allocated. In addition, effective supervision requires that offsite monitoring activities are developed. Finally, a thorough implementation and application of the new AML/CFT law, also through organizational improvements, is also needed to preserve financial stability.

Mr. Moreno and Mr. Montero submitted the following statement:

We thank staff for its report and Messrs. Doornbosch and Josic for their informative buff statement. We broadly share staff's appraisal and would like to offer some comments for emphasis.

Montenegro's economy has grown strongly since 2015 bolstered by large investments associated to the construction of a major highway project, as well as by buoyant tourism. To counter the rise in government indebtedness linked to this project, the authorities embarked on an ambitious medium-term adjustment strategy (with 4.5 percent of GDP in adjustment measures already implemented over 2017–19), despite of which general government debt reached 79 percent of GDP in 2018. Relatedly, external imbalances remained elevated, with a current account deficit of 17 percent of GDP and an external debt ratio of 167 percent of GDP in 2018. All in all, over the short to medium term the evolution of the Montenegrin economy will be tied to the performance of the Bar-Boljare highway. Thus, we support staff's emphasis on this topic throughout the report and on forthcoming Article IV consultations.

We concur with staff on the need to ensure a primary fiscal surplus of at least 2 percent of GDP over the medium term to ensure an adequate reduction path for public debt and rebuild fiscal space to deal with future shocks. This, along with the possible pre-financing of the funding needs for 2020-21, would provide the authorities with ample room for maneuver. We also share staff's views on the desirability of growth-friendly reforms in the areas of government employment, tax expenditure and pensions, as well as a stronger budgetary framework. However, the most pressing concerns are the risks associated with the Bar-Boljare highway project, inter alia, the possibility that this project may crowd out other much-needed investments in the areas of water treatment, education, and healthcare.

We note with concern that previous feasibility studies estimated a low economic return on the overall highway, based on limited potential for toll revenues relative to costs. Moreover, completion of phases 2-4 could cost an additional 25 percent of GDP, which would likely result in still higher public indebtedness. Thus, we support staff's call to pause further highway construction until a new and credible feasibility study is completed. In this vein, we welcome the authorities' intention to undertake a feasibility study in 2020. Additionally, to maximize employment and growth-enhancing effects going forward, we would suggest a project design with a much greater domestic value-added content, including of labor input. We also note that continuation of the highway through a PPP structure could also entail significant fiscal costs, particularly if substantial state guarantees are provided to private contractors. Given the large risks associated with the external financing of these projects, and provided that a suitable return is ensured, we wonder whether it would be adequate to postpone implementation of phases

2-4 until EU entry and then seek the option of financing these investments with structural funds. Staff's comments are welcome.

Full euroization puts a premium on ensuring a strong financial system. In this vein, harmonization of banking laws with EU directives will be crucial. We positively note the relatively smooth resolution of two insolvent banks, which have avoided immediate fiscal and real economy spillovers. This notwithstanding, we concur with staff's recommendation to strengthen banking supervision and welcome the support from MCM's TA. The elaboration of a comprehensive asset quality review is a longstanding topic that must not be delayed any further. This is essential to ascertain true asset values, including collateral, and the adequacy of provisioning, which will be the starting point to address any residual financial vulnerabilities. We take note of staff's assessment that Montenegro has many banks relative to its size (12 banks for a population of over 600,000 people). Judging by the overall degree of capitalization and by the levels of net interest margins vis-à-vis the average EU countries, this atomization does not seem to be hampering the health of the Montenegrin's banking sector—pending results from the AQR. Could staff elaborate on the perceived challenges for bank profitability and financial stability? What available options could the authorities consider for fostering a consolidation of the banking system?

Finally, we note that Montenegro's labor market outcomes are weak, with low labor force participation, high unemployment and use of temporary contracts, and a large share of informal employment. Thus, we commend the authorities for their planned 2 percentage point reduction in labor taxes, which will make the hiring of formal employment at the low-wage segment more attractive. We encourage the authorities to press forward with the approval of the new labor law, which seems to go in the right direction by narrowing the gap between temporary and regular contracts. This is a topic that will warrant careful analysis going forward.

Mr. de Villeroché, Mr. Rozan and Mr. Bouvet submitted the following statement:

We thank staff for the rich set of reports and Mr. Doornbosch and Mr. Josic for their instructive buff statement. We welcome the good performance of the Montenegrin economy over the past two years and the effective implementation of the authorities' fiscal adjustment strategy. We concur with staff's analysis that Montenegro should ensure a balance between debt reduction and an enhanced composition of public spending to sustain a higher level of growth. This requires in particular cautiousness about possible next phases of the Bar-Boljare highway project. In this regard, we are reassured by the authorities' careful approach. We commend the authorities' intentions to strengthen banking supervision as well as to alleviate structural labor market impediments. We associate ourselves with the thrust of the staff appraisal and wish to provide the following comments for emphasis.

Macroeconomic outlook

We welcome the robust growth performance in Montenegro over the last two years, on the back of strong tourism and infrastructure investments, and take note of the more moderate medium-term outlook. In the medium term, private investments related to tourism and the energy sector on the one hand and consumption on the other hand should be the main drivers of growth. Finally, we encourage authorities to remain alert to specific risks linked with external financing environment and fiscal discipline.

Fiscal policy

We commend the authorities for the successful implementation of a fiscal adjustment strategy and encourage them to preserve fiscal sustainability in the medium term while enhancing the quality of public spending. We commend the authorities' strategy to reduce fiscal risks and, in particular, enhance debt management and their commitment to maintain a primary fiscal surplus over the medium term. In line with staff's recommendations, creating fiscal space for pro-growth spending will be instrumental, building on the steps already taken by the authorities.

We share staff's cautiousness regarding the next phases of the Bar-Boljare highway, since it could pose a risk to Montenegro's fiscal stance and debt dynamics. Considering the fiscal and debt impact, as well as the past cost/benefit analysis we welcome the authorities' position not to proceed beyond phase 1 of the project until feasibility and financing issues are thoroughly addressed. More broadly, public investment management should be strengthened, and we encourage the authorities to consider technical assistance to improve the quality, efficiency and priorization of public investment and to better mitigate financing-related risk, such as currency risk. While the dollar has been recently strengthening against the euro, could staff elaborate on the fiscal consequences for Montenegro of the absence of hedging against currency risk, as well as possible steps to mitigate this?

Financial stability

In light of the recent failures in the banking sector, reforms envisaged by the authorities to implement stronger banking supervision are warranted. Although non-performing loans are expected to further decrease in 2019, and banks appear adequately capitalized, the failure of two non-systemic banks in 2018 calls for completing a diagnostic of the banking sector through asset quality reviews. We share staff's main recommendations regarding the enhancement of a risk-based banking supervision. We also welcome the authorities' commitment to update banking regulation through its harmonization with EU directives. This harmonization should improve banks' capital adequacy and mitigate insolvency-related risks. Furthermore, we welcome the authorities' commitment to beef up the Central Bank's AML/CFT Unit in terms of organization, staffing and operational guidelines.

Structural reforms

Steps taken by the authorities to reform the labor market towards a less rigid and dual system should contribute to increasing Montenegro's competitiveness and strengthening its external position. Partly closing the gap between temporary and open-ended contracts should incentivize employers to resort more to the latter, bringing employees more job security and careers opportunities. Besides, we note that the tax wedge remains high, deterring employment in the formal sector and, more broadly, the participation to the labor force. Therefore, reforms under preparations to address these rigidities are welcome. These competitiveness enhancing reforms will need to be astutely articulated with the authorities' intention to increase the minimal wage so as to avoid mutual neutralization. According to staff, what would be the impact on growth and public finance of the labor market reforms underway? Beyond the labor market, could staff indicate what other reforms aiming at the diversification of the economy and the strengthening of the external position could be the most impactful for Montenegro?

