CENTRAL BANK OF MONTENEGRO

FINANCIAL STABILITY REPORT 2019

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ABBREVIATIONS USED IN THE REPORT

GDP	Gross Domestic Product
CBCG	Central Bank of Montenegro
CSDCC	Central Securities Depository and Clearing Company of Montenegro
CHF	Swiss Franc
DAX	Deutscher Aktienindex
DJIA	Dow Jones Industrial Average
DNS	Deferred Net settlement
DSTI	Debt service to income
DTI	Debt to income
ECB	European Central Bank
EONIA	Euro Overnight Index Average
EU	European Union
EUR	Euro
EURIBOR	Euro Interbank Offered Rate
Fed	Federal Reserve
FSIs	Financial Stability Indicators
FTSE	Financial Times Stock Exchange
GBP	Pound Sterling
HH	Hirschman-Herfindahl
HP	Hodrick–Prescott
JPY	Japanese Yen
LIBOR	London Interbank Offered Rate
LSTI	Loan service to income
LTD	Loan to deposit
LTI	Loan to income
LTV	Loan to value
NSF	Net stable funding
IMF	International Monetary Fund
IRS	International accounting standards
MSCI	Morgan Stanley Capital International
IFRS	International Financial Reporting Standards
p.p.	percentage points
PPP	Purchasing Power Parity
PBG	Policy Based Guarantee
ROAA	Return on Average Assets
ROAE	Return on Average Equity
RTGS	Real Time Gross Settlement
USA	United States of America
USD	United States Dollar

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INTRODUCTION

Pursuant to the Constitution of Montenegro and the Central Bank of Montenegro Law (OGM 40/10, 46/10, 6/13, 70/17), the Central Bank of Montenegro is the institution responsible for monetary and financial stability. Since instruments of the CBCG monetary policy are very limited, primarily because the CBCG is not an issuing central bank, its practice is largely aimed at fostering and preserving financial stability, i.e. stability of the banking system as the most important part of the financial system in Montenegro. The CBCG Law prescribes the obligation of publishing Financial Stability Report (Article 39).

The CBCG primarily uses microprudential regulation and supervision for fostering and maintaining financial stability. However, since this approach primarily focuses on stability of individual banks, the CBCG uses, as needed, macroprudential instruments which effects influence the entire system. Thus, attention is paid to the complex relationship between banks and other economic entities in order to adequately assess potential vulnerabilities of the entire economy. The Financial Stability Report is one of the ways in which the CBCG contributes to financial stability as it raises awareness of the sources of risks to financial stability among other economic and financial policymakers in the financial system and the general public.

The Financial Stability Report analyses trends of those risks that are considered to have or may have systemic character (systemic risks). Basically, systemic risk may occur as the consequence of certain internal imbalances and vulnerabilities of the financial system/banking sector, and it may occur as the consequence of external shocks that could hit the economy in general or directly the financial system. Certainly, with the system of communicating vessels and the spillover of instability among economic entities, vulnerabilities can intensify and build up instability of the entire economic system.

The report comprises of four sections. The first section gives an overview of systemic risk trends and assessments. The second section depicts trends and expectations in international economic and financial environment, which is very important considering the connectivity of the Montenegrin economy with the international economic and financial flows. The third section summarises generally accepted local macroeconomic trends and the balance of payments developments as an overview of the relationship between Montenegro and foreign countries, as well as the risks and vulnerabilities in local private real sector and general government to which Montenegrin banks are exposed. The forth and also the main analytical section of the report displays trends and risks in the banking sector and in other relevant segments of the financial system. A spectrum of financial soundness and macroprudential indicators most directly reflects the banking sector stability as a result of activity of both factors discussed in the second and third section of the report and factors generated by the banking sector itself.

1. SYSTEMIC RISKS ANALYSIS AND ASSESSMENT

Generally, systemic risks were relatively moderate at end-2019 and there were no significant deviations relative to end-2018.[1]

When it comes to the non-financial segment of the corporate sector, it should be noted that the debt of resident non-financial institutions and households to banks increased both in nominal terms and (slightly) relative to GDP, which was primarily driven by growth in cash loans to households with higher share of long-term cash loans than in the previous years. Real wages and salaries did not change significantly, but the unemployment rate fell, which expanded the potential number of loan beneficiaries. On the side of public finances, net public debt increased to 65% of GDP, which points to the need for decisive implementation of fiscal consolidation measures in the coming period.

In 2019, the resident nonfinancial institutions" debt towards the Montenegrin banks rose by 42.7 million euros or 4.1%, while the share of this debt in GDP declined from 22.1% to 21.9%. However minor, this was still a continuance of the corporate sector deleveraging in relation to the third quarter of 2008 when this sector's debt peaked (about 55% of GDP). In 2019, the frozen amount based on enforced debtors' debt in the process of enforced collection declined from 635.4 million euros to 616.2 million euros, settling at 12.6% of GDP. The number frozen economic entities grew by 2.9% to 14,605.

Households debt to Montenegrin banks significantly increased over the past few years in relation to GDP and is still considerably lower compared to the leverage peak (over 34% at end-January 2009, 26.8% at end-2018, and 27.7% at end-2019). Real wages were slightly higher in 2019 than in 2018, by 0.4%. On the other hand, the unemployment rate (according to the Labour Force Survey) recorded a further slight decline in 2019 to 15.1%, compared to 15.2% in 2018, while according to the Employment Agency of Montenegro, in December 2019, the unemployment rate stood at 16.21%, which is a decrease of 1.62 percentage points. However, it should be emphasized that this is still a high unemployment rate with a pronounced structural component.

High levels of public debt and public guarantees (although significantly limited by fiscal consolidation measures) are a source and a reflection of systemic risk in Montenegro. Namely, after the reduction of public debt in relation to GDP during 2016 and 2017, a net public debt increased from 62.5% in 2018 to 65% of GDP in 2019, which is mainly the result of construction of the priority section of the highway. The previous mild public debt decline was a result of a vigorous growth of the nominal GDP in relation to the public debt growth and in relation to fiscal deficits, which averaged at 4.5% of GDP in the period 2016-2017. Montenegro's 2019 credit rating according to Standard &Poor`s was B+, with the stable out-

[1] For more on developments in the first months of 2020 and expectations regarding the coronavirus pandemic, see Box 1.1.

look, as confirmed in their mid-March 2020 assessment. Even though fiscal consolidation measures have been giving results, the main challenge for the public finance will continue over 2021 when 227.4 million euro worth debt arising from Eurobonds will mature[2], while the beginning of the 14-year repayment of loan for financing Bar-Boljare highway section is planned for 2021. However, a mitigating circumstance is that most of the missing funds planned in the budget were provided through the issuance of Eurobonds and the World Bank`s PBG program.

When it comes to the banking sector, the very good capitalization of the sector was maintained, since the solvency ratio increased significantly during the year and thus was at an even higher level than prescribed by law. In addition, banks' liquidity remained very good, although the liquidity ratio declined slightly during the year. Among the main structural vulnerabilities of banks, which are assessed as moderate, still stand out: the share of non-performing loans (NPLs) in total loans, growing banks` exposure to the government, growing banks' exposure to households (especially through cash loans), and increasing maturity mismatch between sources and funds (due to the growth of demand deposits on one hand and long-term loans on the other).

The level of non-performing loans remains a significant challenge for individual banks, but not for the system as a whole. The situation improved additionally in the reporting year, as the share of NPLs declined from 6.7% to 4.7%. Although not worrying in terms of amount and at the level of the average in the region countries, this share still puts pressure on the banks` risk appetite, i.e. on the level of lending activity and lending conditions. Although slowed down, credit growth in 2019 was satisfactory (4.5 %.)[3] When we exclude two banks from the data for December of the previous year due to the bankruptcy introduction at the beginning of 2019, the total approved loans of banks compared to the end of the previous year recorded an increase of 320.7 million euros or 11.7%. It was predominantly conditioned by the growth of retail loans, while the growth of loans of resident non-financial institutions amounted to 4.1%. In 2019, the share of (net) loans in assets rose slightly to 58.3%, whereby less than 60% of the banks` assets were directed to loans.[4]

On the other hand, the exposure of banks to the Government (Central Government) increased from 625.9 million euros to 715.7 million euros in 2019, making up 15.5% of banks' assets. This growth was mainly due to the increased debt arising from loans and the increased Government debt towards banks arising from securities. The growth trend of this exposure is continuously supervised by the CBCG.

In 2019, cash (all-purpose) loans to individuals intensified. Thus in mid-October, the CBCG adopted measures to limit the growth of these loans, which will be applied as of 01 January 2020. Namely, new cash loans to individuals amounted to 351.1 million euros (3.2% more than in 2018), while their share in total new loans increased slightly to 69.2%, and the general growth trend of this share has been present for eight years. Similarly, observed through the balance (outstanding principal) of loans granted to all entities, there is a noticeable multi-year increase in the share of cash loans in total loans, as well

[2] The amount of debt initially amounted to 300 million euros. However, bond package valued at 72.6 million euros was redeemed in mid-April 2018.

[3] The growth of loans to residents was 7.9%, but the lower growth of total loans was caused by a decline in loans to non-residents of 16.7%. This decline was primarily driven by a decline in deposits held by banks with foreign banks, which are included in the scope of loans.

[4] The calculations made here do not account for other loan receivables.

as an increase in their maturity. Thus, at the end of 2019, cash loans accounted for 27.9% of total loans, and the share of cash loans with an initial maturity over three years was 93% of all cash loans, or 34.1% of all types of loans with an initial maturity of over three years. On the other hand, at the end of 2012, the same shares were 11.4%, 61% and 11.5%, respectively.

A further decline in lending interest rates affected the decline in the spread between interest rates on loans and deposits during the year, from 5.8 percentage points to 5.6 percentage points, while the average interest rate on new loans (weighted by monthly loan amounts) fell from 6.3% in 2018 to 6% in 2019. However, the interest rate spread on total earning assets, i.e. interest-bearing liabilities, recorded a mild increase from 4.1 percentage points to 4.2 percentage points, and this type of spread did not change significantly over the past ten years. On the other hand, the Hirschman-Herfindahl index rose somewhat in 2019, but remained below 1,100 points (indicating low market concentration), compared to the value of over 2,400 points in the period before the 2008/2009 crisis.

Even „cleaner" banks' balance sheets, i.e. lower allowances for impairment and provisioning costs, contributed to the profit of 50.6 million euros at the system level, which affected the average ROAE in the period 2017-2019 amounting to a solid 6.9%, compared to only 1.5% in the period 2013-2016 and compared to 13.6% in the period 2009–2012.

In general, banks are currently the most stable segment of the economic system, which substantially reflects in the stability and growth in deposits in the banking sector. These deposits grew to 3.48 billion euros (historical maximum) and they made up the largest portion of banks' liabilities and capital (75.5%). With more pronounced credit growth and growth of investments in securities in relation to deposit growth, this expectedly reduced the liquid assets of banks. Namely, the total liquid assets of banks decreased during 2019 by 3.8% to 957.1 million euros, and their share in relation to assets and deposits fell from 22.6% and 28.8% to 20.8% and 27.5%, respectively. However, despite the year-on-year decline, liquid assets remained at a high level in the reporting year. In the context of structural limitations of Montenegro`s economic growth, these liquid assets are currently the banks` best safety reserve against the risk of asset quality deterioration and/or deposit outflow.

Other financial intermediaries - primarily due to their limited size and also the nature of activities they perform (not depository institutions), as well due to solid financial position of some of the more important among them (insurance companies) - do not represent sources of systemic risk.

With regard to the real estate prices, as the key form of property (and collateral) in the situation of underdeveloped financial markets and instruments, it cannot be said that the prices were substantially above the "fundamentals", i.e. that the market was significantly overheated at the year-end. Few years preceding 2018, there was a stagnation of prices in this market, but signs of a significant shift appeared in the period 2018-2019.

Turnover on the Montenegro Stock Exchange amounted to 282.5 million euros (5.8% of GDP) compared to 147.4 million euros from 2018, whereby this high increase in turnover was primarily due to the Government bonds issues in April and May 2019. The Monex index rose 5.2% relative to end-2018 and it was still multiple times lower relative to its maximum values from April 2007.

The CBCG`s payment system and the CSDCC`s securities settlement system, as the financial infrastructure pillars in Montenegro, continued working smoothly in 2019.

Scheme 1.1

Key risks for financial stability, 31 December 2019	
High level of public debt and budget deficit (significantly restricted due to fiscal consolidation measures), considering limited growth prospects of the Montenegrin economy and the possibility of change in euro interest rates in international markets, i.e. costs of debt (re)financing in the future;	↑
Negative feedback loop between a high share of non-performing loans and poor credit growth in the context of uncertain economic growth;	↓
Share of retail cash loans in total loans, with a growing maturity of these loans;	→
Growing exposure of banks to the government considering the challenges in government finances;	↑

Explanation

High systemic risk

Moderate systemic risk

Low systemic risk

Colours represent the levels of risk as a combination of probability of materialisation and a potential impact in case of materialisation during the next two years based on the CBCG expert assessment. The arrow shows the direction of change in the level of risk relative to the previous Financial Stability Report.

Box 1.1 – Coronavirus pandemic and its impact on economy

Due to the appearance of contagious and dangerous coronavirus, the world in the first months of 2020 faced a health threat unprecedented in recent history. The virus originated in China at the end of 2019 when a hospital in Wuhan, in the province of Hubei, informed the local Centre for disease prevention and control about suspicious cases of pneumonia. On 8 January 2020, a new type of coronavirus was identified. The virus was later named *SARS-COV-2* and the disease it causes *COVID-19*.

The virus was transmitted from China to other parts of the world. Thus, on 30 January, the World Health Organization declared the so-called public health threat of international importance and a pandemic on 11 March. In Europe, the first case was officially confirmed in France on 24 January, while Montenegro was the last European country to register the first case of coronavirus infection on 17 March. On 15 April, over two million infected people in 210 countries and territories were officially confirmed in the world, of which over 127 thousand died.

To prevent the spread of the virus, almost all countries have introduced health and sanitary measures to restrict movement and activity, unprecedented in recent history. In Montenegro, the introduction of measures began on 28 February, when travel from Montenegro to Milan and Bologna was prohibited, as well as the entry of passengers from those destinations in Montenegro. Subsequently, the most significant measures were introduced in the following order: 13 March - Prohibition of gathering of population in indoor and outdoor public places; 15 March - Discontinuation of work in public and private educational institutions, hotels and catering facilities and entry of foreign citizens in Montenegro;

16 March - prohibition of public international transport; 17 March - prohibition of intercity transport; 18 March - discontinuation of work for most commercial facilities; 24 March - prohibition of complete intercity traffic, and 30 March - introduction of curfew from 7 pm to 5 am between Monday and Friday, as well as from 1 pm on Saturday to 5 am on Monday.

The epidemic in Montenegro was declared on 26 March, 288 cases of the virus had been officially confirmed by 15 April, of which 229 were ill (34 hospitalized), 55 recovered, and 4 fatal. Due to the virus, 4,760 people were under surveillance. Also, in the last days before 15 April, the number of new cases was declining. All of the above indicated that the situation was under control, but there were still no expectations about imminent abolition of the restrictive health and sanitary measures.

Everywhere in the world, including Montenegro, these measures immediately produced negative consequences for the economy - supply shock, followed by demand shock. Beyond the financial markets where fear and uncertainty were „evident", the decline in the value of many high-frequency data almost immediately began to show that the world is sliding into recession, such as payment operations, prices of oil and other stock exchange commodities, the number of flights in civil aviation, nitrogen dioxide in the air, and the like. For example, based on surveys of thousands of companies and pairing with other indicators, Banque de France estimated that in the regime of health and sanitary restrictive measures, French GDP decreases by about a third annually, so that two weeks of restrictive measures lead to a decline in annual GDP of 1.5%[5].

In addition to the initial direct loss of GDP at the national level, all forecasts should include spillover and spillback effects for which one study from the Bank for International Settlements estimates that they can be equal to the direct loss of GDP[6]. Due to a high uncertainty, the forecasts are really ungrateful, as they directly depend on the following uncertain future developments: how long health and sanitary restrictive measures will last and how fast they will be mitigated, whether there may be new epidemiological waves due to easing measures and how fast economies can return to normal mode of operation when measures are cancelled/relaxed. Nevertheless, the IMF and the World Bank expect the biggest recession since the Great Depression, that is, after World War II.

How the economies of individual countries will react will generally depend on the structure of economies (not all activities are equally affected), from the position of countries before the pandemic to how stimulating governments will be with economic policy measures. In addition, due to the nature of this crisis, it will be necessary to better coordinate measures at the global level, because local hotspots would constantly threaten with new waves of pandemics.

In Montenegro, as in other countries, the crisis will be a kind of test of stability of the economic and financial system, i.e. the test of weaknesses, vulnerabilities and risks that existed before this crisis.

[5] *Point de conjoncture*, Banque de France, 08 April 2020.

[6] *The macroeconomic spillover effects of the pandemic on the global economy*, BMP, 06 April 2020.

2. INTERNATIONAL ECONOMIC AND FINANCIAL ENVIRONMENT

2.1. Global economic trends

The latest IMF assessments showed the global economy growth of 2.9% in 2019 or the year-on-year decline of 0.7 percentage points. As in previous years, growth in emerging and developing economies contributed largely to the global growth of 3.7% while advanced economies reported growth of 1.7%. The USA was the driver of growth among advanced economies (growth of 2.3%), while economies in the euro area and Japan recorded growths of 1.2% and 0.7%, respectively. On the other hand, with the respective growth rates of 6.1% and 4.2%, China and India gave the main boost to growth in emerging and developing economies as well as on the global level. In Russia, economic activity grew by 1.3% or almost twice below that recorded in 2018 (2.5%). It is estimated that a large group of developing and emerging European economies, including Montenegro, recorded economic growth of 2.1% or significantly below 3.2% in 2018 due to a slowdown in the growth of all economies in this group, except of Bulgaria, Croatia, Kosovo, and Northern Macedonia.[7]

Due to the coronavirus pandemic, the IMF predicts the worst recession since the Great Depression in the 1930s, naming it the *Great Lockdown*. Namely, according to the baseline scenario, the decline in GDP in the world will amount to 3%, and will be driven by a decline in almost all leading economies, with the euro area experiencing a stronger decline than the USA. Emerging and developing economies as a group will record a 1% drop in GDP, despite growth of 1.9% in India and 1.2% in China. For a group of developing and emerging European economies, including Montenegro, economic activity is expected to decline by 5.2% in 2020 and then to grow by 4.2% in 2021, with a different decline in 2020 and growth in 2021 recorded by all economies in this group[8]. In 2021, expected global growth is 5.8%, with a significant amount of lost GDP in the period 2020-2021 - higher than the sum of the annual GDPs of Japan and Germany, compared to the situation that was expected before the outbreak of the pandemic.

