MONTENEGRO

Highlights

- **Economic growth has accelerated but public debt is also rising sharply.** The revival of economic activity in the past year has been driven by strong tourism performance and progress on the Bar-Boljare highway project. However, public debt is now well above 60 per cent of GDP and rising.
- **Further progress has been made towards EU accession.** Montenegro has now opened more than two-thirds of the chapters in the EU *acquis* and has provisionally closed two chapters.
- **Renewables power generation capabilities are being enhanced with private sector involvement.** In a landmark project, the first commercial 72MW wind power plant in Montenegro, financed by a major foreign investor, is being completed.

Key priorities for 2017

- **Fiscal policy needs to be tightened.** Public debt is projected to rise to around 80 per cent of GDP by 2018. While Montenegro's growth prospects are good, fiscal surpluses (excluding spending on the highway project) in the coming years would be important for providing reassurance about the country's long-term debt sustainability.
- **Privatisation should be accelerated.** Although most of the economy is in private hands, some important assets remain state-owned and would benefit from new ownership, which could lead to fresh investment. The government should transparently try to expedite deals that are currently under way but not yet complete.
- **Financial sector stability should be strengthened.** Significant progress has occurred in recent years in overcoming the legacy of the global crisis, but there is still significant scope for improvements. Important steps would include: consolidation in the banking sector, asset quality reviews of the main banks, a further reduction of non-performing loans (NPLs) and increase of provisioning levels for those NPLs still on the books, and enhancing non-bank sources of finance.

Main macroeconomic indicators %

	2012	2013	2014	2015	2016 proj.
GDP growth	-2.7	3.5	1.8	3.4	4.0
Inflation (average)	3.6	2.2	-0.7	1.6	0.5
Government balance/GDP	-5.8	-6.3	-2.6	-7.5	-12.1
Current account balance/GDP	-18.5	-14.5	-15.2	-9.7	-10.3
Net FDI/GDP [neg. sign = inflows]	-14.5	-9.6	-10.2	-15.9	-12.1
External debt/GDP	155.9	151.5	154.8	154.1	n.a.
Gross reserves/GDP*	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	56.8	56.4	54.1	53.5	n.a.

*Montenegro uses the euro as its legal tender.

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Macroeconomic performance

The economy rebounded strongly in 2015. GDP growth was estimated at 3.4 per cent, a significant increase on the 1.8 per cent in 2014. The revival of economic activity was driven by a good tourist season, as a drop in Russian tourists was more than compensated by an increase from neighbouring countries, and progress on the Bar-Boljare highway project. The Montenegrin economy depends heavily on tourism, and receipts from foreign tourist arrivals account for about one-fifth of annual GDP. The more dynamic economy had a positive, although small, impact on the labour market. The unemployment rate as of June 2016 was 17.5 per cent, but long-term unemployment is very high, at more than 70 per cent of total unemployment. In the first half of 2016 growth slowed to 1.9 per cent, but the rate is likely to rise sharply in the second half of the year as a result of an increased pace of spending on the highway project, another strong tourism season, and the impact of pre-election spending and increases in social benefits.

Debt-financed construction of the major highway has elevated fiscal and external risks. As of 30 June 2016 the gross government debt of Montenegro amounted to €2.4 billion, or 62 per cent of the projected 2016 GDP. Of gross government debt, 87 per cent is to external creditors. Gross government debt has increased over the course of 2015 for two main reasons. First, in March 2015, the government issued a five-year bond worth €500 million, and second, the Export-Import Bank of China paid in the first tranche (€169 million) of the US$ 944 million loan that the government will use to construct the motorway at a cost of US$ 1.1 billion for the first section (one-third of the total length). An additional €205 million of this loan will be withdrawn in 2016, putting the gross government debt by the end of 2016 at just below 70 per cent of GDP. The government expects the project to stimulate economic activity and boost the country's long-term growth potential. However, only 30 per cent of the investment is subcontracted to domestic companies and most of the labour force will be imported. In addition, the government has engaged in significant pre-election spending on social benefits, and an already very rigid expenditure structure – pensions and wages account for around half of overall expenditure – will limit the scope for fiscal adjustment after the elections in October 2016.

Montenegro's credit rating was downgraded because of rising levels of public debt. Moody's downgraded Montenegro's rating to B1 and maintained the negative outlook in May 2016. At the same time, Standard & Poor's revised Montenegro's outlook to negative from stable. Meanwhile, in March 2016, Montenegro sold €300 million on its sovereign five-year Eurobond at a yield of 6 per cent, two percentage points higher than a year before.

Growth will continue in the short term. The near-term future growth, projected at 4 per cent in 2016 and 3.5 per cent in 2017, is expected to be mainly investment-driven and supported by (i) public investment in transport and energy infrastructure where the construction of the motorway is the key project; and (ii) flagship foreign direct private investments, particularly in the tourism sector. However, rising public debt is a significant concern. Public debt could reach 80 per cent of GDP by 2018, as the government has decided to pursue debt-financed construction of the first part of the motorway.

