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1. INTERNATIONAL ENVIRONMENT

Overview of Macroeconomic Developments and the Financial Crisis Impact – On the Path to Recovery Paved With Uncertainty

The financial crisis and its global escalation in September 2009 spilt over to the real flows and this backfired to further weaken financial markets. Central banks in synergy with fiscal policy then offered a set of measures which, although varying by the country, was based on expansive policy of curbing the financial and economic crisis. The effects of these measures are becoming more discernable, especially in advanced economies.

Thus the global economy saw an over 5% growth in Q1 2010, which is much more than the IMF projection communicated in April this year. Consequently, the IMF revised its April projection of global output from 3% to 4.5% in June this year. The most significant changes that brought about the projection revision are an unexpected growth of Asian economies, production and trade that recorded two-digit growths, and a decline in unemployment in advanced economies.

On the other hand, risks that remain primarily involve the sustainability of fiscal policies that emerged as the responses to the financial crisis and the sustainability of external debt of advanced economies, in particular Greece and other countries in the Euro area experiencing difficulties with their external debts (Portugal, Spain and Italy). In addition, there is a danger that potential prolonging of expansive monetary policy effects could induce inflation increase on the global level as it is known that these effects are often experienced after a substantial time lag. Risks in the forthcoming period are a further instability of the banking sector and potential further decline in real estate prices.

Table 1.1 – IMF projections of most important macroeconomic indicators

	2008	2009	2010	2011	2010	2011	2009	2010	2011
	Projections				Difference from April 2010 projections		Q over Q		
Global GDP	3	−0.6	4.6	4.3	0.4	0.0	2	4.2	4.3
Advanced economies	0.5	−3.2	2.6	2.4	0.3	0.0	−0.5	2.3	2.6
USA	0.4	−2.4	3.3	2.9	0.2	0.3	0.1	3.2	2.6
Euro Area	0.6	−4.1	1	1.3	0.0	−0.2	−2.1	1.1	1.6
Germany	1.2	−4.9	1.4	1.6	0.2	−0.1	−2.2	1.3	1.7
France	0.1	−2.5	1.4	1.6	−0.1	−0.2	−0.4	1.5	1.7
Italy	−1.3	−5.0	0.9	1.1	0.1	−0.1	−2.8	1.1	1.3
Spain	0.9	−3.6	−0.4	0.6	0.0	−0.3	−3.1	−0.1	1.2
Japan	−1.2	−5.2	2.4	1.8	0.5	−0.2	−1.4	1.1	3
Great Britain	0.5	−4.9	1.2	2.1	−0.1	−0.4	−3.1	2.1	1.9
Canada	0.5	−2.5	3.6	2.8	0.5	−0.4	−1.1	4	2.6
Other advanced economies	1.7	−1.2	4.6	3.7	0.9	−0.2	3.1	3.4	4.6
Newly industrialized Asian economies	1.8	−0.9	6.7	4.7	1.5	−0.2	6.1	4.3	6.3
Developing economies	**6.1**	**2.5**	**6.8**	**6.4**	**0.5**	**−0.1**	**5.7**	**6.9**	**6.8**
Central and Eastern Europe	**3.1**	**−3.6**	**3.2**	**3.4**	**0.4**	**0.0**	**2**	**2.3**	**3.5**
Commonwealth of Independent States	5.5	−6.6	4.3	4.3	0.3	0.7			
Russia	5.6	−7.9	4.3	4.1	0.3	0.8	−3.8	3.7	3.9
Developing Asia	7.7	6.9	9.2	8.5	0.5	−0.2	9.8	9	8.7
China	9.6	9.1	10.5	9.6	0.5	−0.3	12.1	9.8	9.6
India	6.4	5.7	9.4	8.4	0.6	0.0	7.3	10.3	8
ASEAN 53	4.7	1.7	6.4	5.5	1	−0.1	5.1	4.9	6.8
Middle East and North Africa	5.3	2.4	4.5	4.9	0.0	0.1			
Sub-Saharan Africa	5.6	2.2	5	5.9	0.3	0.0			
Western Hemisphere	4.2	−1.8	4.8	4	0.8	0.0			
Brazil	5.1	−0.2	7.1	4.2	1.6	0.1	4.4	5.3	4.3
Mexico	1.5	−6.5	4.5	4.4	0.3	−0.1	−2.4	3.5	4.3
EU	0.9	−4.1	1	1.6	0.0	−0.2	−2.2	1.3	1.7
World trade volume	2.8	−11.3	9	6.3	2	0.2			
Imports of advanced economies	0.5	−12.9	7.2	4.6	1.8	0.0			
Imports of emerging and developing economies	8.6	−8.3	12.5	9.3	2.8	1.1			
Exports of advanced economies	1.8	−12.6	8.2	5	1.6	0.0			
Exports of emerging and developing economies	4.5	−8.5	10.5	9	2.2	0.6			

Source: IMF Macroeconomic Outlook, July 2010

Further on we present an overview of the economic crisis effects on international environment, with a special overview of the EU countries, taking into account a relative dependence of Montenegro on this market.

European Union

Economic activity. Although the general opinion is that the EU economic growth is below its actual potential, its recorded output was higher than that forecasted, resulting in the 2010 forecast revision. Namely, due to an increase in external demand and the related industrial output growth, the exports and domestic demand resurged, in particular household consumption, and all that led to an accelerated growth of the EMU and the EU countries. Thus the EMU and EU growths in 2010 are estimated at 1.8% and 1.7%, respectively, which represents improved estimate in relation to that communicated by the European Commission in April 2010 when the EU economic growth was at the level of 1%.

The EU GDP growth in Q2 this year amounted to 1%, thus increasing as of the previous quarter when it saw a modest increase of 0.3%. Economic growth in Q2 was higher than the 0.4% projected by the European Commission.

Table 1.2 – EU and Euro Area GDP growth - European Commission projections

EU	2009	2010	2011
Annual GDP growth	-1.7	0.2	0.6
Q4/Q4	-2.3	1.4	1.9
Average	-4.2	1	1.7
Euro Area			
Annual GDP growth	-1.7	0.3	0.5
Q4/Q4	-2.2	1	1.7
Average	-4.1	0.9	1.5

Source: European Commission, Economic Forecast, Spring 2010

Speaking of the EU growth components in Q2, the main reasons for this increase are growing domestic consumption and investments (cumulatively contributing to the economic growth with 0.6 percentage points) in relation to the combined growth in net exports and inventories which contributed to an aggregate growth of 0.3 percentage points. It should be noted that the economic growth also reflects temporary factors such as an increase in construction work due to the lagging behind during winter. It is assumed that the economy will continue growing to increase by 0.5% in Q3 and 0.4% in Q4.

The elements that point to a further recovery of the economy reflect in the continued growth in investments and consumption to lead to the traditional level of the capacity utilization of 80%. On the other hand, regardless of a modest recovery of available income, a decline in private sector depositing and the labour market stabilization indicate that private consumption will continue growing in the forthcoming period.

Labour market. It represents one of the segments of the EU economy that was most severely hit by the crisis and that started showing some signs of recovery in Q2 this year. Nevertheless, the unemployment rates in the Euro Area and the EU remained at the levels of 10% and 9.6%, respectively. Forecasts on the unemployment rate remained at the April 2010 levels of 9.75% and 10.5% in the EU and the EMU, respectively. The European Commission expects the financial crisis effects to be felt almost five years and induce an increase in long-term unemployment of some 0.7 percentage points.

Table 1.3 – Projections of unemployment rate (%), European Commission, January 2009, April 2009 and April 2010 (comparative overview)

	2007	2008	2009	2010	2011
Belgium	7.5	7.0	7.9	8.8	9.0
Germany	8.4	7.3	7.5	7.8	7.8
Ireland	4.6	6.3	11.9	13.8	13.4
Greece	8.3	7.7	9.5	11.8	13.2
Spain	8.3	11.3	18.0	19.7	19.8
France	8.4	7.8	9.5	10.2	10.1
Italy	6.1	6.7	7.8	8.8	8.8
Cyprus	4.0	3.6	5.3	6.7	7.0
Luxembourg	4.2	4.9	5.4	6.1	6.4
Malta	6.4	5.9	6.9	7.3	7.2
Netherlands	3.2	2.8	3.4	4.9	5.2
Austria	4.4	3.8	4.8	5.1	5.4
Portugal	8.1	7.7	9.6	9.9	9.9
Slovenia	4.9	4.4	5.9	7.0	7.3
Slovakia	11.1	9.5	12.0	14.1	13.3
Finland	6.9	6.4	8.2	9.5	9.2
Euro Area	**7.5**	**7.5**	**9.4**	**10.3**	**10.4**
Bulgaria	6.9	5.6	6.8	7.9	7.3
Czech Republic	5.3	4.4	6.7	8.3	8.0
Denmark	3.8	3.3	6.0	6.9	6.5
Estonia	4.7	5.5	13.8	15.8	14.6
Latvia	6.0	7.5	17.1	20.6	18.8
Lithuania	4.3	5.8	13.7	16.7	16.3
Hungary	7.4	7.8	10.0	10.8	10.1
Poland	9.6	7.1	8.2	9.2	9.4
Romania	6.4	5.8	6.9	8.5	7.9
Sweden	6.1	6.2	8.3	9.2	8.8
Great Britain	5.3	5.6	7.6	7.8	7.4
EU	7.1	7.0	8.9	9.8	9.7
USA	4.6	5.8	9.3	9.7	9.8
Japan	3.9	4.0	5.1	5.3	5.3

Source: European Commission, Economic Forecast, Spring 2010

The current account deficit. Q2 2010 was also marked by significant adjustments and corrections of current and capital accounts of the EU countries due to the revival of external demand, changing oil and oil derivatives prices, declines in food products prices, and reduced levels of foreign direct investments. At end-June this year, the Euro Area recorded a EUR 50.8 billion deficit or 1.1% of GDP, as compared to the current account deficit in the same period in 2009 of EUR 44.7 billion.

Table 1.4 – Current account deficit, % of GDP

	2007	2008	2009	2010	2011
Belgium	3.7	0.2	2.0	3.0	3.3
Germany	7.9	6.6	5.0	4.8	4.8
Ireland	-5.3	-5.2	-2.9	-0.9	-0.6
Greece	-14.7	-13.8	-13.1	-10.3	-8.6
Spain	-10.0	-9.5	-5.1	-4.6	-4.5
France	-2.3	-3.3	-2.9	-3.3	-3.6
Italy	-1.8	-3.1	-3.2	-3.2	-2.9
Cyprus	-11.7	-17.7	-8.5	-7.1	-7.0
Luxembourg	9.7	5.3	-0.4	0.9	1.5
Malta	-6.2	-5.4	-3.9	-4.9	-4.4
Netherlands	8.5	4.2	3.9	5.9	6.4
Austria	3.4	3.6	2.9	3.1	4.1
Portugal	-9.8	-12.1	-10.5	-10.1	-10.0
Slovenia	-4.5	-6.2	-0.9	-1.4	-1.6
Slovakia	-5.1	-6.7	-3.1	-4.5	-4.1
Finland	4.3	3.5	1.5	1.1	1.3
Euro area	**0.3**	**-0.9**	**-0.6**	**-0.4**	**-0.3**
Bulgaria	-22.5	-22.9	-9.6	-6.0	-5.2
Czech Republic	-2.6	-3.4	-1.0	-0.3	-1.5
Denmark	1.5	2.2	4.0	3.9	3.7
Estonia	-17.9	-9.4	4.6	4.9	3.8
Latvia	-22.5	-13.0	8.7	8.3	4.6
Lithuania	-15.1	-11	2.6	2.8	2.0
Hungary	-6.5	-7.2	0.4	-0.2	-0.3
Poland	-5.2	-5.0	-1.6	-2.8	-3.3
Romania	-13.6	-12.7	-4.4	-4.4	-5.6
Sweden	9.1	9.5	7.1	6.1	6.1
Great Britain	-2.7	-1.5	-1.3	-1.8	-2.0
EU	-0.4	-1.1	-0.5	-0.4	-0.4
USA	-5.2	-4.9	-3.0	-3.7	-3.7
Japan	4.8	3.2	2.8	3.1	2.5

Source: European Commission, Economic Forecast, Spring 2010

Inflation. The HICP inflation trended up in Q2 2010. To wit, due to the increase in the prices of consumer goods and a mild growth in the energy and food prices, the euro area inflation amounted to 1.5% at the annual level, which is in line with the April projections of the European Commission. Core inflation dropped from 1.5% in June 2009 to 0.8% in June this year.

As for the prices movements in the EU, the annual HICP amounted to June 2010, which is 0.3% more than projected by the EC, primarily due to an upsurge in prices in Great Britain (of 3.2%).

Table 1.5 – Projections of inflation in the EU and euro area until 2010

	Euro area				European Union			
	2007	2008	2009	2010	2007	2008	2009	2010
Personal consumption deflator	2.2	2.9	0.5	1.2	2.3	3	0.8	1.3
GDP deflator	2.3	2.3	1.5	1.2	2.6	2.6	1.5	1.3
HICP	2.1	3.3	0.4	1.2	2.4	3.7	0.9	1.3
Unit labour costs	1.7	3.3	3.4	0.1	2	3.5	3.3	0.2
Import deflator	1.2	3.9	-4.2	1.8	0.9	4.7	-1.6	2

Source: Economic Forecast, European Commission, Spring 2010

Table 1.6 – Projections of HCPI in the EU and euro area until 2011

	2007	2008	2009	2010	2011
Belgium	1.8	4.5	0.0	1.6	1.6
Germany	2.3	2.8	0.2	1.3	1.5
Ireland	2.9	3.1	-1.7	-1.3	0.8
Greece	3.0	4.2	1.3	3.1	2.1
Spain	2.8	4.1	-0.3	1.6	1.6
France	1.6	3.2	0.1	1.4	1.6
Italy	2.0	3.5	0.8	1.8	2.0
Cyprus	2.2	4.4	0.2	2.7	2.5
Luxembourg	2.7	4.1	0.0	2.6	2.0
Malta	0.7	4.7	1.8	2.0	2.1
Netherlands	1.6	2.2	1.0	1.3	1.5
Austria	2.2	3.2	0.4	1.3	1.5
Portugal	2.4	2.7	-0.9	1.0	1.4
Slovenia	3.8	5.5	0.9	1.8	2.0
Slovakia	1.9	3.9	0.9	1.3	2.8
Finland	1.6	3.9	1.6	1.7	1.9
Euro area	**2.1**	**3.3**	**0.3**	**1.5**	**1.7**
Bulgaria	7.6	12.0	2.5	2.3	1.5
Czech Republic	3.0	6.3	0.6	1.0	1.3
Denmark	1.7	3.6	1.1	2.3	1.5
Estonia	6.7	10.6	0.2	1.3	2.0
Latvia	10.1	15.3	3.3	-3.2	-0.7
Lithuania	5.8	11.1	4.2	-0.1	1.4
Hungary	7.9	6.0	4.0	4.6	2.8
Poland	2.6	4.2	4.0	2.4	1.4
Romania	4.9	7.9	5.6	4.3	3.0
Sweden	1.7	3.3	1.9	1.7	1.6
Great Britain	2.3	3.6	2.2	2.4	1.4
EU	2.4	3.7	1.0	1.8	1.7
USA	2.8	3.8	-0.4	1.7	0.3
Japan	0.0	1.4	-1.4	-0.5	-0.4

Source: Economic Forecast, European Commission, Spring 2010

Projection horizon until end-2010 indicates further significant declines in inflation with the HICP levels of 0.4% and 0.9% in the euro area and the EU, respectively, whereas positive responses to expansive monetary and fiscal policy measures will begin to slightly recover consumer prices so that the respective forecasted inflation is 1.2% and 1.3% (Table 1.5).

Fiscal policy and external debt. Almost all EU and euro area countries have implemented a wide range of expansive fiscal policy measures, which conditioned temporary derogations from the Maastricht Criteria. The fiscal deficit in 2010 is projected at 7.25%. It is expected that fiscal deficits in all EU countries, except Sweden, Bulgaria and Estonia, will exceed the level of 3% of GDP. The reason for the further fiscal deficit increase lies in the fact that automatic stabilizers are still in effect, entailing substantial costs relating to expenses for social programmes. In addition, the European Economic Recovery Plan (EERP) is in full force and it foresees substantial fiscal stimuli aimed at increasing investments and assisting small and medium-sized enterprises. At the same time, the external public debt is projected to increase in 2010 and to reach, taking into account guarantees, 84% of GDP.

