



Montenegro: Staff Concluding Statement of the 2021 Article IV Mission

FOR IMMEDIATE RELEASE

A Concluding Statement describes the preliminary findings of IMF staff at the end of an official staff visit (or 'mission'), in most cases to a member country. Missions are undertaken as part of regular (usually annual) consultations under [Article IV](#) of the IMF's Articles of Agreement, in the context of a request to use IMF resources (borrow from the IMF), as part of discussions of staff monitored programs, or as part of other staff monitoring of economic developments.

The authorities have consented to the publication of this statement. The views expressed in this statement are those of the IMF staff and do not necessarily represent the views of the IMF's Executive Board. Based on the preliminary findings of this mission, staff will prepare a report that, subject to management approval, will be presented to the IMF Executive Board for discussion and decision.

November 17, 2021:

An International Monetary Fund mission conducted the 2021 Article IV Consultation between October 25 and November 17. The team visited Podgorica from November 10 to 17.

Summary

- *The economy is recovering strongly in 2021, due to the rebound in tourism that was supported by targeted government measures. The growth rate this year is expected to be in double digits. Medium-term economic prospects appear promising, but there are also numerous risks. In the short-term, vaccination rates need to accelerate. Once the pandemic fades, the central priority is to lower public and external debt levels to provide more space to support growth, and deal with future economic shocks. The government has made a strong start towards this objective in 2021.*
- *In the current environment, far-reaching reform initiatives call for meticulous design, planning, and implementation. The proposed "Europe Now" package aims to improve living standards for workers, make tax policy fairer, and reduce the size of the informal economy. IMF staff support these priorities while also noting that there could be economic risks associated with the reforms. These risks can be moderated by considering a phased approach to this package, in carefully calibrated steps.*
- *The financial sector appears to have withstood the shock well, in significant part due to the CBCG's COVID-19 support measures. The completion of the Asset Quality Review (AQR) is also welcome. The focus should now be on translating its findings into further strengthening supervision and bank resolution frameworks.*

The economy is recovering from the COVID-19 shock

The pandemic brought a painful toll to Montenegro. The heavy human cost was compounded by a collapse in economic activity. Last year, Montenegro experienced the largest decline in GDP in Europe, primarily due to the collapse in tourism.

The economy is now rebounding strongly. A revival of tourism has helped growth to bounce back in 2021. We expect growth to be in double-digit territory this year, given the strong performance in the second quarter, and indications of a robust summer tourist season

in the third quarter. As of the second quarter, the unemployment rate according to the labor force survey has fallen to 17.1 percent. Nevertheless, many people remain without work, suggesting that continuing with temporary but targeted support to the most vulnerable deserves strong consideration.

Future growth prospects appear promising. The tourism sector should continue to normalize, barring unforeseen surprises from the pandemic. Public and private investment are also expected to recover as the pandemic subsides. The economic scars of the pandemic may not be as deep as feared at the outset of the pandemic. Painful as last year's contraction was, the long-term effects were mitigated by government and CBCG support measures to individuals, companies, and the financial sector. Looking further out, Montenegro has significant growth potential, not just from tourism, but also in renewable energy and the IT sector. This potential would be best unlocked through a combination of stable public finances, a healthy financial sector, a reduction in labor market rigidities, and a stronger business environment.

The outlook is also subject to numerous risks. Prominent among these risks is the pandemic, which could confound expectations of continued recovery in tourism. A rapid acceleration of vaccinations would offer the strongest insurance against downside risks to public health and the economy alike. Public and external debt are still very high. In conjunction with the rising chances of tightening global financial conditions, the ability to deal with future shocks remains limited. Global inflationary forces, currently believed to be transitory, may persist longer.

A substantial reduction in public debt over the medium-term is the central fiscal priority.

The pandemic caused public debt to spike. Before the pandemic, construction of the first phase of the Bar-Boljare highway had caused a significant rise in debt, leaving the economy with limited fiscal resources. Last year, the collapse in GDP and the unavoidable rise in COVID-19-related spending worsened this situation. At the end of 2020, gross public debt exceeded GDP, and is far higher than recommended levels for any emerging economy.

IMF staff view the authorities' decision to issue the Eurobond in December 2020 as appropriate. It has given the country more time to recover from the shock of the pandemic, at a very favorable interest rate. Still, the resources from the bond issue need to be carefully conserved to provide a cushion in these uncertain times, and used wisely on items that safeguard the sustainability of public finances.

Over the medium-term, public debt must be sustainably reduced. A combination of buoyant revenues due to strong growth and lower expenditure will cause a steep reduction in the fiscal deficit this year. The authorities' 2021 deficit target seems well within reach. It is encouraging that the gross public debt is expected to decline to around 90 percent of GDP. We are currently assessing the newly released 2022 budget and medium-term fiscal strategy. It is welcome that the government aims to achieve a primary surplus (the difference between non-interest revenues and non-interest expenditures) in the medium-term. Large enough primary surpluses should be maintained to ensure that public debt is put on a steady downward path.

Progress on public reforms will support debt reduction.