Mr. Mozhin and Mr. Tolstikov submitted the following statement:

We thank staff for the well-written report and Mr. Doornbosch and Mr. Josic for their informative buff statement. Over the last several years, growth of the Montenegrin economy has been robust, underpinned by large investments and expanding tourism sector. We welcome the implementation of the authorities' fiscal adjustment strategy, which strengthened fiscal framework and laid the foundation for future reduction of public debt. The financial system remains sound and resilient, and the authorities are working to further improve banking supervision and reduce AML/CFT risks. As we broadly agree with the staff assessment, we will add only a few comments for emphasis.

The implementation of the fiscal consolidation strategy (FCS), which started in 2017, has been successful so far. Excluding the Bar-Boljare highway spending, the primary balance has improved by 3 p.p. of GDP. While the short-term FCS goals have been mostly achieved, the authorities should now focus on developing a comprehensive medium-term budget framework to anchor medium-term fiscal sustainability. In this regard, we welcome their plans to introduce the three-year budgeting from 2020 and to evaluate the best ways to establish a Fiscal Council. Reforms in tax administration should be operationalized and fully implemented.

The ambitious Bar-Boljare highway project has weighed heavily on public finance and remains an issue of macroeconomic importance. By staff's estimates, full implementation of the phases 2-4 of the project may add up to 25 percent of GDP to already high public debt level. In this regard, it is important to undertake a thorough cost and benefits analysis of the remaining phases, while taking into account their broader impact on the development of Montenegro's and regional economies. We welcome the authorities' decision to move forward with the next phases only after the public debt is reduced to a more sustainable level.

The Montenegro's financial sector remains in a good shape, the banking sector is well capitalized and profitable, while the NPL level continue to decline. At the same time, the bankruptcy of the two small banks highlights the need for improvements in banking supervision. The Central Bank of Montenegro (CBM) is making steps in this direction, including establishing a Supervisory Committee and strengthening its Supervision department. This should be complemented by conduct of a thorough Asset Quality Review by the end-2020. The introduction of a CBM-developed legislative package, which would harmonize banking laws with the EU directives, would further strengthen the financial system.

Continued structural reforms are needed to improve competitiveness and address high informality in the economy. We welcome steps to reduce excessive labor tax wedge, as well as preparation of the new labor law, which can help address rigidities in the labor market. The authorities believe that the minimum wage increase would reduce shadow wage payments, thus improving tax revenues. Given high informality of the labor market, this approach may work for Montenegro. Could staff comment on this issue on the basis of other countries' experience?

Mr. Inderbinen, Ms. Levonian, Mr. Rosen, Mr. Williams, Mr. Djokovic and Mr. Shenai submitted the following joint statement:

We thank staff for a well-written report and Messrs. Doornbosch and Josic for their informative buff statement. Although headline growth has been strong, fiscal and financial risks have risen. The staff report highlights the risks posed by projects such as the Bar-Boljare highway. The first phase of this project has cost around €1 billion and increased public debt by about 25 percent of GDP with limited domestic value-added content. Staff estimates that the growth spillovers from the project—critical to sound public investment—will be moderate. The authorities are now undertaking a significant fiscal adjustment that, as the staff report notes, may not have been necessary absent the highway construction. In this context, we strongly recommend the authorities carefully manage infrastructure investment and continue to enhance financial sector supervision, which can enhance debt sustainability and reduce financial sector vulnerabilities. We broadly concur with staff's assessments and recommendations and offer the following remarks for emphasis.

Solid fiscal discipline is needed to strengthen external viability and reinforce policy credibility given rising debt levels. The recent adjustments to the VAT and wage containment measures helped improve the underlying fiscal position. At the same time, we echo staff's call for more durable public sector compensation and employment reforms going forward. Moreover, we remain concerned that the benefits of ongoing fiscal consolidation efforts could be eroded by exorbitant public investments in the Bar-Boljare highway project. As a small transitioning economy, Montenegro faces a tough task balancing development goals against debt sustainability. This challenge underscores the need for sound institutional arrangements to strengthen fiscal oversight. In this context, the authorities' intentions, as emphasized in the buff statement, to develop a robust public investment management framework alongside considerations of a fiscal council are welcome.

Given risks, we strongly agree with staff on the need to weigh the benefits of further Bar-Boljare highway phases against fiscal costs. We appreciate the authorities' commitment to proceed cautiously as noted in buff statement. That said, we were surprised to see that the authorities plan to explore phase 2 via either PPP or on-budget public procurement in 2020 given the lessons learned from phase 1 construction and the ongoing fiscal and external risks posed by the project. While the planned safeguards and loan concessionality may help improve project feasibility, we note staff's assessment that the growth effects of highway investment are estimated to be moderate compared to a typical investment project.

Going forward, we strongly encourage the authorities to consider potential growth-enhancing effects, domestic employment benefits, and long-term direct and opportunity costs before proceeding with further highway phases and other major infrastructure projects. We would hope that future projects, where pursued, emphasize a much greater domestic value-added content (including labor). Furthermore, we believe that the authorities should consider delaying further highway phases until they can obtain concrete commitments from regional neighbors for greater road interconnections. Also, further borrowing should be euro denominated to reduce the foreign exchange rate risk posed by the project. Could staff provide an update on the status of discussions between the authorities and China Road and Bridge Corporation on future phases?

While the two intervened banks did not cause any adverse contagion effects, there are financial oversight weaknesses that warrant urgent and sustained attention. We commend the authorities' progress on implementing several of the 2015 FSAP recommendations. However, we encourage them to act swiftly on key recommendations that remain outstanding, including undertaking of an asset quality review and adopting risk-based supervision. In addition, the authorities are advised to promptly introduce appropriate macroprudential policies to address worrisome and emerging risks from rising uncollateralized cash loans.

Further strengthening the AML/CFT regime is necessary to increase financial transparency and guard against money laundering risks. We encourage the authorities to continue efforts toward adequately staffing the AML Directorate and to strengthen offsite monitoring and onsite inspections. We also encourage the authorities to monitor reputational and financial integrity risks posed by the investor citizenship program, including by implementing comprehensive due diligence measures on applicants.

Mr. Sun and Ms. Cai submitted the following statement:

We thank staff for the comprehensive reports and Mr. Doornbosch and Mr. Josic for their informative buff statement. Growth in Montenegro was strong and broad-based, while vulnerabilities remain. More needs to be done to reduce the fiscal deficit and strengthen external buffers. We broadly agree with staff's appraisal and would limit our comments as follows.

Further measures are needed to build fiscal buffers and ensure fiscal sustainability. Progress has been made on implementing the fiscal adjustment strategy, including increasing the VAT rate. Going forward, strong discipline and structural reforms in public financial management should be continued to enhance the fiscal position. The authorities' plan to reduce government employment and eliminate tax expenditures is welcome. Meanwhile, fiscal administration capacity, including those for tax and fee collection and currency risk hedging, needs to be enhanced. We welcome the authorities' strong commitment to fiscal consolidation and encourage better prioritization for social spending.

Continued efforts to strengthen debt management are critical to preserving debt sustainability. Driven mainly by the government's issuance of the Eurobonds, external debt increased to 167 percent of GDP in 2018. We agree with staff that public spending efficiency needs to be improved and technical assistance on public investment assessment and management should be strengthened.

Regarding the highway project, the loan agreement signed between China and Montenegro carries a 2 percent interest rate with around 30 percent concessionality. The interest rate and maturity terms are more favorable than those in the market. According to the World Bank's report Montenegro: Preparing for Prosperity, the project meets the test for EU investment projects, and the EIB has shown interest in supporting the project. We appreciate the authorities' cautious approach to launching the second phase and take positive note of EU representatives' recognition of this highway's national, regional, and international significance. We believe that the project will have more positive impact on Montenegro and its neighboring countries both economically and socially. Given the countries' high development needs, we welcome the authorities' intention to explore a PPP structure for some infrastructure projects to avoid taking new debt onto the government's balance sheet. We take note of staff's analysis regarding possible risks in this regard and encourage staff to provide more constructive suggestions to avoid prejudging.

A healthy financial system and a favorable labor market are key to sustainable development. We welcome the recent measures to strengthen banking supervision and encourage more efforts to address the remaining vulnerabilities. We share staff's concern on the structural labor market impediments and encourage the authorities to step up efforts on enhancing labor force participation.