The IMF points to an extreme uncertainty over the baseline forecast scenario, both for 2020 as a year of decline and for 2021 as a year of projected economic recovery, as the situation depends on uncertain factors whose interactions are difficult to predict. Some of the most important factors are: the course of the pandemic, progress in vaccine development and therapy, the intensity and effectiveness of restrictive health measures, the level of supply-side disruptions and production losses, the consequences of a dramatic deterioration in global financial conditions, changes in consumption patterns, changes in people's behaviour, the effects of a change in confidence, and the volatile prices of commodities. At the same time, it more likely that real GDP growth will be lower (rather than higher) than in the baseline scenario.

7 Albania, Belarus, Bosnia and Herzegovina, Bulgaria, Montenegro, Croatia, Kosovo, Hungary, Moldova, Poland, Romania, Russia, Northern Macedonia, Serbia, Turkey and Ukraine.

8 For Montenegro, the IMF forecasts a 9% drop in GDP in 2020, followed by a 6.5% recovery and GDP growth in 2021.

Table 2.1

Overview of selected global indicators, %						
Indicator	2018	Estimate for 2019	Forecasts		Differences relative to October 2019 forecasts, percentage points	
			2020	2021	2020	2021
Real growth of GDP						
World	3.6	2.9	-3.0	5.8	-6.4	2.2
Advanced economies	2.2	1.7	-6.1	4.5	-7.8	2.9
USA	2.9	2.3	-5.9	4.7	-8.0	3.0
Euro area	1.9	1.2	-7.5	4.7	-8.9	3.3
Japan	0.3	0.7	-5.2	3.0	-5.7	2.5
Emerging and developing economies	4.5	3.7	-1.0	6.6	-5.6	1.8
China	6.7	6.1	1.2	9.2	-4.6	3.3
India	6.1	4.2	1.9	7.4	-5.1	0.0
Russia	2.5	1.3	-5.5	3.5	-7.4	1.5
European emerging and developing economies	3.2	2.1	-5.2	4.2	-7.7	1.7
Commodity prices, average rate						
Oil	29.4	-10.2	-42.0	6.3	-35.8	10.9
Non-energy products	1.3	0.8	-1.1	-0.6	-2.8	-1.9
Consumer prices, average rate						
Advanced economies	2.0	1.4	0.5	1.5	-1.3	-0.3
Emerging and developing economies	4.8	5.0	4.6	4.5	-0.2	0.0

Source: IMF, April 2020

The prices of stock exchange goods increased during 2019[9] by 3.4%, primarily as a result of the increase in oil prices by 17.9%, while the prices of food and beverages increased by 5.5% and the prices of industrial inputs rose 3.9%[10]. During 2019, the price of aluminium dropped from 1,920 $/t to 1,771 $/t, thus continuing the decline that began in mid-2018 when the price reached almost 2,300 $/t.

Due to the coronavirus pandemic, stock exchange goods' prices fell by 21.7% in the first three months of 2020, driven by a sharp drop in oil prices by 49.2%. The price of aluminium fell by 9.1%, to 1,611 $/t. According to the IMF forecasts, oil prices will fall by an average of 42% in 2020, while the decline in non-energy prices, as a heterogeneous group of commodities, will be insignificant.

2.2. Global financial trends

Leading central banks, with some exception of the Fed, continued with their extremely expansive monetary policies in 2019, maintaining their reference interest rates at record lows and continuing with the programme of purchasing government and corporate securities on the secondary market (quantitative easing).

[9] December 2019 to Decembar 2018.

[10] However, average prices fell by 8.3%, as a result of lower average oil prices by 10.2%.

As of July, the Fed made three drops of their federal funds rate, pushing its year-end range to 1.5% - 1.75% compared to 2.25% - 2.5% from the beginning of the year. As of August 2019, the Fed cancelled a gradual reduction of its securities portfolio established within the quantitative easing programme[11].

During 2019, the ECB lowered only the interest rate on overnight deposits with the Eurosystem (from -0.4% to -0.5%), so that the so-called the interest rate on the main refinancing operations throughout the year was 0%. On the other hand, the ECB maintained its securities portfolio, formed through a quantitative easing program, at the same level from January to October (reinvesting the principal) and, starting in November, initiated new purchases of securities amounting to 20 billion euros per month.

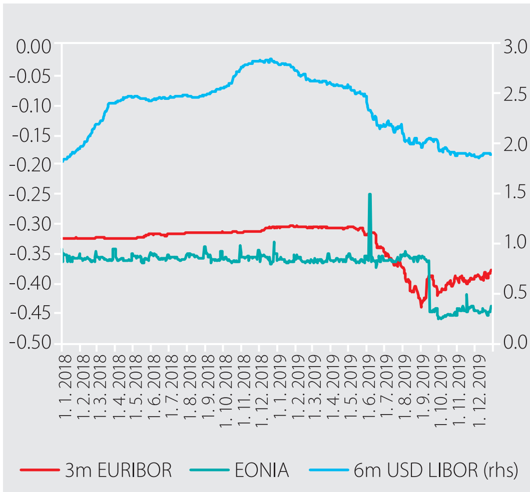
The Bank of England, the Bank of Japan, and the Swiss National Bank maintained their interest rates at the level of 0.75%, 0.1%, and -0.75% throughout the year, respectively.

In terms of quantitative easing - the total assets of the Fed, the Eurosystem, and the Bank of Japan in 2019 increased by 2.2%, 0.5%, and 3.8%, respectively.

Short-term reference interest rates "mirrored" the reference interest rates of the central banks. The six-month *USD LIBOR* thus fell by 1 percentage point in 2019 to 1.9%, while the three-month *EURIBOR* fell by 0.1 percentage points to -0.38%, and *EONIA* also declined by 0.1 percentage points to -0.45%[12]. However, their percentage decreases were significant and amounted to 33.5%, 23.9%, and 25.3%, respectively.

Graph 2.1

Short-term market interest rates, 2018–2019, %



Source: Bloomberg

The record low interest rates of the Fed are expected to continue, which was indirectly announced after the FOMC session held on 15 March 2020. It should also be noted that the Fed has not published regular quarterly economic forecasts after that session, one of which is the Fed`s forecast/expected reference interest rate in the future. At a press conference after the session, the Fed Chair, Mr. Powell, said that the forecasts were not published because the future economic situation very much depends on the spread of the virus and the duration of measures in its sup-

[11] In early 2019, the Fed reinvested on monthly level, only matured principal for treasury bonds exceeding 30 billion US dollars, and 30 billion US dollars for agency securities secured by mortgage loans. These limits were cancelled as of August 2019.

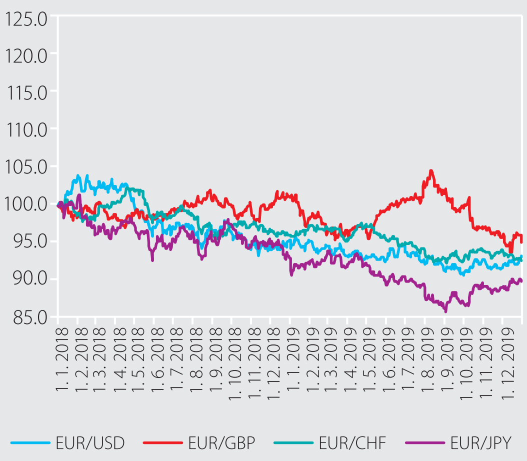
[12] As of 1 October 2019, the methodology for calculating the *EONIA* rate has been changed so that it is calculated as the sum of the euro short-term interest rate (*€STR*) and 8.5 basis points. At the same time, *€STR* became the official reference market interest rate, while the calculation/publication of the *EONIA* rate will be discontinued by the end of 2021.

pression, which is unknown. In these circumstances, it is considered that, in order to accurately inform the public, publishing forecasts would be more of an obstacle than an aid. Powell also expressed expectations that the Fed will return to regular publication of forecasts in June 2020.

Even before the pandemic, the euro area economy was more fragile than the US economy. The problem is largely structural/chronic, therefore, it is expected that the ECB will continue to maintain a record low level of interest rates. This was also announced at the meeting of the Governing Council of the ECB in March 2020, where it was stated that the rates will be at the same or lower level until it was clearly and consistently confirmed that inflation was moving towards the target of below, but close to 2%. On the other hand, reinvestment within the quantitative easing will continue only after a longer period of time, after the increase in interest rates.

Graph 2.2

Nominal euro exchange rate, 2018–2019, 1 January 2018 = 100



Source: Bloomberg, CBCG calculations

The euro depreciated nominally against the leading global currencies in 2019, specifically 2.2% against the USD, 3.2% against the JPY, 3.5% against the CHF, and 5.9% against the GBP. Measured by variance ratio, the highest exchange rate fluctuation of the euro was in relation to the GBP, followed by CHF and JPY, while the fluctuation in relation to the US dollar was the mildest. EUR depreciated to USD from 1.1467 to 1.1213 USD for 1 EUR, ranging on average at the level of 1.1194 USD for 1 EUR.

Generally, the situation of extremely low yields on government bonds deepened in 2019. The fact that the Swiss 10-Year Government Bond Yields continue to average below zero (at -0.5%) serves as the most radical example of this. In the euro area countries, yields generally declined significantly both compared to the end of the year and at the average annual level. For example, the average debt yields in 2019 and the change in yields compared to 2018 for the following countries were: Greece (2.6%, -1.6 percentage points), Italy (1.9%, -0.7 percentage points), Portugal (0.8%, -1.1 percentage points), Spain (0.7%, -0.8 percentage points), Ireland (0.3%, -0.6 percentage points), France (0.1%, -0.6 percentage points) and Germany (-0.2%, -0.7 percentage points). Government Bond Yields of Japan experienced no major changes (-0.1% on average against 0.1% in 2018), while yields on government bonds of Great Britain and the USA recorded significant decreases in relation to those recorded in 2018.

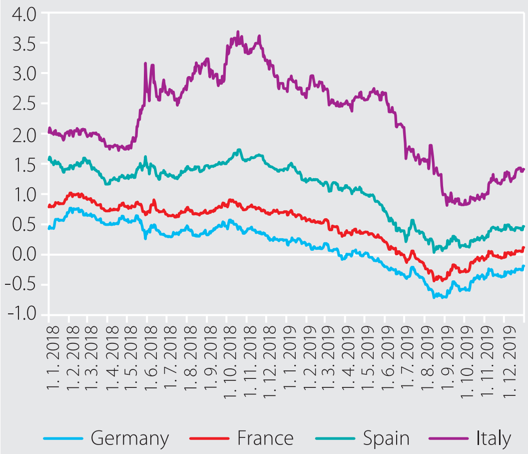
The spreads, which are the differences between a country's bond yields and the German government bond yields were even lower than in 2018, that is, still very compressed, with the exception of Italy and Greece. With regard to 10-year government bonds, spreads on French, Italian, and Spanish debt averaged at 0.34 percentage points, 2.12 percentage points, and 0.87 percentage points, respectively. This is extremely low bearing in mind the problems Italian and Spanish banking sectors have been experiencing as well as vulnerabilities regarding the external debt of these countries. Secondly, it leads to delays of necessary fiscal and structural reforms in these countries and their absence will deteriorate the economic position of these countries once the normalisation period occurs, that is, when yields on government debt of these countries start to rise.

Observing through the TED spread[13] and the VIX index[14], the level of instability in the financial markets was similar to 2018, as the TED spread was roughly at around 0.3 percentage points, and the VIX index at the level of about 15 points.

Gold prices, as specific indicator of stress and risk in global economy and at the financial markets, were substantially higher than in 2018, by 9.8% observed by the average prices level, while their increase was 18.3% in relation to end-2018. During 2019, the prices of gold experienced major oscillations, increasing from 1,300 $/oz to nearly 1,550 $/oz early in September, and dropping to 1.520 $/oz towards the year-end.

Graph 2.3

10-Year Government debt Bond Yields in the euro area, 2018–2019, %



Source: Bloomberg

The stock markets in developed countries were quite optimistic, although with a lot of volatility, so the leading indices mostly achieved a notable growth compared to the end of the year, or only a slight increase (in some even a decline) relative to the average annual value. At the same time, some indices, such as the New York *DJIA*, reached historically the highest values in 2019, while the London *FTSE 100* or the Frankfurt *DAX* reached values close to record. On the other hand, the stock exchange index MSCI for emerging and developing markets increased by 15.4% compared to the end of 2018, and viewed through the average values in 2019 compared to 2018 recorded a decrease of 5.2%.

In addition to the record high values of stock exchange indices, the values of real estate in most developed countries were at the historically highest levels in 2019, such as in the USA where nominal real estate prices were well above pre-Global Financial Crisis values. Moreover, in some developed countries, real estate prices were at record levels. The factor that undoubtedly influenced the growth of real estate prices (as well as the growth of financial asset prices) in the period after the Global Financial Crisis is the policy of historically low interest rates of leading central banks. Certain parameters, however, showed that no significant bubbles were formed - which was the position of the Fed management, although in Europe these developments were recognized as a problem by a growing number of relevant institutions, and they were addressed by various macroprudential policy measures and/or other policies to preserve financial stability.

However, a significant downward adjustment in real estate prices will inevitably occur due to the coronavirus pandemic, which will vary by the country, among other things, depending on the extent to which real estates was previously overvalued.

[13] TED spread is the difference between the three-month LIBOR and the interest rate on three-month U.S. treasury bills in percentage points.

[14] A measure of the expected volatility of the US stock prices.

Box 2.1 – Coronavirus pandemic and measures of leading central banks

In response to the coronavirus pandemic, central banks intensified expansionary monetary policy and introduced unprecedented additional programs and measures, mainly in March and April 2020.

In response to the coronavirus-induced crisis, the Fed cut the reference interest rate twice in March 2020, to 0% - 0.25%, the rate was last seen in December 2015. Also, at end-March, it was decided to intensify the quantitative easing, i.e. to start conducting new purchases of government and agency securities in whatever the amount necessary to stabilize the functioning of the market, i.e. to encourage favourable credit conditions for households and businesses.

In response to the crisis, on 12 March 2020, the ECB decided to make new purchases of securities in the amount of the mentioned monthly purchases, in the total amount of 120 billion euros by the end of 2020. Then, on 18 March, the ECB decided to add the amount of 750 billion euros of new securities purchases by the end of the year under a separate urgent asset purchase program related to the pandemic[15]. Furthermore, additional long-term refinancing operations have been temporarily introduced (*LTRO*), while a number of conditions concerning the third series of targeted long-term refinancing operations (*TLTRO III*) have been made very favourable, all with the aim of reducing liquidity pressures and creating the most favourable financial conditions in the markets. Also, on 7 April, a number of measures were introduced to relax the criteria for collateral for the Eurosystem credit operations. One of them was suspending the minimum credit rating criteria for Greek sovereign debt as collateral in the Eurosystem credit operations.

Also, the ECB's supervisory function has introduced a number of measures within its scope. Most importantly, banks are allowed to use capital according to the so-called second pillar guidelines, capital preservation buffers, as well as the use of liquid assets previously accumulated in order to meet the regulatory requirements for the liquidity coverage ratio. In addition, partial use of lower quality equity instruments instead of those that are qualified as regular core capital is allowed, including more flexible prudential treatment of loans for which states have provided guarantees or introduced moratoriums, flexibility in calculating expected credit losses (*ECL*) in the context of IFRS 9, and a recommendation to suspend the payment of dividends by banks to their shareholders was adopted[16].

The Bank of England halved its interest rate in March 2020, setting it at a historical low of 0.1%, and introduced several other measures in response to the coronavirus crisis.

In the context of quantitative easing, during the first quarter of 2020, the assets of the Fed, the Eurosystem, and the Bank of Japan rose by 26.1%, 7.9%, and 3.7%, respectively.

Also, the coronavirus crisis led to a sharp increase in yields on ten-year government debt in mid-March 2020, with those government securities that were perceived as safer less pronounced and ultimately such that the average yields on them in the first quarter, and especially in March, were even lower than in 2019 (Germany, USA). On the other hand, for the other abovementioned euro area countries, growth of yields was more pronounced but the average yields on their securities were still lower

[15] *Pandemic Emergency Purchase Programme*, PEPP.

[16] In addition to the ECB measures, many central banks or other institutions in the euro area countries, in the role of the so-called appointed or competent bodies for individual capital buffers, abolished or relaxed capital requirements based on capital buffers, either at the system level or for individual banks (depending on the type of buffer). In addition to measures in the form of capital buffers, many other measures in the field of macroprudential policy have been adopted.

in March 2020 than in 2019. Additionally, although daily spreads relative to Germany were on the rise for many of these countries in mid-March, the average spread was not significantly higher than the average spread in 2019, and for some of the countries it was even smaller.

3. DOMESTIC ECONOMIC ENVIRONMENT

3.1. General macroeconomic developments

According to preliminary Monstat data, real annual GDP growth of 3.6% was recorded in 2019. Data by industries shows that overall growth was spurred by growths reported in the tourism, construction, retail trade and mining and quarrying sectors. According to the GDP components of by the consumption method, the growth was driven by the growth of personal spending of households (contribution of 2.1 percentage points) and a decline in the negative balance of visible exports (1.2 percentage points) compared to 2018.

The preliminary growth rate of 3.6% is significantly higher than the projections of the Ministry of Finance of 2.8% as of early 2019 or the estimate of 3.1% from the beginning of 2020[17]. This is due to a significantly lower growth rate of visible imports and higher growth than projected in the categories of government spending and changes in inventories. Nevertheless, this rate represents a significant slowdown of economic activity after an average annual growth of 4.9% in 2017 and 2018.

Before the onset of the coronavirus crisis, the Ministry of Finance forecasts indicated that growth rates in 2020 and 2021 would be 3.4% and 2.8%, respectively. According to the pessimistic scenario, which was mainly based on the slower dynamics of investments, as well as on the significantly slower growth of tourism revenues, the Ministry of Finance forecasted growth of 1.4% and 1.9% for the same years.

According to the CBCG model projection made before the pandemic, the central projection of the GDP growth rate in 2020 was 3.3%. The projected rate reflected growth in domestic spending, private investments, and exports mainly driven by tourism spending. However, after the appearance of the coronavirus, the movement of real GDP in Montenegro in 2020 will deviate significantly from that previously projected. The impact of the coronavirus pandemic was difficult to project precisely and reliably at the time of writing as it is not known how fast the virus will spread or how long it will last. Also, it is a type of shock that we have not faced before and there is no basis from which to use some initial assumptions for the forecast[18].

On the other hand, before the pandemic, international institutions' estimates of GDP growth for Montenegro in 2020 ranged from 2.5% to 3.1%. Unfortunately, new forecasts show that the recession in Montenegro in 2020 is almost certain, as for many other countries. Thus, the IMF forecasts a decline in Montenegro's 2020 GDP of 9%[19], and the World Bank projects a decline in the range of -5.6% to -9%[20].

[17] The latest estimates from the European Commission also indicated a growth rate of 3.1% (*Autumn 2019 Economic Forecast* , November 2019).