Table 1.7 – Projections of fiscal expenditure and public debt in the EU and the euro area

	Euro Area				EU			
	2007	2008	2009	2010	2007	2008	2009	2010
TOTAL REVENUES	45.4	44.7	44.8	44.4	44.9	44.5	44.1	43.8
TOTAL EXPENDITURES	46.1	46.6	50.1	51	45.7	46.8	50.1	51.1
BALANCE (3) = (1) – (2)	-0.6	-1.9	-5.3	-6.5	-0.8	-2.3	-6	-7.3
Interest expenditure (4)	2.9	3	3	3.2	2.7	2.7	2.8	3.1
Primary balance (5) – (3) + (4)	2.3	1.1	-2.3	-3.3	1.9	0.4	-3.2	-4.3
Cyclically-adjusted balance	-1.9	-2.9	-3.9	-4.7	-2.1	-3.3	-4.6	-5.6
Cyclically-adjusted primary balance	1.1	0.1	-0.9	-1.5	0.6	-0.5	-1.8	-2.5
Structural budget balance	-1.8	-2.8	-3.9	-4.7	-2	-3.1	-4.6	-5.5
Gross public debt	66	69.3	77.7	83.8	58.7	61.5	72.6	79.4

Source: Economic Forecast, European Commission, Spring 2010

USA

In Q1 2010, the USA recorded an increase in economic activity in relation to the previous year, yet showing a slowdown in comparison with Q4 2009 when it was 5.6%. First assessments indicate a 3.2% annual increase in Q1, showing the economic activity uptrend for three subsequent quarters. The USA growth in Q2 amounted to 2.4%, in comparison with the 2009 growth of 3.7%.

Minor slowdown in GDP was primarily due to a decline in the private sector inventories. At the same time, exports reduction and housing prices stagnation reflected on the economic slowdown. On the other hand, domestic consumption picked up pace and rose by almost 2.1 percentage points in Q2 2010 (the highest increase in the last three years) or 11% at the annual level, thus having positive effects on the private sector`s profit increase of 5.5% in comparison with Q1.

As for the unemployment rate, it oscillated from 9.7% in March, rising to 9.9% in April, again coming down to 9.7% in May and staying at the level of 9.5% in June. The only positive steps forward in both Q1 and Q2 is the employment of highly qualified staff and health care personnel. n addition, it is estimated that the unemployment rate will move downward by 1 percentage point by the end of 2010.

As for real salaries, their increase was insignificant, a mere 0.1 percentage points. According to the U.S Department of Labor, USA productivity declined in Q2 2010 by 1.8%, which is a substantial downturn if compared to the annual productivity increase in Q1 of 6.1%. Regardless of productivity increase, numerous analysts believe that the labour market will face a very slow recovery in the forthcoming period, largely depending on productivity rather than on employment increase.

The inflation rate in Q2 amounted to 1.1% at the annual level, as compared to 2.3% in March this year, which is mostly due to a decline in energy prices and revived domestic demand regardless of salaries` stagnation.

The Federal Open Market Committee (FOMC) retained low interest rates between 0% and up to 0.25%, with the plan not to make any corrections in the long-term, whereas the discount rate also remained at the low 0.75%.

Japan

The Japanese economy has finally started showing signs of recovery, primarily owing to an increase in aggregate external demand from the Chinese and the EU market, but there has been no similar trend when it comes to domestic demand as it shows revival at a very slow pace. An increase in exports and productivity, as well as the growing investment activity of the private sector, will drive further economic growth, but inelastic unemployment, a decline in real salaries that affect poor aggregate demand of the private sector (-0.1%) and a decrease in the state investments (-0.1%) represent reasons for concern. Thus, real GDP rose by 1.2% in Q1 this year (see Table 1.2) primarily owing to the exports increase (quarterly increase of 0.9%).

Industrial output continues trending upward, accompanied by a substantial 7% increase in Q1, and a much slower growth of 1.4% in Q2 due to seasonal adjustments, but it is important to note that industry has been recording increases for five consecutive quarters.

Exports record substantial annual increase of 9.5% in Q2 mostly to China (regardless of monthly decline of 1.6% in June this year), the USA and the EU, thus staying on the upward path for five consecutive quarters. On the other hand, monthly developments show that exports dropped in June by 0.3%.

As for unemployment growth that amounted to 5% at end-Q1 this year, the rate remained at 5.3% in June which is the third month in a row, whereas real salaries remained at their Q1 levels.

The Q2 increase in prices has been gradually slowing down, primarily owing to the stagnation in the prices of consumer goods and further exploitation of the existing inventories. Price stability has been preserved so that Q2 CPI inflation amounted to 0.2% in June this year, which is a 0.1 percentage point decline in comparison with the previous month. Inflation remains stable both owing to the low prices of oil and agricultural products, so that the general assumption is that there will be no inflationary pressures in the forthcoming period.

Table 1.8 – Overview of most important macroeconomic indicators of the Japanese economy

	2009.				2010	2010
	Q1	Q2	Q3	Q4	Q1	Q2
Real GDP	**-3.6**	**1.5**	**-0.1**	**1.0**	**1.1**	**0.1**
Domestic demand	**-3.0**	**-0.3**	**-0.5**	**0.4**	**0.5**	**-0.2**
Private demand	-3.3	-0.6	-0.4	0.3	0.4	-0.1
Private consumption	-0.8	0.7	0.4	0.4	0.3	0.0
Non-residential investments	-1.3	-0.6	-0.3	0.1	0.1	0.1
Residential investments	-0.2	-0.3	-0.2	-0.1	0.0	0.0
Private inventory	-0.9	-0.4	-0.2	-0.2	0.1	-0.2
Public demand	0.3	0.3	-0.1	0.1	0.1	-0.1
Public investments	0.1	0.3	-0.1	-0.1	0.0	-0.1
Net exports of goods and services	**-0.6**	**1.8**	**0.3**	**0.5**	**0.6**	**0.3**
Exports	-3.8	1.2	1.1	0.7	1.0	0.9
Imports	3.2	0.6	-0.8	-0.2	-0.4	-0.5
Nominal GDP	**-3.7**	**-0.1**	**-0.6**	**0.1**	**1.4**	**-0.9**

Source: Monthly report of the Bank of Japan, September 2010

Influence of international environment on Montenegro

It is evident that the current international environment adversely affects Montenegro, but there have been some positive movements that reflect in an increase in external demand, prudential interest rate policy, and recovery of employment, with all these combined to result in growth of the Montenegrin exports, remittances, maintenance of price stability, and easier access to international capital markets (foreign funding), with potential positive effects on FDI inflow. However, it is important to note that as long as there are global recession pressures, with a particular emphasis on the EU Member States, they will continue having negative impact on Montenegro as they reflect on numerous sectors: construction, tourism, manufacturing industry, the banking system, the capital market, and the like. General conclusion is that although recession processes still remain in certain global economy segments, thus representing potential causes of instability in the long-term (stagnation of employment and growing external debt), signs of gradual revival of global economy prevailed in Q2 2010, expecting to have a positive effect on financial stability of Montenegro in the upcoming quarters.

2. MACROECONOMIC ENVIRONMENT IN MONTENEGRO

2.1. GDP movements

After the longstanding accelerated GDP growth, the year 2009 ended with the GDP decline of -5.7%. Although there are no official data on GDP movements in the first six months of 2010, there are indications that recession is easing, with certain parameters that determine GDP trends have been showing the tendency toward putting an end to the rapid economic downturn and some indicators have been even recording a mild uptrend. Positive trends in the first six months of the current year, as compared to the same period a year ago, were recorded in forestry and some transportation segments, while overall industrial output and the tourism industry registered minor declines. This period was characterized by an increase in gross salaries, low inflation, both at the annual level and on average (period-on-period). Rough estimates show that economic activity was on a downturn in the first half-year, while it is expected that growth will be recorded in Q3.

Economic developments in the first half-year were as expected. The uptrend in unemployment that had been present as of April (the maximum level in this year) was halted, net salaries have been on a mild increase, as has been retail trade, while the annual inflation remains low. Indirect taxes remain stable, accompanied by an increase in household and corporate deposits, thus having positive effects on overall financial stability. On the other hand, potential risks that remain are problems with the status of employees in the metal industry, insufficient liquidity of banks, and growing aggregate losses with an ongoing increase in companies with frozen accounts.

Estimate of GDP movements in 2010 and their impact on financial stability

Taking into account the limited availability of numerous data, it is difficult at this moment to give any forecasts on GDP movements in 2010. However, considering individual sectors such as forestry, trade and numerous transportation segments whose indicators were positive in the first six months of the year (industrial production also in Q3), it can be expected that economic activity will start with a gradual recovery.

Most international financial institutions have forecasted a negative rate of growth of Montenegro's GDP in 2010, but the EBRD projection as of May this year forecasts a moderate 0.1% growth. Tables 2.1 to 2.5 show the estimates of GDP movements and selected economic indicators given by the relevant international financial institutions.

Table 2.1 – Montenegro`s 2010 GDP estimates given by international financial institutions (in %)

Institution	Estimated rate of growth in 2010
World Bank	...
IMF	-1.8
EBRD	0.1
Moody`s	-1.0

Table 2.2 – Montenegro: selected economic indicators, 2006-13[1] (under current policies)

	2006	2007	2008	2009 Preliminary	2010	2011	2012	2013
					Projections			
Real economy								
Nominal GDP (millions of €)	2,149	2,680	3,086	2,941	2,935	3,128	3,383	3,641
Gross national saving (percent of GDP)	1.4	-5.6	-11.2	-9.2	2.0	9.0	11.0	13.0
Gross investments (percent of GDP)	25.4	33.8	40.6	18.0	19.0	21.0	21.0	22.0
Unemployment rate (in %)	14.7	11.9	10.7	11.4				
	(Annual percentage change)							
Real GDP	8.6	10.7	6.9	-6.6	-1.8	4.5	5.5	5.0
Industrial production	1.0	0.1	-2.1	-32.2				
Tourism								
Arrivals	16.3	18.8	4.8	1.6				
Nights	13.9	22.9	6.9	-3.1				
Consumer prices (period average)	3.0	4.2	8.5	3.4	-0.6	3.0	3.0	2.9
Consumer prices (end of period)	2.8	7.7	7.2	1.5	-0.7	3.7	2.7	3.2
GDP deflator	9.0	12.7	7.7	2.1	1.6	2.0	2.5	2.5
Average net wage (12-month)	15.3	19.9	23.3	11.4				
Money and credit (end of period, 12-month)								
Bank credit to private sector	138.9	175.9	25.0	-13.6				
Enterprises	112.2	191.0	20.9	-15.4				
Households	193.0	153.7	32.0	-10.9				
Bank deposits – private sector	119.5	99.5	-14.1	-11.4				

[1] Source: IMF Country Report No. 10/155, May 2010

Table 2.3 – Montenegro: balance of payments, 2008 -15 (under current policies)

	2008	2009	2010	2011	2012	2013	2014	2015
		Prelim.			Projection			
	In millions of euros							
Current account balance	-1,564	-896	-499	-383	-348	-341	-366	-394
Trade balance	-2,082	-1,371	-1,163	-1,123	-1,188	-1,273	-1,402	1,542
Exports	467	296	365	420	475	511	550	582
Imports	-2,550	-1,668	-1,528	-1,544	-1,663	-1,784	-1,951	-2,124
Services balance	399	385	497	670	751	836	930	1,036
Receipts	751	680	798	893	991	1,099	1,219	1,352
Expenditure	-351	-296	-302	-223	-240	-263	-289	-316
Net factor income	46	5	77	-26	-14	-14	-14	-14
Compensation of employees	137	150	135	144	156	167	179	191
Investment income	-91	-144	-58	-170	-170	-182	-193	-205
Current transfers, net	73	85	90	96	104	112	119	127
Government	9	5						
Remittances	64	80						
Capital and financial accounts	1,330	540	455	459	434	432	463	496
Capital account	0	2	0	0	0	0	0	0
Financial account	1,330	538	455	459	434	432	463	496
FDI, net	552	911	308	199	251	270	288	307
In Montenegro, net	625	944						
Abroad, net	-74	-33						
Portfolio investment,net	-16	-42	0	0	0	0	0	0
Other	639	-275	146	259	183	162	175	189
General government	-7	143						
Commercial banks	551	-303	-105	-93	-6	-3	-2	-1
Other non-bank sectors	95	-115	251	352	189	165	177	190
Net errors and omissions	235	356	50	53	58	62	66	70
Change in official reserves	155	-57	94	-22	-28	-30	-30	-32
Memorandum items	In percent of GDP							
Current account balance	-50.7	-29.8	-17.0	-12.2	-10.3	-9.4	-9.4	-9.5
Merchandrile trade	-67.5	-45.7	-39.6	-35.9	-35.1	-35.0	-36.0	-37.2
Exports	15.1	9.9	12.5	13.4	14.0	14.0	14.1	14.0
Imports	-82.6	-55.5	-52.1	-49.4	-49.2	-49.0	-50.2	-51.3
Services balance	12.9	12.8	16.9	21.4	22.2	23.0	23.9	25.0
Receipts	24.3	22.7	27.2	28.6	29.3	30.2	31.3	32.6
Payments	-11.4	-9.9	-10.3	-7.1	-7.1	-7.2	-7.4	-7.6
Foreign direct investment	17.9	30.3	10.5	6.4	7.4	7.4	7.4	7.4
Gross external debt	95.1	98.2	105.1	108.6	107.6	106.1	105.5	105.3

Sources: Central Bank of Montenegro and IMF projections

Table 2.4 – Vienna Institute projections[2]

	2008	2009	2010P	2011P	2012P
Real GDP growth (%)	6.9	-5.3	-1.0	2.0	3.0
Consumer prices (% y-o-y change)	7.4	3.4	1.0	3.0	3.0
Unemployment rate (as per Labour Force Survey)	17.2	19.1	20.0	20.0	20.0
Current account (% of GDP)	-50.7	-29.8	-16.0	-17.0	-17.0

Table 2.5 – EBRD projections

	Real GDP growth									
	GDP growth (year over year per cent hange)						Memorandum item GDP growth within year			
	2008	2009	EBRD forecast in Jule 2010		EBRD forecast in May 2010		2008	Forecast (may 2010)		
			2010	2011	2010	2011		2009	2010	2011
Central Europe and Baltic states										
Croatia	2.4	-5.8	-1.3	3.0	0.3	1.8	0.2	-4.5	0.0	2.9
Estonia	-3.6	-14.1	0.2	3.4	-0.4	3.3	-9.2	-9.5	-0.5	4.1
Hungary	0.6	-6.3	1.2	2.1	1.0	2.3	-2.5	-4.0	0.4	3.5
Latvia	-4.6	-18.0	-2.0	3.0	-3.0	3.0	-10.3	-16.9	1.9	3.5
Lithuania	2.8	-14.8	-1.0	3.0	-1.5	3.0	-2.2	-12.1	-1.8	2.7
Poland	5.0	1.8	2.7	3.3	2.6	3.3	2.6	3.6	1.7	3.8
Slovak Republic	6.2	-4.7	3.1	3.4	3.4	3.4	1.6	-2.6	0.9	4.0
Slovenia	3.5	-7.8	0.0	2.6	1.3	2.2	-0.8	-5.5	1.7	2.2
Average	**3.5**	**-2.9**	**1.7**	**3.1**	**1.8**	**3.0**	**0.3**	**-1.0**	**1.1**	**3.6**
South-eastern Europe										
Albania	7.0	3.3	1.4	2.3	1.4	3.1	2.8	-0.8	7.0	3.4
Bosnia and Herzegovina	5.4	-3.2	0.4	1.7	0.3	1.7				
Bulgaria	6.0	-5.0	-1.2	2.5	-1.2	3.0	3.5	-5.9	1.5	2.6
FYR Macedonia	4.8	-0.5	0.5	2.5	2.2	2.5	1.0	1.2	1.2	3.1
Montenegro	7.0	-5.3	-0.1	2.0	0.1	2.0				
Romania	7.1	-7.1	-3.0	0.0	0.0	3.0	3.1	-6.5	2.6	1.9
Serbia	5.5	-3.0	1.9	3.0	2.1	3.2	2.8	-1.6	1.5	3.9
Average	**6.6**	**-5.4**	**-1.5**	**1.2**	**0.3**	**2.9**	**2.9**	**-4.8**	**2.2**	**2.3**

We expect that the end of Q3 will practically mark the end of recession in Montenegro. It is difficult to give any forecasts at this moment about the 2010 growth, but rough estimate indicates somewhere between -0.5% and 2%. A higher rate of growth should certainly be expected in 2011, thus further contributing to the maintenance of financial stability.