With these remarks, we wish the authorities every success in their policy endeavors.

Mr. Mouminah, Mr. Alkhareif and Mr. Alhomaly submitted the following statement:

We thank staff for the comprehensive report and Mr. Doornbosch and Mr. Josic for their insightful buff statement. We commend the authorities for the strong economic performance over the past two years, supported by public and private sector investment, among others. However, Montenegro is facing several challenges, which underscore the importance of safeguarding fiscal sustainability, strengthening financial sector, and advancing structural reforms. We broadly agree with staff appraisal and offer the following comments for emphasis.

On the fiscal front, we are comforted by the recent improvement in public finances due to the implementation of a fiscal adjustment strategy. Here, we welcome the recent tax administration improvements under MTA and encourage the authorities to press ahead with their efforts to further strengthen revenue mobilization. In this connection, we concur on the urgent need to reduce the currently high public debt, including through preserving fiscal adjustment going forward. At the same time, we share staff's view on the importance of investing in public infrastructure that would offer the most economic and social returns, in addition to ensuring efficient public spending. The new law on PPPs is a step in the right direction, but we encourage the authorities to put in place effective measures to mitigate any future fiscal risks in this regard.

We welcome the positive progress made by the authorities in strengthening banking supervision. In this connection, we encourage the authorities to continue their efforts to further strengthen supervision, as recommended by staff, and address any remaining vulnerabilities. Conducting an asset quality review (AQR) is also critical. In addition, we encourage the authorities to take further actions to mitigate financial stability risks by continued strengthening of the AML/CFT framework.

Finally, we welcome the authorities' commitment to improve labor market outcomes and to enhance competitiveness, which is essential to support inclusive growth. In this regard, we commend the efforts to boost formal employment including by reducing labor tax wedge. We also welcome the authorities' efforts to eliminate skills mismatch in the labor market. Here, we encourage the authorities to carefully evaluate the impact of the planned minimum wage increase.

With these comments, we wish the authorities success in their future endeavors.

Mr. Mojarrad and Mr. Alavi submitted the following statement:

We thank staff for their informative report and Mr. Doornbosch and Mr. Josic for their insightful buff statement. We concur with the thrust of the staff appraisal and offer the following comments for emphasis.

Montenegro's economy continues to perform well with robust growth, supported by public spending on infrastructure, rising private investment and a thriving tourism sector. Inflation has been low, gross international reserves are assessed to be adequate, and the unemployment rate has been steadily falling. We welcome these positive developments, but note the significant challenges ahead, including the concerns about public finance sustainability and the impact of persistently large current account deficits on external stability. In the meantime, a rigid labor market and unfavorable demographics are expected to continue to weigh on economic growth over the medium term. Going forward, a well-coordinated mix of prudent fiscal, financial sector and labor market policies and supportive structural reforms are needed to address these challenges and to unleash the country's growth and development potentials.

We commend the authorities' strong commitment to fiscal consolidation aimed at putting public finance on a firm footing - as reaffirmed by Mr. Doornbosch and Mr. Josic. In this context, the successful implementation of the bulk of the envisaged measures in the fiscal strategy merits recognition, and the sizable decline in the fiscal deficit projected for 2019 is commendable. However, the authorities' heavy reliance on debt financed public investment projects has increased government debt and debt guarantees significantly leaving no fiscal space in the event of shocks. Nonetheless, we are comforted that the views of staff and the authorities are aligned on the need to postpone further debt financed spending on highway construction, until public debt declines to a sustainable level. There also seems to be agreement on the importance of having a robust investment management and a functioning PPP framework in place to prudently mange fiscal risks and to prevent transfer of large liabilities to the public sector, given the authorities' desire to use PPP for the construction of next phases of

Bar-Boljare highway project. In the meantime, determined efforts to expand the tax base, improve tax discipline and rationalize current expenditures are crucial to help rebuild fiscal space.

Montenegro has a well-capitalized and broadly profitable banking sector and yet the banking sector is perceived to be the riskiest segment of the financial sector due to its potential exposure to money laundering, especially given stretched bank oversight. We look forward to the central bank's planned asset quality review aimed at diagnosing potential areas of vulnerability. We are encouraged by the continued efforts to improve the regulatory framework including by the modernization of the credit registry, the implementation of IFRS and tightened asset classification rules which should improve risk assessment and reduce information asymmetries. The planned initiatives on harmonizing banking laws with EU directives and the ongoing efforts to align banking supervision and crisis management processes with EU practices and enhancing AML/CFT framework are all positive steps towards strengthening financial sector stability and integrity.

Montenegro is seeking to join the EU by 2025 and is aspiring to attain a level of development and prosperity close to that of the EU average. Achieving these goals requires sustained high and broad-based growth buttressed by an array of focused and well targeted structural reforms to create a favorable business climate and improve competitiveness. In view of the still high level of unemployment and substantial informal labor activity, comprehensive labor market reforms are crucial to foster flexibility, increase labor force participation, reduce labor tax wedge and address labor shortages in the key sectors. In this context, we look forward to an accelerated adoption and enactment of the new Labor Law. In the meantime, reduced the government footprint in the economy, strengthening institutions and improving governance should remain an integral part of the authorities' reform agenda going forward.

With this we wish the authorities every success.

Mr. Raghani, Mr. Sylla and Ms. Nankunda submitted the following statement:

We thank staff for a comprehensive set of reports on Montenegro and Mr. Doornbosch and Mr. Josic for their informative buff statement.

Montenegro's economic growth remains strong driven by both domestic and external factors, further policy adjustments and reforms are needed to sustain the momentum while addressing rising fiscal and debt vulnerabilities. We welcome Montenegro's solid economic growth in 2017 and 2018 led by strong private consumption and large public and private investments. We also note that the unemployment rate has declined while inflation has risen slightly. Nevertheless, albeit progress in fiscal adjustment, the fiscal deficit remained elevated, public debt rose further, and the current account deficit widened. To address these imbalances, we encourage the authorities to implement growth-friendly adjustment measures that will ensure fiscal and debt sustainability. Maintaining the momentum this year and beyond is warranted by the prospect of no further construction past the first phase of the highway project and the uncertainty stemming from the external environment. This, coupled with the projected moderation of consumption growth over the medium term, calls for an adroit policy mix to carefully balance the desired fiscal and growth objectives. In addition, efforts should be pursued to preserve financial sector stability—through enhanced supervision and regulatory frameworks—and to promote labor market flexibility.

We broadly agree with staff assessment and policy recommendations and offer the following remarks for emphasis.

Pursuing fiscal consolidation is essential to safeguarding the sustainability of public finances. We note that revenue-generating measures dominate the fiscal consolidation package and the authorities continue to make progress in the implementation of tax administration reforms. They have also further reduced tax arrears. Fiscal adjustment should continue including through phasing out tax exemptions and reducing inefficient employment in public sector to create fiscal space needed to sustain investment and preserve social spending. Tightening eligibility for early retirements should add to fiscal gains while supporting purchasing power along with the indexation of wages and benefits to inflation. We also encourage the authorities to further strengthen expenditure controls and to promptly address risks associated with public-private partnerships (PPPs). Regarding the Bar-Boljare highway project, we urge the authorities to carefully weigh the credibility and fiscal sustainability risks of proceeding before feasibility and financing concerns are addressed. We are reassured by Mr. Doornbosch and Mr. Josic's statement that the authorities "will refrain from new major debt-financed project" and ensure that "public debt is put on more sustainable level, and favorable conditions are secured, potentially with a grant element", to pursue the second phase of the highway project. Can staff elaborate on the steps being taken, if any, to ensure such conditions? Looking forward, we see merit in putting in place a comprehensive medium-term budget framework to ensure greater observance of fiscal targets and welcome the authorities' plan to begin a medium-term budget starting in 2021.