[18] A number of leading central banks ceased to publish new forecasts, such as the Fed or the Bank of France.

[19] *World Economic Outlook*, 14. April 2020.

[20] *ECA Economic Update Spring 2020*, 29 April 2020.

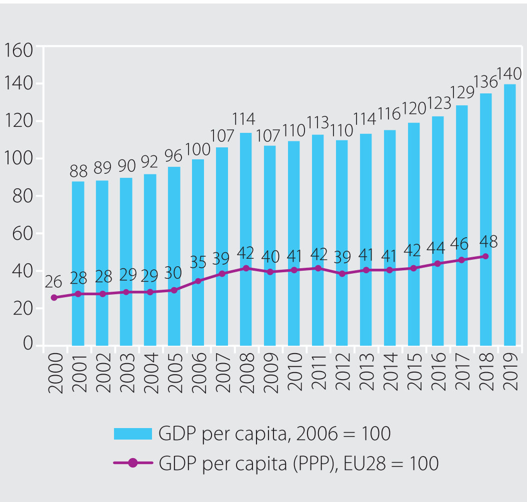
One of the key problems will be that restrictive health measures directly affect tourism, which is the main economic activity in Montenegro. The World Tourism Organization forecasts a decline in foreign tourist arrivals in the world by 20-30%, with a decline in tourism revenues by almost one third in comparison with the decline of foreign tourist arrivals during the Great Recession in 2009 which amounted to 4%[21]. Based on data on foreign tourist arrivals in member countries, the OECD forecasts a 45% drop in world tourism in the restrictive measures scenario by the end of June, or 70% if restrictive measures last until the end of August[22]. Standard & Poor`s, in extensive budgets for a large number of individual countries, simulated the effects of declining tourism revenues by 11%, 19% and 27%, which would hit Montenegro's GDP in 2020 by -2.2 percentage points, -3.9 percentage points and -5.5 percentage points, respectively.[23]

However, what is encouraging is that after such crises, economic recovery is much faster than after classic crises. Therefore, international financial institutions project a high growth of economic activity in Montenegro in 2021. According to the IMF projection, the growth of Montenegro in 2021 should amount to 6.5%, and according to the World Bank projection 3.6%.

Historically, real GDP per capita in 2019 was 40.3% higher than the one achieved in 2006, and 23% higher relative to that in 2008 due to low average growth rates in between 2009 and 2014 and partly due to an increase in the population in Montenegro over the same period[24]. Observed by purchasing power parity, Montenegro`s 2018 GDP per capita amounted to 48% of the EU average compared to 41% in 2014 and 42% in 2008. Convergence in relation to the EU was thus ceased in the aftermath of the 2008/2009 economic and financial crisis, after the growth from 26% to 42% during the period 2000–2008. However, Montenegro's growth recorded in the period 2015-2018 induced a substantial advance in regards to convergence, which will be further enhanced after the 2019 data processing by Eurostat.

Graph 3.1

Montenegro's GDP per capita, 2000–2019



Source: MONSTAT, Eurostat, CBCG calculations

Measured by consumer price index, prices increased by 1% in December 2019 y-o-y, which was a slowdown of inflation compared to 1.6% from December 2018. In general, the December average of inflation rates for the period 2010–2019 amounted to 1.6%, currently showing no substantial inflation or deflation risks, if observed in medium-term. Historically, price stability in Montenegro has been constant since the introduction of the euro as the legal tender, with minor oscillations over the years.

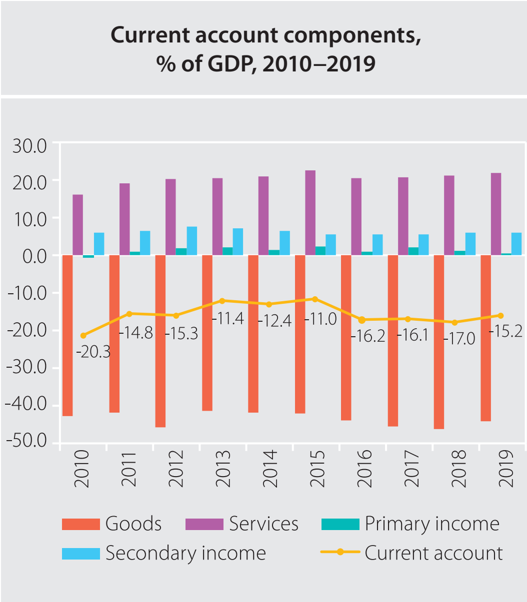
[21] *International tourism arrivals could fall by 20-30% in 2020*, 27 March 2020.

[22] *Stress Scenario: The Sovereigns Most Vulnerable To A COVID-19-Related Slowdown In Tourism*, 17 March 2020.

[23] *Tourism Policy Responses*, 31 March 2020.

[24] CBCG assessment.

Graph 3.2



Source: IMF, CBCG calculations

The current account deficit amounted to 743.6 million euros in 2019 or 15.2% of GDP, which was a significant increase compared to a deficit of 792.8 million euros or 17% of GDP in 2018. As expected, this deficit was generated by the balance in the goods account, which amounted to -2.07 billion euros (compared to -2.05 billion euros in 2018), the deepening of which was offset by a more positive balance on the services account compared to the previous year. The goods account deficit widening was driven by an increase in the visible imports from 2.49 billion euros to 2.53 billion euros. To an extent, such a rise in the goods deficit was to be expected in view of the implementation of significant infrastructure projects[25].

As in the previous years, the 2019 deficit was primarily funded by foreign direct investments and their net inflow of 344.7 million euros or 7% of GDP. In addition, the deficit was significantly financed by new/net government borrowings on international markets through securities (portfolio investments), in the amount of 318.9 million euros. Historically, the permanent current account deficit was financed through foreign direct investments but also through portfolio investments and other foreign investments, with the accumulation of Montenegro's external debt taking place in parallel, in all resident sectors, not only public sector, although public external debt was the most emphasized.

3.2. Position of non-financial institutions[26]

In 2018, the debt of non-financial institutions to banks saw a rise[27] from 1,031.8 million euros to 1,074.6 million euros, thus ceasing a general standstill of this debt initiated after 2011 and following the extensive deleveraging recorded between September 2008 and end-2011. In relation to GDP, deleveraging of non-financial institutions continued after 2011, albeit at slower pace, resulting in the debt balance of 21.9% of GDP at end-2019 (compared to 22.1% at end-2016 and 29.8% of GDP at end-2011). A new debt of non-financial institutions based on new loans taken from banks in 2019 amounted to 554 million euros, which was 5% more y-o-y. In reference to the purpose, new debts mostly referred to loans granted for liquidity for working assets of 49.4% (60% in 2018). This had been the most common type of loan granted to non-financial institutions for years[28].

[25] Observed in relation to GDP, the trade deficit and visible imports decreased in 2019 compared to 2018.

[26] Since Montenegro does not have the financial account statistics. i.e. an overview of financial assets and liabilities by all institutional sectors of the economy, the position of non-financial institutions and households is primarily monitored through their relationship with Montenegrin banks through data the latter submit to the CBCG.

[27] Non-financial institutions cover resident business entities (private and state companies), and entrepreneurs.

[28] These data refer to all legal persons but they are sufficiently representative, since 76.2% of total debt arising from loans to legal persons in 2019 referred to non-financial institutions.

As deposits of non-financial institutions fell to the level of 1.05 billion euros during the year, at the end of 2019, non-financial institutions again became a net debtor of the banking sector after a few years in the amount of only 26.2 million euros or 0.6% of total bank assets. This situation much different than that in April 2009 when non-financial institutions were a net debtor with as much as 36.8% of banks' total assets.

However, it is worth mentioning that the actual balance of indebtedness of non-financial institutions cannot be viewed only through their debt to banks since the latter sold the major part of their assets to third parties, mostly parent banks, either through factoring companies founded by them or through other entities for purchase of receivables. Banks sold assets in the amount of 882.2 million euros between 2006–2019. A significant portion of the sold assets referred to non-performing loans (debt) of nonfinancial institutions, which is still present in debtors' balances.

At end-2019, the number of frozen business entities in the CBCG's enforced collection system was 14,605, which is the annual increase of 2.9%. In relation to the total number of 48,278 active business entities, 30.3% of them were frozen, i.e. 2.7 percentage points less than at the end of 2018. Total debt based on which business entities were frozen amounted to 616.2 million euros, or 3% less compared to the previous year. Due to high debt concentration, the debt of the top ten borrowers stood at 111.9 million euros (18.2% of debt), and that of the top 50 borrowers was 249.7 million euros (40.5% of debt).

A total of 2,202 economic entities were under uninterrupted account blockage up to 365 days with the frozen amount of 30.2 million euros, whereas a total of 12,403 economic entities were blocked over 365 days, with the frozen amount of 586 million euros, accounting for 95.1% of the total frozen amount, thus this debt will remain uncollectable for the most part. However, sound non-financial institutions seem to have increased their deposits, which is indicative of the improved liquidity.

When it comes to the maturity of non-financial institutions` debt to banks, debts maturing after three years accounted for the main share of 55.5% at end-2019 (56.4% at end-2018)[29]. Debt with the agreed maturity of over one-year made up 77.5% of debt. In reference to the debt currency structure at end-2019, debts in euros accounted for 99.7%, while a mere 0.3% referred to debt in other currencies, which was a situation that has not changed essentially over the past years.

Although still relatively poor, the quality of debt of non-financial institutions to banks additionally improved during 2019. According to the banks' classification, non-performing loans amounted to 80.4 million euros at end-2019 compared to 107.2 million euros at end-2018. Thus, the share of non-performing debt in total non-financial institutions' debt declined from 10.4% to 7.5% (35.6% at end-Q1 2013). However, in addition to repayment by debtors, decline of this share in recent years was influenced by at least two important factors: 1) transfer of significant amounts of non-performing debt outside the balance sheet of banks, and 2) write-offs of non-performing debt from the balance sheet of banks.

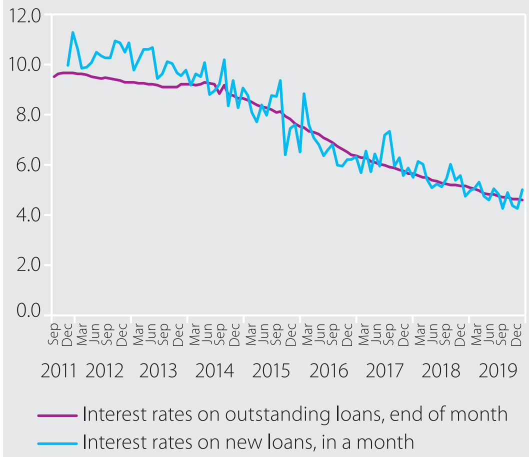
In 2019, the average interest rate on total non-financial institutions' debt based on loans declined further from 5.2% to 4.7%, signalling a continuance of the rate's downtrend. Similarly, this year, the

[29] Data are given according to the initially agreed maturity.

average interest rate on new loans declined from 5.5% to 4.9% (compared to 10% in 2012)[30]. The price of borrowing of non-financial institutions was still substantially high although it significantly dropped in the last five years. Moreover, this decline in the price of borrowing was not enough to substantially change the nonfinancial institutions' position, which serves as a confirmation that a lower borrowing price is just one of the prerequisites for achieving profitability and international competitiveness of these institutions. When it comes to non-financial institutions, structural factors, that is, the overall business environment plays a more significant role.

Graph 3.3

Interest rates on debt of non-financial institutions, %, 2012–2019



Source: CBCG

3.3. Households' position

In 2019, the households' leverage towards banks additionally increased[31] from 1.25 to 1.36 billion euros, strongly fuelling this debt`s growth initiated in 2013 after a period of deleverage between September 2008 and end-2012. The level of indebtedness of the population thus reached its historically peak. Observed in relation to GDP, the debt of the population increased by 0.9 percentage points in 2019 (amounting to 27.7% of GDP), following a growth of 0.8 percentage points in 2018. Prior to that, the debt of the population in relation to GDP generally stagnated in the period 2013-2017 (25.5% of GDP at end-March 2013 and 26% of GDP at end-2017). Debt of the population to banks became higher than the leverage of non-financial institutions for the first time in 2016, which intensified in the period 2017-2019.

In 2019, households` debt based on new loans amounted to 507.4 million euros, which was an increase of 2.7% y-o-y. In reference to purpose, as much as 69.2% (68.9% in 2018) of the new debt referred to cash loans (all-purpose loans), which has been the most represented type of loans to the household sector for years. In addition, new leverage based on loans for apartment purchase and refurbishing declined both in absolute terms from 71.7 million euros to 84.5 million euros and as a share in total new households' leverage from 14.5% to 16.7%.

The multi-year net creditor position of households to banks was reversed to a net debtor position during 2019 due to a steady growth of retail loans and a simultaneous slight decline in retail deposits, which amounted to 1.32 billion euros at the end of 2019. At end-2019, net debtors position of house-

[30] The rate is obtained by weighting monthly interest rates on new debt with monthly amounts of new debt.

[31] Households also include resident natural persons.

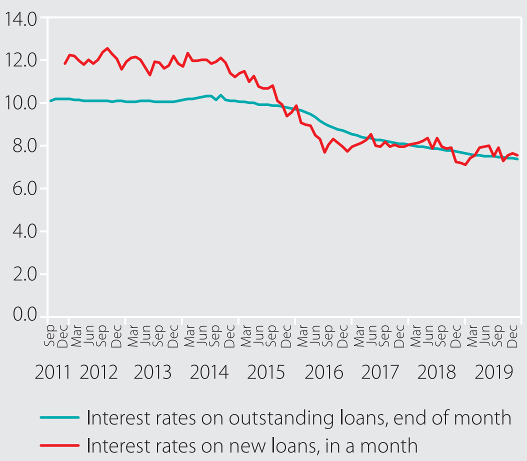
holds accounted for 0.9% of total assets of banks compared to net creditor position of 1.8% at end-2018, while at end-April 2009, households was net debtor of the banking sector in the amount of 12.9% of total assets of banks.

With regard to the maturity of the households' debt to banks, the debt with maturity of over three years accounted for the main share of 93.1% of debt at end-2019 (92% at end-2018), mainly due to the cash loans-based leverage[32]. Debt with the agreed maturity of over one year made up 98% of debt. In reference to the debt currency structure, the debt in euros accounted for 99.7% at end-2019, while just 0.3% referred to debt in other currencies, thus showing a continued downtrend in the share of debt in other currencies, primarily in CHF.

The quality of debt of households to banks additionally improved during 2019. According to the banking classification, non-performing debt of households amounted to 53.6 million euros at end-2019 compared to 53.4 million euros at end-2018. Thus, the share of non-performing debt to total debt of households declined from 4.3% to 3.9% (compared to 12.6% at end-Q1 2013).

Graph 3.4

Interest rates on households' debt, %, 2012–2019



Source: CBCG

An average interest rate on total households' debt based on loans additionally declined during 2019 from 7.8% to 7.5%, continuing the rate's downtrend initiated after 2014. Similarly, the average interest rate on new leverage declined from 8.1% to 7.8% in 2019 (compared to 12% in 2012)[33]. However, the price of households' leverage is obviously still high despite its substantial decline in the last five years.

According to the Labour Force Survey, the unemployment rate was at the level of 15.1% in 2019, which was only 0.1 percentage points lower than in 2018, while according to the Employment Agency of Montenegro, the unemployment rate stood at 16.21% in December 2019, which is a decrease of 1.62 percentage points. After a substantial decline in unemployment during the last boom (2006-2008), when it dropped from 30.3% in 2005 to 16.8% in 2008, the rate saw a mild downtrend followed by oscillations in some of the subsequent years, clearly indicating a prominently structural character of unemployment in Montenegro.

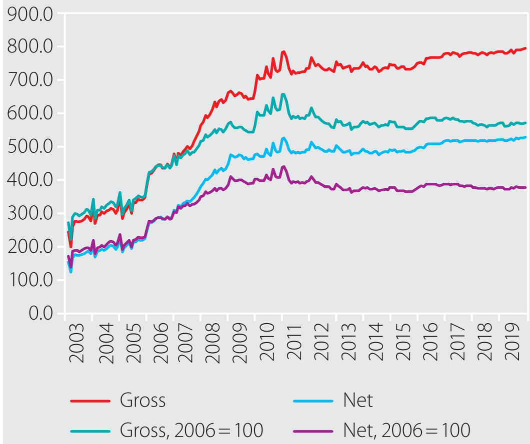
[32] Data are given according to the initially agreed maturity.

[33] The rate is obtained by weighting monthly interest rates on new debt with monthly amounts of new debt.

Observed through the average 12-month data, nominal net wages rose by a mere 0.8% in 2019, from 510.8 euros to 514.7 euros (mostly resulting from fiscal consolidation), which was their highest annual level since the introduction of euro as the legal tender in Montenegro. On the other hand, real net wages saw an average increase of 0.4% in 2019[34]. However, they remain below the historical maximum recorded in 2010. Compared to 2006, both nominal and real wages increased, by 81.9% and 31.6%, respectively.

Graph 3.5

Nominal and real wages in Montenegro, in euros, 2003–2019



Source: Monstat; CBCG calculations

3.4. Government finances

The 2019 government budget recorded a deficit of 143.6 million euros (2.9% of GDP) or 1 million euros above planned. Its structure shows that revenues were 51.1 million euros higher than planned (2.8%), primarily revenues from VAT (37.8 million euros or 5.7%), and even from health insurance contributions (8.9 million euros or 5%). On the other hand, expenditures were 52.1 million euros or 2.6% higher than planned. Expenditures increased primarily due to higher capital expenditures in the current budget (33.1 million euros or 56%) and repayment of guarantees (29.3 million euros or 310 %), followed by higher interest expenditures (9.9 million euros or 10.4%) compared to the plan. The lower execution of the capital budget compared to the plan (23.5 million euros, or 8%) acted in the direction of reducing expenditures. The budget plan for 2019 also planned the position of „repayment of liabilities from previous years“, and it was relatively successful, since expenditures amounted to 20.7 million euros compared to the planned 18.5 million euros.

The budget deficit has been recorded for eleven consecutive year, averaging 4.8% of GDP in the period 2009–2019. If it gets confirmed by the budget annual accounts, the deficit in 2019 would be the lowest one in that period.

According to the latest Ministry of Finance data on debt, the balance of public debt, amounted to 3.8 billion euros or 77.2% of GDP as at 31 December 2019, of which external debt made up 3.13 billion euros, internal debt was 580 million euros and debt of local self-governments accounted for 80.4 million euros[35]. Thus, the public debt increased by 7.1 percentage points of GDP during the reporting year after

[34] The calculations were made by deflating nominal wages by the consumer price index, i.e. the cost of living index using 2006 as the base year.

[35] Net public debt amounted to 3.2 billion euros, or 65% of GDP.

a growth of 5.9 percentage points of GDP in 2018. Previously, the debt decreased during 2016 and 2017 by an average of 1 percentage point of GDP. In that two-year period, debt grew by an average of 6.8% per year in absolute terms, but it declined in relation to GDP, due to stronger nominal GDP growth relative to public debt growth.