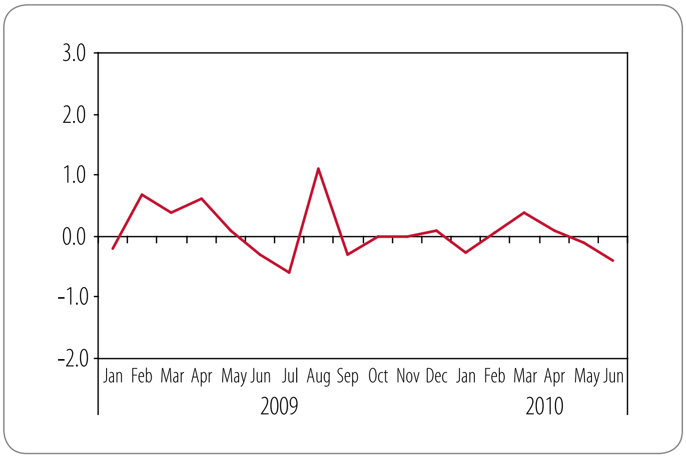
[2] Source: wiiw (June 2010), Eurostat. Forecasts by wiiw and European Commission (Economic Forecast, Spring 2010) for EU-15.

2.2. Inflation

Consumer prices in Montenegro recorded a 0.2% decline in June this year in comparison with end-2009. Regardless of a 0.3% increase in the prices under „food and non-alcoholic beverages", which weight in overall consumer basket is simultaneously the highest, the respective 6.4% and 1% declines in the prices under "dwelling" and "alcoholic beverages and tobacco" resulted in overall decline in consumer prices of 0.2%.

Graph 2.1

Consumer prices, monthly rate of growth



Source: Monstat

The prices of certain food products recorded decline in the first six months of the current year, vegetables of 7.4%, meat of 0.9%, milk, cheese and eggs of 0.3%, whereas the prices of fruit, oils and fats, and sugar rose by the respective 24.9%, 1.4% and 5.6%, the overall price increase of the „food and non-alcoholic beverages" amounted to 0.3%. The prices under "alcoholic beverages and tobacco" recorded a 1% decline due to the prices of alcoholic beverages that dropped by 2.5%. The lower prices of electricity (-11.3%), as well as of maintenance and repair of the dwelling, by -3.5%, and rents (a new product in the consumer basket) by -6.5%, resulted in a 6.4% decline of prices under the "dwelling" category. The prices under "clothes and footwear", "communication" and "culture and recreation" declined by the respective 0.2%, 0.1% and 1.7%. The prices under "household furnishings and equipment", "restaurants and hotels" and "other goods and services" increased by the respective 0.4%, 1.9% and 0.5%, while the prices under "education" did not change in the reporting six months.

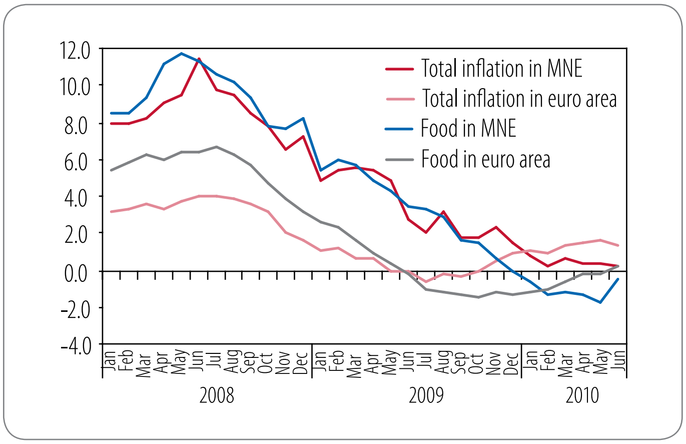
The annual increase in the consumer prices amounted to 0.2% in June this year, whereby the highest growth recorded the prices under "transportation", "restaurants and hotels" and "health care" of the respective 12%, 2.4% and 2.3%. The severest annual decline recorded the prices under "dwelling", of 7.6%, mainly due to the 13.8% decrease of the electricity prices.

The annual rate of **core inflation** amounted to 0.04% in June this year, being 0.19 percentage points lower than total inflation. The share of core inflation in total inflation was 13.5%, administrative (and partially) controlled prices contributed no less than 168.1%, whereas the share of the prices of agricultural products was negative, - 81.6%.

As of the crisis emergence, food prices dictated inflation to a great extent, as shown in Graph 2.2. A decline in food prices (at the annual level), especially as of the second half of 2009, also influenced a downtrend in total inflation.

Graph 2.2

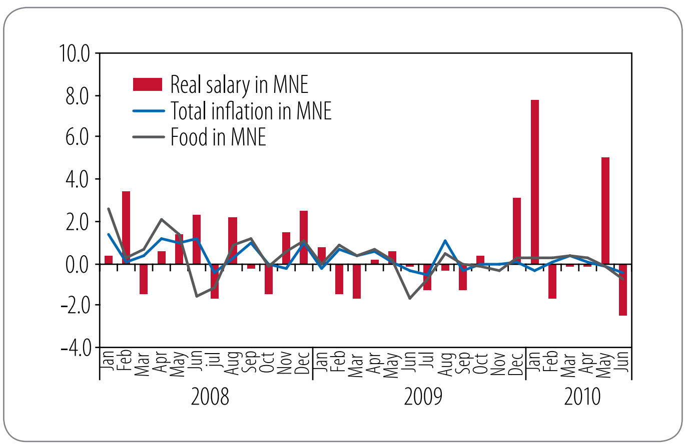
Comparison of total inflation and food prices in Montenegro and the euro area (annual change)



Source: Monstat and Eurostat

Graph 2.3

Movement of inflation, food prices and real wages (monthly change)



Source: Monstat

The global financial crisis reflected on a decline in aggregate demand, especially in 2009, which resulted in low rates of inflation in most countries, including Montenegro. Inflation continued trending downward in the current year, mostly owing to low prices of certain food products, as well as the lower electricity prices (reduced in January this year). However, the movement of the prices of liquid fuels that are dictated by the movement of global oil prices, as well as the announcement of increases in wheat and other food prices that Montenegro imports, could exert a substantial influence on inflation trends, but a very low rate of inflation could be expected at the annual level. Our estimate is that by the 2010 year-end inflation will range between 0.5% and 2.5%, which is not the level that could pose a threat to financial stability.

2.3. Fiscal deficit/surplus

The ongoing impact of the global economic crisis on Montenegro in Q2 2010, as well as difficulties in the revival of economic activity primarily in construction, trade, tourism and transportation, resulted in deviations from the size and dynamics of the fiscal projections. This is the reason why the collection of the budget and public revenues was lower than planned, thus resulting in the fiscal deficit.

Table 2.6 shows the period-on-period increase of current budgetary revenues in Q2 2010 of 1.9%. The severest period-on-period drop was recorded by the revenues from corporate profit tax and personal income tax, which is the consequence of the new tax legislation passed in January 2010 that reduced the personal income rate from 12% to 9% and abolishing monthly advance payment of profit tax in order to mitigate illiquidity of legal persons.

Table 2.6 – Movement of fiscal surplus/deficit

Description/Period	2009.				2010.	
	Q1	Q2	Q3	Q4	Q1	Q2
Current revenues	216.7	501.6	833.6	1.182.8	213.6	510.9
Consolidated expenditures	224.6	482.8	841.0	1.251.8	250.2	522.9
Montenegro budget surplus (in million €)	-7.9	18.8	-7.4	-69.1	-36.6	-12.0
% share in GDP*	-0.3%	0.6%	-0.2%	-2.3%	-1.1%	-0.4%

* Surplus/deficit ratio in the reporting quarter and estimated GDP in 2009 (EUR 3,003 million) and 2010 (EUR 3,201.0 million).

Source: Ministry of Finance

Current budget revenues in the first half of 2010 amounted to EUR 510.9 million or 16.0% of the estimated GDP. These revenues were 2.5% lower than planned due to the lower collection of corporate profit tax, VAT, real estate turnover tax, and excise tax). Compared to the same six-month period in 2009, these revenues rose by 1.9%. The collected budget revenues provided the regular payout of wages, pensions and social contributions, servicing of all state liabilities to its citizens and the international community, as well as the continued implementation of initiated investment projects.

Preliminary data of the Ministry of Finance show that total budget revenues in the first half-year, together with the state-owned Funds, amounted to EUR 534.7 million or 16.7% of the estimated GDP. The budget spending also included the regular servicing of liabilities to international and domestic financial institutions, as well as the regular servicing of all users of and participants in the budget.

Table 2.7 – Source revenues of the Budget and Funds

Description	Plan Jan-June 2010 in mil €	Realization in Jan-June 2010 in mil €	% of realization	Deviation in absolute terms
TAXES	335.66	305.29	90.95	-30.37
Personal income tax	35.52	39.43	111.01	3.91
Corporate profit tax	34.95	13.62	38.97	-21.33
Real estate turnover tax	2.78	2.58	92.81	-0.20
VAT	172.30	168.66	97.89	-3.64
Excise tax	64.09	52.58	82.04	-11.51
International trade and transactions tax	21.21	23.09	108.86	1.88
Other Republic taxes	4.81	5.33	110.81	0.52
Contributions	143.64	166.80	116.12	23.16
Contributions for pension and disability insurance	88.08	102.42	116.28	14.34
Contributions for health insurance	51.10	57.61	112.74	6.51
Contributions for unemployment	4.46	4.69	105.16	0.23
Other contributions	0.00	2.08	.	2.08
DUTIES	9.73	10.52	108.12	0.79
FEES	13.36	12.23	91.54	-1.13
OTHER REVENUES	17.93	14.46	80.65	-3.47
Receipts from loan repayment	3.87	1.60	41.34	-2.27
CURRENT REVENUES	524.19	510.90	97.46	-13.29

Source: Ministry of Finance

Consolidated budget expenditures[3] amounted to EUR 522.9 million or 16.3% of the estimated GDP. In comparison with the same six-month period in 2009, this is an increase of 8.3%, but they were 21.8% lower than planned for the reporting period. These reduced expenditures were the result of the Government's austerity measures that were adopted with a view to ensuring a rational spending of budget funds at all levels. To that end, one of the additional austerity measures is the lower monthly plan of consumption for all spending units.

The main expenditure item represents gross salaries, 17.5%, which is 0.6% of GDP.

Table 2.8 – Consolidated expenditures of the budget and state-owned funds, January – June 2010/

DESCRIPTION	Plan for 2010 in mil €	Realization in Jan-June 2010 in mil €	% of realization
Current expenditures	278.01	214.31	77.09
Gross salaries and contributions charged to employer	144.82	120.57	83.26
Other personal earnings	10.48	5.67	54.10
Expenses for material and services	61.27	39.19	63.96
Current maintenance	14.69	10.36	70.52
Interest	16.07	14.82	92.22
Lease	4.7	3.22	68.51
Subsidies	22.69	18.37	80.96
Other expenditures	3.29	2.11	64.13
Transfers for social protection	210.62	200.28	95.09
Transfers to institutions, individuals, NGOs and public sector	87.52	75.06	85.76
Total capital expenditures	84.49	26.75	31.66
Borrowings and loans	2.78	2.20	79.14
Provisions	5.05	4.29	84.95
CONSOLIDATED EXPENDITURES	668.47	522.89	78.22
Repayment of debts to residents	42.26	86.98	205.82
Repayment of liabilities from previous period	33.34	57.56	172.65
Repayment of debts to non-residents	21.67	20.44	94.32
TOTAL EXPENDITURES	765.74	687.87	89.83

Source: Ministry of Finance

Observing the **surplus/deficit** as the difference between current revenues and consolidated expenditures, whereby the first are reduced for borrowings, accepted transfers, donations and receipts from property sale, and the latter were reduced for the repayment of loan principal and issued securities in the country and abroad, the Budget of Montenegro[4] ran a deficit in the first six months of 2010 to the amount of EUR 12.0 million[5] or 0.4% of GDP. Nevertheless, it should be expected that the deficit will increase in the last quarter of the year due to the envisaged substantial capital expenditures.

3 Total expenditures less debt repayment.

4 Budget of Montenegro and state-owned Funds

5 Methodology of *surplus/deficit* calculation, OGRM 71/05

Potential risks to which the fiscal stability may be exposed are the following:

- delay of some privatisation projects and consequently lower privatisation revenues;
- lower VAT revenues, particularly due to the lower visible imports (75% of VAT revenues relate to the imported goods);
- lower customs and excise tax revenues due to the lower imports;
- lower FDI inflow;
- potential closing of certain large enterprises in the medium-term;
- increase in subsidies and transfers;
- potential pressure on salaries increase;
- over accelerated increase in public debt; and
- substantial capital expenditures.

Regardless of all taken austerity measures, it is obvious that a part of the fiscal deficit will have to be externally funded. If we add to this the deteriorated global financing conditions, hindered access to and the higher costs of money, as well as the opting for external financing, there is also a risk of the growing public debt which amount in absolute terms (excluding guarantees) has almost doubled in the past five years, which is the fact that should be taken into account.

The aforesaid represent the risk to financial stability, even more so if the state will be forced to default in the servicing of its liabilities due to the deterioration of the existing circumstances. This could also result in the defaulting of the budget beneficiaries towards banks, which could in turn lead to an increase in past due loans and consequently having repercussions on liquidity, profitability, and the banks` lending activity.

2.4. Public Debt

Situation - At the first half of 2010 end, the public debt of Montenegro was EUR 1,115.3 million or 34.8% of the estimated GDP for 2010. The public debt recorded decline in the first two quarters of 2010. At the first half of 2010, public debt was by EUR 24.5 million lower in relation to end-2009 due to the domestic public debt decline, and it amounted to 38% of GDP at 2009-end. Montenegro belongs to the group of countries with low borrowings. The currency structure of the foreign debt is favourable since total domestic debt was in EUR, while 81% of the foreign debt was also in EUR, and the remaining part was in SDR (Special Drawing Rights) which indicates low foreign exchange risk. The SDR component is present resulting from the IDA loan arrangement between Montenegro and the World Bank, as well as due to the favourable interest rate (0.75% at the annual level), the chances were worth taking. The interest rates and maturities are favourable.

Table 2.9 – Trends in public debt, I quarter 2009 – II quarter 2010

	Public Debt	% of GDP	Foreign public debt	% of GDP	Domestic public debt	% of GDP
I quarter 2009	1,016.2	33.8	550.4	18.3	465.8	15.5
II quarter 2009	1,003.6	33.4	553.3	18.4	450.3	15.0
III quarter 2009	1,071.2	35.7	645.2	21.5	426.0	14.2
IV quarter 2009	1,140.2	38.0	699.9	23.3	440.3	14.7
I quarter 2010	1,130.1	35.3	719.8	22.5	410.3	12.8
II quarter 2010	1,115.3	34.8	737.8	23.0	377.5	11.8

Domestic public debt

Situation – In the first three quarters of 2009, the internal debt recorded constant decline, while it recorded growth in the last quarter of 2009. In the first two quarters of 2010, domestic public debt declined by EUR 62.8 million in relation to 2009-end. The domestic public debt in the first two quarters of 2010 was reduced due to the regular repayment of instalment of debt from restitution by EUR 19.7 million, reduced municipal indebtedness by some EUR 14.2 million, repayment of loans with commercial banks and non-financial institutions by EUR 29.4 million, as well as by the repayment of the regular instalment of the debt on pensions instalments amounting to EUR 15.3 million.

It is assumed that the domestic public debt will increase in the coming period due to increased repayment of obligations for unpaid pensions, restitution, debts of the companies as well as for new debts for financing important projects.

Foreign public debt

Situation – In 2009, foreign public debt recorded constant growth, which continued in the first two quarters of 2010. In relation to the first half of 2009 end, it increased by EUR 37.9 million and it amounted to EUR 737.8 million or 23% of GDP. Currency and interest structure was favourable.

As the result of issuing Eurobonds, the foreign public debt shall record growth since the end of the third quarter.

Guarantees

At the end of June 2010, guarantees of the Government were EUR 219.1 million, or 6.8% of GDP, i.e. 19.6% of public debt.