Continuing to address financial sector vulnerabilities will be key to preserving the stability of the overall sector. We note that the banking sector is well capitalized, liquid and stable. In addition, we welcome the authorities' plans to address the financial sector's vulnerabilities through improving the CBM's supervisory and regulatory framework, conducting an asset quality review (AQR) and tackling the NPLs. Strengthening the supervision of banks and non-banks should continue to be prioritized, along with improvements in the AML/CFT framework. Furthermore, we are encouraged by the progress achieved in the implementation of the FSAP recommendations. Could staff comment on the current regulatory landscape for Fintech in Montenegro and whether the envisaged improvements to the AML/CFT will consider the challenges and opportunities presented by these innovations?

The authorities should continue to implement critical structural reforms aimed at supporting growth. While important strides have been made in improving the business environment, competitiveness continues to be hampered notably by high unit labor costs, sluggish productivity growth and limited labor market flexibility. To support longer term growth, the structural reform agenda should be accelerated, notably through labor market reforms to foster job creation and reduce the weight of the informal sector in the economy. In this regard, we welcome the authorities' plans to adopt a new labor law in 2019 and encourage them to implement the reforms steadfastly.

With these comments, we wish the authorities of Montenegro success in their future endeavors.

The representative from the European Central Bank submitted the following statement:

We would like to thank Messrs. Doornbosch and Josic for their informative buff statement, and Staff for their report. We broadly agree with Staff and would like to highlight a few items.

We broadly share Staff's views and agree that growth is expected to moderate from recent high levels. Supported by strong government infrastructure investment, growth remained high in 2017 and 2018 at near 5 percent. However, due to changing dynamics in public infrastructure investment, the outlook is for growth to start slowing already in 2019 towards around 3 percent and to stay around that level in the medium term.

We agree with Staff's views on sustainability concerns regarding current fiscal policy and the need to consolidate public finances in the medium term. Public financing of large-scale infrastructure investment has placed a significant burden on Montenegro's public finances and put government finances on an unsustainable trajectory. We therefore concur with IMF staff that maintaining a sizeable primary budget surplus in the medium term will be crucial to return public debt to more sustainable levels and to create fiscal space to react to adverse economic shocks.

Fiscal sustainability efforts would also benefit from the creation of a comprehensive medium-term budget framework. In view of Montenegro's use of the euro as its official legal tender there is no scope for conducting its monetary policy independently, which correspondingly raises demands on other policy areas. A comprehensive medium-term budget framework would be conducive to the consolidation of government finances and to ensuring improved adherence to fiscal targets. Further, we see the establishment of such a framework as a good opportunity to review the modalities and planning on the highway construction currently under consideration. This would help ensure long-term fiscal sustainability, foster the channeling of scarce public resources to the most productive investment projects and reduce risks of potential shocks from adverse public finance dynamics and of negative effects on external financing from developments in the euro exchange rate.

Despite comfortable financial and solvency conditions, the banking system remains subject to vulnerabilities and measures are needed to enhance its resilience. Montenegro's banking sector currently seems to register comfortable levels of aggregate solvency, liquidity and profitability. However, this should not provide a false sense of safety and remaining pockets of vulnerability need to be addressed. The large number of banks operating in Montenegro given its economic size may be creating difficulties for banks. This is especially so for small banks of little systemic relevance which, if faced with difficulties, could warrant supervisory scrutiny and, if necessary, the adoption of remedial measures early on to safeguard public trust in the banking system. Moreover, there is scope for bolstering the resources of the deposit insurance fund to recover pay-outs triggered by the recent bankruptcy of two institutions and to strengthen the resilience of the banking system to future shocks.

We agree with Staff that decisive supervisory action is required to restore financial system soundness. Forcefully applying prudential regulations as well as strengthening supervisory quality and efficiency is of the essence and, as recommended by IMF staff, a comprehensive asset quality review would bring clarity about the full extent and exact location of impaired assets across the financial system. This would also help to further reduce the still sizable stock of non-performing loans. Besides, we would like to encourage authorities to eliminate obstacles outside the responsibility of the supervisor that prevent a successful resolution of non-performing debt, such as legal, judicial or institutional bottlenecks, preferably in close co-operation with all stakeholders involved. In line with IMF staff, we also see a need to closely monitor the lending practices of banks, specifically in consumer loans, with an eye to detecting overly generous credit standards and to counter emerging risks with the help of the recently formalized macroprudential policy toolkit.

The Acting Chair (Mr. Furusawa) made the following statement:

Montenegro has enjoyed strong growth in recent years, bolstered by the large investment in tourism. However, several domestic and external challenges remain, including the fiscal sustainability risk stemming from efforts to close the infrastructure gaps. As Directors have noted in their gray statements, it is critical to continue with fiscal adjustment through both revenue and expenditure measures to create space for pro-growth and social spending. In this context, we have highlighted the need for a cautious and prudent approach to the major highway project, including from a public-private partnership (PPP) arrangement. Other priorities are identified, including strengthening the banking sector supervision and advancing structural reforms to improve labor market outcomes and boost competitiveness.

The staff representative from the European Department (Mr. Seshadri), in response to questions and comments from Executive Directors, made the following statement:[1]

I will make a few remarks to broaden the context with which the Acting Chair began. First, I would like to highlight that the Fund and the authorities maintain an exceptionally open, healthy, and year-round dialogue that spans macroeconomic and structural policies, but also an active agenda of technical assistance (TA).

Due to conjunctural developments, this 2019 Article IV consultation focused on three main areas—fiscal sustainability, financial stability, and labor markets—but this discussion has been constantly informed and nourished by a much broader set of interactions that we have had with the authorities throughout the year. Among the three areas that I mentioned, the

[1] Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these minutes.

first two took up the largest share of the Article IV mission, so I will address them first.

Regarding fiscal sustainability, the authorities have commendably persevered with the fiscal adjustment strategy that they embarked upon in 2017. This resulted in a marked improvement in public finances. The non-highway primary balance has swung from a deficit of 1 percent of GDP in 2016 to a surplus of around 2 percent of GDP in 2018. This is quite significant.

However, public debt remains high. It limits the room for countercyclical maneuver and limits the room for investment in future growth. The authorities do recognize this and have taken welcome steps toward establishing fiscal credibility. Maintaining a healthy primary surplus over the medium-term, as well as the renewed commitment to take a cautious and measured approach to the Bar-Boljare highway project, are essential for consolidation of their recently won fiscal gains.

Regarding financial stability, the events of late 2018 have spurred the authorities to move in a far more decisive manner to enhance financial sector and Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) supervision. They have strengthened the supervisory oversight structure within the central bank and are in the process of strengthening off-site supervision with enhanced resources and more staff. They are aligning the laws and the guidelines governing financial institutions and their supervision with international standards. They have begun the process of getting an asset quality review off the ground, and this has been a longstanding recommendation.

These are only the first steps. The next and, frankly, more challenging task, is to meaningfully operationalize these legal, institutional, regulatory, and supervisory changes into an effective risk-based framework. The Fund will continue to support the authorities in these endeavors through technical assistance (TA), which will continue to feed into our main recommendations and suggested priorities further down the road.

On labor markets, the challenge is to tackle impediments that cause low labor participation rates intertwined with a high degree of informality that has persisted for years. Again, policy is moving in the right direction with efforts underway to reduce the high tax wedge, as well as the forthcoming new labor law. Some of the informality among low-wage workers could conceivably also be tackled through commensurate policy changes that at the appropriate time introduce a more progressive element to income taxation. This would be desirable for other reasons as well. Such innovations will be considered for discussion in future Article IV consultations when technical and institutional capacities of tax administration have improved sufficiently. Through our TA agenda, we are jointly laying the groundwork for such improvements. It will take a little time for such efforts to bear fruit, but the right steps have been taken by the authorities.

Mr. Corvalan made the following statement:

We thank staff for the clear report and Mr. Doornbosch and Mr. Josic for the helpful buff statement. We broadly agree with the staff's assessment of the economic situation in Montenegro and take positive note of the authorities' commitment to continue rebuilding fiscal buffers and reassess the large public finance infrastructure project, such as phases 2, 3, and 4 of the Bar-Boljare highway project, while considering alternative projects with a high rate of return. In this regard, we encourage the authorities to make use of the TA on Public Investment Management Assessment (PIMA) that the Fiscal Affairs Department (FAD) could provide to the government.