Table 3.1

Main categories of Montenegro's budget, 2018–2020

	2018 (statement of accounts)		2019 (estimate)		2020 (Plan)	
	million euros	% of GDP	million euros	% of GDP	million euros	% of GDP
Budget revenues	**1,746.0**	**37.4**	**1,885.1**	**38.4**	**1,988.4**	**39.6**
direct taxes	717.5	15.4	744.1	15.2	747.1	14.9
indirect taxes	875.9	18.8	974.9	19.9	996.6	19.8
non-taxable income	152.6	3.3	166.1	3.4	244.7	4.9
Budget expenditures	**1,914.9**	**41.1**	**2,028.8**	**41.3**	**2,038.3**	**40.5**
Current expenditures	1,650.2	35.4	1,756.4	35.8	1,808.4	36.0
Wages, gross	459.8	9.9	472.9	9.6	502.8	10.0
Transfers for social welfare	544.5	11.7	554.4	11.3	577.7	11.5
Capital expenditures	264.7	5.7	272.4	5.5	230.0	4.6
Surplus/deficit, cash	**-168.9**	**-3.6**	**-143.6**	**-2.9**	**-50.0**	**-1.0**
Net increase/decrease of liabilities	28.1	0.6	-	-	-	-
Surplus/deficit, adjusted	**-197.0**	**-4.2**	-	-	-	-

Source: Ministry of Finance

Debt arising from Eurobonds accounts for a significant share in the external debt. Montenegro entered the international bond market for the first time in September 2010 and there have been seven Eurobond issues since. The first five issues are repaid, so the current outstanding issues are those from 2016, 2018, and 2019. In mid-April 2018, a Eurobond issue in the amount of 500 million euros was executed under a 7-year maturity and at the interest rate of 3.375%. Among other things, a part of the principal of bonds issued in 2016 was repurchased in the amount of 72.6 million euros (which reduced the debt to 227.4 million euros). Then, at the beginning of October 2019, there was a Eurobonds issue of 500 million euros, with the agreed maturity of ten years and the interest rate of 2.55%.

Government budget realised a portion of its funding needs through four issues of bonds in the Montenegro Stock Exchange, bearing in mind surpluses of liquid assets of banks and their conservatism in lending to non-financial institutions and households. At the beginning of March 2018, the issue from March 2014 was fully repaid, and in mid-November 2020, the issue from 2016 will be repaid. In addition, in the second half of April 2019, the state issued two series of bonds. Seven-year bonds in the planned amount of 50 million euros and at the interest rate of 3.5% were sold through one tranche, with the realization of the amount of the issue slightly above the planned. Five-year bonds with an interest rate of 3% were sold through two tranches, but even after the second tranche, the planned issue amount of 140 million euros was not executed[36].

[36] In the first tranche, 24.6 million euros were collected, and 67.8 million euros in the second tranche conducted at the end of May.

Recent issues of Eurobonds and bonds issued on the Montenegro Stock Exchange have significantly extended the average maturity of bond debt, and the cost of borrowing has been declining for years. However, in the meantime, the period 2020-2021 will be very challenging for public finances, especially in the context of the coronavirus crisis. Namely, in November 2020, 80.4 million euros for bonds issued on the Montenegro Stock Exchange in 2016 will have to be paid. In March 2021, the amount of 227.4 million euros of Eurobonds non-redeemable principal from 2016 will have to be paid. Also, the repayment of the loan for funding highway will begin in 2021, which will additionally pressure the government finances. Namely, the subject of the loan arrangement for highway signed in October 2014 with the Chinese Exim Bank is a loan of 944 million U.S. dollars with a 6-year grace period and a 14-year repayment period after the expiry of the grace period. As at end-2019, the debt towards Exim Bank stood at 671.7 million euros (translated into euros), and every new withdrawal will increase the public debt arising from that loan.

In the medium term, it is expected that the withdrawal of funds based on the loan with Exim Bank will contribute to a further increase in Montenegro's debt in other foreign currencies in the medium term - a couple of percentage points more from the current 20%. This will significantly expose the country to a risk of the euro depreciating against the US dollar, so before the start of loan repayment, it is planned to conclude a hedge agreement, which is still a current issue and the subject of intensive activities of the Ministry of Finance.

Prior to the coronavirus pandemic, the Ministry of Finance projected a public debt growth to drop notably to 62.5% of GDP in 2022, while the lower-growth scenario projection for the same year was 68.3% of GDP.

At end-2019, the balance of debt arising from government guarantees stood at 244.3 million euros or 5% of GDP. Moreover, the balance of debt arising from external guarantees amounted to 199 million euros (4.1% of GDP), while the balance of debt on domestic guarantees was 45.4 million euros (0.9% of GDP). At the end of 2018, the balance of debt on guarantees amounted to 287.5 million euros or 6.2% of GDP. In general, the state pursued a moderate and prudent policy of issuing guarantees in the recent period since they are given in a relatively limited number and exclusively for infrastructure and development projects. In the period 2016–2018, only three guarantees were issued for loans given to the Railway Infrastructure of Montenegro, PE „Regional Water Supply" and the Montenegrin Electricity Transmission System. In 2019, six guarantees were issued: three for loans given to the PE "Regional Water Supply of the Montenegrin Coast", one for loans given to each of the Railway Infrastructure of Montenegro, Elektroprivreda Crne Gore, and the Housing Association of Teachers of Montenegro „Solidarno".

4. FINANCIAL SYSTEM

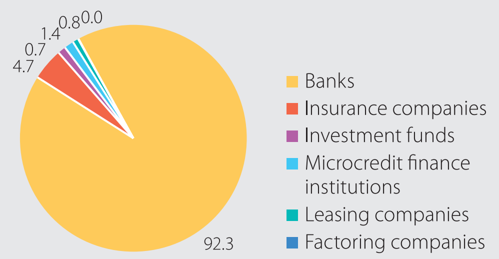
At the end of 2019, total assets of the financial sector of Montenegro reached 5 billion euros, which compared to GDP amounted to 101.6%. In the structure of the financial sector of Montenegro during 2019, there were no major changes compared to the previous period. Banks play the central role in financial intermediation as their assets make up 92.3% of total assets of the financial sector. At the end of 2019, there were 13 banks operating in Montenegro, whose capital was in majority foreign ownership (79.7%). In respect to the country of origin of the foreign capital, three main proprietary interests originate from Austria, Hungary, and Slovenia.

In terms of importance, insurance companies accounted for 4.7% of total assets of the financial sector at the end of 2019 and they represent a growing segment of the financial system. According to the types of insurance, companies that deal with non-life insurance still prevail. The rest of the financial sector is small or relatively underdeveloped.[37]

Microcredit financial institutions, as a complementary structure to the banking sector, recorded high growth rates of assets in the last six years, which in 2019 amounted to 10.8%. The share of microcredit financial institutions in total assets of the financial sector was 1.4% at end-2019. Unlike the euro area countries, investment and pension funds and the rest of the financial intermediation sector in Montenegro are still underdeveloped. Moreover, at the end of 2019, there were no active pension funds[38].

Graph 4.1

Montenegro's financial sector structure, %, end-2019



Source: National supervisory authorities

During 2019, the Montenegrin banking market underwent changes that resulted in an increase in market concentration after its perennial decline. The first change was related to a reduction of the number of banks after the bankruptcy of two banks, which increased the shares of other banks in total assets and, consequently, the market concentration. The second change was *de facto* enlargement

[37] Investment funds, microcredit financial institutions, leasing companies, factoring companies and receivables repurchase companies.

[38] Two pension fund management companies lost their operating licenses, and liquidation proceedings were initiated in the pension funds managed by these companies.

of the market through acquisitions among existing banks in the system[39]. The third change was the increase in individual relative position of some banks in terms of assets, loans or deposits, regardless of the first two groups of factors.

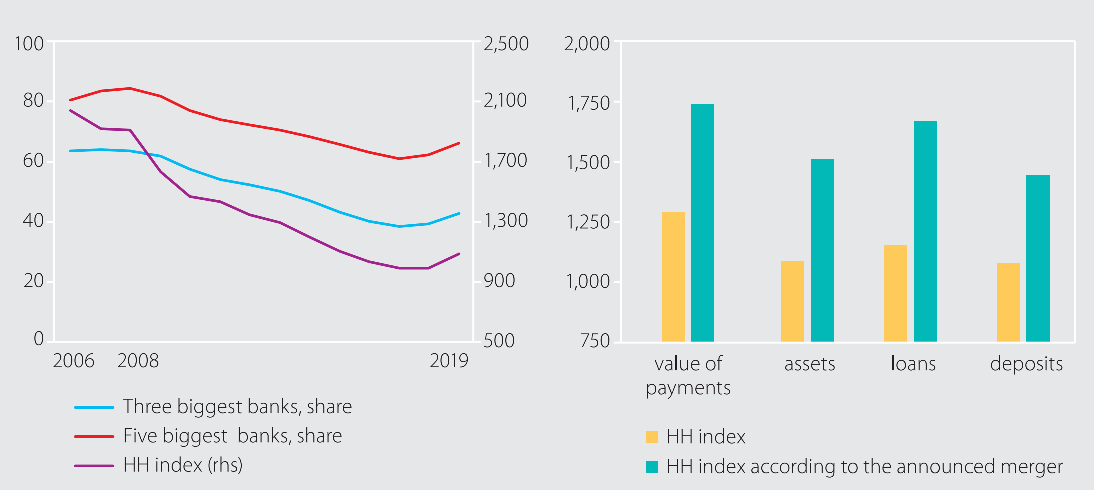
Given that the formal merger of Podgorička banka with Crnogorska komercijalna banka was announced for the end of 2020, the concentration of the banking sector according to the HH index was still relatively low (1,091 points). In reference to assets, the market share of three and five largest banks was declining, respectively amounting to 42.8% and 66.1% at end-2019.

If concentration and market share were viewed through the ownership dimension (merger of the two mentioned banks) then the situation would be significantly different. Namely, the market concentration according to the HH index would change from low to moderate, with an index value of 1,509 points. The three largest banks would account for over a half of total assets (54.6%), and the five largest banks for about three quarters of total assets. In loans and deposits, the three largest banks would cover 60.2% and 52.6% of the market, respectively.

If we observe payment operations, the market concentration was higher both in terms of the value of payments and the number of payments. At the end of 2019, according to the value of payments, three, five, and seven largest banks covered the market with 49.4%, 72.3%, and 87.6%, respectively. On the other hand, considering the system through the announced merger of the two mentioned banks, the market concentration measured by the HH index would be 1,738 points, while the shares of the three and five largest banks in payment transactions, according to the value of payments, would be 60.3% and 83.1%, respectively.

Graph 4.2

HH index, market shares (%), 2006–2019



Source: CBCG

[39] Crnogorska komercijalna banka AD Podgorica became the owner of Societe Generale Montenegro banka AD Podgorica, which temporarily returned the original name Podgorička banka AD Podgorica.

Box 4.1 – CBCG measures in relation to the coronavirus pandemic

The Central Bank of Montenegro acted very quickly in order to mitigate the negative effects of the coronavirus on financial stability. Thus, at its session held on 17 March 2020, the CBCG Council adopted a Decision on temporary measures to mitigate the negative effects of the new coronavirus on the financial system (OGM 19/20), and at the session held on 31 March 2020, the decision was supplemented with a couple of additional measures (OGM 28/20).

The key measure was the right to a moratorium, i.e. temporary suspension of payment of all debtors' obligations related to loan repayment for up to 90 days. During the moratorium, interest would not be charged but calculated, so upon expiration of the moratorium it will be added to the outstanding principal and then repaid through slightly increased annuities until the end of the extended loan repayment period. Such treatment of interest is typical and has been applied in all countries that have introduced moratoriums during the current crisis, that is, most countries in the region and a large number of countries in the EU. Also, during the moratorium period, the default interest cannot be calculated nor any legal action to collect the loan by the bank (including forced collection) can be initiated. Also, loans will not be reclassified to a lower classification group.

Second, a bank may approve a loan restructuring at a debtor's request, whereby the loan can be prudently treated as a new loan, if actual or expected negative impact of the coronavirus pandemic on the debtor's financial position can be proved and if the bank estimates that its financial position can improve after the restructuring. Loan restructuring can be carried out in the same way for those loans that are subject to the Decision on Macroprudential Measures Related to Retail Banking Loans, in such a way that, inter alia, the maturity of retail cash loans unsecured by adequate collateral can be extended to two more years.

Third, banks are prohibited from paying dividends to shareholders other than payments in the form of bank shares, and fourth, banks may, under certain conditions, break the exposure limits specified in Article 58 of the Banking Law. These measures apply accordingly to lessors and lessees and to microcredit financial institutions and users of their loans.

In the first few days of the implementation of the decision, ending on March 31, over 60 thousand debtors applied for the moratorium, with over 45% of debtors among natural persons and almost 75% of debtors among legal persons.

In general, the measures are calibrated so as to maximize the financial position of debtors, with large concessions from banks that will not have any cash inflows on the basis of loans included in the moratorium for up to three months. In addition to the adopted measures, the CBCG will carefully and continuously monitor the current epidemiological and economic situation, and act with all available measures, if necessary.

4.1. Banks' balance sheet structure

Despite the oscillations during the year, the balance sheet of banks increased this year as well, by 4.5%, and at the end of the year it amounted to 4.6 billion euros. Many balance sheet items reached record values at the end of the year - cash and deposit accounts with central banks, loans, securities, deposits, and capital.

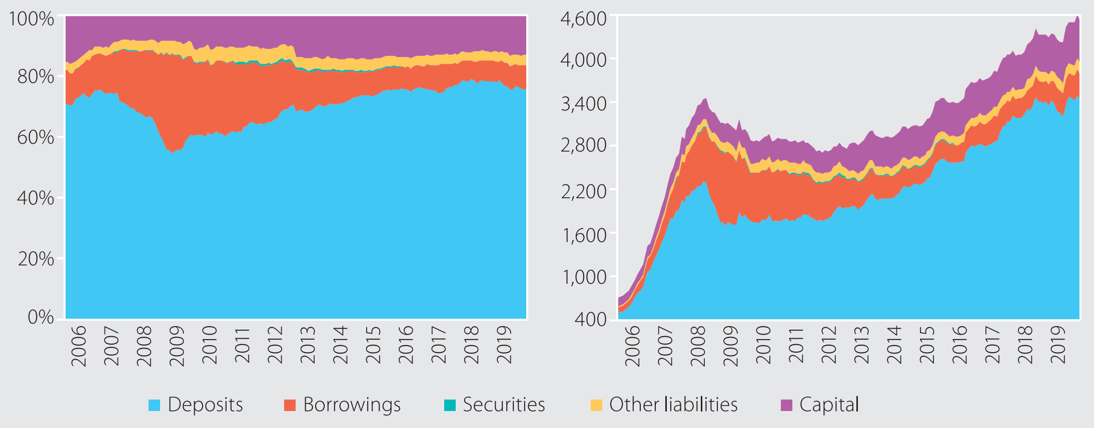
Deposits were the dominant source of banks' financing for many years and they accounted for 75.5% of liabilities at the end of the year. During 2019, deposits suffered a negative impact due to the reduction in the number of banks in the system. On the other hand, at the end of November 2019, deposits were at their historical peak (3.55 billion euros). However, at the end of 2019, the annual growth of deposits was only 0.5%[40], and they amounted to 3.48 billion euros. Also, in the context of mentioned changes in the banking sector, deposits of resident non-financial institutions and retail deposits recorded a substantial decline in Q2, and this was significantly offset in the second half of the year. However, at the end of 2019, deposits of these two sectors were lower than at the end of the previous year. On the other hand, general government deposits increased.

The share of non-resident deposits in total deposits increased slightly this year as well, to 22.6%. The largest decline in deposits was recorded among non-resident individuals. On the other hand, the largest annual growth of deposits was recorded in the non-resident non-financial sector, which compensated for the decline in deposits of non-resident natural persons.

Bank financing from borrowings increased in 2019, both in terms of amount and share in total liabilities. For certain banks, the share of borrowings in total liabilities is not negligible; however, for

Graph 4.3

Liabilities and capital: structure (lhs) and amount in million euros (rhs), 2006–2019



Source: CBCG

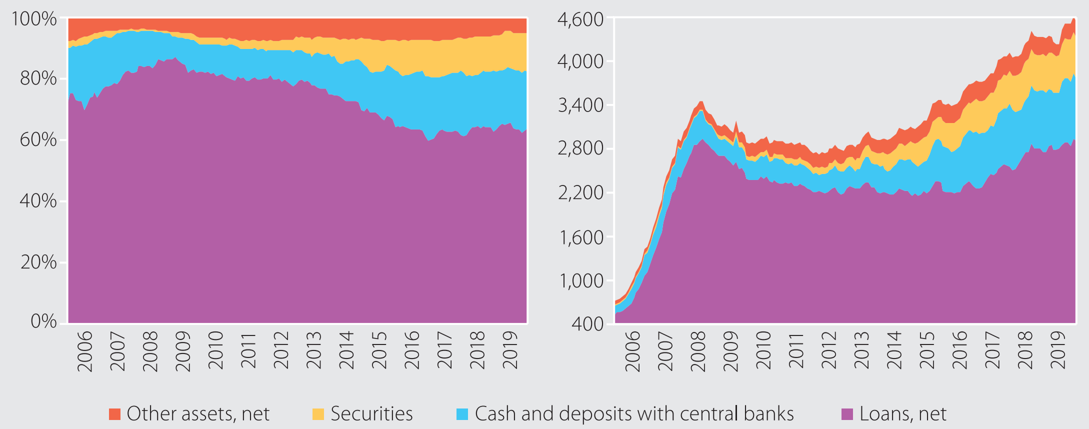
[40] If two banks in which bankruptcy was introduced at the beginning of 2019 were excluded from the data from the end of 2018 (database), the growth of deposits during 2019 would amount to 8%.

now, the growth of loans does not represent a systemic risk to financial stability in terms of amounts, maturities, and currency structure of borrowings.

On the assets side, some of the key positions in 2019 reached historically highs. Most importantly, in nominal terms, loans were higher than at the peak of the 2007/2008 credit boom. However, what represents a significant difference on the assets side between the credit boom years and today is the continuous increase in investment in securities. Thus, at the peak of the credit boom, net loans accounted for 84.8% of assets, while at the end of 2019 this share was 63.9%.