Major structural reform developments

Montenegro is making progress towards EU accession. As of September 2016, Montenegro had opened 24 negotiating chapters (out of 35), and had provisionally closed two: Science and Research; and Education and Culture. Chapters opened in the past year include: Agriculture and Rural Development; Food Safety, Veterinary and Phytosanitary Policy; and Fisheries. While the first two areas are seen by the European Commission as in a state of "some level of preparation", the last is perceived to be at an "early stage". Montenegro launched negotiations to join the European Union in 2012 and hopes to open all negotiation chapters by the first half of 2017.

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The crisis tax was extended for 2016 but its rate was lowered. The government has decided to lower the so-called crisis tax on higher personal incomes as of 2016 from 13 per cent to 12 per cent, aiming to ease the burden on private companies. The tax was introduced in February 2013 as a provisional measure in order to boost budget revenues. Gross monthly salaries of over €720 (€479 in net terms) have since then been taxed at 15 per cent, compared with a standard tax rate of 9 per cent. The tax was reduced to 13 per cent in 2015.

Little progress has been made in 2016 on privatisation. The 2016 Privatisation Plan envisaged the privatisation of the country's key transport companies – the nation's airline, Montenegro Airlines, the rail freight operator, Montecargo, as well as the port of Bar. In addition, the privatisation of some tourism assets still in state hands was envisaged, such as the Institute Igalo, as well as preparation of tenders for Hotel Group Budvanska Rivijera and Ulcinjska Rivijera. A tender for the Igalo Health Institute was completed in April 2015 and the results of the tender, with US/UK company International Wellness Group (IWG) being the only bidder for the 56 per cent of shares owned by the government, were adopted by the Privatisation Council in August 2015. However, the tender commission terminated negotiations with IWG in May 2016. Also, the government has started talks with Porto Montenegro-Damen consortium on the Port of Bijela concession. The consortium is seeking to use the site as a place for yacht repairs. In February 2016 the consortium filed the sole bid in the tender for the 30-year concession. The state has been trying to sell a 61.57 per cent stake in the company since 2005, but all four tenders that have been called since then have failed. There is willingness on both sides to reach an agreement, but the process involves several stakeholders which need to align their respective interests, including responsibility for environmental clean-up, which is to be financed by the World Bank. The shipyard was declared bankrupt in 2014 and the government has facilitated the sale of the shipyard's movable and immovable property. In October 2016 the government launched the sale of its stake in the Port of Bar.

Renewables power generation capabilities are being enhanced with private sector involvement. In a landmark project, the first commercial 72MW wind power plant in Montenegro, an investment of Akuo Energy, a French producer of renewable energy, is being built, with construction starting in mid-2015. This is the first large-scale investment in Montenegro's electricity generation capacity since the 1980s. Once constructed and operational, the wind farm will represent 8 per cent of the total installed capacity and 6 per cent of total electricity production in Montenegro. Project completion is expected in the first quarter of 2017.

Montenegro's power monopoly (EPCG) has separated its distribution unit into a standalone company. The long-overdue functional separation happened in June 2016, following a decision by the EPCG board of directors. The new company – Crnogorski Elektrodistributivni Sistem (CEDIS) – is fully owned by EPCG. The government has a 57 per cent stake in EPCG, Italy's A2A controls 42 per cent of the company's stock, and the remainder belongs to smaller shareholders. After months of discussions, a new management contract was signed in August 2016 between A2A and the government, which gives A2A a €250 million put option to sell its stake back to the government. In addition, EPCG has signed a deal with Czech Skoda Praha on the construction of the second unit at the country's sole Pljevlja thermal power plant.

The banking system's health is gradually improving, but risks remain. Credit to the real economy turned positive again in 2015 and the overall credit activity of the banking sector appears to be improving gradually. However, profitability of the overall sector remains weak. Only four banks managed to generate a return on equity of above 5 per cent. The NPL ratio declined from 25 per cent in 2011 to 11.7 per cent as of the end of June 2016, but many of the bad assets were shifted to factoring companies that are fully owned by the originating banks, making the extent of effective relief for the banks unclear. Also, the "Podgorica approach", under which banks and companies were supposed to engage in voluntary restructuring and out-of-court work-outs, has proved to be problematic for the banks. In its June 2016 report the IMF noted that solvency stress tests strongly indicated inadequate provisioning on NPLs in four Montenegrin banks. Elsewhere in the financial sector, a new all-encompassing law covering factoring, leasing, micro-crediting and credit guarantee operations is being drafted.

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The government has decided to hike pensions, primarily the lowest ones. As of 1 July 2016, the 20 per cent increase will be for the lowest pensions. All other pensions (of more than €123 per month) have been increased by 3 per cent. This will cost the budget an additional €6.5 million this year, and would be another reason for the planned budget revision in the second half of the year. Earlier in 2016, parliament adopted legislative amendments to the Law on Social Welfare under which mothers of three or more children who have worked for at least 25 or 15 years, respectively, will receive lifetime benefits equal to 70 per cent of the average wage. Public sector wages were also raised during 2016.