FINANCIAL STABILITY REPORT 2010

CENTRAL BANK OF MONTENEGRO

CENTRAL BANK OF MONTENEGRO

FINANCIAL STABILITY REPORT 2010

Podgorica, 2011

PUBLISHED BY:	Central Bank of Montenegro Bulevar Svetog Petra Cetinjskog 6 81000 Podgorica Telephone: +382 20 664 997, 664 269 Fax: +382 20 664 576
WEB SITE:	http://www.cb-cg.org
CENTRAL BANK COUNCIL:	Radoje Žugić, MS, Governor Milojica Dakić, MS, Vice -Governor Velibor Milošević, MS, Vice -Governor Asim Telaćević Milivoje Radović, PhD Milorad Jovović, PhD Srđa Božović, PhD
TRANSLATED BY:	Central Bank of Montenegro, Translation Services Division
DESIGNED BY:	Andrijana Vujović
PRINTED BY:	Studio MOUSE
PRINTED IN:	100 copies

ABBREVIATIONS

AD	Shareholding company
CBM	Central Bank of Montenegro
CEFTA	Central European Free Trade Agreement
DNS	Deferred net settlement
DOO	Limited liability company
EBRD	European Bank for Reconstruction and Development
EMU	European Monetary Union
EPCG	Electric Power Company of Montenegro
EU	European Union
EUR	Euro
EXIM	Export-import bank of China
FDI	Foreign direct investments
FOMC	Federal Open Market Committee
GDP	Gross domestic product
HICP	Harmonized Index of Consumer Prices
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IMF	International Monetary Fund
KAP	Aluminium Plant Podgorica
KFW	German Development bank
LAMP	Land Administration and Management Project
MFI	Micro-credit financial institution
MIDAS	Montenegro Institutional Development and Agriculture Strengthening
MONSTAT	Statistical Office of Montenegro
ROA	Return on Assets
ROE	Return on Equity
RTGS	Real-time gross settlement system
UN DESA	United Nations Department of Economic and Social Affairs
USD	US Dollar
VTB	Bank for Foreign Trade (Vneshtorgbank)
WALEIR	Weighted average lending effective interest rate
WIIW	Vienna Institute for International Economic Studies

CONTENTS

INTRODUCTORY NOTES

There is no unique approach to defining financial stability or a unique definition of financial stability. Financial stability refers to undisturbed functioning of key financial system elements. One of the most popular definitions that was adopted by the European Central Bank is that "financial stability can be defined as a condition in which the financial system – comprising of financial intermediaries, markets and market infrastructures – is capable of withstanding shocks and the unravelling of financial imbalances, thereby mitigating the likelihood of disruptions in the financial intermediation process which are severe enough to significantly impair the allocation of savings to profitable investment opportunities."

In addition, a generally accepted and used definition of financial stability in some EU Members States is the one that defines financial stability as the possibility of a financial system to: (a) efficiently allocate economic resources; (b) assess, valuate and manage financial risks; and (c) mitigate macroeconomic and financial shocks.

Pursuant to Article 143 of the Constitution of Montenegro, "the Central Bank of Montenegro is an independent organisation accountable for monetary and financial stability and the functioning of the banking system." Incorporation of a clear provision on financial stability in the Constitution of Montenegro is one of the rare cases in Europe. This emphasizes the fundamental importance of financial stability and creates a strong basis for monetary policy with a clear focus. The Financial Stability Report contributes to clarifying the factors and defining the levels of stability in our country in order to draw the attention of all actors and all authorities to the financial stability preservation.

The report analyzes the factors that could affect financial stability, both those generated in the very financial system or otherwise (such as international environment and macroeconomic developments in the country).

Significant changes in both international and macroeconomic environment may influence trends in a small and open economy such as Montenegro and lead to the creation of market imbalances that affect economic growth and development. Declines or slowdowns of economies with which Montenegro is connected through export/import flows, growing energy prices (oil or electricity), natural catastrophes (earthquakes, floods and the like) could all generate negative effects on a financial system through the exposure to market risks. Political factors, both on a local and global level, could generate uncertainties in the market and create negative expectations that may lead to panic reactions.