Graph 4.4

Assets: structure (lhs) and amount in million euros (rhs), 2006–2019



Source: CBCG

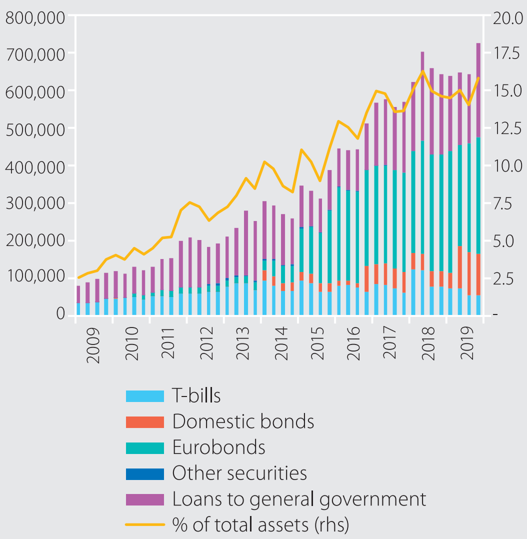
In 2019, banks continued to invest extensively in securities, and investments reached a double-digit growth (13.8%), accounting for 12.6% of assets. As in the previous period, most of new investments in securities related to government securities. The largest increase in investments was recorded in domestic government bonds (primarily in the second quarter), while banks maintained investments in Eurobonds at a similar level, and investments in T-Bills slightly decreased. The share of investments in securities outside the public sector also increased.

At the end of 2019, banks' exposure to the government increased to 16.1% of total assets, which amounted to 742.4 million euros[41]. This year, the government also used the possibility of new borrowings with banks (87 million euros), thus its liabilities to Montenegrin banks on this basis increased by 17.7% up to 257.5 million euros.

[41] The exposure relates to government securities and loans granted to the general government.

Graph 4.5

Banks' exposure to the General Government, in thousand euros and as % of assets, 2009–2019



Source: CBCG

Banks perceive all these investments as investments with favourable interest rates in relation to their risk ratio, which banks found especially attractive in recent years. In addition, regulatory risk weight for this type of investments is 0%, whereby banks make profit for this type of portfolio and do not have any related regulatory capital requirements.

The leading positions of banks' receivables from non-residents (deposits, cash and loans) fell in 2019. Total receivables from non-residents stood at 593 million euros or 12.9% of assets at end-2019. On the other hand, loans payable (borrowings) from abroad increased to 7.1% of total liabilities, while foreign deposits amounted to 19.7% of total liabilities of banks. Total liabilities to non-residents amounted to 1,096.9 million euros or 23.8% of total assets and liabilities. Thus, net foreign assets of banks stood at -10.9% of their total assets and liabilities at end-2019.

4.2. Credit growth and non-performing loans[42]

Solid lending activity of banks was also present in 2019, and the growth rate was 4.5%[43]. Previously, banks intensified lending in the period 2017 - 2018, with growth rates of 11.8% and 8.5%, respectively. Total loans reached the historically highest level in November 2019, while at the very end of the year, that sum amounted to 3.06 billion euros. Lending activity in terms of new loans amounted to 1.23 billion euros or 4.9% more than in the previous year, the highest in the past eight years.

The gap between the loan ratio of the non-financial sector[44] and GDP and the long-term trend of this ratio has remained negative (-5.5%), which is a trend since the fourth quarter of 2011. Looking at this analytical tool, it can be said that general credit growth, despite solid growth rates, at this moment, does not generate risks to the stability of the financial system[45].

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[42] Unless otherwise stated, the data on loans presented in this chapter, as well as in the rest of the report, refer to loans and other receivables of the credit type on a gross principle (with corresponding value adjustments), without accrued interest and prepayments and accruals of interest fees.

[43] Looking at the system without banks in which bankruptcy was introduced, credit growth was 11.7%.

[44] Resident natural persons (households and entrepreneurs) and resident non-financial institutions (state and private companies).

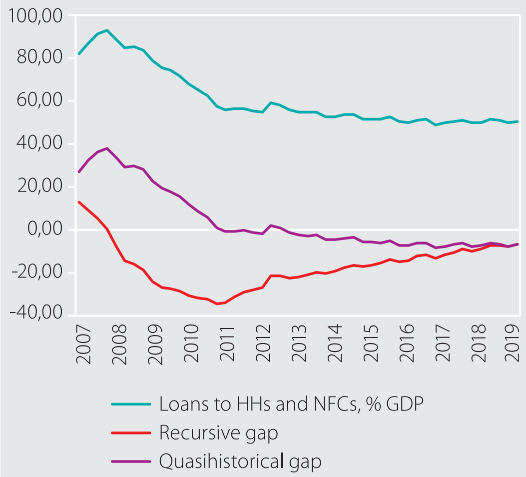
[45] The gap measures the difference between the current and the long-term trend of the loan/GDP ratio. In this case, the recursive gap refers only to the data available at the end of a given quarter and is calculated only for a given quarter ("ignoring" the data relating to subsequent quarters), while the quasi-historical gap is calculated for the last and all previous quarters taking into account all historical data available on 31 December 2019.

The largest share of banks' loan portfolio refers to retail loans (44.3%), which have been increasing over the past eight years. The annual growth rate of retail loans was positive in the last six years, and it averaged 11.1% in the period 2016 - 2018. At end-2019, this rate was 8.6%. Moreover, retail loans grew faster than nominal growth in economic activity for the fourth year in a row. It is quite clear that this sector is very important for banks and it was the loans of the retail sector that had the greatest impact on the total loans to reach their historical high in November 2019.

The same can be seen through the volume of new retail loans, which exceeded half a billion euros for the first time in 2019. Among new loans, one type of loans has stood out in recent years - cash loans, which banks have used as a substitute for other types of loans. Given the growing imbalance in the maturity and method of securing these loans, the CBCG responded with macroprudential policy measures. On the other hand, housing loans are the second largest type of new retail loans. Banks have intensified this type of lending in the past five years, granting new retail loans for this purpose in the amount of 346 million euros.

Graph 4.6

Credit-to-GDP gap, 31 December 2019, in percentage points



Source: CBCG

Box 4.2 – CBCG`s macroprudential measures involving retail loans

In October 2019, the Central Bank of Montenegro adopted the Decision on macroprudential measures related to retail banking loans (OGM 58/2019), which tightens the conditions for approving retail loans, primarily in terms of their security and maturity. The indirect goal of the CBCG is to take measures to establish sustainable retail lending, which has the ultimate goal of preserving stability of the financial system.

Namely, cash (all purpose) retail loans have been a key driver of credit growth in recent years. At the end of 2019, they accounted for 27.9% of total loans. For the purpose of comparison, cash loans accounted for 11.4% of loans at the end of 2012. Since that period, cash loans have grown at an average annual growth rate of 21.4%, which was 15.4% in 2019. Also, this type of loans becomes dominant in new retail loans. Over two thirds (69.2%) of new retail loans in 2019 were cash loans. Very similar trends in these loans were in other countries in the region, which has led many central banks to react to limit this segment of lending activity.

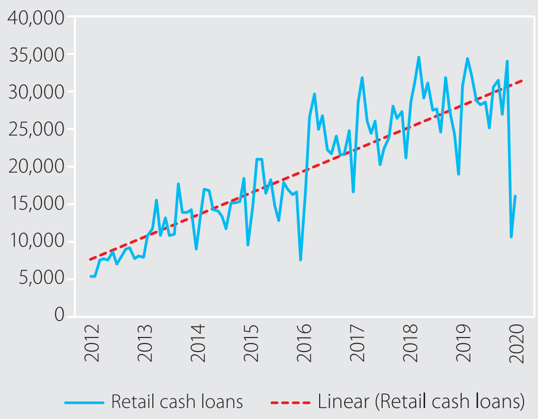
What was primarily important for these loans and what decisively influenced the CBCG to introduce these measures were disproportionately long maturities and weak collaterals. Thus, the CBCG prescribed that as of 1 January 2020, when approving retail cash loans whose repayment period exceeds eight years, banks must require that the loan is fully secured with quality collateral. In addition, banks that have an exposure to retail cash loans granted with the remaining repayment period of more than six years exceeding their own funds by 50% may approve retail cash loans with a repayment period of more than six years only if the loans are secured by quality collateral.

Also, banks are obliged to calculate individual debt ratios, *LTI, DTI, LSTI, DSTI*, and *LTV* for all types of retail loans and to keep records of these ratios and determine acceptable levels of these ratios separately for retail cash loans.

The following chart shows monthly trend of the amount of new retail cash loans and the effect of measures in the first months of 2020, which shows a clear decline in these loans.

Graph 1

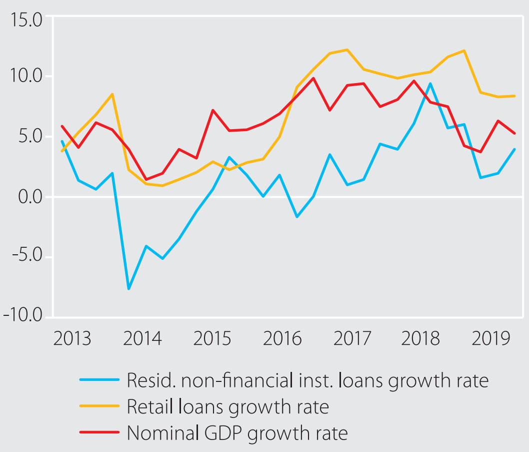
Monthly amounts of new retail cash loans in 000 euros, 2012 – February 2020



Source: CBCG

Graph 4.7

Annual growth rate of retail loans, resident non-financial institutions, and nominal GDP, %, 2013–2019



Source: CBCG

Loans of resident non-financial institutions account for 35.1% of total loans, and the share of these loans has been declining for many years. For the last seven years, only in two quarters, their growth rate was higher than the nominal GDP growth rate, and at the end of 2019 they were at 63.5% of their historical maximum in 2008. However, loans to the resident non-financial sector increased by 4.1% on the annual basis. Looking at the activities of resident legal persons, most loans were given to trade, construction, and accommodation and food services, respectively.

Observing by new loans, this is still the sector that banks finance the most (554 million euros in 2019). As in the previous years, the main share of new loans to resident non-financial institutions referred to loans for liquidity (working capital), where the corporate sector recorded the highest demand for loans with agreed maturity up to one year.

According to the results of the survey on credit activity for the fourth quarter of 2019[46], credit standards for total loans of non-financial institutions ("corporate sector" in the survey) were slightly tightened for companies of all sizes, with similar expectations for the first quarter of 2020. Banks cited the deterioration of the economic situation and higher collateral risk as key expected reasons for tightening credit standards for new loans. In terms of credit conditions, banks significantly reduced interest margins and commissions/fees for companies in 2019, regardless of their size, and the same was expected for the first quarter of 2020. As opposed to this, collateral requirements tightened during the year.

During 2019, banks recorded a large increase in demand for loans for all companies, regardless of their size and maturity. There were expectations for demand growth in the first quarter of 2020, primarily from large companies and for short-term loans. As factors of expected growth in demand for corporate financing, banks highlighted in the survey that companies needed working capital, debt restructuring, and capital investments.

Credit standards for total retail loans were eased during the year, to be tightened only in the fourth quarter, especially for consumer loans. Also, there were expectations for the continuation of tightening of credit standards in the first quarter of 2020, primarily for consumer loans. Banks estimated that interest margins and commissions/fees decreased during the year. The number of rejected requests for loans decreased mainly for all types of loans, and in the fourth quarter of 2019 it increased slightly for consumer loans.

Household demand for loans grew steadily during the year, which, however, was not expected for the first quarter of 2020. As a factor in the growth of demand, banks recorded the need for refinancing, but also purchase of real estate and durable consumer goods (cars, furniture, and the like).

In terms of FX risk, the loans' currency structure is still very favourable. The marginal part of loans (0.4%) refers to loans in other foreign currencies, which is a longer period and characterizes banks' loan portfolios.

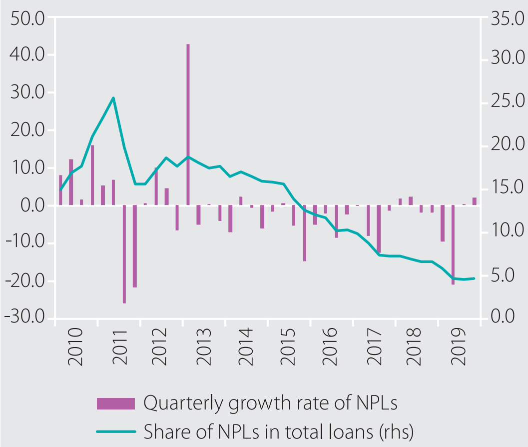
In reference to the maturity structure of loans as per initially agreed maturity, long-term loans accounted for 90% (not including credit-type receivables) at end-2019. However, observed in terms of remaining loan maturity, the share of long-term loans appears to be significantly lower, 68.7%.

Credit risk diminishing, observed through the share of non-performing loans, continued in 2019. The annual decline in the share of non-performing loans was significant and amounted to 2 percentage points, thus, non-performing loans at the system level accounted for 4.7% of total loans at the end of 2019. What largely pushed the share of non-performing loans down is the fact that two troubled banks went bankrupt. In addition, the shares and amounts of non-performing loans generally declined with banks covering 90% of the banking sector's assets.

[46] The survey was conducted before the onset of the coronavirus pandemic.

Graph 4.8

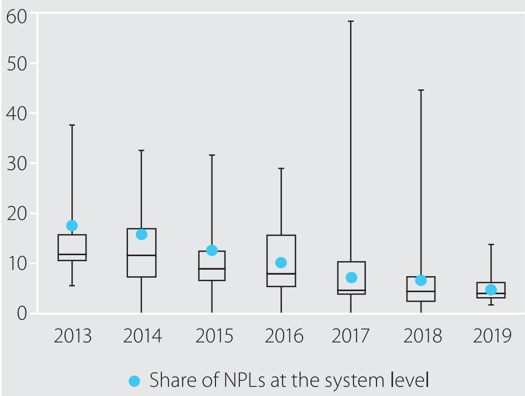
Quarterly growth rate of NPLs and share of NPLs in total loans, %, 2010–2019



Source: CBCG

Graph 4.9

Distribution of the share of non-performing loans and their share at the system level, %, 2013–2019[47]



Source: CBCG

At the end of this year, the amount of non-performing loans (144.6 million euros) was 26.5% lower than at the end of the previous year. In relation to GDP, the amount of non-performing loans continued to decline, which amounted to 2.9% at the end of 2019 (compared to 4.3% at the end of 2018). On the other hand, loans that were over 30 days past due (115.9 million euros or 3.8% of total loans) at the end of 2019 was 36.6% lower than at the end of 2018.

At the end of 2019, the dispersion of the share of non-performing loans by banks was significantly different compared to the previous two years. The range between the minimum and maximum at the end of 2019 was far smaller (due to the banks in which bankruptcy was introduced at the beginning of 2019), and also the gap between the first and third quartile was smaller. Only one bank had a share of non-performing loans more than 10%, while the next largest share of non-performing loans was 7.5%.

Growth was recorded by loans from category A, with a double-digit growth rate for this year as well (11.7%). In the previous two years, the growth of A loans was 11.5% in 2018 and 16.9% in 2017. This was also the expected trend, having in mind the huge inflow of new loans, which are on a continuous uptrend.

However, judging by the amounts of loans from categories B and C, credit risk increased in 2019 and loans from both categories recorded double-digit growths at the end of the year of 14.9% and 17.1%, respectively. The increase was present only in some banks, but could still be an early sign of credit risk increase, in the broader context of general credit growth.

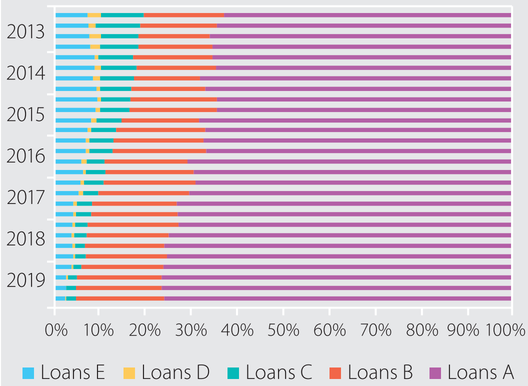
[47] Reading from the bottom up, the graph's horizontal lines for each year mark the minimum, first quartile, second quartile (median), third quartile and maximum.

Category D loans were by far the smallest and they declined further during the year. Finally, E category loans recorded a decline of 5.9%.

At the end of 2019, restructured loans amounted to 180.8 million euros and they accounted for 5.9% of total loans, and the amount of restructured loans was slightly lower (2.8%) compared to the end of 2018. The largest decline in these loans was recorded in loans to resident legal persons engaged in trade, as well as in retail loans. On the other hand, resident legal persons engaged in construction were the largest beneficiaries of restructured loans at the end of this year (42.5 million euros).

Graph 4.10

Trends of classified loans, 2013–2019



Source: CBCG

Credit risk arising from the part of the portfolio related to resident non-financial institutions, judging by the amount of non-performing loans, decreased this year as well. The annual decline in the amount of these loans at the end of 2019 was 26.5%, while their share in total loans of resident non-financial institutions fell from 11.4% to 7.6%. It should be noted that this is a trend that has lasted for many years. For comparison, NPLs of non-financial institutions amounted to 14.5% of total loans at the end of 2017 and 19.8% at the end of 2016. The share of loans more than 30 days past due in total loans of resident financial institutions stood at 5.3%.

The highest concentration of non-performing loans is still with resident legal persons engaged in trade and construction (9.4% and 7.7%, respectively), with bank receivables on NPLs of these persons being significantly lower compared to the previous year (14% trade and 20.2% construction).

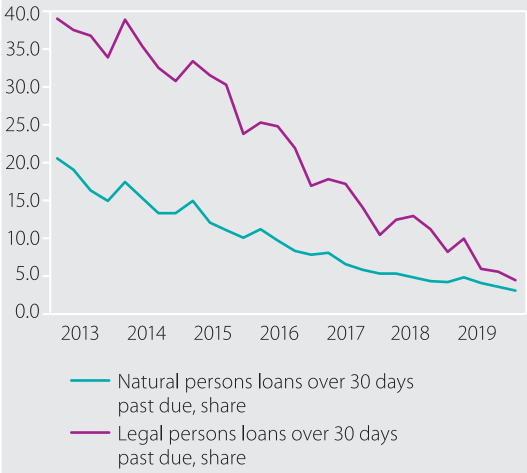
As in the previous period, credit risk was less pronounced among households. Namely, the amount of retail non-performing loans was almost the same compared to the end of 2018. On the other hand, the share of retail non-performing loans at the end of 2019 was 3.9%, and it was on a downtrend due to the growth of total retail loans. The share of retail loans that are more than 30 days past due in total retail loans was identical (3.9%).

The coverage of non-performing loans by value adjustments for loan losses amounted to 48% at end-2019.[48] The net non-performing loans to capital ratio amounted to 13.8% at end-2019. This ratio was trending downwards for several years, signalling a decline in the amount of capital exposed to credit risk.

[48] In order to achieve consistency of the coefficients in this paragraph, non-performing loans include both interest receivables and prepayments and accruals, because for value adjustments there is no separate classification of quality for interest and prepayments and accruals, but only for the total amount/sum: principal, interest and prepayments and accruals.