- **Tax administration reform.** It will be important to effectively complete the ongoing merger of the tax, customs, and games of chance agencies into a single entity. Thereafter, the focus of this entity can be dedicated to implementing proposed revenue reforms that the government is planning.
- **SOE reform.** The government is also aiming for courageous changes to the state-owned enterprise (SOE) sector through the establishment of a new entity named "Montenegro Works". For this new entity to be successful, it requires robust institutional and legal

frameworks. It needs to have legal and financial capacity to comprehensively restructure enterprises and/or sell them, be politically independent and subject to proper oversight. Other countries have set up similar entities with varying degrees of success, depending on the effectiveness of these basic frameworks. IMF staff are in discussions with the authorities to explore possible cooperation to help strengthen SOE oversight, drawing on the lessons learned from international experience.

- A new **Public Administration Reform** strategy is needed to maximize the value that taxpayers realize from the public sector. We understand that the authorities are currently working on such a strategy.
- **Strengthening public investments.** The IMF has recently completed a Public Investment Management Assessment (PIMA). It is key to have a clear framework for selection and appraisal of projects - including PPPs, keeping in mind that they are an integral part of the public sector balance sheet.

Reform initiatives should balance the injection of dynamism, with careful design, planning, and implementation.

The government has proposed an ambitious reform package. If the “Europe Now” plan were to be fully implemented, the net minimum wage would increase from 250 euros to 450 euros a month, healthcare contributions (of some 4 percent of GDP) would be abolished, and wages up to 700 euros a month would be exempt from personal income tax. The package aims to (i) reduce the gap between the minimum wage and the minimum consumption basket; (ii) entrench a progressive personal income tax; (iii) reduce the size of the grey economy; and (iv) attract investment and create jobs due to a lower labor tax wedge. These objectives are highly desirable – if successfully achieved, they could help to reduce some long-standing structural impediments to Montenegro’s growth.

However, big changes enacted in a single step may also carry significant risks of unintended effects. These include: (i) the risk of higher overall unemployment and/or a rise in informal employment; (ii) risks of compounding inflationary forces and/or reduced global competitiveness if wage increases are not matched by productivity growth; and (iii) possible revenue losses to the state and/or local governments, if intended revenue-raising measures do not yield expected results in a sustained manner, or are not fully implemented.

These risks could be moderated by considering a phased approach, in carefully calibrated steps.

- It is important that far-reaching reforms are based on commensurately robust design, and administration preparation.
- From an implementation perspective, it would be prudent to begin with aspects of the plan that are intended to raise revenues. Elements of the plan which involve revenue losses should be phased in at a later stage, in the view of IMF staff.
- Concomitantly, on the minimum wage, we recommend that increases are also implemented in distinct and clearly communicated phases. The “Europe Now” package assumes that a large share of wages is not declared to the tax authority and are paid “under the table”. While there is considerable evidence that such payments exist, there also appears to be significant variation and uncertainty over their size across regions of the country, and across sectors of the economy.

Relative to single-step implementation, a phased-in approach offers the ability to make corrections along the way. IMF staff stand ready to provide technical advice on phasing the package in, if this is the course that is eventually chosen.

The financial sector appears to have weathered the pandemic well.

The CBCG's support measures provided an important cushion during the pandemic. Policies such as the moratoria on debt repayments and temporary easing of reporting requirements helped to shore up company and household finances. This provided a significant buffer to the economy and helped avoid an even deeper downturn. Now that the economy is recovering, it is appropriate that most of these policies are now being phased out.

Capital and liquidity of banks appear to be adequate. The successful completion of the asset quality review was encouraging. It provided a reassuring picture of banking system balance sheets, as of end-2019. The system-wide capital adequacy ratio is above the regulatory minimum and liquidity remains adequate. As the pandemic support measures are phased out, system-wide non-performing loans could increase, but are expected to remain manageable. Vigilant monitoring and supervision are required during this transition.

Remaining challenges in the financial sector will require careful attention. It is possible that some banks will experience a larger-than-average deterioration in asset quality. IMF staff welcome the introduction of the new Law on Resolution of Credit Institutions and encourage the CBCG to ensure that bank resolution strategies are well-tailored and credible. In addition, the new Law on Credit Institutions will ensure alignment with EU frameworks.

There has been encouraging progress in strengthening the anti-money laundering (AML/CFT) framework – notably in relation to the legal framework and working towards implementing relevant EU legislation. The second National Risk Assessment (NRA) in December 2020 is helping to shape measures to reduce the risk of money laundering and terrorism financing. Strong implementation of these measures is key, and will help the country prepare for its upcoming 2023 (AML/CFT) assessment to be conducted by the Council of Europe. In their efforts to modify the Investor Citizenship Program, the authorities are encouraged to focus on attaining the strongest financial integrity safeguards (e.g., robust vetting of applicants and enhanced measures for transparency and oversight).

The mission would like to thank the authorities and other interlocutors for their hospitality, and for the candid and constructive discussions. The IMF looks forward to further strengthening relationships with all counterparts through regular dialogue to help Montenegro realize its aspirations and meet future challenges.