On the financial sector, we see merit in the central bank of Montenegro's willingness to go ahead with the asset quality review by the end of 2020. This initiative is essential to guide future actions of the regulators and supervisors of the financial system and improve the system's soundness. We take positive note of the central bank's legislative package to harmonize banking laws with the EU directives. Following international practices is highly advisable.

Finally, we appreciate the authorities' readiness to discuss with staff in the context of future Article IV consultations their medium-term plans to tackle some enduring issues that have been a drag on economic growth for many years. In this regard, the proposed initiatives to modernize the functioning of the labor market in order to promote greater labor force participation, increase formal sector employment, and address competitiveness challenges constitute an important step in the right direction.

Mr. Rosen made the following statement:

I thank staff for their informative and thorough report and for the comments. We issued a joint gray statement with our colleagues, Ms. Levonian and Mr. Inderbinen. I will focus my remarks on the Bar-Boljare highway project. This chair believes this project is an example of a poor borrowing decision compounded by troubling overseas lending by China Ex-Im Bank. The highway project has produced benefits for the lender and for the China Road and Bridge Corporation, while providing limited benefits and a huge debt burden for the people of Montenegro. The resulting heavy debt burden and limited growth spillovers shows that the terms were not favorable to the authorities. As the staff report describes, to build 41 kilometers of highway, Montenegro's debt-to-GDP ratio rose by nearly 25 percentage points. This fiscal cost is tremendous when considering the highway will remain largely unused for the foreseeable future, and as staff notes, a rush to complete the highway will further jeopardize fiscal sustainability. The project had a small multiplier effect, as noted in the 2017 selected issues paper, as the highway was built using primarily imported machinery and Chinese labor. The small growth effect comes at the cost of a significant fiscal adjustment to stabilize and reduce debt over the medium term.

As the staff report makes clear, this significant fiscal adjustment would not have been necessary, had the authorities refrained from taking the loan. The near-term fiscal costs could be justified if the highway would have produced a high rate of return. However, this is unlikely as the return is dependent on completion of the remaining two sections of the highway project, which could be more costly than the first section.

Furthermore, as staff note, previous studies have shown a low rate of return even if the entire project is completed. This is an unfortunate example of unsustainable borrowing and lending practices. We strongly urge the authorities to reconsider proceeding with further phases of the road until they can reliably address many of the concerns laid bare in the staff report. Finally, we hope that creditor nations will refrain from unsustainable lending in the future.

Mr. Benk made the following statement:

We thank staff for the comprehensive reports and answers to our questions. We issued a gray statement, so let me just emphasize a few points.

We commend the authorities for their commitment to the fiscal consolidation strategy that started in 2017, which would ensure the sustainability of public finances over the medium term. However, putting debt on a downward trajectory will require that the authorities carefully weigh the benefits of the continued construction of the Bar-Boljare highway phases against fiscal costs, and take measures to strengthen the public investment framework. In this vein, like several other Directors, we encourage the authorities to request PIMA TA and to ensure that the new PPP law incorporates the Fund and the World Bank staff recommendations.

The irregular activities exercised by a few banks that went undetected for some time by the supervisory authority, and the recent closure of two small banks highlight the need for stronger banking supervision and strong implementation of the key recommendations pending since the 2015 Financial Sector Assessment Program (FSAP). While carrying out an asset quality review by the end of 2020 and improving the AML/CFT framework will be critical, so will the cooperation and the sharing of information of other supervisors with Montenegro.

Going forward, boosting investment, improving productivity, and accelerating the pace of institutional convergence with the European Union (EU) will require the swift implementation of structural reforms aimed at addressing weaknesses in the business environment, specifically those related to governance and the inefficient judiciary and reducing labor costs.

Mr. Rozan made the following statement:

I thank staff for the useful report and answers to our questions and Mr. Doornbosch and Mr. Josic for their buff statement.

I just wanted to emphasize a few points. First, I want to commend the authorities for their very successful implementation of a fiscal adjustment strategy over the past two years with a sizeable improvement of the fiscal position. This fiscal discipline is all the more important given that the growth trends are decreasing from 2019 onwards, as the side effects of the large infrastructure project investment are starting to wear off.

We do share staff’s cautiousness regarding the Bar-Boljare highway, because several questions regarding economic returns and financing options remain pending. Maintaining fiscal space in Montenegro would be instrumental to reining in debt and investing in future growth. We are reassured by the authorities’ careful approach and the commitment to refrain from further debt financing for any major investment projects and to conduct the due diligence needed for any future phase of this highway project. We share the other chairs’ calls for the need to do a PIMA, which would be useful for the future. Like other colleagues, we would encourage the authorities to be quite careful regarding the possibility of substituting that financing with a PPP since that can also entail sizeable fiscal or quasi-fiscal risk.

We share the staff's assessment of the good progress that has been made on supervision and regulation, and we agree that now is the time to implement the good legislative changes and supervisory changes that have occurred over the past few years. Finally, we encourage the authorities to continue on the positive trends on structural reforms and ensure that the labor market reform is going in the right direction.

Mr. Chikada made the following statement:

We thank the mission team for their informative report as well as the elaboration this morning and Mr. Doornbosch and Mr. Josic for their helpful buff statement. In our gray statement, like many other Directors, we also highlighted the importance of rigorous cost and benefit analysis on the infrastructure projects, so I will limit my comments on the cost side. As general advice, I would like to underscore the importance of long-term costs. While some project costs may appear inexpensive initially with low upfront fees, what matters is the long-term costs. What I mean here is that one needs to consider not just the interest payment streams, but also maintenance cost of the infrastructure, which tends to be overlooked even though infrastructure such as roads and bridges are supposed to have a long-life period. If the quality of the infrastructure is poor and less durable, long-term maintenance costs of such infrastructure could be much larger than initially envisaged. Given the complexity of the infrastructure project, we believe the staff's analysis and advice on the Montenegrin highway project has provided a good basis for the authorities to take more prudent steps, and we would like to ask staff to continue carefully monitoring and assessing developments of this national project, which could also provide good lessons for other countries as well.

Mr. Montero made the following statement:

We thank staff for the report and Mr. Doornbosch and Mr. Josic for their informative buff statement. We have issued a comprehensive gray statement, so I would like to focus my intervention on two comments, one for emphasis and another one as a complement to our gray statement.

Beginning with the latter, we would like to underscore that the best development strategy for Montenegro is to join the EU and enjoy the many benefits of belonging to this political and economic union. To this end, we call on the authorities to focus their efforts on making progress to fulfill all the requirements to be able to join the EU by 2025.

Second, we join others in asking for a more prudent or cautious approach regarding the next phases of the Bar-Boljare highway. There are reasonable doubts regarding the economic and social returns of this huge investment project. We would suggest, like others, to wait until a credible—and I underline credible—feasibility study is completed, before going ahead with the next construction phases.

Mr. Sun made the following statement:

We thank staff for the comprehensive report and Mr. Doornbosch and Mr. Josic for the informative buff statement. We issued a gray statement, and I would like to offer some remarks on the highway project. Montenegro has great potential for growth but faces a significant infrastructure gap. If you look back at the development of the Bar-Boljare highway, you will find that the first design document was finished in 1998, more than 20 years ago. Subsequently, about nine documents were prepared to justify the project, which shows that the highway has great strategic importance.

We all agree that highways can contribute enormously to industry and productivity growth, better regional and national economic performance, and enhanced international competitiveness. Take the United States as an example. According to research done by the U.S. Department of Transportation, over the period of 1950 to 1989, U.S. industries realized production cost savings averaging 18 cents annually for each dollar invested in the road system. It took the United States almost 40 years to improve the highway network and achieve economic benefits. For small states with high development needs like Montenegro, perhaps a longer prospective approach is needed, and concrete support, more trust, and more patience are crucial to help the authorities realize their catch-up developmental strategy. That said, we encourage the authorities to conduct careful feasibility studies, strengthen debt management, and improve public spending efficiency supported by targeted TA. With these remarks, we wish the authorities all the best.