Graph 4.11

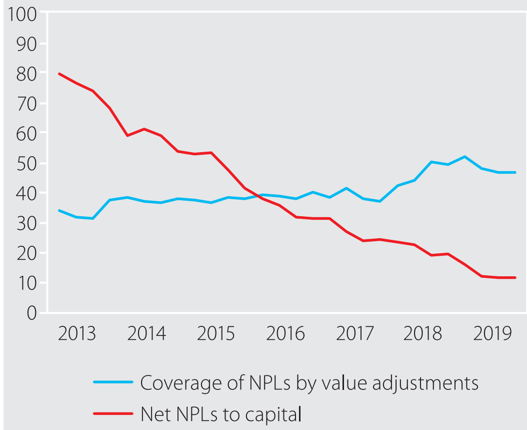
Natural and legal persons` loans that are over 30 days past due, 2013–2019



Source: CBCG

Graph 4.12

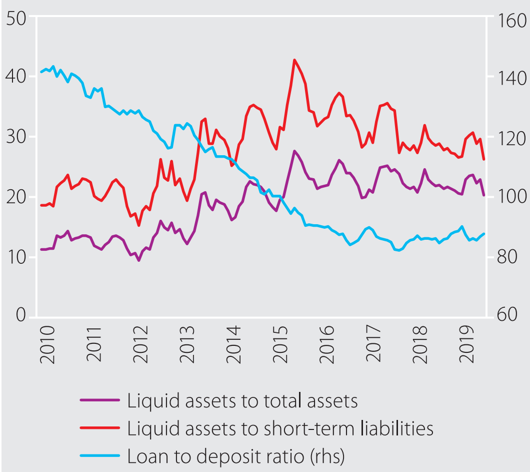
Selected credit risk indicators, %, 2013–2019



Source: CBCG

Graph 4.13

Liquid assets and loans to deposits ratio, %, 2010–2019



Source: CBCG

4.3. Liquidity

The banking sector was highly liquid in 2019 as well. Thus, liquid assets accounted for 20.8% of total assets, amounting to 957.1 million euros. In absolute terms, liquid assets decreased by 3.8% y-o-y.

The loan to deposit ratio (88.1%) recorded annual growth for the second consecutive year. The long-term decline of this ratio was definitely stopped due to stronger lending activity, and at the end of 2019 also due to lower deposit growth. In 2019, after seven years, retail sector was a net debtor. At the end of 2019, it was also the sector of resident non-financial institutions.

The liquid assets to short-term financial liabilities ratio (according to their remaining contractual maturity) was 27.1%, which was less than at the end of 2018. In addition to a slight decline in liquid assets, the decline in this ratio was further contributed by continued growth of short-term liabilities, which increased by 185.2 million euros in 2019.

Demand deposits have an advantage in the structure of deposits by maturity this year as well, and for the fifth year in a row they were higher than time deposits. At the end of 2019, they accounted for 71.4% of total deposits whereas, for the purpose of comparison, their share was 42% at the end of 2013. This can be explained by a declining trend of deposit interest rates so time deposits became less attractive. Maturity match of financial assets and financial liabilities per the remaining contractual maturity points to a negative cumulative gap in the period from one to 365 days, and from one to 5 years (3.3% of the total sources of funds).

Significant funds for liquidity needs are available to banks in a very short period of time, primarily deposits that banks hold in settlement accounts with the CBCG (other than reserve requirement), which amounted to 434.5 million euros. Also, banks hold funds with financial institutions abroad, which are mostly in the form of demand deposits. At the end of 2019, these deposits amounted to 218.3 million euros and they accounted for 22.7% of liquid assets. In addition, banks held cash in the amount of 172 million euros in their vaults.

4.4. Solvency

Observed through capital ratios, at the aggregate level, the resistance to shocks of Montenegro's banks was satisfactory. Many parameters were significantly better at the end of 2019 than they were at the end of the previous year.

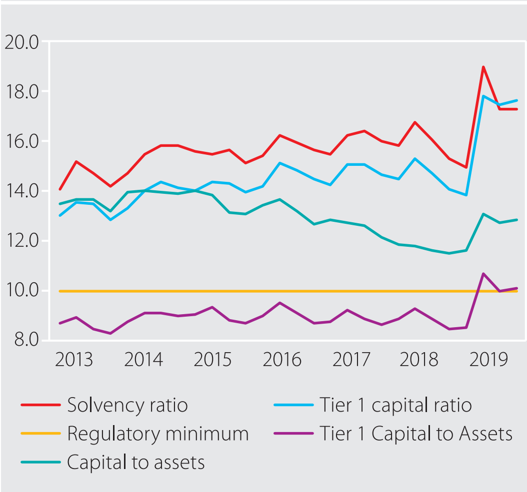
Banks' capital increased by 17% and it reached 600 million euros at the end of the year. In addition to the growth in absolute terms, the share of capital in total assets and liabilities increased to 13%. Core capital (Tier 1) recorded a significant annual growth (25.2%) and its share in the total assets and liabilities increased to 10.1% but it has not record significant changes over the years. In relation to risk-weighted assets, core capital amounted to 18.1% at the end of 2019 and it was 3.8 percentage points higher than at the end of the previous year.

Core capital was higher in almost all banks and its growth was driven by the recapitalization of the Crnogorska Komercijalna Banka (CKB) for the purpose of acquiring Societe Generale Montenegro Bank, which was carried out at the end of Q2 2019. The regulatory capital to risk weighted assets ratio (solvency ratio) recorded the highest value since Q1 2008, amounting to 19.5%. By the end of the year, the solvency ratio was lower (17.7%), but its value was still higher than in recent years. The solvency ratio of all banks was significantly above the statutory minimum and the ratio of the five largest banks ranged from 15% to 23.7%.

Four banks recapitalised during the reporting year. In addition to CKB, the value of the recapitalization of the other three banks amounted to 8 million euros.

Graph 4.14

Selected capital ratios, %, 2013–2019



Source: CBCG

Box 4.3 – Law on Credit Institutions and capital requirements

At the end of 2019, the Parliament of Montenegro passed the Law on Credit Institutions[49], which implemented the international regulatory package Basel III in Montenegro. Technically, this introduced the Regulation (EU) No 575/2013 (*CRR*[50]) and the Directive 2013/36/EU (*CRD*[51]) into the domestic regulatory framework. Thus, by adopting this law, Montenegro has additionally fulfilled its obligations from the process of accession to the European Union, aiming at full harmonization with the acquis communautaire from Chapter 9 - Financial Services.

This law provides the Central Bank of Montenegro with a legal basis for the use of the most characteristic macroprudential measures - capital buffers. These are: the capital conservation buffer, the countercyclical capital buffer, the structural systemic risk buffer, and the buffer for systemically important institutions – (global (G-SII) and other (O-SII[52]).

Table 1

Classification of macroprudential instruments in the banking sector

	CRD IV Tools	CRR Tools	Other Tools
Capital-based measures	Countercyclical capital buffer Structural systemic risk buffer O-SII buffer G-SII buffer	Risk weight for the real estate sector and intra-financial sector exposures Capital conservation buffer Own funds	Leverage ratio
Liquidity-based requirements		Liquidity requirements Large exposures	*NSF* *LTD*
Borrower-based measures			*LTV* *LTI* *DSTI* *DTI*
Other measures		Large exposure limits Disclosure requirements	Margin and haircuts requirements

Source: Cabral I. et al. (2019): Macroprudential policy at the ECB: Institutional framework, strategy, analytical tools and policies, ECB

Capital conservation buffer (*CCoB*) obliges credit institutions to maintain additional 2.5% of capital in the form of regular core capital. With the beginning of the implementation of the Law (1 January 2021), this capital requirement will amount to 0.625%, which will increase in phases until the prescribed amount of 2.5% is reached.

Countercyclical capital buffer (*CCyB*) aims to mitigate pro-cyclicality in the credit activity of credit institutions. It works in such a way that in the ascending phase of the credit cycle, a capital reserve is created - a buffer, which reduces the possibility of excessive credit growth in the system, and which also

49 OGM 72/19

50 Regulation (EU) No 575/2013 of 26 June 2013 on prudential requirements for credit institutions and investment firms.

51 Directive 2013/36/EU of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms.

52 The implementation of the buffer for systemically important credit institutions will be postponed until Montenegro's accession to the EU, so a more detailed description of that buffer has been omitted from this box.

increases the resilience of credit institutions in the event of a crisis when the buffer is also released, thus discouraging excessive abstinence from lending.

A credit institution is obliged to maintain the countercyclical capital buffer in the form of regular core capital and the buffer is equal to its total amount of risk exposure multiplied by the so-called specific countercyclical buffer rate. The CBCG is the appointed authority for determining the rate of countercyclical buffer for the territory of Montenegro and it is obliged to calculate quarterly the so-called a benchmark on which to base estimates to determine the countercyclical buffer rate. The buffer rate that the CBCG can set for domestic exposures ranges between 0% and 2.5% (exceptionally even more), provided that at the beginning of the application of the law it will not be able to be higher than 0.625% and then it will increase in phases.

Structural systemic risk buffer (*SRB*), aims to prevent or mitigate structural systemic risks, which cannot be adequately addressed by other buffers or measures. The buffer rate determined by the CBCG can be applied to all credit institutions or to one or more subgroups of credit institutions and it can range from 1% to 3% (more in exceptional cases). The CBCG is obliged to review the obligation to maintain a buffer for structural systemic risk at least every two years.

Buffer for other systemically important credit institutions (*O-SII*) refers to systemically important credit institutions operating in Montenegro, which are not important on the global level. The O-SII credit institution shall be assessed on the basis of at least one of the following criteria: 1) the size of the credit institution, 2) the importance of the credit institution for the economy of the European Union or Montenegro, 3) the importance of the cross-border activity of the credit institution and 4) the connection of the credit institution or group with the financial system. Detailed conditions and manner of determining the O-SII of credit institutions are prescribed by the CBCG, which is obliged to review the determination of the O-SII of credit institutions once a year, as well as the buffer related to those institutions. The buffer can be up to 2% and it is allocated in the form of regular core capital.

Table 2

Overview of capital requirements according to the Law on Credit Institutions

Capital requirement	Rate	Implementation	Law on Credit Institutions
O-SII buffer (Buffer activation is not mandatory)	2% most	2021	Article 163
SRB (Buffer activation is not mandatory)	1% - 3% also more	2021	Article 150
CCyB	For Montenegro: 0% - 2.5% also more	special rate up to 0,625% in 2021	Articles 139 and 387
		special rate up to 1.25% in 2022	
		special rate up to 1.875% in 2023	
CCoB	2.5%	0.625% in 2021	Articles 138 and 386
		1.25% in 2022	
		1.875% in 2023	
Supervisory capital requirement, Pillar 2 (specific for each bank)	No limit	It is being implemented through existing regulations, and will be significantly upgraded	---
Total capital adequacy ratio, Pillar 1	8%	2021	Article 134
Tier 1 capital adequacy ratio, Pillar 1	6%	5.5% up to 30 June 2021	Articles 134 and 382
Common equity tier 1 capital adequacy ratio, Pillar 1	4.5%	4% up to 30 June 2021	Articles 134 and 382

Source: CBCG

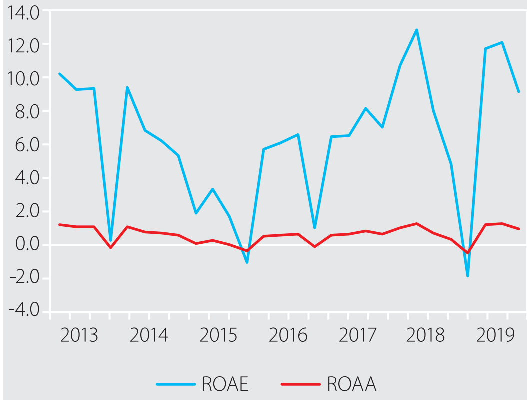
4.5. Profitability, interest rates and competition

Net profit of banks in 2019 amounted to 50.6 million euros, which was about twice as much as in the previous year. This difference is partly due to the introduction of bankruptcy in two banks, but most other banks still increased their profits in 2019. The five largest banks, which individually exceed 10% of market share by assets, had a profit of 40.8 million euros. Return on average assets (ROAA - 1.2%) and return on average equity (ROAE - 9%) recorded the year-on-year increases.

Banks' interest income, driven by solid lending activity, rose for the second year in a row. Banks continued to diversify interest income, given that the portfolio of securities increased by 13.8% during the year and their share in total assets by 1 percentage point to 12.6%. Banks invested mainly in securities issued by the state of Montenegro (83.8%). The share of these revenues in total interest income was 9.4%.

Graph 4.15

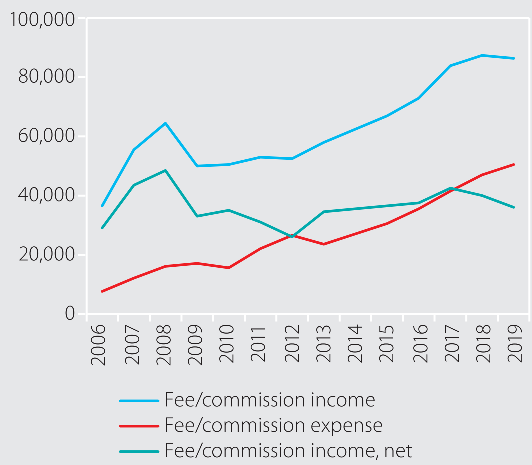
Selected profitability ratios, %, 2013–2019[53]

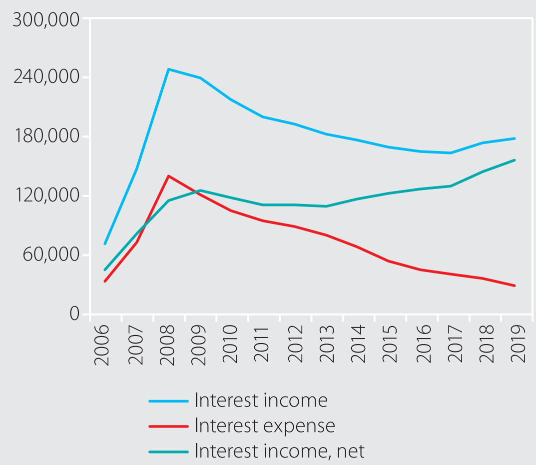


Source: CBCG

Graph 4.16

Interest income/expenses, and fees and commissions income/expenses, thousand euros, 2006–2019



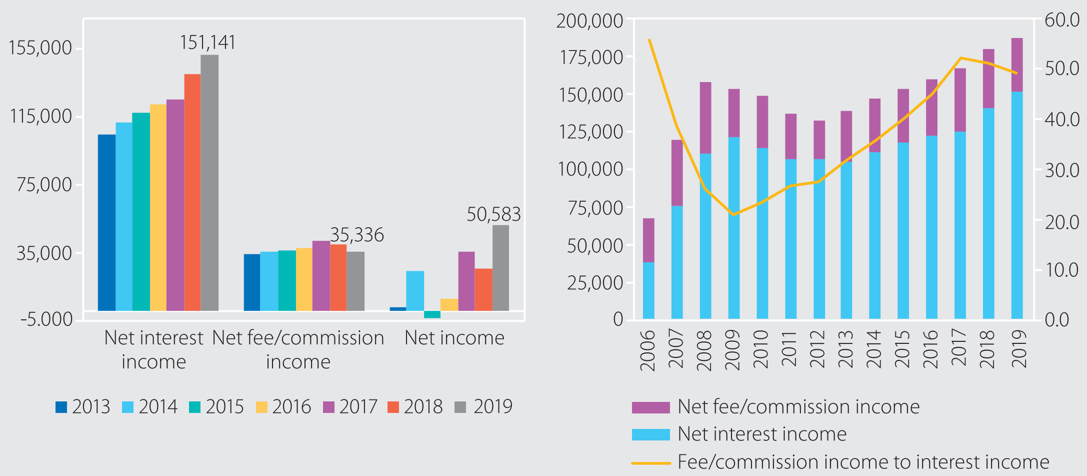


Source: CBCG

[53] Quarterly data for the first three quarters refer to cumulative amounts - first three months, first six months, and first nine months of the year, respectively, and for annual period they were transferred by multiplying by 4, 2, and 4/3.

Graph 4.17

Interest income/expenses, fee and commission income/expenses: interrelation and comparison to total result, thousand euros, 2006–2019



Source: CBCG

Interest expenses continued to decline. Banks currently finance themselves mostly from domestic deposits but the deposit interest rates fell considerably, albeit at a slower pace than in the previous period. As a result of increased income and the decline in interest expenses, net interest income recorded significant growth for the second year in a row, and this is generally a continuation of their perennial growth.

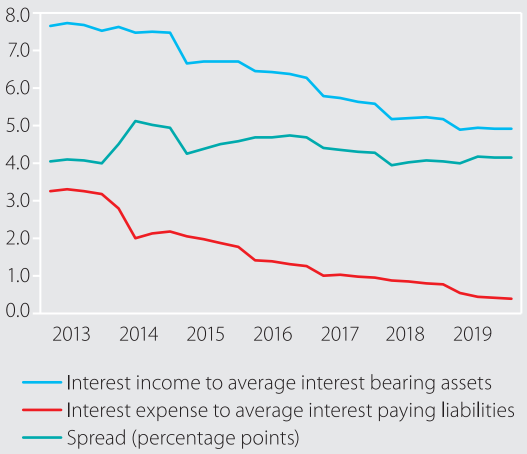
Net fee and commission income was slightly lower. Of course, after the 2008/2009 economic and financial crisis, income from fees and commissions generally gained higher importance in the total income of banks, so e.g. the ratio of this income and interest income in 2009 was 20.8%, reaching 49.1% in 2019.

At the end of 2019, the income-expenses spread[54] was generally at the level of the previous year and it remained at above 4 percentage points, and it differed significantly by banks, ranging from 0.5 to 5.5 percentage points. Lower interest rate spread could strain banks' profitability in the medium term, bearing in mind the size and current status of Montenegro's economy.

[54] Interest rate spread is calculated as the difference between the interest income to average earning assets ratio and the interest expenses to average interest-bearing liabilities ratio.

Graph 4.18

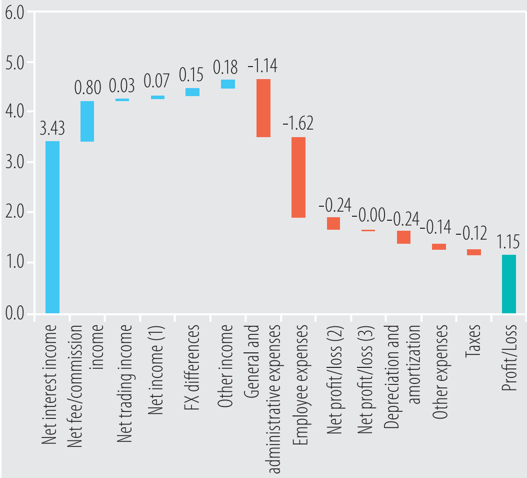
Income/expenses spread (percentage points) and its components (%), 2013–2019[55]



Source: CBCG

Graph 4.19

Components of banks' statement of financial result in 2019, share in ROAA, percentage points[56]



Source: CBCG

Certainly, decomposition of the ROAA shows that net interest income has the largest positive contribution. On the other hand, employee expenses and general and administrative expenses accounted for the largest share of costs. Banks allocated 12% more for employees than in the previous year. The contribution of allowances for impairment to ROAA was much lower in 2019 and it amounted to 0.24 percentage points.