Table 2.10 – Issued guarantees of the Government

Creditor	Loan	Borrower	Year of signing	Signed amount	Withdrawn until 30 June 2010	Debt as of 30 June 2010
EIB	European Roads project	Monteput	2004	24,000,000	24,000,000.00	24,000,000.00
EIB	Power Sector Reconstruction	EPCG	2002	11,000,000	8,023,090.00	7,811,472.00
EIB	Airports Modernisation	Airports of Montenegro	2004	12,000,000	11,000,000.00	10,900,000.00
EIB	Montenegro Loan for SMEs	Commercial banks	2009	91,000,000	29,592,000.00	29,592,000.00
EBRD	Airports Modernisation	Airports of Montenegro	2003	11,000,000	10,235,127.00	7,246,974.00
EBRD	Regional Water Supply Project – Phase I of the Construction of the Southern Branch	Regional Water supply	2007	8,000,000	8,000,000.00	7,666,666.67
EBRD	Regional Water Supply Project – Phase II of the Construction of the Southern Branch	Regional Water supply	2008	7,000,000	7,000,000.00	6,708,333.33
EBRD	Montenegro Rail Infrastructure Rehabilitation Project - Phase III	Rail company of Montenegro	2009	4,000,000	489,263.14	489,263.14
EBRD	Montenegro Rail Infrastructure Rehabilitation Project II	Railway Infrastructure of Montenegro	2009	15,000,000	650,000.00	650,000.00
KfW	Hydro Power Plant Perucica	EPCG	2003	3,580,000	3,055,065.34	1,395,000.00
KfW	Hydro Power Plant Piva	EPCG	2007	16,000,000	2,572,039.37	2,572,039.37
KfW	Substation Ribarevine	EPCG	2007	5,400,000	536,000.00	536,000.00
KfW	Replacement of filters in TE Pljevlja and the Expansion of the substations Podgorica - Ribarevine	EPCG	2008	15,000,000	8,863,740.00	8,863,740.00
KfW	Opportunity Bank	Opportunity Bank	2009	15,000,000	15,000,000.00	15,000,000.00
KfW	NLB	NLB	2009	16,000,000	5,000,000.00	5,000,000.00
OTP	Aluminium Factory Podgorica	Aluminium Factory Podgorica	2009	49,680,000	49,643,728.60	49,643,728.60
EXIM Kina	Purchase and repair of ships	Crnogorska plovidba	2010	47,396,000,00	0.00	
WTE Wassertechnik	Waste water project	Municipality of Budva	2010	29,250,000,00	0.00	
Abu Dhabi Fund for Development	Water supply project	Regional Water Supply	2010	18,977,884,37	0.00	
Credit Suisse	Support to Steel Factory Niksic	Steel Factory Niksic	2010	26,300,000,00	18,987,471.62	18,987,471.62
Deutsche Bank	Support to Aluminium Factory Podgorica	Aluminium Factory Podgorica	2010	22,000,000,00	22,000,000.00	22,000,000.00
as of 30 June 2010					224,647,525.07	219,062,688.73

Source: Ministry of Finance

At present, adding the domestic guarantees to the amount, the total guarantees amount to EUR 242.3 million or about 7.6% of GDP.

Table 2.11 – Domestic guarantees issued in 2009 and 2010

Creditor	Borrower	Amount
NLB Montenegrobank	Bauxite Mines Shc. Niksic	5,000,000.00
Podgorička bank	Pobjeda Shc. Podgorica	2,970,000.00
Hipotekarna bank	Montenegro Airlines	2,700,000.00
NLB Montenegrobank	Montenegro Airlines	1,800,000.00
Erste Bank	The Montenegrin Fund for Solidarity Housing Development	3,800,000.00
Erste Bank	Rail transport of Montenegro	7,000,000.00
Totally withdrawn as of 30 June 2010		**23,270,000.00**

Source: Ministry of Finance

Potential public debt

Hydro power plants at Moraca River[6] - The public announcement for the award of a concession for constructing hydropower plants on the Moraca River has been signed. The share of the state is still unknown, because it will depend on the bids of the potential concessioners, and it is expected that the Government would have to invest about EUR 65 million for relocating, expropriation and restoration of the Moraca Monastery in the period 2011-2016.

Motorway[7] - The amount of Government's obligations in constructing the motorway remains unknown at present. The total amount of obligations will be known after the answer of the EIB, which is negotiated to with the Greek-Israeli consortium. The agreement was made that the state does not participate with the initial EUR 25 million, thus the state shall not have any obligation during the construction of the first part in the four-year period. When the motorway starts to be used, the Government will have obligations during the concession period, amounting from EUR 82 million to EUR 106 million for the part of 63.5 kilometres, while it is expected that the obligation for all three parts would amount between EUR 120 million and EUR 160 million, providing that all three of them are built.

Risks – The debt sustainability analysis shows that the public debt of Montenegro is sustainable, and that the difficulties may appear in the case of extremely negative GDP trends, long-term budget deficit and overtaking the significant amount of the public debt. However, although the public debt is still within the limits determined by the Maastricht Criteria, its speed increase tendency is worrying. The graph 2.4 shows the public debt trend in the period 2006 - 2009.

In the first two quarters of 2010, the regular repayment of debt (principal and interest) amounted to EUR 114.5 million, including the repayment of obligations from previous years, while the 2010 Budget foresees that the repayment of debt to residents and non-residents, including the repayment of obligations from previous years would amount to EUR 159.9 million. Taking into consideration

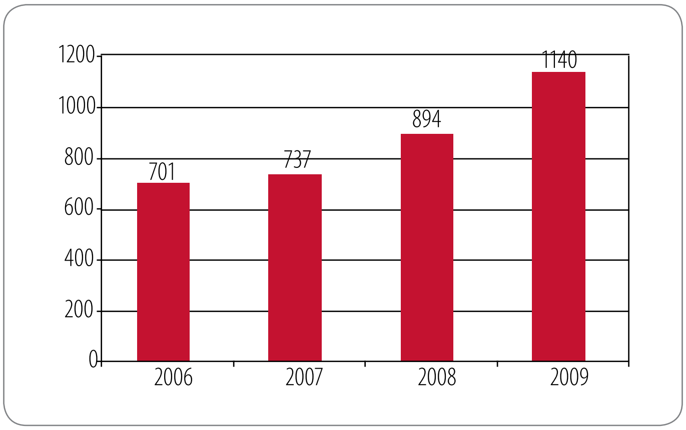
6 This document does not deal with undisputable positive effects of constructing the hydro power plants, but the analysis of the public debt and other variables influence to the financial stability of Montenegro.

7 The source of data is the Ministry of Transport.

the new debt from Eurobonds, it is expected that the public debt for this basis would increase by 4.8% of GDP at the end of 2010. Since public debt amounted to 34.8% of GDP at the II quarter end, at the 2010-end it would grow to 39.6% of GDP, increased by the abovementioned net increase. It means that the public debt, increased by guarantees, amounts to 42.2% of GDP. The potential new borrowings for the construction of the motorway and the hydro power plants should be added to this amount[8]. Taking into account the debt maturity structure, the financial stability risks are not present in the short-run, but they may present in the medium term.

Graph 2.4

Public debt trend in the period 2006 – 2009 (EUR million)



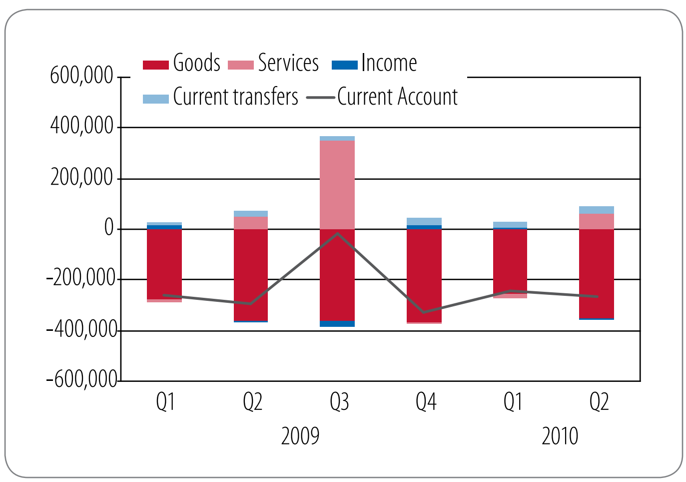
The mitigating factor is that the public debt is mostly in EUR at long-term fixed interest rates, with long repayment period and the relatively equal annual servicing, and that there are no short-terms.

2.5. Balance of payments with the special attention to the current account deficit

The gradual recovery of the economic and the external trade activity in the first half of 2010 affected the trends at the current account. After the decline of current account deficit in 2009, this trend continued also in 2010. Current account deficit in the first half of 2010, according to preliminary data, amounted to EUR 508.8 million, and it was by 7.7% lower due to lower external trade deficit. Positive trend was recorded at the current transfers and services sub-accounts, which recorded a surplus growth by 41.6% and 7.8%, respectively. Since there were no significant privatizations in 2010, the significant net foreign direct investments inflow was recorded amounting to EUR 314.3 million.

Graph 2.5

Trends in current account sub-accounts, EUR thousand



Source: CBM

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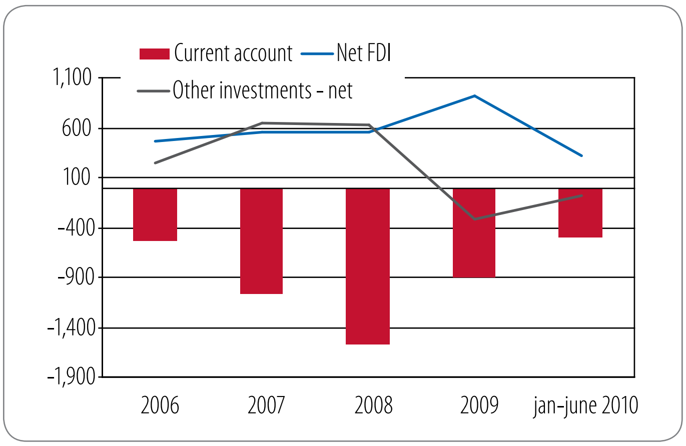
8 The hydro power plants bear significantly lower risk, taking into account the amount the state should allocate for this purpose, as well as the positive effects which would derive from the construction of the hydro power plants.

Total foreign trade recorded approximately the same volume as in 2009, while, at the same time, the external trade deficit amounted to EUR 607.4 million, being 5% lower than in 2009. The coverage of external trade deficit with the surplus recorded at other sub-accounts was 16.2%. The imports of goods increased due to the mild recovery of the economic activity in the reporting period. In the first half of 2010, according to preliminary Monstat data, visible exports amounted to EUR 142 million, or 15% more compared to 2009, while imports declined by 1.8%. A very low exports/imports ratio is still present, indicating structural problems in the Montenegrin economy and the need of stimulating export-oriented production and the increase in competitiveness of domestic products at the international market.

Montenegro has not utilized the period of high FDI inflow for improving the competitiveness of domestic products.

Graph 2.6

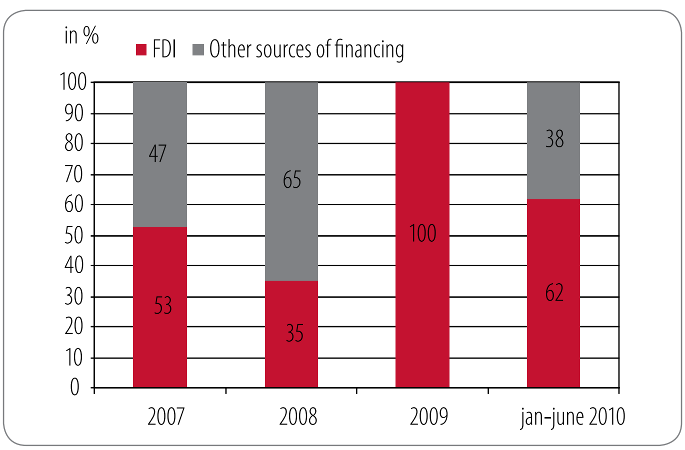
Net FDI, other investments and current account deficit



Source: CBM

Graph 2.7

Current account deficit financing, in %



Source: CBM

Net FDI inflow in the first half of 2010, according to preliminary data, amounted to EUR 314.3 million or 3.7% less than in 2009. Foreign investments into domestic companies and banks amounted to EUR 204.8 million (55.3% of total inflow), while inflow from intercompany debt amounted to EUR 82.4 million (22.2%). Total investments into real estates amounted to EUR 77.3 million (20.9%). Other investments sub-account recorded net outflow amounting to EUR 79.9 million in the first half of 2010, compared to the same period of 2009 when it recorded net inflow amounting to EUR 23.2 million. In the reporting period, banks reduced their foreign obligations, while debts of the general government and the private sector increased. Increased borrowings in the long-term period may lead to the enormous borrowings and problems in debt servicing, which would require performing structural measures in order to decrease external trade misbalance.

The more realistic overview of economic trends may be given after the third quarter, due to the significant seasonal character of tourism. However, it is not realistic to expect important decline in current account deficit in a medium-term period, taking into accounts of the announced capital and infrastructural projects. High FDI inflow in the last few years was financing the current account deficit, but the problem was in the inflow structure. The highest FDI inflow in the earlier years was recorded from privatization and the sale of real estates, but these resources are limited. The only way of maintaining (increasing) FDI inflow is by increasing "greenfield" investments, especially in the output sector, because it establishes new companies and increases exports, thus contributing to the better current account balance.

Potential risks that may negatively affect the current account deficit in the coming period are deteriorated conditions in the aluminium industry (Aluminium Plant Podgorica), which would lead to the considerable decline of goods exports and subsequently to higher external deficit, as well as negative trends in tourism, which affected the mitigation of the external trade deficit in the previous years. The aforementioned gives real expectations that the current account deficit financing may be provided in the short-term and medium-term periods, without aggravating the financial stability, because very high foreign capital inflow may be expected in this period.

2.6. Real estate market

In terms of Montenegro, real estate market is one of the most sensitive segments of Montenegrin economy, which decline (of demand) lead to the most important negative results to the financial flows, as well as to the flows of the real Montenegrin economy. For the first time in the second quarter of 2010, the real estate market recorded a mere increase by 3.1%, but the figure inevitably points that the further declining trend in the real estate prices started in the second quarter of 2007 was finally stopped. In that period, it was estimated that the prices of the housing objects fell by 33.5%, which is a somewhat higher decline compared to Croatia, which decline in housing objects prices is estimated to amount to about 25%. The average price per square meter in Podgorica was used as the approximation of the real estate trends.

Table 2.12 – Summary statistics of the average value, standard deviations, minimum and maximum prices of individual housing objects types, in EUR

Period	Price in EUR	Chain index	Base index
November 2007	1697.56	100.00	100.0
March 2008	1738.30	102.4	102.4
November 2008	1525.50	87.8	89.9
March 2009	1402.10	91.9	82.6
September 2009	1223.1	87.2	72.1
March 2010	1128.3	92.2	66.5
June 2010*	**1161.5**	**102.9**	**68.4**

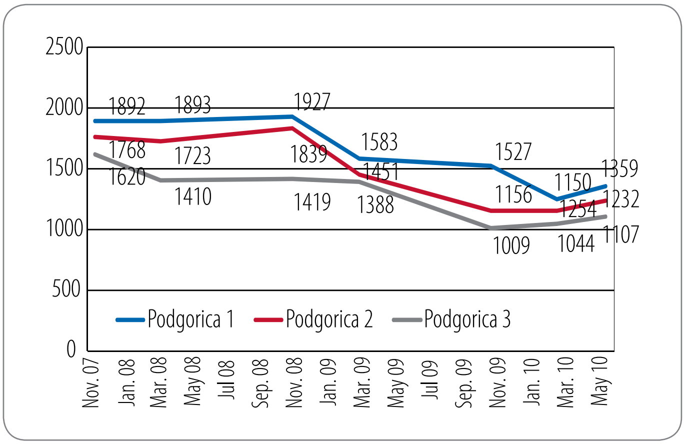
* Since 2010, the CBM introduced quarterly hedonic index of real estates in Montenegro.

Source: CBM, 2009

Besides the simultaneous decline in prices of all three zones, the primary trend was the price equalization, i.e. the reduction of difference in price the three zones, which indicates that the demand

Graph 2.8

Trend in Average price of housing object per zones in the period November 2007 – June 2010, in EUR



Source: CBM, 2009

for flats placed at the most exclusive locations was significantly lower.

The decline in the real estate prices especially resulted in higher illiquidity of construction companies, which was reflected to the increase in borrowings of this sector from the banking sector, thus being, after the trade and tourism sectors, the third sector by the economic sectors aggregate borrowings. At the same time, the financing sources of real estate demand reduced significantly: in 2009 and the first half of 2010, banks almost completely stopped to grant mortgage loans, the FDI level into real estates drastically reduced, while the decline of households available income additionally reducing the real estate demand. It may be generally assessed that this sector had adverse effects to the financial stability causing numerous risks. The potential danger may be if the instability of the sector lasts for a longer period and leads to the impossibility of servicing loans by many construction companies. In such conditions, the mortgage shall not mean much, especially regarding the unfinished buildings.