Mr. Alkhareif made the following statement:

I would like to start by thanking Mr. Doornbosch and Mr. Josic for their informative buff statement, and I thank staff for the excellent work, particularly the mission chief's remarks about the cooperation with the Montenegro authorities. We encourage staff to step up the cooperation, including the capacity development in various sectors.

We have issued a gray statement, so I would limit my remarks to two points. On the fiscal front, we are encouraged by the recent improvement in the public finances due to the implementation of the fiscal adjustment strategy. We also welcome the recent tax administration improvements and encourage the authorities to continue their efforts to further strengthen domestic revenue mobilization.

We also share staff's view on the importance of investing in public infrastructure that would offer the most economic and social returns, in addition to ensuring efficient public spending and fiscal sustainability. The new law on PPPs is a step in the right direction, but we encourage the authorities to put in place effective measures to mitigate any fiscal risks in this regard.

Second, we welcome the positive progress made by the authorities in strengthening banking supervision. We encourage the authorities to continue their efforts to further strengthen supervision and address any remaining vulnerabilities. Conducting an asset quality review is critical in this regard. We encourage the authorities to take further action to mitigate financial stability risks by strengthening the AML/CFT framework, as mentioned by the mission chief. With these remarks, we wish the authorities continued success.

Mr. Doornbosch made the following concluding statement:

I thank all the Directors on behalf of our Montenegrin authorities for their valuable comments and policy recommendations. We have already shared most of their written comments with the authorities, and the remainder will be shared today and early next week. I would like to take this opportunity to provide some additional remarks on three points, and I will start with the highway project and public finance.

It is very important to emphasize, as we did in our buff, that the authorities do not intend to initiate phase 2 in 2020. At the same time, it is important to bear in mind that Montenegro is a small state, and small states face specific challenges, including that they do not enjoy the benefits of the economic scale. An important consequence is that, as was also recognized in the 2014 Staff Guidance Note on the engagement with small states, that key public infrastructure is often under-profiled, which can adversely impact competitiveness. Infrastructure costs are not exactly proportional to the size of the economy. Building infrastructure in a mountainous region cannot be done for the same price as in a flat country. The first phase of the highway was the most difficult and most expensive part of the project, and the authorities believe that the competitiveness of Montenegro, which is highly dependent on tourism, is hampered with zero kilometers of highway at the moment. They believe that in the near future and over the long-term, the highway will bring sizeable economic returns and not remain largely unused through the development of summer and winter tourism, through connectivity and trade, but also by helping decrease the regional development gaps.

It is as important to mention that the phase 1 of the highway project will start generating revenues as soon as it is finished and will enable further private investment in the tourism and the energy sectors in the northeastern region of the country. Therefore, this issue is not a symbolic one. It is a strategic and development one. Hence, the execution of the project is running well. The cost overrun is almost entirely explained by the fact that the authorities decided not to hedge the exchange rate risk of the dollar-denominated loans. This was a conscious decision at the time, but with the benefit of hindsight, this does not seem to be the wisest decision. However, for the authorities, the priorities at the moment are the continuation of the fiscal consolidation strategy and the preparation of a new feasibility study of the entire highway project, as suggested by staff. The feasibility study will take into account the current potential of the Bar-Boljare, the potential of winter tourism in the north and eastern regions, and the connection with the Serbian highway.

Once the new feasibility study is done—and it is, indeed, very important to also take the quality of infrastructure investment into account, as mentioned by the Japanese Chair—and once public debt is put on a sustainable level and favorable financing conditions are secured, only then would the authorities consider continuing with the construction. This is very important to mention as the basis for decision-making by my Montenegrin authorities.

On a personal note—and this is not shared by my authorities, and it is a bit like cursing in church—I have worked on infrastructure projects in the Netherlands for many years, and I have seen many cost-benefit analyses, and I think no metro line or railway would have been built if the decision as based only on a cost-benefit analysis. I believe it is also very important to think about the long-term perspective. But this is my personal reflection, and my authorities certainly do not take that position.

Second, on the supervisory approach of the central bank of Montenegro, the authorities have requested ongoing TA to implement a more risk-based supervision, and the report of the first TA mission is being finalized, and the authorities will continue with the implementation of the recommendations, including on the improvements in off-site supervision. Similarly, the authorities recognize that as a small state with high capital inflows, the banking system is prone to AML/CFT risks. In this context, as we indicated in our buff statement, they have made significant organizational improvements by establishing a separate department for supervision of AML/CFT risks and with an additional level of oversight at the board level by establishing a supervisory committee. Staffing is almost complete, and the unit will be fully operational shortly.

Lastly, on the remaining FSAP recommendations, in the last three years, the authorities have implemented most of the 2015 FSAP recommendations, which was recognized by staff and many Directors. The remaining recommendation on the asset quality review is in the pipeline. The authorities strongly agree that a full-scale asset quality review by a reputable agency is needed to assess the quality of the domestic banking system. They are having bilateral consultations with several EU member central banks to help them prepare the asset quality review manual, and they are in the process of selecting the assessor. They aim to complete the assessment by the end of 2020.

The authorities would like to thank Mr. Seshadri and the entire team for their excellent engagement and all the help in shaping their policies during the past year. They would also like to thank the different TA teams from the Legal Department (LEG), from FAD, from MCM, from the Statistics Department (STA), as well as management, for each and every TA mission that was provided to the authorities, without which many of the improvements would not have been possible.

The authorities would particularly like to thank Mr. Lindquist. He has worked on Montenegro for several years, and he was the spiritual father of the last fiscal consolidation strategy. They wish Mr. Lindquist all the best in his future endeavors.

The Acting Chair (Mr. Furusawa) noted that Montenegro is an Article VIII member, and no decision was proposed.

The following summing up was issued:

Executive Directors agreed with the thrust of the staff appraisal. They welcomed the strong recent growth performance of the Montenegrin economy, bolstered by large investment projects and buoyant tourism, and took positive note of the significant fiscal adjustment since 2017. Notwithstanding these achievements, Directors stressed the importance of continued fiscal adjustment, further efforts to strengthen banking sector supervision, and fiscal and structural reforms to support inclusive growth over the medium term.

Directors welcomed the authorities' continued implementation of their medium-term adjustment strategy, which has improved the underlying fiscal position over the last two years. Amid high debt levels, Directors concurred that the maintenance of a strong primary fiscal surplus over the medium term is necessary for government debt to decline to safer levels. Directors also called for further efforts to improve the efficiency of public spending, including by carefully managing infrastructure investment, rationalizing government employment and tax expenditures and furthering pension reforms. In this context, Directors encouraged the authorities to move forward with their plans to develop medium-term budgetary and public investment management frameworks. They noted that such initiatives would help create fiscal space over the medium term for greater high-productivity capital spending and targeted social spending and promote fiscal and debt sustainability.

Directors underlined that caution is needed in implementing the next phases of the Bar-Boljare highway project until feasibility, cost-benefit analyses, and financing issues are fully addressed. In this context, Directors underscored the need to consider the trade-offs between undertaking the highway investment vis-à-vis other priority spending needs to meet Montenegro's development goals. In a similar vein, Directors agreed that PPP arrangements should be approached with caution to reduce the risk of assuming significant contingent fiscal liabilities.

Directors welcomed recent measures to strengthen banking supervision, including the establishment of a Supervisory Committee, recent refinements in asset classification rules and ongoing efforts to bolster the capacities and resources in off-site supervision. Notwithstanding these efforts, Directors underscored the importance of furthering risk-based supervision, introducing macroprudential measures when warranted, harmonizing banking laws with the EU Directives, and completing the planned asset quality review by the end of 2020. Directors also encouraged the authorities to strengthen the AML/CFT supervisory framework, including through enhanced monitoring of potential reputational and financial integrity risks posed by the investor citizenship program.