The downtrend in the weighted average lending interest rate (for the entire loan portfolio of banks i.e. on unpaid principal/debt) continued in 2019, amounting to 0.4 percentage points. The weighted average deposit interest rate declined less amounting to 0.2 percentage points. At the end of December 2019, the weighted average lending interest rate was 6.01%, while the weighted average deposit interest rate was 0.41%. The interest spread slightly decreased and it was 5.6 percentage points at the end of the year.

In general, borrowing by natural persons was more costly compared to resident non-financial institutions. The spread between lending interest rates (on total loans, i.e. on outstanding principal/debt) for natural persons and resident non-financial institutions reached 2.83 percentage points at the end of December 2019 as it had been steadily increasing since 2012 when it stood at its lowest level of 0.82 percentage points.

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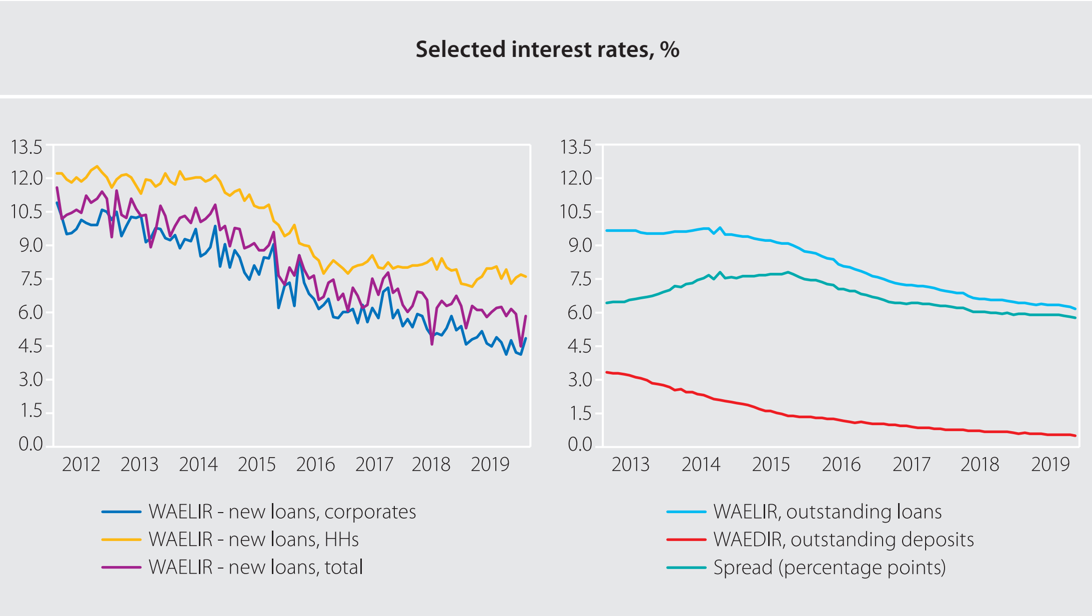
55 Quarterly data for the first three quarters referred to a cumulative amount - first three months, first six months and first nine months of the year, respectively, and for annual period they were transferred by multiplying by 4, 2, and 4/3.

56 Net profit/loss: (1) due to derecognition of financial instruments that are not measured at fair value through profit and loss statement, (2) from impairment of financial instruments that are not measured at fair value through profit and loss statement, and (3) financial instruments at fair value through profit and loss statement that are not held for trading.

Graph 4.20



Source: CBCG

Interest rates on new loans were similar. Lending interest rate on new loans for the whole of 2019 (weighted by the monthly amounts of new loans) was 0.29 percentage points lower compared to 2018 and amounted to 6%. For comparison, the rate from 2018 was 0.57 percentage points lower compared to the rate in 2017. As in the previous years, the decrease was mostly influenced by resident non-financial institutions whose new loans had interest rates that were 0.58 percentage points lower than in 2018, i.e. 4.9%.

4.6. Sensitivity analysis

Sensitivity testing on four credit risk tests showed significant resilience of banks, with some sensitivity of individual banks in the first and fourth test. Namely, one bank did not pass the first test with the total amount of missing capital of 11.4 million euros, while one bank did not pass the fourth test as it was lacking capital in the amount of 7.4 million euros. However, the solvency ratio at the sector level did not fall below the statutory minimum after any of the tests applied.

As expected, the sensitivity to interest rate risk and the sensitivity to FX risk test showed minor negative impacts on the solvency ratio. In the first case, the solvency ratio declined by 0.3 percentage points to 17.4% at the sector level, while in the latter case, the system level decline was only 0.02 percentage points.

Table 4.1

Sensitivity analysis of credit and market risks, 31 December 2019								
No.	Test	Solvency ratio after the test, %					Lacking capital at the sector level, thousand euros	Number of banks that did not pass the test
		Min	Q1	Q3	Max	System		
		Solvency ratio before the test, %						
		13.0	15.3	20.1	42.2	17.7		
Credit risk test								
1	Negative reclassification of classified loans' structure[57]	4.8	14.3	16.5	40.6	15.5	11,401	1
2	Increase in non-performing loans by 30% and value adjustments by 40%	11.5	14.7	19.2	41.9	17.0	0	0
3	Large debtor bankrupt[58]	11.2	14.3	17.4	40.7	16.5	0	0
4	Largest debtor bankrupt	-5.8	12.1	13.6	37.4	14.1	7,374	1
Market risks test								
1	Interest rate increase by adding 2 percentage points to cumulative gap of interest rate sensitive positions with 181–365 days maturity	11.8	15.0	20.4	43.0	17.4	Not calculated	0
2	Adjustment of net open FX position by 20%	13.0	15.3	19.9	42.2	17.7	Not calculated	0

Source: CBCG

Table 4.2

Sensitivity analysis of liquidity risk, 31 December 2019							
No.	Test	Coverage by immediately available liquid assets, thousand euros (606,011 as at 31 December 2019)			Coverage by available liquid assets, thousand euros (736,078 as at 31 December 2019)		
		Lacking amounts (-), sector	Number of banks that did not pass the test	Lacking amounts (-) for banks that did not pass test	Lacking amounts (-), sector	Number of banks that did not pass the test	Lacking amounts (-) for banks that did not pass test
1	Outflow of 30% of deposits	-436,724	12	-439,143	-306,657	11	-313,457
2	Outflow of 30% of demand deposits	-141,471	6	-176,989	-11,404	4	-107,765
3	Outflow of 30% of demand deposits: 20% for natural persons and 40% for legal persons	-168,354	8	-194,506	-38,287	5	-100,909
4	Outflow of term deposits 30% for natural persons and 40% for legal persons	278,597	4	-19,741	408,664	3	-5,504
5	Outflow of deposits of the largest depositor	375,354	2	-14,908	505,421	1	-9,662
6	Outflow of 50% of deposits of 10 largest depositors	174,063	5	-37,566	304,130	3	-8,899
7	Outflow of 100% of deposits of public sector	175,221	4	-98,415	305,288	3	-68,050

Source: CBCG

The sensitivity to liquidity risk test, actually tested as a risk of deposit run, was conducted through seven extremely severe and less probable tests. In addition to the most liquid banks' funds, the tests assumed very conservatively the possibility of using only 50% of the reserve re-

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[57] Reclassification of the structure of classified loans and receivables is implemented as follows: 1) category A – "pass" - calculated in the amount of 90%, and category B increased by 10% of loans from category A, 2) category B – "special mention assets" – calculated in the amount of 95% of the increased category B, 3) category C – "substandard assets" – calculated in the amount of 5% from category B, whereby 95% of category C was kept, 4) category D – "doubtful assets" - calculated in the amount of 5% from category C, while 95% from category D was kept, and 5) category E - "loss" – amount increased by 5% of the amount from category D.

[58] Median value of the debt of banks' 20 top debtors.

quirement[59]. On the other hand, the possibility of using bank funds in the form of demand deposits abroad, which amounted to 218.3 million euros at the end of 2019, was not assumed nor the remaining 50% of required reserve requirement (130.1 million euros). In addition, the possibilities of selling non-cash assets (for example: securities) or taking loans from parent banks, other participants in domestic or foreign markets or possibly from the CBCG or the state, were not taken into account.

Even under these rigorous assumptions, testing expectedly indicated good liquidity of the sector as a whole, although in the case of the first three tests the sector did not have liquid funds to respond to deposit withdrawals even after using 50% of reserve requirement, where the most problematic was the first test. In all other cases, inadequacy of liquid funds to cover deposit outflow appeared in individual banks. The most pronounced inadequacy, and after the use of 50% of reserve requirement funds, occurred after the seventh test when three banks failed the test with the liquidity shortfall of 68.1 million euros.

However, with the use of deposits that banks have in foreign accounts and with the full amount of reserve requirement, the system as a whole could respond to the withdrawal of deposits in the first test, along with deficits at the level of several banks. Moreover, with the use of the mentioned deposits abroad and full reserve requirement, only one bank would not be able to respond to the withdrawal of deposits within the seventh test, while all other banks would pass the scenario from the seventh test and from all other tests (except the first). Again, it should be kept in mind that these conditions also exclude some of the abovementioned additional layers of liquidity in the form of sale of securities or possible borrowing from other entities.

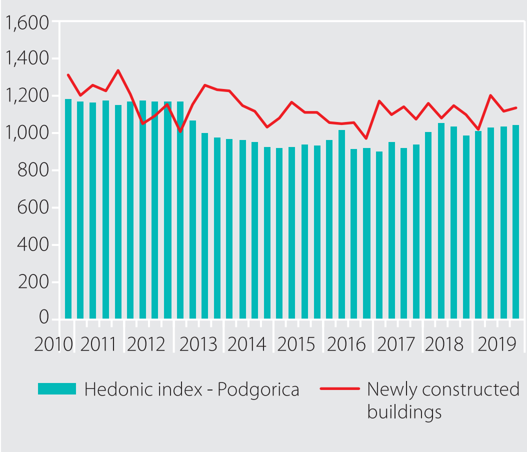
4.7. Real Estate Market

The parameters that characterized the real estate market in 2019 recorded extremely positive trends, due to better lending conditions and favourable macroeconomic conditions in the past year. Nevertheless, the business of the construction sector recorded less pronounced positive trends compared to the previous period. The results of a survey conducted in December suggested that the average price of a real estate amounted to 1,045.2 euros per square meter, which represents the year-on-year increase of 5.8%.[60]

The average price per square meter of a new apartment in Montenegro amounted to 1,135 euros in Q4 2019, recording the year-on-year in-

Graph 4.21

Prices of residential buildings obtained using the Hedonic Index and prices of apartments in newly constructed buildings, in euros



Source: CBCG and Monstat

[59] Pursuant to the Decision on Bank Reserve Requirement to be Held With the Central Bank of Montenegro (OGM 88/17), a bank may use up to 50% of the reserve requirement without the fee charged by the CBCG, if it returns taken funds by the end of the working day. Technically, even with the CBCG fee of 12% per annum, the bank can use more than 50% of reserve requirement, i.e. use reserve requirement for a period longer than the end of the working day.

[60] As per the Hedonic Index obtained from the CBCG survey where the prices do not reflect actual prices but essentially represent subjective prices of the real estate owners, i.e. the prices below which they would not be willing to sell their property.

crease of 3.4%. However, it should be noted that the differences in the prices of residential units in newly built buildings depend mostly on the share of the Montenegrin Fund for Solidarity Housing Development, thus, the higher the share of these housing units, the lower the prices of newly built housing units and vice versa.

Based on a survey conducted by the Central Bank of Montenegro[61], most agencies (66.7%) estimate that the average price per square meter was higher in 2019 compared to 2018, while 33.3% believe that the prices are at the same level as in previous years. Turnover growth of 50% was recorded by the surveyed agencies, while 27.8% of respondents had lower turnover. When it comes to expectations for 2020, 44% of agencies expect the real estate prices to rise. An equal share believes the prices will remain unchanged, while 11.1% expects real estate prices to fall in 2020.

Housing loans are a significant determinant of the real estate market demand and the most important trends are presented in Table 4.3.

Table 4.3

Housing loans trend, 2007-2019					
Year	stock at year-end	y-o-y growth, %	Per capita (in €)[62]	% of GDP	% of total loans
2007	222,592		362.2	8.3	8.9
2008	264,073	18.6	429.0	8.5	8.9
2009	349,042	32.2	565.6	11.7	13.2
2010	350,880	0.5	566.8	11.2	13.9
2011	325,793	-7.1	525.6	10.0	13.8
2012	309,729	-4.9	499.3	9.7	13.2
2013	317,987	2.7	512.1	9.5	13.2
2014	315,089	-0.9	507.0	9.1	13.3
2015	308,869	-2.0	496.5	8.5	12.9
2016	328,558	6.4	528.0	8.3	13.6
2017	330,983	0.7	531.8	7.7	12.3
2018	365,737	10.5	587.7	7.9	12.5
2019	413,424	13.0	664.5	8.6	13.5

Source: CBCG and Monstat

In December 2019, housing loans increased by 13% compared to the same month of 2018, which is the most intensive annual growth after the economic and financial crisis in the period 2008/2009. At the same time, this is the second year that the annual growth of housing loans is in double digits. This may be the result of increasingly favourable lending conditions. Namely, the weighted average effective interest rate on new housing loans was 4.87% at the end of 2019. Although the past year was a period of a relative stagnation in interest rates, they have been recording a downward trend for a long time. There is

[61] For the purposes of the analysis, 75 real estate agencies were surveyed, most of which have their activities in Podgorica and the coastal region of Montenegro. Out of a total of 75 respondents, 18 submitted their answers.

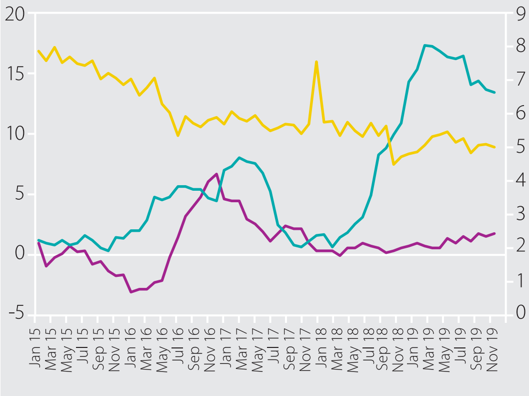
[62] Data on population include Monstat estimates.

also a significant increase in liquidity potential in the real estate business. The amount of deposits of this activity increased by 75.7% compared to 2018.

The share of housing loans in the structure of total loans also increased. In 2019, it amounted to 13.5% of total loans, which is an increase of 1 percentage points compared to the previous year. The share of loans in GDP increased by 0.6 percentage points and it amounted to 8.6% of estimated GDP in 2019. The share in GDP was still significantly lower than the average that is typical for the EU countries (about a third of the value), which may be the result of lower solvency of citizens, but also less favourable lending conditions compared to the EU countries. In addition, the amount of housing loans per capita in the past year (664.5 euros) is significantly higher than the average net salary in Montenegro (515 euros). On the basis of housing loans, indebtedness per capita increased by 13.1% in relation to the previous year.

Graph 4.22

Annual growth in net earnings and housing loans, and interest rates on housing loans, %



Source: CBCG

In terms of supply, it can be concluded that there was stagnation and a slight decline in parameters in the construction sector. In 2018, the share of gross value added of construction in GDP was 5.9%, which is a decrease of 0.7 percentage points compared to the previous year. Liquidity potential also decreased in 2018 and 2019 by 3.2% and 8.8%, respectively. In 2019, it amounted to 137.1 million euros. On the other hand, the annual growth rates of deposits in this sector were particularly pronounced in 2016 (53%) and 2017 (65.8%), and it can be concluded that from the supply aspect, stagnation in the real estate market can be expected in the coming period. The stimulus for construction may be the implementation of significant tourism and infrastructure projects in Montenegro.

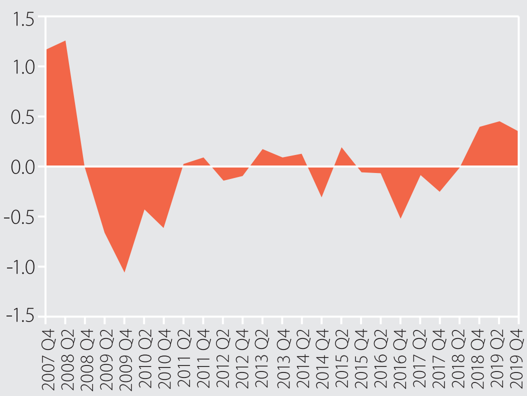
Given the above, and the stagnation of interest rates on housing loans, but also less expressive GDP growth rates, we can expect stagnation of real estate prices in the coming period. Also, 44.4% of the surveyed real estate agencies believe that prices will remain unchanged in the coming period, while 11.1% believe that they will fall.

Having in mind the importance of the real estate market for the business cycle and financial stability, a risk assessment was performed in this market. For the given assessment, four essential series were used that would approximate the real (fundamental) value of the property. Any major deviation from the calculated real estate value could be a signal of increased risk in the real estate market which, as the financial crisis has shown, may affect financial stability.

Four series were used for the given analysis: the ratio of subjective real estate prices and net earnings in Podgorica, the ratio of new construction prices and net earnings in Montenegro, the percentage share of the value of effective construction hours in GDP and the share of housing loans in GDP. The first two series approximate the factors that determine demand (purchasing power of the population). The third series approximates the factors that affect the supply in the real estate market. The fourth series approximates the situation in the banking sector, which significantly determines the trends in the real estate market. These series are available for the period 2007-2019, and two series were interpolated due to unavailability of data. The *principal component* analysis was applied to these four series, which creates a new variable that includes the common variability of the given series during the specified period.

Graph 4.23

Deviation from the real value of real estate during the period 2007 - 2019



Source: CBCG

In order to estimate the deviations from the real value of real estates, cyclic movements were calculated using the HP filter method (applying the recommendations of Ravn and Uhlig (2004) in the estimation). The given cyclical movements are presented in Graph 4.23.

Based on the given graph, it can be estimated that the period up to 2008 was characterized by overestimated real estate values on the market (*boom*), while the period 2008–2011 was characterized by much underestimated real estate values (*bust*). The 2011-2017 period was characterized by weaker oscillations in the real estate market, and in the last two years there was a slight overestimation of real estate values. It is also noticeable that this overestimation tends to fall. Given the small deviation but also the overall analysis of the real estate market, it is estimated that the risk of the real estate market is not high.