On the other hand, the potential chance may be through the programme "1000+ flats for you." The project is a good basis for bridging the illiquidity problems of the construction sector, reducing the activation of banking sector mortgages by starting the lending activity through the significant granting of the mortgage loans, as well as balancing the offer and demand for flats, which is still in high disproportion.

3. FINANCIAL SYSTEM

3.1. Banking System

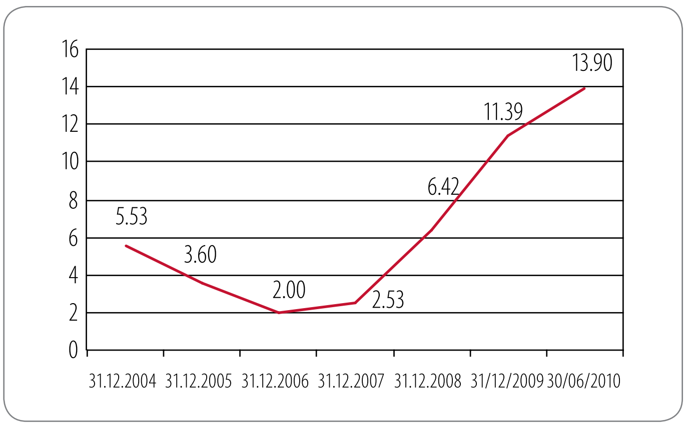
3.1.1. Credit Risk

Credit risk is the most important risk in Montenegrin banking system considering enormous growth rates of banks' portfolios that occurred in the previous period. Credit risk management assessment is based, inter alia, on the assessment of adequacy of the classification of assets and off balance sheet items and allocation of loan loss provisions pursuant to the prevailing regulations.

With regard to high growth in newly granted loans in the previous two years, abrupt deterioration in asset quality occurred in 2008 when management of banks, guided by profit and quick income, has not made objective assessment of financial capacity of borrowers to repay loans from primary sources. All parameters of asset quality in the system deteriorated due to the underestimation of risks taken. Moreover, conservative prudential rules as opposed to international standards additionally contributed to the said deterioration.

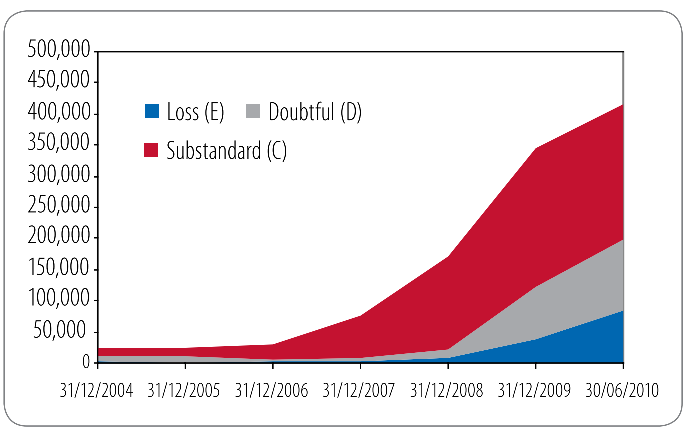
Graph 3.1

Non-performing assets to total assets in period 2004 – June 2010

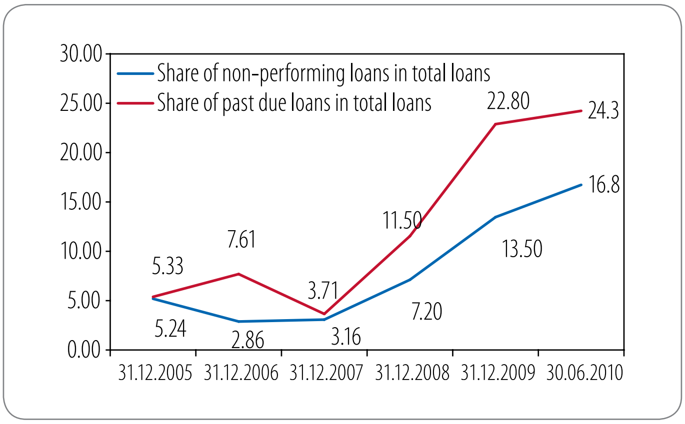


Graph 3.2

Non-performing assets in period 2004 – June 2010



Graph 3.3
Non-performing loans and past due loans to total loans in period 2004 – June 2010



In addition, the fact that the percentage of past due loans is increasing indicates that the increase in non-performing loans can be expected also in the following period.

The analysis of loan portfolio of banks disclosed that the banks mostly did not perform fair classification of assets exposed to risk, and consequently, they did not calculate adequate reserves for asset items.

Banks were exposed to the following shocks through the creation of scenarios for credit risk stress testing:

1. reclassification of assets and application of maximum prescribed (A, B, D, E) and the average provisioning rates (C)[9];
2. increase in non-performing assets and required amount of reserves;
3. bankruptcy of one of 20 largest borrowers of a bank (realistic exposure);
4. bankruptcy of the largest – top 1 borrower of a bank (realistic exposure);

Direct impact to the following key balance sheet positions was achieved through the implementation of the defined assumptions of stress testing scenario: own funds, capital required for risks, new amount of required provisions for asset item losses which synthetically reflected on the solvency ratio.

Solvency ratio in all banks in the system was above the prescribed minimum of 10% as of 30 June 2010.

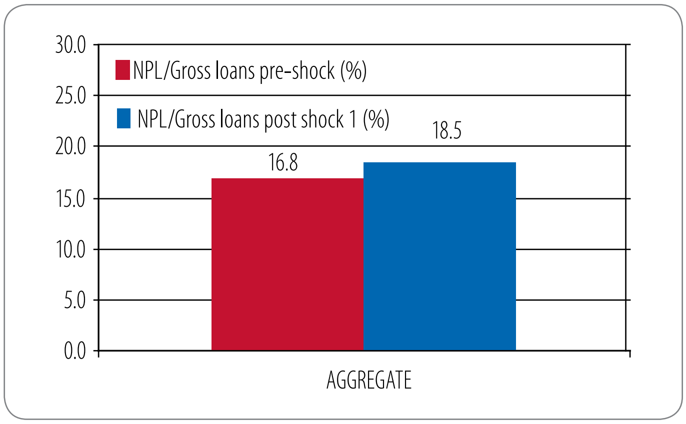
Shock 1 – Reclassification of assets and application of prescribed (A, B, D, and E) and the average provisioning rates (C);

Due to assumptions for shock 1, solvency ratio decreased from 16.48% to 12.42% at the aggregate level. Solvency ratio was lower in ten banks. Three banks in the system recorded solvency ratio below legally prescribed minimum of 10%. The decline in solvency ratio in ten banks ranged from 0.50 to 13 percentage points.

[9] This scenario contains detailed instructions on reclassification of classified loans, prescribed rates for individual loan categories and average rate of provisions.

The banks should provide capital in the amount of EUR 26.9 million to reach solvency ratio of 10%. Reclassification of loans reflected on an increase in share of non-performing loans at the aggregate level ranging from 16.8% to 18.5%.

Graph 3.4
Non-performing loans in total loans after shock 1 as at 30 June 2010



Shock 2 – Increase in non-performing assets and required amount of reserves

This shock is applied to the initial balance in banks. It has been assumed that non-performing assets (C, D and E) would increase by 20% and, accordingly, the level of required reserves would increase by 30% at the level of individual banks as well as at the system level.

Solvency ratio at the aggregate level decreased from 16.48% to 15.48%. None of the banks recorded solvency ratio below legally prescribed minimum of 10% after application of shock 2. The decline in solvency ratio in all eleven banks ranged from 0.08 to 1.67 percentage points.

Shock 3 - Bankruptcy of one of 20 largest borrowers of a bank (realistic exposure)

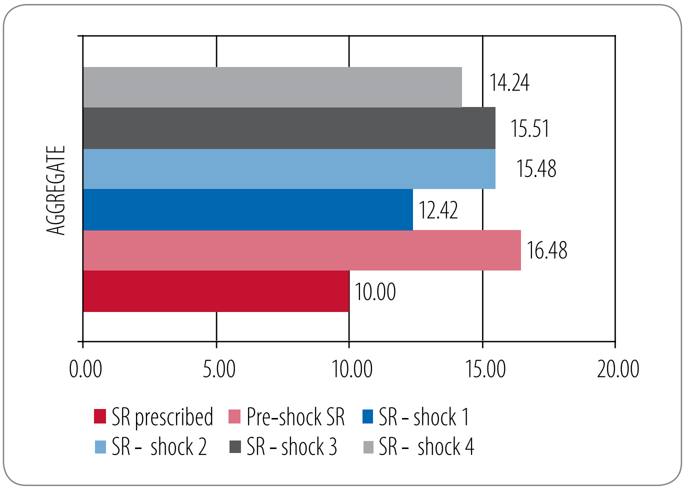
The shock of deterioration in large exposures of the banks was based on the assumption that one of 20 largest borrowers in the system of each individual bank would be unable to meet its liabilities, whereby the amount of credit borrowing was calculated by using the mean value of their total exposure to the bank. Simultaneously, exposures decreased by the mean value of provisions that refer to 20 largest debtors of the bank (realistic exposure).

Shock 3 was applied to the initial balance of the individual banks and the system as a whole as of 30 June 2010, and it resulted in a decrease in solvency ratio, which ranged from 16.48% to 15.51% at the aggregate level. The decline in solvency ratio in eleven banks ranged from 0.42 to 1.84 percentage points. Solvency ratio in all banks in the system was above the prescribed minimum of 10%.

Shock 4 - Bankruptcy of the largest – top 1 borrower of a bank (realistic exposure)

The shock of deterioration in large exposures of the banks was based on the assumption that the largest borrower in the system of each individual bank would be unable to meet its liabilities from the aspect of its total exposure to a bank. The amount of debt decreased by the amount of provisions for given exposures, that is, Shock 4 is based on realistic exposure of the bank.

Graph 3.5
Solvency ratio at aggregate level, after shocks 1, 2, 3, and 4 as at 30 June 2010

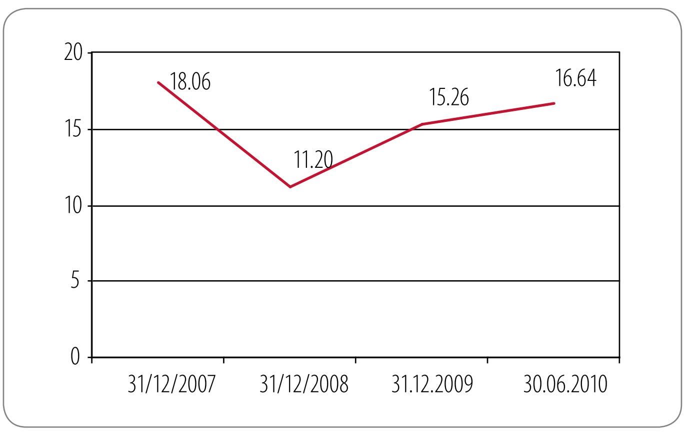


Shock 4 was applied to the initial balance of the individual banks and the system as a whole as of 30 June 2010, and it resulted in a decrease in solvency ratio, which ranged from 16.48% to 14.24% at the aggregate level. The decline in solvency ratio in eleven banks ranged from 1.49 to 5.09 percentage points. One bank reported solvency ratio below the prescribed minimum of 10%, which required additional capital in amount or EUR 553 thousand.

3.1.2. Liquidity Risk Management

Negative effects of global financial crisis primarily affected the banks' liquidity. Therefore, liquidity risk management is very important for the banking system as a whole. With a view to adequate liquidity risk management, and pursuant to the Decision on Minimum Standards for Liquidity Risk Management in Banks, the banks are obliged to create policy and procedures for liquidity risk management, perform gap analysis, determine exposure limits, establish adequate maturity match of assets and their sources and submit daily and ten-day reports on liquidity indicators to the Central Bank.

Graph 3.6
Liquid assets to total assets ratio in period 2007 – June 2010



According to data as of 30 June 2010, liquidity of commercial banks was characterized by the growth in key liquidity ratios in relation to the previous year. Liquid assets ratio[10] amounted to 16.64% as at June-end 2010, and it showed an increase of 1.38 percentage points as compared to the previous year-end.

Banks' liquid assets amounted to EUR 496.1 million as of 30 June 2010, and it showed an increase of EUR 128.7 million or 35% in one-year period.

[10] Cash and deposits with depository institutions reduced by 50% of reserve requirement

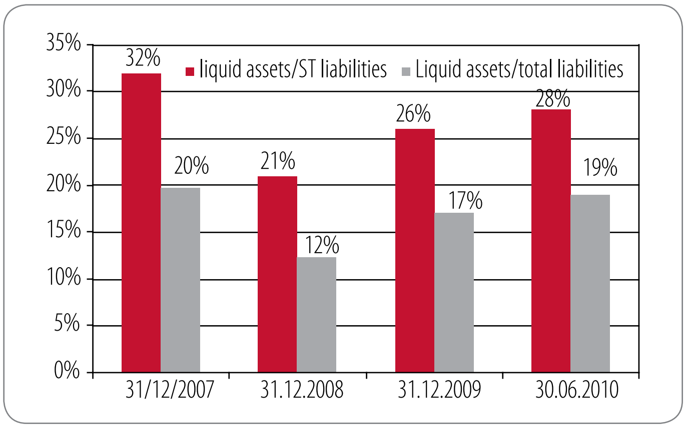
The improvement of banks' liquidity was affected by the amendments to the Decision on Use of the Reserve Requirement of Banks Held with the CBM, as well as by the support of parent banks, especially in the period of the most evident liquidity crisis. However, after stabilisation and the increase in the deposits, certain banks decreased their lending activities and allocated significant funds for servicing their liabilities to parent banks.

Maturity coverage of loans by deposits was satisfactory in short period, but long-term deposits to long-term loans ratio was unsatisfactory, which pointed to intensified financing of these loans from borrowings and capital.

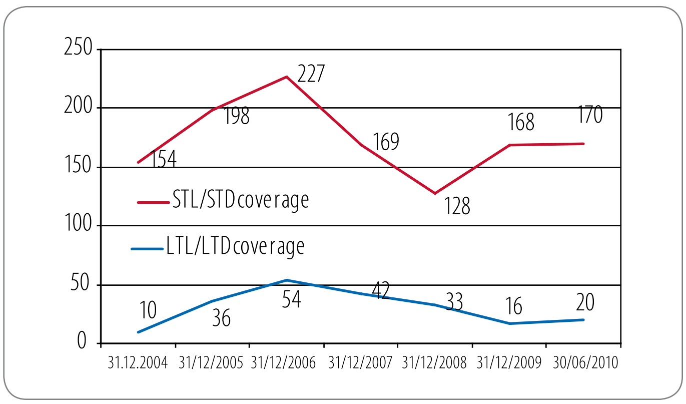
Loans to deposits ratio amounted to 1.29 as at June-end 2010. This ratio amounted to 1.49% in the same period of the previous year.

As of January 2009, banks have submitted reports in accordance with the new Decision that prescribes calculation of liquidity ratio as liquid assets to short-term liabilities ratio. Minimum daily amount of this ratio was 0.9, while ten-day ratio amounted to 1. During 2009, this ratio was satisfactory at the aggregate level, however it was not on an ongoing basis at one bank in the system, and occasionally it was below the prescribed minimum in two more banks. During 2010, liquidity improved in banks and all banks in the system met required amounts of ratio.

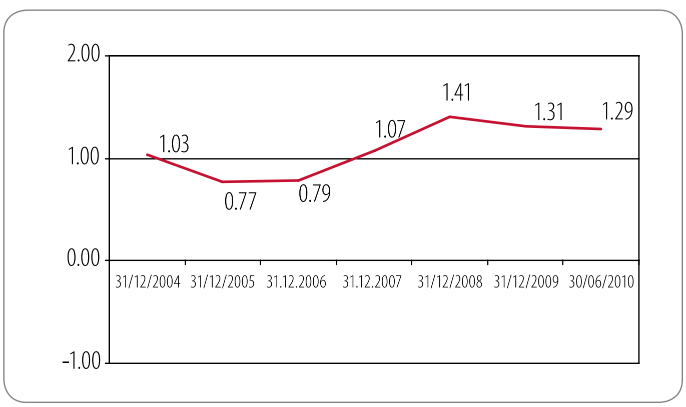
Graph 3.7
Liquid assets to short term liabilities ratio and liquid assets to total liabilities ratio in period 2007 – June 2010



Graph 3.8
Maturity coverage of loans by deposits at aggregate level



Graph 3.9
Loans to deposits ratio in period 2004 – June 2010



Liquidity Risk Stress Testing

Cash and deposits with depository institutions to deposits ratio at the aggregate level ratio amounted to 30.93%. However, one bank significantly deviated from the aggregate average having this ratio of only 13.35%, which negatively reflected on the stress testing results of this bank.