Directors noted the importance of structural reforms to boost competitiveness and inclusive growth and improve Montenegro’s external position and labor market outcomes over the medium term. While welcoming the authorities’ recent efforts to reduce the labor tax wedge and the proposed labor law to selectively reduce some gaps in employment protection between temporary versus open-ended contracts, Directors encouraged the authorities to carefully consider the impact of the planned minimum wage increases.

It is expected that the next Article IV consultation with Montenegro will be held on the standard 12-month cycle.

APPROVAL: October 6, 2021

CEDA OGADA
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

Outlook/Risks

1. ***We would have appreciated a more in-depth analysis of the highway project's potential positive long-term effects on productivity and tourism in the current staff report. Staff comments would be welcome.***

- The completion of phase 1 of the highway will provide some benefit to the development of winter tourism in the north of Montenegro, as it will connect one of the larger winter tourism towns. There are two other ski areas in the envisaged Phase 2 area, which jointly with Phase 1 would account for the lion's share of the winter tourism areas. For Phases 3 and 4, significant results can come only if the Serbian side of the construction is completed. Even then, Serbian exports/tourism going through/to Montenegro would have to sizably increase beyond existing levels to generate strong returns.

- The timing and financing of both the Montenegrin and Serbian sections of the highway are subject to unusually large uncertainties. This limits the ability and scope to shed much additional light, through rigorous modeling of tourism and productivity, to the pre-existing studies which generally conclude that the fundamental bankability of the project is weak (with the exception of one confidential study conducted locally).

- The Selected Issues Papers for the 2017 Article IV consultation, however, did take a different approach and analyzed the impact of phase 1 of the highway on economic growth during the construction phase (through demand effects) and after construction (through supply-side effects). The impact of supply-side effects was projected using the 2014 WEO's estimates on the impact of infrastructure investment on future economic output. Staff concluded that the future supply-side effects of phase 1 of the highway would be smaller than for a typical investment project, due to low projected traffic and the small size of the population currently living along the route of phase 1. Staff estimated that total GDP with the highway in 2023 would be about 4¼ percentage points of 2014 GDP higher than without it. These estimates were only based on phase 1 of the project, as the timing and feasibility of future phases remains uncertain.

Fiscal Policy

2. ***Could staff elaborate on the reasons behind the lower projection for the primary fiscal balance from 4.5 percent of GDP to 2.7 percent?***

- Based on the original 2018 budget, staff had projected in the 2018 Article IV Staff Report that the primary fiscal surplus would peak at nearly 4½ percent of GDP in 2020. However, tobacco excise revenues subsequently disappointed, as smuggling (which had been relatively dormant) rose much faster than anticipated in the wake of large excise increases. The authorities adjusted tobacco excise rates in the July 2018 supplemental budget, necessitating a reduction of revenue projections by about ½ percent of GDP. In addition, the July 2018 supplemental budget expanded the envelope for the gross wage bill (based on new hiring that had occurred) and increased expenditures in the health sector. Relative to previous projections, staff increased projected expenditures by about 1 percent of GDP over the medium term. These developments – and some changes to the timing of highway expenditures – explain most of the change in staff's projections.

3. ***Could staff comment on the prospects of effecting the pension reforms in the near/medium term?***

- The authorities were unable to reach agreement with the social partners during negotiations on pension reforms in 2018. While the authorities remain in constant dialogue with the social partners, it appears unlikely that a new pension reform will be agreed before the general elections scheduled for late 2020.

4. ***Within the context of strengthening Montenegro's PPP frameworks, we support staff's recommendation for a PIMA assessment. Could staff indicate and explain the authorities' views on this recommendation?***

- Staff has recommended that the authorities request a PIMA assessment. The authorities have expressed interest in learning about the contents and benefits of a PIMA assessment and are deciding whether to request an assessment at this time. At present, the authorities are mainly interested in TA and capacity building to support the Ministry of Finance's ability to analyze the fiscal risks stemming from PPP projects. An FAD TA mission introduced the authorities to the P-FRAM tool earlier this year, and the authorities have expressed interest in follow-up training.

5. ***We note that the draft [PPP] framework in its current form needs strengthening to align with best practices for mitigating fiscal risks. In line with this, we welcome staff's comment on the authorities' willingness to address the gaps in the draft law before submission to parliament.***

- The authorities have already incorporated extensive comments from FAD on the draft Law on PPPs. Most of the remaining staff recommendations would need to be addressed outside the purview of the Law on PPPs itself. For example, recommendations such as the integration of a PPP project pipeline with the on-budget project pipeline and improvements to reporting and statistical treatment of PPPs would need to be addressed through budget procedures and guidelines for fiscal statistics. The authorities have acknowledged room for further improvement and intend to address shortcomings during the process of implementation of the Law on PPPs.

6. ***Has staff any information about the preparation of [feasibility studies for future phases of the highway]?***

- According to the Ministry of Transport, work on a new feasibility study began in March 2019, financed by a grant from the Western Balkans Investment Framework. The study is being done by a consortium of European companies and is expected to be completed by March 2020. The feasibility study will look at the viability of the entire remaining Montenegrin sections of the highway. We also understand that it will look at the feasibility of phase 2 alone. The authorities have promised to give staff access to the new feasibility study when it becomes available.

7. ***Staff states that an element of grant financing would be need in order for the continuation of the [highway] construction project to be feasible (para. 22). Could staff provide further information on the terms and conditions of project financing so far?***

- Box 1 on page 5 contains information on the financing arrangements for the current phase of highway construction (phase 1). China Ex-Im Bank has provided a USD-denominated loan for 85 percent of the total cost. The loan carries a 2 percent interest rate and a 20-year repayment period. Principal payments begin in 2021. The remaining 15 percent of construction costs are being financed through other budgetary financing mechanisms. Phase 1 does not include grant financing. Even if the new feasibility study indicates stronger economic viability of the project than the earlier ones, it is staff's view (through the lens of safeguarding fiscal sustainability), that it would not be advisable to proceed with Phase 2, unless at least 20 percent were to be grant financed.

8. *Could staff provide an update on the status of discussions between the authorities and China Road and Bridge Corporation on future phases?*

- The authorities have discussed with China Road and Bridge Corporation (CBRC) the possibility of continued collaboration on future phases, though no commitments have been made. In March 2018, the Ministry of Transport signed with CBRC a Memorandum of Understanding in which CBRC expressed interest in continued cooperation on the project on PPP principles. The MOU states that this declaration does not preclude other parties from expressing interest in future work on the project. It is important to note that this MOU predates the authorities' statements during the recent Article IV mission that they would take a cautious approach to the construction of further phases and await the results of the new feasibility study before moving ahead with any substantive planning or financing-related activities.
- According to the authorities, other foreign companies have also expressed interest in future work on the project. The authorities have emphasized to staff that future partners will be selected through a competitive tender process.

9. *We wonder whether it would be adequate to postpone implementation of phases 2-4 until EU entry and then seek the option of financing these investments with structural funds. Staff's comments are welcome.*

- Risks to fiscal sustainability from future highway expenditures would clearly decline commensurately with the degree of grant financing that the authorities can secure. The European Commission has mentioned in the past that 2025 is the earliest possible expected date for Montenegro's EU accession. Based on the pace of progress so far, it appears quite unlikely that the all future highway phases (2-4) can be completed before 2025.

10. *Can staff elaborate on the steps being taken, if any, to ensure [favorable financing conditions, potentially with a grant element, for the highway project]?*

- The authorities have approached the Western Balkans Investment Framework (which is financed with grants from the EC and bilateral donors and loans from the CEB, EBRD, and EIB) to request a grant to cover 20 percent of the cost of phase 2. Any decision can come only after the on-going new feasibility study is completed.

11. *While the dollar has been recently strengthening against the euro, could staff elaborate on the fiscal consequences for Montenegro of the absence of hedging against currency risk, as well as possible steps to mitigate this?*

- Montenegro is a euroized economy, with all local debt and most foreign debt denominated in euros. The China Ex-Im Bank loan, denominated in U.S. dollars, has increased the share of foreign currency debt from 4 percent in 2014 to a projected peak of 22 percent (16 percent of GDP) in 2021. Since the signing of the loan contract in 2014, the USD has appreciated about 18 percent against the euro, increasing the value of the debt in domestic currency.