The limitations of this analysis consist of short series that do not cover the complete business cycle from the period before 2007 but also the sensitivity of the HP filter method to the length of the series. Also, the analysis would be improved if the number of variables used for *principal component* analysis were higher. The series that would, in case of availability, improve the quality of risk assessment are investments in real estate, investments in the construction sector, the amount of rent, and the like.

4.8. Capital Market

The turnover on the Montenegro Stock Exchange amounted to 282.5 million euros (5.8% of GDP) in 2019, compared to 147.4 million euros in 2018. Almost doubled turnover compared to last year is a consequence of the government bond issues conducted in April and May (142.6 million euros). At the same time, the entire primary turnover on the stock exchange involved these bonds issues.

Trading with shares made up 86.2% of the secondary turnover, of which trading with shares of companies amounted to 120.6 million euros and trading with shares of investment funds amounted only 51.4 thousand euros. The rest of the secondary turnover (19.3 million euros) referred to bond turnover, with government bond trading in the amount of 13.7 million euros, i.e. trade in corporate bonds in the amount of 5.6 million euros.

At end-2019, the SE indices Monex and MNSE10 stood at 11,403.61 and 777.61 points, respectively, recording the respective year-on-year growths of 5.2% and 7.1%.

4.9. Payment System

Payment system of the CBCG - RTGS system and DNS system, as the main payment infrastructure in the country worked smoothly and according to the schedule of the system during almost all 254 working days in 2019. The only downtime (lasting five minutes) was recorded on 30 September, while two extensions of the system were realized on 30 September (15 minutes) and 7 October (60 minutes). In addition, as in the previous year, on 31 December the operation of the system was slightly different in relation to other working days.

A total of 11.5 million payments, worth 16.8 billion euros were effected, which is 3% i.e. 11.4% more than in 2018. Of the total number of payments, 39.1% were realized in the RTGS system whose share in the total value of payments was 94.7%. On the other hand, 60.9% of the total number of payments was effected in the DNS system (5.3% of the total value of payments), which means that the ratio of the number and value of payments effected in both systems was approximately the same as in 2018.

A relatively small number of rejected and pending payments was recorded, which indicates that liquidity of participants in the system was excellent, and that the reasons for putting payments on hold, i.e. the reasons for refusing payments, were primarily technical. For example, due to a lack of funds in the account, only 69 payments (all in the RTGS system) were put on hold, of which 66 were effected after the inflow of funds during the day, and only three were rejected at the end of the day.

Observing the intraday liquidity of banks, it can be said that the initial balances of the RTGS accounts of banks were largely sufficient to cover their outgoing payments, with some variations by banks.

5. CONCLUSION

As in most countries, the current coronavirus crisis will almost inevitably induce recession in Montenegro. It is difficult to predict the extent of the recession, but it is likely to be rather pronounced given that restrictive health measures directly affect tourism, the leading industry in Montenegro, as well as the fact that Montenegro`s fiscal room is relatively limited. Also, it is reasonable to expect growth of the budget deficit, the consequent growth of the public debt, deterioration of the financial position of the population and the economy and, consequently, growth of non-performing loans in the portfolios of banks.

Pressures on government finances pose a systemic risk in Montenegro. In that respect, the level of public debt is neither the key problem nor the only cause of the problem, but it is, to a large extent, a consequence of the activity of other economic impacts, primarily structural factors. In general, the public debt growth in the case of Montenegro points to a persistently weak international competitiveness, high spending relative to low accumulation, and increased dependence on foreign capital inflows. In the context of the ongoing coronavirus pandemic and its economic consequences, a decisive continuation of measures of responsible and well-balanced fiscal policy is necessary, with the aim of bringing Montenegro into a relatively safe zone.

A substantial portion of public debt was created in the period of relatively available and cheap money on international financial markets, which largely resulted from the policy of historically lowest interest rates of the leading central banks. Against this background, the state managed and still manages to borrow under low interest rates compared to the historical standards. However, even in such circumstances, interest expenses were significant and estimated at 105.7 million euros (2.2% of GDP) in 2019, while their 2020 projections point to the amount of 104.3 million euros (2.1% of GDP). Therefore, a period of normalisation of interest rates on the international financial market, which will occur at a certain point in time (albeit not in the near future), will pose a particular challenge to financing interest expenses and debt refinancing. In addition, the current coronavirus crisis will represent an additional challenge to public finances.

In general, the balance of government finances is of high significance for financial stability even without direct financial links between the government and banks. The reason for this lies in the fact that the government sector is the country`s largest employer and investor but its financing is based on the private sector. Therefore, every imbalanced and unsustainable financing period that leads to a public debt bubble must be followed by a period of fiscal consolidation. A gradual balancing of spending would be more preferable than a sharp one, however, even gradual balancing generates pressures on the financial positions of both retail and corporate sectors that subsequently spills over to banks through difficulties in loan repayment and a decline in deposits as the most important source for banks for credit growth financing. Certainly, due to the growth of public debt, fiscal consolidation measures were implemented, which gave positive results in previous years.

Increasing direct financial linkage between the government and banks contributes to the complexity of Montenegro's position. Exposure of the banking sectors to the state after the economic and financial crisis 2008/2009 records a continuous growth and at the end of 2019 it reached 758.4 million euros or 16.5% of total bank assets[63] although this risk is still within tolerable limits. The reasons for strengthening this link were ambivalent. Banks realised favourable interest income compared to risks taken with these investments, in the context of their risk aversion in the post-crisis period and a lack of better alternative solutions. Also, banks were additionally motivated as they did not have to allocate additional capital since these investments were treated as riskless (according to the Basel standards applicable in Montenegro). On the other hand, liquid assets of banks were a valuable source of financing for the government, which was particularly prominent in the recent period during which the government faced the challenge of financing debt in the international market. However, although growing, this indebtedness is not a threat to financial stability, and it is still lower than in a number of EU countries, but it is also subject to careful monitoring by the CBCG.

Banks are currently the soundest segment of the economic and financial system, primarily due to the fact that they are largely subsidiaries of major banking groups from advanced European economies - Austria, Hungary, and Slovenia. These groups contributed to the stability of their subsidiaries in Montenegro by providing know-how as well as various forms of financial support - recapitalisation, borrowing under favourable interest rates, and repayment deadlines.

In recent years, and especially after the closure of two vulnerable banks, the challenge related to non-performing loans significantly weakened (a share of 4.7% at the end of 2019). Therefore, non-performing loans are currently a problem of individual banks. Still, it should be noted that a decline in the share of non-performing loans was largely achieved through write-offs and sale of bad assets, which leads to a conclusion that the issue was removed from the banking sector rather than actually resolved. Only recently, when the supervisory authority of the CBCG over non-banking financial institutions became fully operational, all dimensions of this problem can be understood better.

Banks still have the perception of a high credit risk in the real economy, which is best indicated by relatively limited lending activity (although additionally intensified in 2019), as well as still high lending interest rates (regardless of the substantial reduction of average lending interest rate) and other lending conditions. A negative feedback loop between a high share in non-performing loans and stagnant credit growth weakened additionally in 2019, however, in view of all the above said, it is early to say that all problems have been resolved. In addition, the current coronavirus pandemic and its economic consequences are likely to bring back to the fore the problem of non-performing loans but the banking sector is expected to respond successfully thanks to significant and high-quality layers of liquid assets and capital.

Credit growth in the reporting year was driven by retail loans, with the largest contribution coming from cash loans, both in terms of approved amounts and in terms of maturity of these loans. For example, at the end of 2019, the debt balance (outstanding principal) on cash loans accounted for 27.9% of total loans, and the share of cash loans with the initially agreed maturity of more than three years in all cash loans with that maturity was 34.1%, compared to 19% of the same share for housing loans. In general, the maturity structure of cash loans is currently incomparably closer to the maturity struc-

[63] The data represent the sum of all types of exposures to central government and exposures on loans to local government and social security funds.

ture of housing loans than a few years ago. There may be several reasons for this, and one of the possible ones is a partial substitution of housing loans with cash loans, taking into account significantly simplified procedures, lower security requirements, and the absence of some of the related loan costs.

Having in mind the credit history of this type of loan, it can be said that banks adequately control that risk. However, the problem may arise in the potential downward phase of the business cycle, i.e. in case of rising unemployment and/or falling real earnings. Therefore, the CBCG adopted measures to limit the growth of cash loans granted to individuals, which have been in force since 1 January 2020.

Even cleaner banks' balance sheets, i.e. lower allowances for impairment and provisioning costs, contributed to the realization of profit of 50.6 million euros at the system level, which affected the average ROAE in the period 2017-2019 amounting to a solid 6.9%, compared to only 1.5% in the period 2013-2016 or versus -13.6% in the period 2009–2012.

In addition, there are 13 banks (as of 15 April 2019) operating on the market, with the HHI per assets (which has generally been on a downtrend in the post-crisis period) currently standing below 1,100 points. The longstanding strengthening of competition on the Montenegrin market is encouraging but it would be very unwelcoming if it results in excessive relaxing of lending standards and consequently inadequate risk management assessment, which could potentially bring back the issue of non-performing loans. However, there are no serious and firmly grounded findings that would point to credit standards lowering at this point.

ANNEX

Table 1 – Financial Stability Indicators (FSIs), 2009–2019

	2009	2010	2011	2012	2013*	2014	2015	2016	2017	2018	2019			
	XII	XII	XII	XII	XII	XII	XII	XII	XII	XII	III	VI	IX	XII
Basic indicators of financial stability for banks														
Regulatory capital / risk weighted assets [1]	15.7	15.9	16.5	14.7	14.4	16.2	15.5	16.0	16.4	15.6	15.3	19.5	17.7	17.7
First class regulatory capital / risk weighted assets [2]	13.5	12.9	14.0	12.9	13.0	14.4	14.2	14.7	15.0	14.4	14.1	18.3	17.9	18.1
Net non-performing loans / capital [3]	51.2	93.1	61.5	67.6	82.4	61.1	43.7	27.4	18.7	8.6	4.7	2.7	3.5	3.5
Non-performing loans / total loans [4]	13.6	21.0	15.3	17.3	20.6	18.8	14.8	11.5	8.4	7.4	6.6	5.3	5.3	5.1
Non-performing loans / total loans [5]	13.5	21.0	15.5	17.6	17.5	15.9	12.6	10.3	7.3	6.7	5.9	4.8	4.7	4.7
Loan structure by institutional sectors, in relation to total loans														
Residents	98.3	97.5	97.0	96.4	96.6	96.9	96.5	96.0	97.1	95.2	95.9	96.1	96.1	96.2
Structure of total loans by institutional sectors: banks	0.0	0.0	0.0	0.0	0.0	0.1	0.1	0.0	0.0	0.2	0.2	0.3	0.3	0.3
Structure of total loans by institutional sectors: central bank	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Structure of total loans by institutional sectors: other financial corporations	0.2	0.4	0.5	0.1	0.1	0.2	0.1	0.3	0.2	0.3	0.4	0.5	0.5	0.5
Structure of total loans by institutional sectors: general government	2.9	3.0	6.2	5.7	7.7	5.8	5.2	5.7	8.1	8.2	7.5	7.3	7.0	9.1
Structure of total loans by institutional sectors: non-financial corporations	56.6	54.6	48.0	47.8	46.0	45.8	45.8	43.0	41.3	38.9	39.6	39.4	38.6	37.9
Structure of total loans by institutional sectors: other resident sectors	38.6	39.4	42.3	42.7	42.8	45.1	45.3	47.0	47.5	47.6	48.1	48.5	49.6	48.4
Non-residents	1.7	2.5	3.0	3.6	3.4	3.1	3.5	4.0	2.9	4.8	4.1	3.9	3.9	3.8
ROA [6]	-0.6	-2.7	-2.5	-3.1	0.1	0.8	-0.1	0.2	1.0	1.0	-0.1	1.5	1.6	1.3
ROAE [7]	-6.7	-25.0	-23.8	-30.2	0.7	6.0	-0.7	1.5	7.6	8.5	-1.0	12.0	12.6	10.0
Interest margin / gross income [8]	65.0	63.5	60.8	61.0	58.5	60.2	58.7	58.6	54.5	56.1	60.9	59.6	57.3	56.6
Interest-free expenses / gross income	70.5	70.7	75.8	83.0	73.8	75.9	81.4	76.6	73.0	76.3	86.5	69.7	69.2	74.9
Liquid assets / total assets [9]	11.6	13.7	11.5	16.0	20.0	22.2	24.8	24.5	25.3	22.6	21.8	20.9	24.3	20.8
Liquid assets / short-term liabilities [10]	37.9	40.2	36.3	50.5	57.5	66.8	87.0	51.4	49.2	35.4	33.5	32.0	35.9	31.1
Net open position in foreign currencies / capital [11]	0.6	0.6	0.9	-0.7	0.5	0.6	2.1	1.6	0.8	0.0	0.7	0.6	0.5	0.6
Additional financial stability indicators														
Bank														
Capital / Assets [12]	9.7	9.4	10.1	9.1	8.2	9.0	8.7	8.7	8.6	8.4	8.5	10.7	10.1	10.1
Large exposures / capital [13]	83.9	105.7	98.6	199.6	162.8	139.4	154.5	153.4	140.7	126.8	122.2	86.1	113.2	99.5
Geographical structure of loans, in relation to total loans [14]														
Montenegro	---	---	---	---	---	---	---	---	---	95.2	95.9	96.1	96.1	96.2
Geographical structure of total loans: developed economies, excluding China	---	---	---	---	---	---	---	---	---	0.7	0.6	0.6	0.6	0.6
Geographical structure of total loans: other emerging and developing economies, including China	---	---	---	---	---	---	---	---	---	2.9	2.4	2.8	2.8	2.6

Table 1 – Financial Stability Indicators (FSIs), 2009–2019 – coninued

	2009	2010	2011	2012	2013*	2014	2015	2016	2017	2018	2019			
	XII	XII	XII	XII	XII	XII	XII	XII	XII	XII	III	VI	IX	XII
Geographical structure of total loans: Africa	---	---	---	---	---	---	---	---	---	0.0	0.0	0.0	0.0	0.0
of which: sub-Saharan Africa	---	---	---	---	---	---	---	---	---	0.0	0.0	0.0	0.0	0.0
Geographical structure of total loans: Central and Eastern Europe	---	---	---	---	---	---	---	---	---	1.4	1.7	1.7	1.7	1.7
Geographical structure of total loans: Commonwealth of Independent States and Mongolia	---	---	---	---	---	---	---	---	---	0.1	0.0	0.0	0.0	0.0
Geographical structure of total loans: Asian developing countries, including China	---	---	---	---	---	---	---	---	---	0.0	0.0	0.0	0.0	0.0
Geographical structure of total loans: Middle East	---	---	---	---	---	---	---	---	---	1.5	0.6	1.0	1.0	0.9
Geographical structure of total loans: western hemisphere	---	---	---	---	---	---	---	---	---	0.0	0.0	0.0	0.0	0.0
Gross active position in financial derivatives / capital [11]	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross passive position in financial derivatives / capital [11]	0.3	0.2	0.1	0.1	0.0	0.0	0.0	0.2	0.0	0.1	0.0	0.1	0.0	0.1
Trading revenue / total revenue [15]	1.2	2.1	3.8	2.7	2.0	2.5	2.5	3.1	3.0	1.8	3.1	2.6	3.3	3.8
Employee expenses / non-interest bearing expenses	44.3	46.0	43.3	42.4	43.0	41.2	37.3	39.0	38.2	34.9	32.0	36.1	35.1	37.3
Difference between reference interest rates on loans and deposits (in basis points) [16]	551	637	644	624	682	736	730	652	612	580	575	573	574	561
Customer deposits / total loans, excluding interbank loans [17]	67.5	75.3	86.6	99.0	96.5	110.4	123.4	126.4	132.2	123.1	119.7	113.1	123.9	116.1
Loans denominated in foreign currencies / total loans [18]	4.0	4.0	2.2	1.8	1.6	1.5	1.5	1.1	0.7	0.5	0.5	0.5	0.4	0.4
Liabilities denominated in foreign currencies / total liabilities [19]	6.4	6.9	4.9	4.8	4.3	4.7	6.9	6.4	6.5	6.4	6.4	5.6	5.3	6.5
Real Estate Market														
Residential real estate prices, annual percentage change [20]	---	---	---	-13.5	6.8	-16.1	7.4	-12.5	10.7	1.8	-11.9	11.6	-2.4	3.4
Housing loans / total loans	14.4	15.7	16.1	16.1	15.3	15.6	15.0	15.0	13.9	13.7	14.3	14.6	14.9	14.6
Commercial real estate loans / total loans [21]	---	---	---	---	5.1	5.5	6.3	6.8	7.4	6.7	6.4	6.4	6.5	6.1

The text of all footnotes can be found in the excel file available at *https://www.cbcg.me/en/statistics/statistical/financial-soundness-indicators*, and here, as the most important, the footnotes are shown below.

4/ Non-performing loans refer only to the principal of loans classified in categories C, D and E, without interest and prepayments and accruals of interest and fees. On the other hand, total loans (in addition to the principal) include interest and prepayments and accruals of interest and fees for loans classified in categories A and B, while interest and prepayments and accruals of interest and fees for loans classified in categories C, D and E are excluded from the scope. Exceptionally, for the period before 2013, total loans in addition to the principal include only the mentioned interest rates, because data on prepayments and accruals of interest and fees were not available.
Prior to 2013, loans classified in category E (i.e. in the worst classification category - „loss") were kept in off-balance sheet, so that the counter of this indicator (i.e. non-performing loans) contains loans classified as E, while the denominator of this indicator (i.e. total loans) does not contain the same.
5/ Internal definition, according to the methodology used in the CBCG.
By definition, interest and prepayments and accruals of interest and fees are completely excluded from both non-performing loans and total loans. Also, according to the requirements of IFRS 9 (former IAS 39), the definition treats bank deposits with other banks and depository institutions as loans, which is especially relevant for account No. 1009 (from the Decision on the Chart of Accounts for Banks, OGM 82/17, 71/19, former Decision on the Chart of Accounts for Banks, OGM 55/12). Prior to 2013, the definition of loans did not include the aforementioned deposits.

* On 1 January 2018, IFRS 9 replaced IAS 39, with a limited impact on the comparability of data series before and starting from 1 January 2018.
IAS 39 was introduced on 1 January 2013. The introduction of IAS 39 caused incomparability of a significant number of data series before and starting from 1 January 2013. Most importantly, on this day: non-performing loans increased, as well as accounting capital, total loans to lesser extent, and assets to even lesser extent. The comparability of loan loss provisions, and therefore the comparability of net profit, was also affected by the change. As a consequence, all indicators calculated using these data series are basically not comparable before and starting from 1 January 2013. The consistency of other data series or indicators, such as liquid assets or capital adequacy ratios, has been largely maintained.

Source: Quarterly and monthly reports of banks; MONSTAT

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