In this quarter, testing of banks' sensitivity with respect to liquidity risk referred to the following:

1. withdrawal of 30% of total amount of deposits,
2. withdrawal of 30% of demand deposits,
3. withdraw al of 40% of households' demand deposits and 30% of legal persons' deposits,
4. withdrawal of 30% of households' time deposits and 25% of time deposits of legal persons,
5. withdrawal of deposits of the largest depositor,
6. withdrawal of deposits of ten largest depositors, and
7. withdrawal of 100% of state deposits.

Banks' ability to cover the loss incurred based on the above-mentioned was tested through the following:

- available liquid funds (the difference between cash and deposits with depository institutions and allocated amount of reserves as of 30 June 2010), and
- available liquid funds (free liquid funds increased by 50% of the reserve requirement amount).

Shock 1: Withdrawal of 30% of total amount of deposits

Loss of depositors' confidence in the banking system was simulated and it resulted in the withdrawal of 30% of total deposits with all banks. In these conditions, seven banks in the system would show lack of liquid funds that would result in the banking system illiquidity of EUR 109.5 million. If the reserve requirement of 50% was used, five banks would still have been illiquid, as well as the entire banking system.

Shock 2: Withdrawal of 30% of demand deposits

Demand deposits' share in total deposits amounted to 38.3%. If 30% of these deposits were withdrawn, the banking system would still be liquid in the amount of 225.3 EUR million, and one bank would report lack of liquid funds. That problem could be successfully solved by using the reserve requirement.

Shock 3: Withdrawal of 40% of households' demand deposits and 30% of legal persons' deposits

Simulation of withdrawal of 40% of households' demand deposits and 30% of legal persons' demand deposits would result in lack of liquid funds with one bank. That problem could be successfully solved by using the reserve requirement.

Shock 4: Withdrawal of 30% of households' time deposits and 25% of time deposits of legal persons

Simulation of withdrawal of 30% of households' time deposits and 25% of legal persons' time deposits would result in lack of liquid funds with one bank, while the banking system would have surplus of EUR 124.9 million. One bank would still be illiquid in amount of EUR 29.5 million by using the reserve requirement in amount of 50%.

Shock 5: Withdrawal of deposits of the largest depositor

The concentration of deposits of one depositor (top 1) in four banks was below 10%, while in two banks it exceeded 25%.

If the withdrawal of these deposits would occur, stress testing results showed that two banks would still have illiquidity problems that could not be solved by using the reserve requirement. One bank would still have illiquidity problems in amount of EUR 46.4 million, while another bank would still be illiquid in amount of EUR 2.5 million.

Shock 6: Withdrawal of deposits of ten largest depositors

The concentration of deposits of ten largest depositors was evident with all banks ranging from 13.06% to 89.64%. If these deposits were withdrawn in the amount of 50%, three banks would have been illiquid. Despite of using reserve requirement, all three banks would still be illiquid in the amount of EUR 44.5 million, of which one bank accounted for EUR 44 million.

Shock 7: Withdrawal of 100% of demand deposits

High concentration of state deposits in relation to total deposits was evident with three banks, ranging from 10.39% to 46.26%.

Stress testing of banks' liquidity was performed assuming that the state deposits (deposits of the Government of Montenegro, its agencies, state funds, municipalities and state companies) would be withdrawn in the amount of 100%. In this situation, one large bank would become illiquid in amount of EUR 108.6 million. That bank would still be illiquid in amount of EUR 98.6 million, despite the use of the reserve requirement.

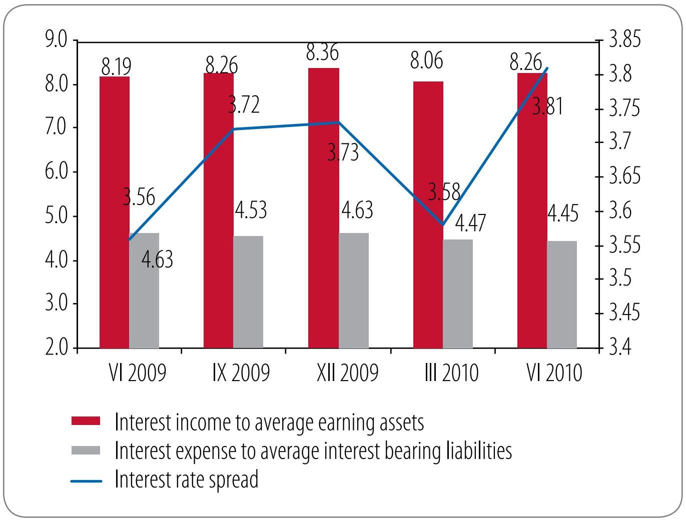
3.1.3. Market Risk Management

Banks are obliged to manage all market risks[11] they are exposed to in their operations in accordance with the Decision on Minimum Standards for Market Risks Management in Banks.

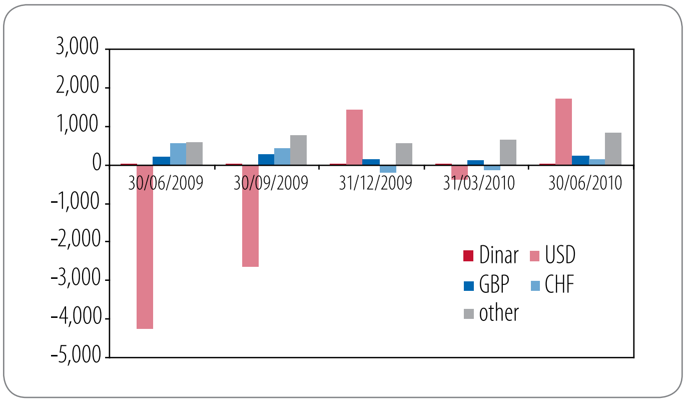
Overall level of market risk is currently low. FX risk was low. FX risk was low due to euroisation of Montenegrin economy and its significance is higher in real sector, export-oriented companies selling their products in US dollars. Interest rate risk was evident due to risk premium growth and loss growth with individual banks, but it further affects the economy and households rather than the banks.

[11] Interest rates and FX positions are main sources of market risk in Montenegrin banking system.

Graph 3.10
Interest Rate Spread



Graph 3.11
Aggregate exposure to FX risk



Aggregate interest rate spread oscillated in one-year period. As of 30 June 2010, interest rate spread amounted to 3.81 percentage points, while it was 3.56 percentage points in the same period of 2009. Interest rate spread at individual banks' level was different ranging from 2.54 to 9.23 percentage points.

FX risk was low. The most used currency was USD. As of 30 June 2010, the banking system had more funds than liabilities in USD currency in the amount of EUR 1.72 million.

Aggregate balance sheet in all foreign currencies amounted to EUR 2.9 million or 0.97% of core capital as of 30 June 2010. Aggregate balance sheet in all foreign currencies amounted to EUR 1.9 million or 0.66% of core capital as of 30 June 2009.

Market Risk Stress Testing

Interest rate risk and FX risk were covered by stress testing.

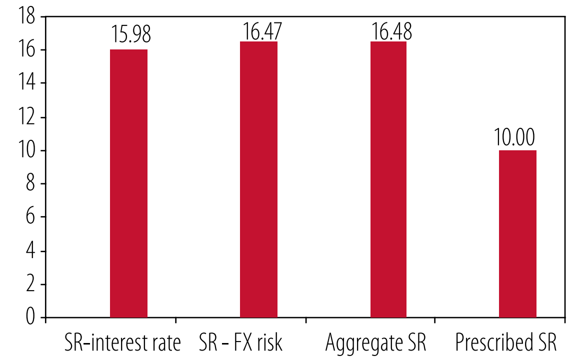
The sensitivity of assets and liabilities positions to interest rate risk was tested through the application of the increased level of interest rate of 2 percentage points to cumulative difference (gap) between assets and liabilities positions, sensitive to the change of interest rate at the level of individual bank and the system as a whole.

Stress testing results of direct impact of interest rates' change to sensitive assets and liabilities positions showed decrease in solvency ratio at the system level. To wit, solvency ratio at the aggregate level decreased from 16.48% to 15.98%, while the decrease in ten banks ranged from 0.03 to 1 percentage points.

The exposure of Montenegrin banking system to direct FX risk is limited since euro is the official payment currency. Namely, only 6.14% of the assets at the aggregate level are denominated in foreign currency with the largest exposure of individual bank of 22.76% in Hypo-Alpe-Adria Bank. FX exposure of other banks ranged from 0.04% to 5.04%. Net open FX position at system level was positive amounting to EUR 547 thousand.

Stress testing of direct FX risk was based on net open FX position (so called spot position), i.e. on the assumption that own funds would be corrected by 30% (+ -) of the value of net open position both at the individual bank level and the system level. Solvency ratio at the aggregate level after stress tests would slightly decrease by 0.01%, whereby the decrease in seven banks ranged from 0.01 to 0.71 percentage points.

Graph 3.12
Market risk stress testing - solvency ratio as of 30 June 2010

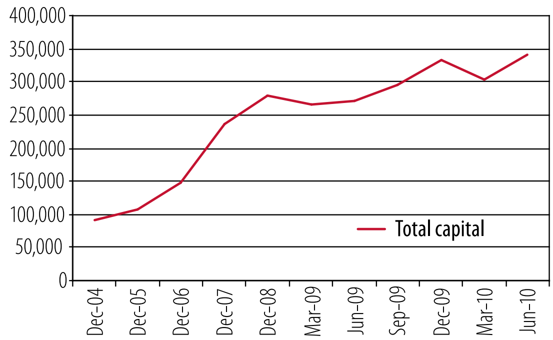


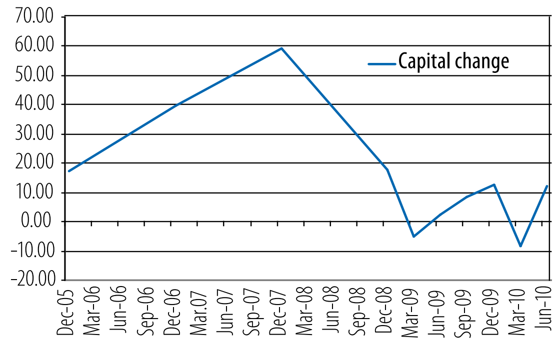
3.1.4. Capital of the Banking Sector

During economic growth, total capital of the Montenegrin banks was growing fast along with the banks' total assets growth. The growth continued in crisis period, however, mostly due to recapitalisation of the banks, which was due to the growth negative indicators, primarily negative financial operating results and inadequate credit risk management.

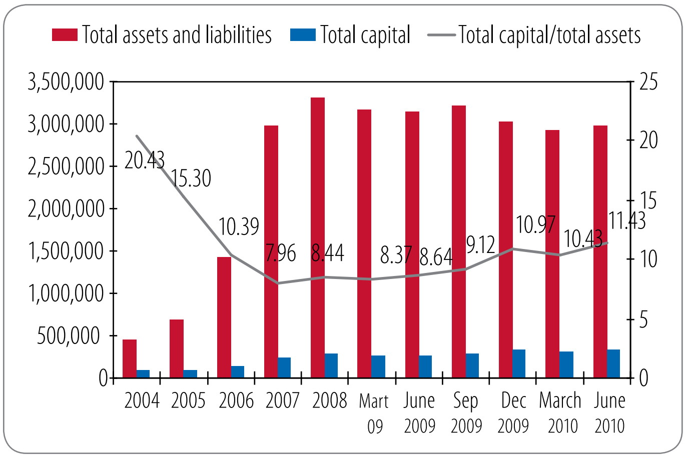
Total capital of banks amounted to EUR 340.8 million as of 30 June 2010. It showed an increase in relation to Q1 of this year (12.0%), 2.7% in relation to 2009 year-end and 25.6% in relation to 2009 June-end.

Graph 3.13
Capital in period 2004 – June 2010 (EUR and %)

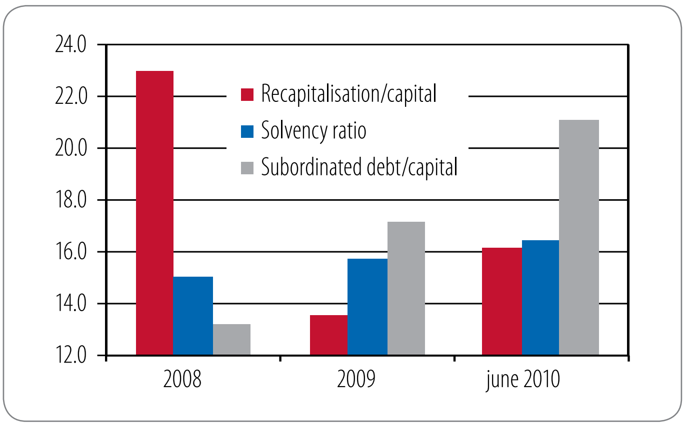




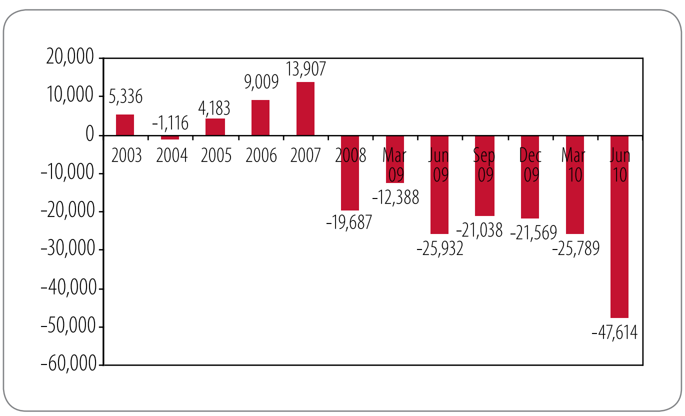
Graph 3.14
Capital and total assets and liabilities in period 2004 – June 2010



Graph 3.15
Capital ratios, 2008 – June 2010



Graph 3.16
Financial result at aggregate level for period 2003 – June 2010 (EUR 000)



Total capital to total assets and liabilities ratio increased in the last two years (see Graph 3.14), as a result of total assets and liabilities decline and capital growth.

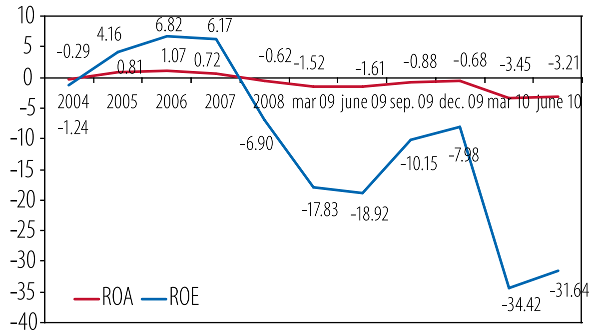
Solvency ratio at the aggregate level amounted to 16.48% as of 30 June 2010, and it increased significantly in comparison with Q1 of this year, 2009 year-end and 2009 June-end. Solvency ratio in all banks in the system was above the prescribed minimum of 10% as of 30 June 2010.

3.1.5. Profitability of the Banking Sector

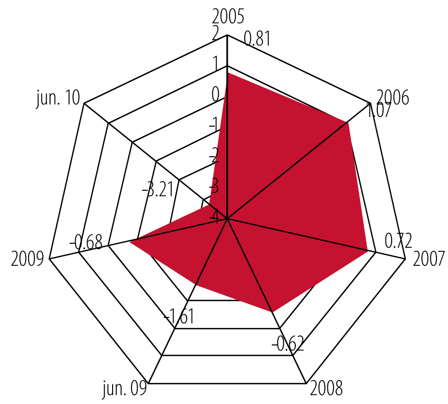
Profitability of the banking system has deteriorated since 2008 reporting loss of EUR 47.6 million at 2010 June-end. This loss mostly referred to two large banks. The profitability of banks was affected by both biased and objective factors. Biased weaknesses in some banks primarily referred to poor credit risk management, which as a result would require allocation of higher loan loss provisions disclosed by supervision in accordance with regulatory framework as well as high overhead expenses. Objective factors referred to prudential restrictions of lending growth in 2008, withdrawal of deposits from Q4 2008 and hindered access of banks to external sources of financing.

Negative financial result led to negative ROA and ROE at aggregate level. The graph 3.17 shows level and trend of those indicators.