- Hedging instruments are available on a market basis or through international financial institutions such as the World Bank. Principal payments on the loan begin in 2021.

Financial Sector and AML/CFT Policies

12. ***Could staff elaborate on the perceived challenges for bank profitability and financial stability? What available options could the authorities consider for fostering a consolidation of the banking system?***

- The planned AQR will be critical to determine whether the current net interest margin fairly reflects the risks in the banking system. The new regulatory framework will likely increase regulatory costs, which could be partially mitigated by efficiency gains but ideally also by lower provisions, as the legacy impact on balance sheets of the 2008 crisis is fading. Montenegro's small size can make it difficult for smaller banks to establish economies of scale and also represents a challenge for profitability.
- Increased regulatory costs and the difficulty in establishing economies of scale may spur some additional consolidation in the banking sector. Staff's overall view is that market forces should guide this process, while the authorities should ensure a level playing field while maintaining a highly rigorous set of requirements for licensing. The planned increase in the minimum capital (in euros) for new banks (as part of the new regulatory framework) should ideally help reduce requests for new bank licenses, and it could also be helpful in fostering consolidation.

13. ***Staff's comments are welcome whether there are any new banking licenses in the pipeline and the scope for consolidation in the banking system.***

- Staff is not aware of any pending new bank license applications under consideration by the central bank. As noted in the Staff Report, Montenegro still has many banks relative to its geographical size and population. With the recent bankruptcy of two banks and the pending acquisition of Societe Generale's subsidiary by OTP, the number of banks will decline from 15 to 12. Aspects of the new banking sector regulatory framework are likely to increase regulatory costs, which could spur additional consolidation.

14. ***Staff's comments on the main components of the recently launched investor citizenship program and how the authorities will address potential reputational and integrity risks are welcome.***

- Montenegro's citizenship by investment program allows granting 2000 citizenships (without prior residence requirement) in exchange for (i) EUR 100,000 fee to the budget earmarked for less developed areas, (ii) a minimum of EUR 250,000 or EUR 450,000 of investment (depending on the region of Montenegro) in tourism, agriculture and processing industry designated by the government, and (iii) EUR 15,000 application fee and separate due diligence fees to private agents. No citizenship applications had been considered by the time of the Article IV visit, as the authorities were developing the necessary secondary legislation.
- At this stage, measures aimed at addressing potential reputational and integrity risks include checks of applicants by the Ministry of Internal Affairs and the Prime Minister's office and vetting of applicants by private due diligence agents distinct from the private intermediary agents in charge of filing the applications on behalf of applicants.

15. ***Staff's comments on whether the update to the national Risk Assessment has been finalized and the main findings are welcome.***

- The Montenegrin authorities initiated an update to the 2015 national risk assessment with the assistance of the Council of Europe at the end of 2018. The assessment was not finalized by the time of the Article IV visit.

16. ***Could staff comment on the current regulatory landscape for Fintech in Montenegro and whether the envisaged improvement to the AML/CFT will consider the challenges and opportunities presented by these innovations?***

- Montenegro is at an early stage of Fintech development. The authorities' recent focus has been on updating the regulatory framework to comply with relevant EU Directives as part of the accession process. As part of this process, the authorities are updating the legal framework for payment system. The authorities have expressed to staff a desire to explore the Fintech regulatory framework in the future.
- AML/CFT risks posed by Fintech were not covered in the Article IV discussion, and staff will follow-up on this topic with the authorities. Staff recommendations on strengthening the risk-based approach to supervision of financial sector would assist the authorities in ensuring that the virtual asset service providers effectively implement AML/CFT requirements and are supervised in line with the FATF standards.

Labor Markets and Competitiveness

17. ***Considering the authorities' plans to increase the minimum wage by 15 percent, which exceeds both accumulated inflation and average wage gains of 6 percent since the last increase in 2013, we are wondering how the increase would impact the labor market and employment and whether it could trigger increases in social schemes.***

- The large grey economy in Montenegro makes the labor market impact of an increase in the minimum wage difficult to estimate. On the one hand, a large minimum wage increase could result in a sizeable increase in the average wage, depending on the share of labor that earns the minimum wage. Widespread anecdotal evidence suggests that many workers report the minimum wage for tax purposes while receiving additional salary that is not reported to the tax authorities. For these employees, actual wages may not rise.
- The Ministry of Finance, using micro data from the statistical agency and tax authorities, estimates that the average monthly wage will increase by less than 1 percent due to the minimum wage increase, which suggests that the impact on employment levels will be modest. The previous minimum wage increase in 2013 (of 30 percent) did not lead to an appreciable increase in the average monthly wage or reductions in employment.
- The minimum wage increase will result in a modest increase in spending on unemployment benefits (estimated to be less than 0.1 percent of GDP), which are linked to the level of the minimum wage. Neither pensions nor government wages (except those earning the minimum wage) are indexed to the level of the minimum wage.

18. ***According to staff, what would be the impact on growth and public finance of the labor market reforms underway? Beyond the labor market, could staff indicate what other reforms aiming at the diversification of the economy and the strengthening of the external position could be the most impactful for Montenegro?***

- Staff expects the initial impact on economic growth of the new labor law and reduction to the labor tax wedge to be modest. Over time, an increase in employment under regular contracts relative to temporary contracts could lead employers to invest further in their employees, thus boosting productivity. The reduction of the labor tax wedge provides an additional incentive for employers to hire workers through formal channels, though we should recognize that even with the 2 p.p. reduction in the tax wedge, the tax wedge (around 38 percent) remains much higher than in North Macedonia, Albania, or Kosovo. Additional factors such as tax administration effects and the design of social benefits are also likely to have an impact on labor force participation choices.

- The reduction in the employers' health insurance contribution by 2 p.p. will reduce revenues by about 0.5 percent of GDP, though this is partially offset by reduced contributions by the government on behalf of its employees.
- The Montenegrin economy has limited scope to diversify in the near term. As there is limited capacity for the production of capital goods necessary to implement the large-scale investment projects that have driven growth in recent years, Montenegro will continue to rely on imported goods and capital. Montenegro's existing goods exports have a low level of value added. One potential area for diversification is in the energy sector, where Montenegro has made significant progress in attracting new investment in hydro, solar, and wind energy production.
- Further efforts to encourage diversification will depend on the success of policies to attract FDI beyond real estate and tourism. Reforms both to enhance governance and increase competitiveness are likely to be important prerequisites.
- The maintenance of a tighter fiscal position will be the most important policy to strengthen the external position. It will also be important that investments in tourism and infrastructure are efficiently implemented in high return projects to generate sufficient growth and tourism flows in the future to service external debt.

19. ***Staff's views on the possibility that the minimum wage increase would force greater payment of salaries through formal means, as argued by the authorities, are welcome.***

- Given the large size of the grey economy in Montenegro, it is plausible but by no means clear that an increase in the minimum wage will improve tax revenues. An FAD TA mission estimated that a 15 percent increase in the minimum wage could increase tax revenues by about 0.3 percent of GDP, through personal income tax and social contributions revenues. However, staff has emphasized that the minimum wage should not be used as a tool for revenue collection. It is also important to note that the simultaneous reduction in the labor tax wedge, which will reduce revenues, will make it difficult to identify the impact of the minimum wage increase on revenues with reliable precision.

20. ***Could staff comment on the possibility that the increase in the minimum wage will improve tax revenues on the basis of other countries' experience?***

- Several other countries in the region experience a similar phenomenon, with many wage earners reporting the minimum wage and an additional salary payment made through informal channels. Romania recently implemented repeated large increases in the minimum wage coinciding with measures that reformed labor taxation and compensation of public sector employees. In the case of Romania, there was no direct indexation to the minimum wage that automatically triggered an increase in expenditures. However, in practice, public sector wages also increased, thus increasing expenditures. On balance, the overall result appears to have been broadly neutral to the fiscal balance. However, it is not implausible to believe that in isolation the increase in the minimum wage may have increased revenues.