The report concludes by giving an overview and direction of potential threats to financial stability and the assessment of financial stability is based on expert evaluation.

1. INTERNATIONAL ENVIRONMENT

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

The financial crisis effects that escalated on a global scale almost two years ago have started abating. Monetary and fiscal policy on the global level was expansive during 2010. Economic growth was rather uneven by the country and region. Some advanced economies, including the USA and Germany, managed to recover relatively quickly as the recovery was supported by external demand from Asian developing countries. On the other hand, numerous advanced countries (Great Britain, France, Spain, Italy, Japan) have been recording negative indicators of growth which still do not allow drawing a definite conclusion of their full recovery.

The global economic growth in Q3 2010 averaged 3.5% annually, which is much above the IMF projections as of April 2010. That is why the IMF revised its global growth projections in 2010 from 4.5% (October) to 4.7% (the latest projection as of January 2011). The 2011 growth estimate remained at 4.5%.

Risks that remain primarily involve the sustainability of fiscal policies that emerged as the response to the financial crisis, with the main focus on fiscal sustainability and the sustainability of external debt of advanced economies, in particular Greece and Ireland, as well as other countries in the Euro area that have been experiencing difficulties with their external debts (Portugal, Spain and Italy). In addition, the expressed level of risk remains present in the real estate market that has been stagnating, as has the available private sector income. Furthermore, it is now almost certain that due to the prolonged effects on expansive monetary policies, accompanied by instability in oil exporting countries, inflationary pressures keep growing on the global scale. Going forward, risks that remain are unstable banking sectors and the expected inflation growth on a global level.

Table 1.1 – IMF projections of selected macroeconomic indicators

	2009	2010	Projections		Difference from October 2010 projections		Q4-on-Q4		
			2011	2012	2011	2012	Estimate 2010	Projection 2011	2012
Global GDP	-0.6	5.0	4.4	4.5	0.2	0.0	4.7	4.5	4.4
Advanced economies	-3.4	3.0	2.5	2.5	0.3	-0.1	2.9	2.6	2.5
USA	-2.6	2.8	3.0	2.7	0.7	-0.3	2.7	3.2	2.7
Euro Area	-4.1	1.8	1.5	1.7	0.0	-0.1	2.1	1.2	2.0
Germany	-4.7	3.6	2.2	2.0	0.2	0.0	4.3	1.2	2.7
France	-2.5	1.6	1.6	1.8	0.0	0.0	1.7	1.5	1.9
Italy	-5.0	1.0	1.0	1.3	0.0	-0.1	1.3	1.2	1.4
Spain	-3.7	-0.2	0.6	1.5	-0.1	-0.3	0.4	0.8	1.9
Japan	-6.3	4.3	1.6	1.8	0.1	-0.2	3.3	1.4	2.4
Great Britain	-4.9	1.7	2.0	2.3	0.0	0.0	2.9	1.5	2.6
Canada	-2.5	2.9	2.3	2.7	-0.4	0.0	2.7	2.7	2.6
Other advanced economies	-1.2	5.6	3.8	3.7	0.1	0.0	4.5	4.7	2.9
Newly industrialized Asian economies	-0.9	8.2	4.7	4.3	0.2	-0.1	5.9	6.2	3.1
Developing economies	2.6	7.1	6.5	6.5	0.1	0.0	7.2	7.0	6.8
Central and Eastern Europe	-3.6	4.2	3.6	4.0	0.5	0.2	4.3	3.5	3.9
Commonwealth of Independent States	-6.5	4.2	4.7	4.6	0.1	-0.1	3.5	4.8	4.3
Russia	-7.9	3.7	4.5	4.4	0.2	0.0	3.4	4.6	4.3
Developing Asia	7.0	9.3	8.4	8.4	0.0	0.0	9.1	8.6	8.4
China	9.2	10.3	9.6	9.5	0.0	0.0	9.7	9.5	9.5
India	5.7	9.7	8.4	8.0	0.0	0.0	10.3	7.9	8.0
Asian countries 5*	1.7	6.7	5.5	5.7	0.1	0.1	5.1	6.4	5.2
Latin America and the Caribbean	-1.8	5.9	4.3	4.1	0.3	-0.1	4.8	5.0	4.3
Brazil	-0.6	7.5	4.5	4.1	0.4	0.0	5.2	5.1	4.0
Mexico	-6.1	5.2	4.2	4.8	0.3	-0.2	3.2	5.0	4.5
Middle East and North Africa	1.8	3.9	4.6	4.7	-0.5	-0.1	...	...	...
Sub-Saharan Africa	2.8	5.0	5.5	5.8	0.0	0.1	...	...	...
South Africa	-1.7	2.8	3.4	3.8	-0.1	-0.1	3.6	3.4	4.1
EU	-4.1	1.8	1.7	2.0	0.0	-0.1	2.5	1.4	2.2
World trade volume	-10.7	12.0	7.1	6.8	0.1	0.2	...	...	...
Imports of advanced economies	-12.4	11.1	5.5	5.2	0.3	0.1	...	...	...
Exports of emerging and developing economies	-8.0	13.8	9.3	9.2	-0.6	-0.1	...	...	...
Exports of advanced economies	-11.9	11.4	6.2	5.8	0.2	0.3	...	...	...
Exports of emerging and developing economies	-7.5	12.8	9.2	8.8	0.1	0.2	...	...	...