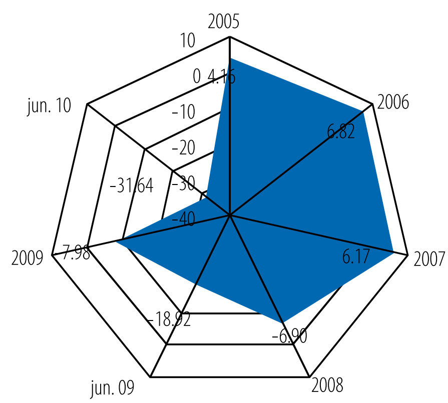
Graph 3.17
ROA and ROE at aggregate level in period 2004 - June 2010



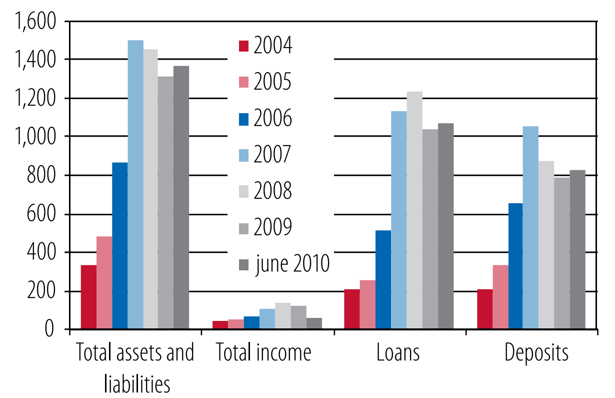
Graph 3.18
ROA, 2005 – June 2010



Graph 3.19
ROE, 2005 - June 2010



Graph 3.20
Banks' performance indicators per employee in period 2004 - June 2010



An increasing trend in banks' performance indicators per employee was interrupted in 2008 and 2009, while it showed gradual recovery in 2010.

3.2. Micro-credit Financial Institutions

Total assets of micro-credit financial institutions (MFIs) amounted to EUR 66.1 million as of 30 June 2010. Total assets declined by 12.4% in relation to 2009 year-end and it declined by 14.9% over one-year period.

Net loans were dominant in MFIs asset structure (76.2%) at 2010 June-end. Cash made up 19.6% and other assets made up 4.2% of total assets of MFIs.

Total MFIs loans amounted to EUR 54.3 million reporting a decline of 17.5% in relation to 2009 year-end and annual decline of 24.9%. Of total MFIs loans, 7.4% referred to loan loss provisions.

Observed by industries, loans to agriculture sector (57.4%) were dominant in the loan portfolio structure, while loans to services, tourism and hotel management sectors made up 24.3%, loans to trade sector were 10.7% and households loans made up 6.2% of total MFI loans. Long-term loans (94.3%) were dominant in maturity structure of MFI loans.

The most significant share in the structure of liabilities was borrowings (68.7%) amounting to EUR 45.4 million as of 30 June 2010. Foreign capital was mainly the source of financing of MFI which is directed through micro credit lines to agriculture producers, entrepreneurs from services, retail manufacturing and trade sectors.

Total MFI capital amounted to EUR 19.1 million or 19.3% of total liabilities and capital as of 30 June 2010. Of total MFI capital, 73% referred to donated capital, while undistributed profit made up 27% of total capital. MFIs reported negative financial result of EUR 0.8 million at the end of the observed period.

Interest rates on loans were on an uptrend in 2009 and the first half of 2010. Average weighted effective interest rate (AWEIR) was 27.68% as of June-end 2010. It increased by 0.21 percentage point in relation to previous year-end, while annual growth was 0.48 percentage points.

Micro-credit financial institutions reported small share in total loans granted and assets of the financial system (2.3% and 2.2% respectively as at June-end 2010). Therefore, their risk to financial stability is small. In addition, considering the fact that MFIs cannot take deposits in accordance with the Law, there is no threat of spreading panic, which additionally minimises risk to financial stability.

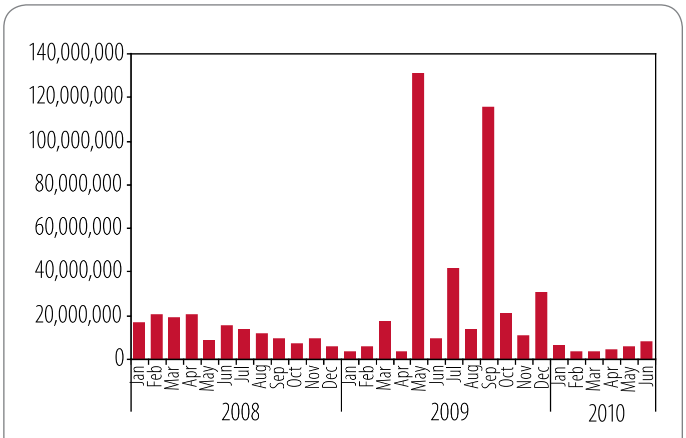
3.3. Capital Market

Although the first half of 2010 reported a slight increase in prices of some securities, turnovers still remained low, therefore, their trend has not changed. Some improvement can be expected in the forthcoming period, which is indicated through the shift of investors' portfolios towards shares of companies. This represents obvious evidence that share prices have reached floor or they are close to reach the floor. Share of turnover of various types of bonds in total turnover was evident in the first six months 2010, which indicates that the investors have turned to more secure „investment material". However, risks to this market should not be neglected. These are the following: low market liquidity, fear of further market decline, poor protection of proprietary rights, deficiencies in regulating capital market and the like. Global financial crisis affected substantially the decline in available funds for investments and significant growth in sensitivity to risk of all investors. Therefore, future investment decisions of investors will likely be guided by the principle of safe investment, besides the possibility to increase profit.

Average monthly turnover for the first six months was only EUR 5.4 million being substantially below the average monthly turnover reported in 2009 (EUR 33.8 million).

All three exchange indices declined, except for Nex Montenegro Stock Exchange index which increased in June 2010 in relation to the previous month. Turnover at Montenegro Stock Exchange reported significant growth as compared to the previous quarter. However, it showed a year-on-year decline. Nex Montenegro Stock Exchange reported fall in turnover in both comparative periods. Capitalisations on both exchanges declined in three reference comparable periods. Liquidity measured by turnover coefficient significantly improved at Nex Montenegro Stock Exchange, while it deteriorated at

Graph 3.21
Total turnover at Montenegrin stock exchanges, by months



Source: Montenegro Stock Exchange and Nex Montenegro Stock Exchange

Montenegro Stock Exchange. The table below shows the changes of most important indicators at the stock exchanges:

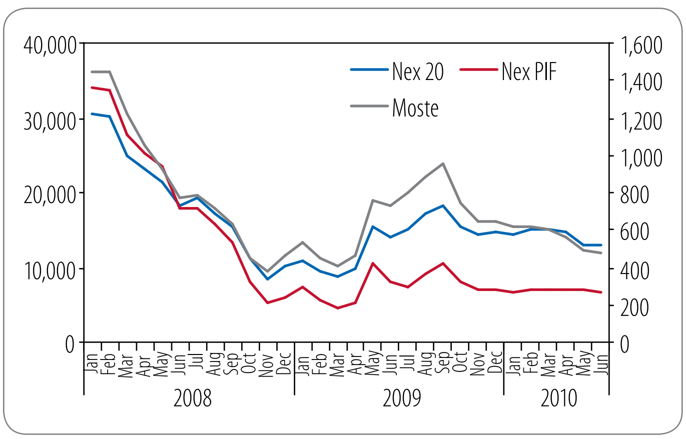
Table 3.1 – Indicators at Montenegrin stock exchanges, June 2010 (%)

Indices	MOSTE	NEX 20	NEXPIF
As of 30 June 2010	479.88	13,063.41	6,572.19
Relative index change in % (annually)/during2010/monthly	(-34.3) / (-24.9) / (-1.9)	(-7.9) / (-10.5) / (1.4)	(-17.8) / (-6.4) / (-4.1)
	Montenegro Stock Exchange	Nex Montenegro Stock Exchange	
Total turnover, in EUR – Q2 2010	**10,432,256**		**7,536,291**
Relative turnover change in % (as compared to Q1 2010)/Q2 2009	(90.0)/(-92.2)		(-16.7)/(-21.4)
Capitalisations	**2,619,337,920**		**1,913,617,018**
Relative change in capitalisation in % (annually)/during2010/monthly	(-9.1) / (-11.1) / 2.2)		(-11.0) / (-6.4) /(-2.4)
Turnover coefficient	**0,001427**		**0,002292**
Relative change in turnover coefficient in % (annually)/during2010/monthly	(-28.5) / (-85.2) / (-20.6)		(28.9) / (93.2) / (366.3)

Source: Montenegro Stock Exchange and Nex Montenegro Stock Exchange

All three indices reported a decline with slight oscillations. Moste recorded a decline of 24.9% as at June-end 2010 as compared to 2009 year-end, whereby NEX 20 fell by 10.5% and NEX PIF by 6.4% over the same period.

Graph 3.22
Indices at Nex Montenegro Stock Exchange and Montenegro Stock Exchange (NEX20 and NEX PIF- left scale and MOSTE - right scale)



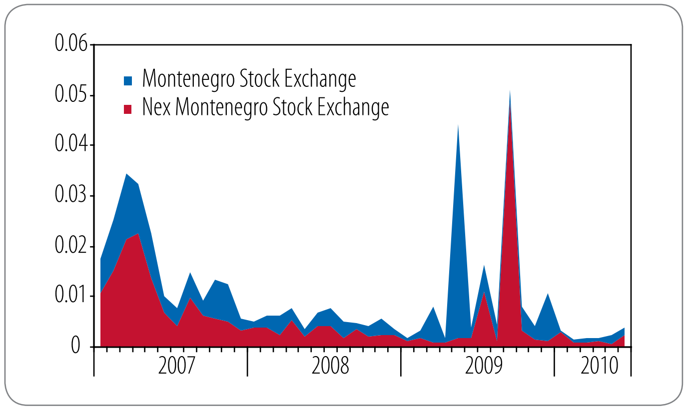
Source: Montenegro Stock Exchange and Nex Montenegro Stock Exchange

Observed by their historical values reached in 2007, the following decline in indices was reported at June-end 2010: Moste – 5.1 times, NEX20 – 3.7 times, and NEX PIF – 7.7 times.

Deceleration of decline in Montenegrin stock exchanges is obvious; however, final recovery will depend on the volume of investment by big investment funds and individual portfolio investors. Even though the influence of capital market on the financial system is not critically important, the fact that good portion of loans was granted for the purchase of shares at capital market should not be neglected. Simultaneously, inflow of funds from this market can affect favourably movements in the banking system.

On the other hand, growth in credit borrowings of both investment funds and individual investors (Lombard loans) contributed significantly to the growth of credit risk of the banking sector in the previous period. Yet, it is not expected that this market will pose any threat to the financial stability.

Graph 3.23
Turnover coefficient



Source: Montenegro Stock Exchange, Nex Montenegro Stock Exchange

3.4. Insurance Market

Ten insurance companies performed their insurance business at Montenegrin insurance market in the first half 2010, of which five insurance companies were engaged in life insurance, four insurance companies were engaged in non-life insurance, while one insurance company was engaged in both life and non-life insurance. License was revoked to one insurance company at 2009 year-end.

Table 3.2 – Insurance companies operating in Montenegro, June 2010

	Insurance class
Lovćen Insurance A.D.	Life/Non-life
Sava Montenegro Insurance A.D.	Non-life
Swiss Insurance A.D.	Non-life
Grawe Insurance A.D.	Life
Atlas life A.D.	Life
Uniqa Non-life Insurance A.D.	Non-life
Uniqa Life Insurance A.D.	Life
Delta Generali Insurance A.D.	Non-life
Delta Generali Life Insurance A.D.	Life
Merkur Insurance A.D.	Life

Source: Insurance Supervision Agency

Total share capital of the insurance companies amounted to EUR 36.4 million as of June-end 2010 and it showed year-on-year increase by 5%. Some 86.8% or EUR 31.6 million of total share capital of the insurance companies referred to foreign capital. Share of foreign capital in total capital grew by 17 percentage points in one-year period. With regard to the ownership structure of insurance companies, majority of them are foreign owned, whereby Sava Montenegro, Grawe, Merkur, Uniqa Non-life and Uniqa Life insurance companies are 100% foreign owned, Lovćen is 91.9% foreign owned, while the ownership structure of other insurance companies is mixed.

Total gross premium reported at insurance market at June-end 2010 was EUR 30.7 million which showed year-on-year decline of 4.6%. Gross premiums of non-life insurances of EUR 26.8 million reported dominant share (87.2%) in the structure of growth premium of insurance companies. Year-on-year decline in gross premium of non life insurances was 5.5%. Written premium in life insurance was EUR 3.9 million recording an annual increase of 1.9%.

With regard to the structure of gross premiums in non-life insurance in the second quarter 2010, majority share had compulsory insurances (53.9%), which share declined by 3.8 percentage points in one-year period.

Life insurance showed the largest share of 86.7% in gross premiums of life insurance, which together with supplementary insurance made up 96.5% of total written premiums in life insurance. Some 2.477 new life insurance policies were concluded during the first six months of the current year. However, effects of the financial crisis in the observed period primarily reflected in hindered collection of premiums of insurance companies, which resulted in the reversal of large number of policies (2.627 policies) and intensified request for policy surrenders (275 policies were surrendered). This reflected in decrease in total number of active policies at period-end as compared to their number at the beginning of the accounting period.

Total assets of insurance companies amounted to EUR 102.1 million as at June-end 2010. Other short-term placements and receivables were dominant in the structure of total assets (45.8%), followed then by other long-term financial placements (11.7%), investment real estates (10.0%), construction buildings (9.7%) and other items that made up 22.9% of total assets. In total assets of the insurance sector, the largest share had Lovćen Insurance (45.2%), Sava Montenegro (19.78%) and Grawe Insurance (11.87%).

In the structure of total liabilities and capital, the largest share had technical provisions (60.2%) in the amount of EUR 61.4 million, capital and reserves (28.8%) in the amount of 29.4 million and other (11.06%). In the structure of technical provisions, the largest portion of funds was allocated for outstanding claims (53.2%) in the amount of EUR 32.7 million or total technical provisions, followed then by unearned premiums (27.3%) in the amount of EUR 16.78 million and mathematical reserves (16.85%) in the amount of EUR 10.35 million.

Solvency margin of insurance companies was EUR 18.2 million while guarantee reserves amounted to EUR 26.0 million at Q2 2010. Guarantee reserve to solvency margin ration at the Montenegrin insurance sector level was 142.5% as of June-end 2010, which indicated that the insurance companies in Montenegro were solvent at the end of Q2 2010.

Insurance market in Montenegro represents small yet growing part of the financial system (3.3% of estimated GDP for the first half 2010). Due to still insufficient development of the insurance market and insufficient development of the financial market, particularly money and bonds markets, as well as due to legal obligation of the insurance companies to conduct more conservative placement policy, the insurance companies have not yet faced with the level of the risk that is present in banks and investment funds. Considering the abovementioned facts, insurance market shares the same faith of the financial crisis effects as the rest of the financial system, but it does not have significant influence on financial stability of the overall system of Montenegro. However, the increase in losses of insurance companies from EUR 3.3 million to EUR 8.6 million in 2009 raises a concern[12].

[12] When compiling this report, the authors of this document did not have at their disposal data on losses/gains of insurance companies for the first half of 2010.

4. FINANCIAL INFRASTRUCTURE

Financial infrastructure in Montenegro is made up by a set of institutions which are providing legal and regulatory framework for effective and safe performance of financial intermediation. Safe and efficient financial infrastructure contributes to financial stability and based on current technical and technological development, it becomes crucial for successful operations of modern internationally integrated financial market.

4.1. Payment System

Payment system represents a vital component of the financial infrastructure that enables undisturbed functioning of the economic system of Montenegro.

Table 4.1 – RTGS and DNS CBM system availability in period January – June 2010

Month	Business days	Business hours	Business minutes	Extension in min	Production in min	Suspension in min	Availability of the system
I-09	20	170			10,200		100.00%
II-09	20	170			10,200		100.00%
III-09	22	187			11,220		100.00%
IV-09	22	187			11,220		100.00%
V-09	18	153			9,180		100.00%
VI-09	22	187		30	11,250	47	99.58%
VII-09	21	178	30		10,710	47	99.56%
VIII-09	21	178	30		10,710		100.00%
IX-09	22	187		7	11,227		100.00%
X-09	22	187			11,220	2	99.98%
XI-09	21	178	30		10,710		100.00%
XII-09	23	195	30		11,730		100.00%
2009.	254	2159		37	129,577	96	99.92%
I10	20	170			10,200		100.00%
II-10	20	170			10,200		100.00%
III-10	23	195	30		11,730		100.00%
IV-10	22	187			11,220		100.00%
V-10	19	161	30		9,690		100.00%
VI-10	22	187			11,220	107	99.46%

Some 107 minutes of suspension of the system occurred in the first two quarters 2010 in RTGS and DNS system of the Central Bank of Montenegro for 22 business days which produced 11.220 minutes of production. System availability was 99.46% in June 2010, while in other months this availability was 100%.

Total realised national payment system transactions amounted to EUR 9,185 million in period January – June 2010. They showed a year-on-year decrease by 3%.

These ratios indicate the presence of extended effect of recession factors influencing on the decline in economic activity in Montenegro thereby increasing the vulnerabilities that may be transferred to the financial stability. However, signals from real sector encourage that positively affect the expectations and perspectives of economic recovery.

Table 4.2 – Comparative indicators of total realised national payment system transactions in period I-VI/2009-I-VI2010

Period	Total payment system transactions	Chain index	Business days	Daily average	Interbank payment system transactions	Daily average	Share of Interbank	Internal payment system transactions	Daily average	Share of internal
I-09	1,263,982,448	50	20	63,199,122	481,776,600	24,088,830	38.12%	782,205,849	39,110,292	61.88%
II-09	1,485,710,519	118	20	74,285,526	564,265,674	28,213,284	37.98%	921,444,845	46,072,242	62.02%
III-09	1,814,353,390	122	22	82,470,609	820,134,897	37,278,859	45.20%	994,218,493	45,191,750	54.80%
IV-09	1,673,972,004	92	22	76,089,637	679,320,874	30,878,222	40.58%	994,651,130	45,211,415	59.42%
V-09	1,467,660,242	88	18	81,536,680	529,501,167	29,416,731	36.08%	938,159,076	52,119,949	63.92%
VI-09	1,793,290,766	122	22	81,513,217	689,202,341	31,327,379	38.43%	1,104,088,425	50,185,837	61.57%
Total I-VI/09	**9,498,969,369**		**124**	**76,604,592**	**3,764,201,552**	**30,356,464**	**39.63%**	**5,734,767,817**	**46,248,128**	**60.37%**
I10	1,062,103,329	45	20	53,105,166	418,029,249	20,901,462	39.36%	644,074,080	32,203,704	60.64%
II-10	1,348,058,127	127	20	67,402,906	575,029,019	28,751,451	42.66%	773,029,109	38,651,455	57.34%
III-10	1,738,167,222	129	23	75,572,488	723,526,791	31,457,687	41.63%	1,014,640,431	44,114,801	58.37%
IV-10	1,627,079,634	94	22	73,958,165	712,105,541	32,368,434	43.77%	914,974,093	41,589,732	56.23%
V-10	1,531,727,590	94	19	80,617,242	642,477,815	33,814,622	41.94%	889,249,775	46,802,620	58.06%
VI-10	1,878,204,541	123	22	85,372,934	820,642,037	37,301,911	43.69%	1,057,562,505	48,071,023	56.31%
Total I-VI/10	**9,185,340,443**		**126**	**72,899,527**	**3,891,810,451**	**30,887,385**	**42.37%**	**5,293,529,992**	**42,012,143**	**57.63%**
Index I-VI-10 / I-VI-09	97				103			92		

It can be concluded from the above mentioned that the payment system has been functioning in a satisfactory level so far and it did not represent threat to financial stability. However, the completion of construction of beck up location would be very important in the following period as well as the availability increase of the payment system through further technical and technological improvement of the system.

4.2. Regulatory Credit Registry

The Central Bank of Montenegro initiated development of credit registry in 2005. Credit registry is aimed at gathering data on retail and corporate loans and providing information which contribute to better assessment and better credit risk management in banks. Information obtained from banks were used at the beginning in the Central Bank for the purpose of conducting more efficient examinations, while at the later stage, the information from the credit registry was made available to banks and micro credit financial institutions. Besides information on loans, banks are obliged to submit information on all issued guarantees, credit cards, lease operations, overdrafts and other receivables that expose a bank to risk.

Banks and MFIs have the right to review data from credit registry. The purpose is to influence on better credit risk management through information sharing with commercial banks and MFIs on clients applying for new loans. Banks have the possibility to verify credit histories in the registry when a client applying for a new loan through identification number for companies or uniform identification number of natural persons.

The report obtained from database of credit registry includes all obligations that legal or natural person has based on loans with all banks in Montenegro, as well as interest and regularity in repayment and/or servicing of debt.

Contingent borrowings of a client can be determined based on report that reflect on the number of guarantees or sureties a client has issued for other legal or natural persons. Contingent borrowing of a client – natural person can be determined based on loans granted to other natural persons where it can be identified number of times and amount those clients were guarantors to other persons. The abovementioned indicates that banks can find information relevant for adequate assessment of clients' creditworthiness.

Banks can obtain reports on total indebtedness of a client in the system of banks and MFIs, which along with the information on earnings, turnover, and net income, gives clear picture of successfulness of client operations and its credit capacity. In addition, history of regularity in loan repayment in the previous period and regularity in loan repayment with other banks in the system can be reviewed from the report.

Number of clients – users by active loans of the banks' system from Regulatory Credit Registry (RCR)

	31.12.2007	31.12.2008	31.12.2009	30.06.2010
Natural persons:	123729	133961	117047	111780
Legal persons:	5193	5603	5207	5127
Total:	128922	139564	122254	116907

Number of clients from RCR in total loan receivables (loans, lease operations, credit cards and overdrafts) of the system of banks

	31.12.2007	31.12.2008	31.12.2009	30.06.2010
Natural persons:	165465	184872	171153	171153
Legal persons:	8594	6137	5787	5837
Total:	174059	191009	176940	172762

Table 4.3 - Number of searches from the Regulatory Credit Registry

	Period		
	September – December 2008	January – December 2009	January – June 2010
Number of searches	26.910	119.576	87.465

Full picture of credit history of loan beneficiaries influences on the possibility of credit risk assessment from the clients' level to the banking system level as a whole and represents one of efficient mechanisms for credit risk management. It indirectly influences on the level of financial stability in the country.

4.3. Records of registered mortgages (mortgage registry)

For the purpose of undisturbed performance of financial intermediation in the banking system, the existence of accurate and timely registration and records of registered mortgages is extremely important. The most frequent insight in securing loans of clients is registration of mortgages and real estate property in Montenegrin economy. From the aspect of financial stability, the information on the amount of overall encumbrance on property provides the banks with the information on encumbrance of indebtedness of the citizens.

Besides credit registry which is very important source of information on creditworthiness of citizens, the banks also have at their disposal information at web site of the Real Estate Administration which provides amount and type of restrictions over citizens' properties.

5. CONCLUDING REMARKS

International environment – Montenegro as small highly open economy operates as a part of global economy and largely depends on global developments, particularly on developments in EU countries and neighbouring countries (CEFTA countries). Global recovery has already started, however it is largely uneven and slower in those regions that are important for Montenegro as shown in table 5.1.

Table 5.1 – Comparative overview of recovery of selected countries from international environment

Forecast	Real GDP growth (annual change, %)	
	2010	2011
EU 27	0.9	1,6
EU 15	0.9	1.7
CEFTA		
Bosnia and Herzegovina	0	1
Croatia	-1.5	2
Serbia	1	2

Source: WiiW

Significant fiscal and monetary stimuli applied in the previous period largely contributed to global recovery. However, their further restriction may seriously jeopardise public finances and lead to inflation growth at global level, while their premature withdrawal threats to absorb still vulnerable economies in double-dip (w-shaped) crisis.

Domestic macroeconomic environment – After three-year period of expansion that was characterised by dynamic increase in domestic demand and investments, Montenegro faced with suspension and deceleration of economic growth under the effects of global financial crisis. A downward trend continued also in Q1 2010, when economic activities further declined.

Positive trends and recovery elements of economic activities were noted in Q2 2010, in both banking and real sectors and further recovery is expected by the end of this year which would lead to positive growth and influence on stabilisation of the remaining part of the financial market. Economic decline gave rise to significant changes in functioning of Montenegrin economy: domestic demand fell as a result of decline in total salaries and level of consumers' wealth (both economy and households), credit terms and conditions tightened up, fiscal adjustment was made and the like. Economic growth is expected from -0.5% to 1.5% in this year. Economic growth will positively influence on financial stability, and possible extension of recession would represent serious risk, particularly for the banking system.

Negative trends at real estate market are still present, hindering the position of construction sector which reflect on further decline in activities of this sector and irregular fulfilment of obligations to the banking sector. Government project "1000+ apartments" could, to a certain extent, mitigate the existing problems.

Annual inflation rate amounted to 0.2% in June 2010. Global financial crisis affected the decline in aggregate demand, which resulted in decrease in pressure on prices on both national and international levels. In 2010, inflation is expected between 0.5% and 2.5%, and this movement does not jeopardise financial stability.

Due to national and international factors, foreign trade misbalance in Montenegrin economy significantly changed. This primarily reflects in significant decline in current account deficit from 50.7% of GDP (2008 - the largest level) to 29.8% of GDP in 2009, and further decline during Q2 2010[13]. The analysis of foreign trade flows indicates that the improvement in foreign trade misbalance is not currently a result of improved situation in Montenegrin economy but global crisis and reduced domestic demand. Balance of payment current account deficit was financed through capital flows. Therefore, Montenegro is not threatened by balance of payment crisis. Potential risks in medium term, which could negatively influence on the movement of current account deficit, are deterioration of conditions in aluminium industry (Podgorica Aluminium Plant) and possible negative developments in tourism sector.

Fiscal deficit higher than maximum amount of the one defined by Maastricht criteria is expected in this year. Due to significant decline in economic activity, foreign debt still increased amounting to 23.0% GDP at end Q2 2010. Internal public debt at end of Q2 amounted to 11.8% GDP; therefore, total public debt amounted to 34.8% of estimated GDP at end of Q2. Debt increase will also result from the first issue of Eurobonds at international financial market. However, accelerated growth in public debt raises a concern. The fact is that share of Montenegrin public debt in GDP was lower than in EU countries, and that creation of fiscal deficit and public debt increase was necessary in fight against crisis. However, besides the existing level of public debt, total amount of issued guarantees of 7.6% of GDP that may become potential public debt should be bore in mind. The largest threat to sustainability of public debt would be its further growth based on over-indebtedness of the state during the construction of highway and hydro power plants. In these conditions, public debt would

[13] CBM expresses reserves on registered values of exports and imports. Similar reserves expressed also IMF after consultations held based on IV Agreement in IMF.

bear specific risk to financial stability, particularly if negative GDP growth rates and extension of fiscal deficit would appear after 2012. Risks were not so high in short-term period, while they were higher in medium-term and long-term periods. All these indicators point to the necessity of conducting further fiscal adjustment and providing balanced budget in 2012.

Financial system – Effects and negative consequences of global financial and economic crisis in the last two years reflected seriously and largely on financial system in Montenegro. Nevertheless, it can be noted that situation in the banking system consolidated in 2010.

Extended recession impact contributed to the increase in past due and non-performing loans during 2009 and 2010. Increase in past due and non-performing loans was evident in almost all banks, being the most evident in three systemic banks. Share of past due and non-performing loans was more than tripled by Q2 2010 in relation to their values before crisis reaching level of 24.3% and 16.8% respectively in total loans. Overall banking system recorded negative financial result at Q2 end-2010.

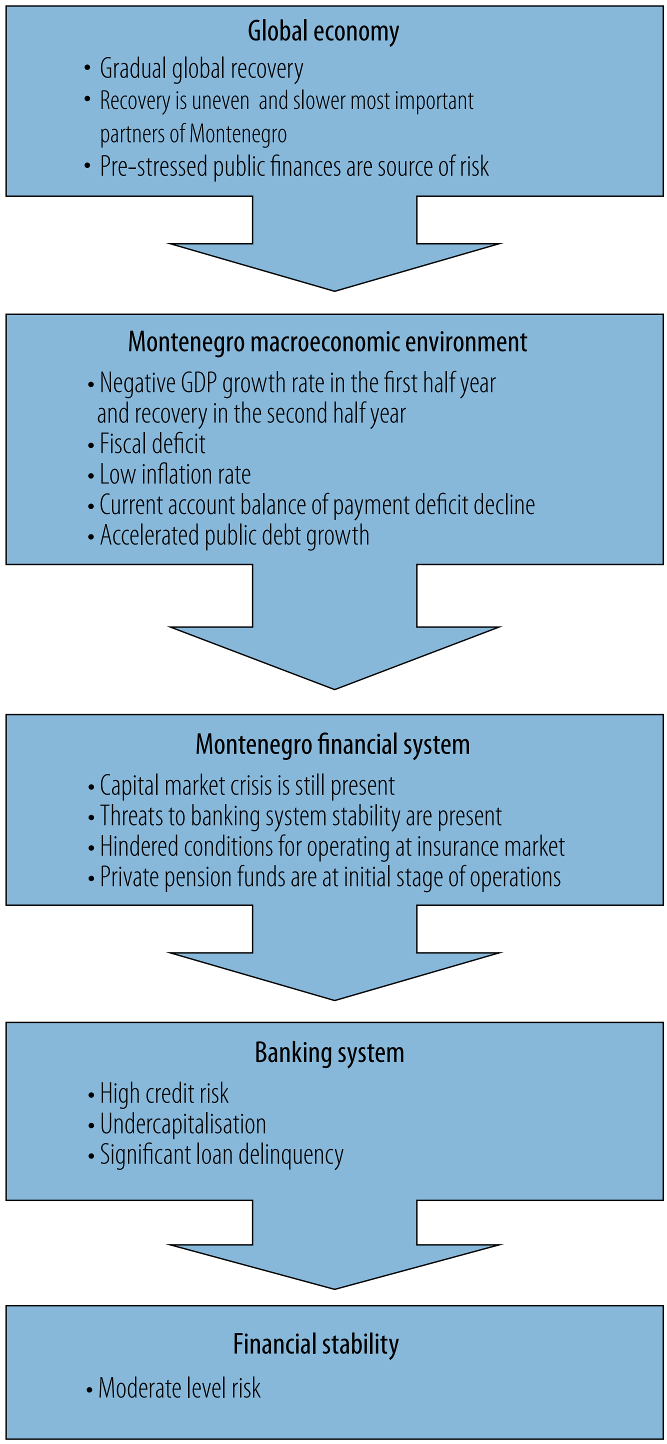
With respect to risks prevailing in Montenegrin banking system, credit risk is the dominant one. Stress testing showed that tested shocks would jeopardise certain banks. They confirm that recapitalisation of a number of banks is needed, since the existing level of capital is not adequate to risks assumed. Increase in defaulted obligations of clients to banks raises a concern, which may increase loss against banks' capital in the forthcoming period. An encouraging fact is that certain number of banks recapitalised in the first half of the current year.

Liquidity risk is the first risk the banks faced at outset of financial crisis. Amendments to liquidity management standards and CBM measures established the balance between liquidity needs and available liquid funds. In 2010, all liquidity risk indicators were satisfactory which indicates that the banks controlled this type of risk in their daily management. Only in case of extreme shocks, liquidity risk in certain banks would appear.

Overall level of market risk is currently low. Sensitivity to interest rate risk and FX risk was low to moderate in majority of banks; therefore these risks do not represent threat to financial stability.

Capital market crisis is still present reflecting on constant decline in indices, but it still does not have high impact on financial stability directly. However it indirectly impacts the level of economic and citizens' wealth and financial stability as well. Capital market in Montenegro is still thin, representing very limited source of financing for Montenegrin companies since issues of new shares and corporate securities are very rare. Economy is directed to banking system as main source of financing.

Insurance market is small but growing part of Montenegrin economy. Although loss was present during 2008 and 2009, currently there are no threats to financial stability.


Global economy
• Gradual global recovery
• Recovery is uneven and slower most important partners of Montenegro
• Pre-stressed public finances are source of risk
Montenegro macroeconomic environment
• Negative GDP growth rate in the first half year and recovery in the second half year
• Fiscal deficit
• Low inflation rate
• Current account balance of payment deficit decline
• Accelerated public debt growth
Montenegro financial system
• Capital market crisis is still present
• Threats to banking system stability are present
• Hindered conditions for operating at insurance market
• Private pension funds are at initial stage of operations
Banking system
• High credit risk
• Undercapitalisation
• Significant loan delinquency
Financial stability
• Moderate level risk