* Including Indonesia, Malaysia, the Philippines, Thailand and Vietnam.
Source: World Economic Outlook Update, IMF January 2011

European Union

GDP - The estimated annual GDP growth in the EU and the Euro area countries amounted to 1.8% and 1.7%, respectively. These indicators suggest that there has been the post-crisis recovery, but growth remains slowed down.

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

EU	2010	2011	2012
Annual GDP growth	0.3	0.8	0.7
Q4/Q4	2.3	1.6	2.3
Annual average	1.8	1.7	2.0
Euro Area			
Annual GDP growth	0.3	0.7	0.6
Q4/Q4	2.1	1.5	2.0
Annual average	1.7	1.5	1.8

Source: European Commission, Economic Forecast, Autumn 2010

Recent forecasts show that the EU and the Euro area GDP growth in 2011 of the respective 1.8% and 1.6% could be expected due to the recovery of private spending and increased exports. However, it should be noted that a rather high level of disparity in growth dynamics of individual countries are to be expected. Thus, Germany's economic growth is projected at the annual level of 2.4%, whereas Spain is expected to grow by a mere 0.8%.

Labour market – represents one of the segments of EU economy that has strongly felt the financial crisis impact. Nevertheless, the unemployment rate in the Euro area and the EU remained at 10% and 9.6%, respectively, with obvious fluctuations by the country, ranging from 20.2% in Spain to 4.5% in the Netherlands at end-2010. Estonia recorded the highest year-on-year unemployment decline (from 16.1% to 14.3%), whereas the country that registered the highest unemployment increase was Greece (from 9.7% to 12.9%). The projected decline in the EU unemployment rate in 2011 is insignificant, reducing just to the level of 9.5%.

Table 1.3 – Unemployment rate (%) – European Commission projections

	2007	2008	2009	2010	2011	2012
					Projection	
Belgium	7.5	7.0	7.9	8.6	8.8	8.7
Germany	8.4	7.3	7.5	7.3	6.7	6.3
Estonia	4.7	5.5	13.8	17.5	15.1	13.6
Ireland	4.6	6.3	11.9	13.7	13.5	12.7
Greece	8.3	7.7	9.5	12.5	15.0	15.2
Spain	8.3	11.3	18.0	20.1	20.2	19.2
France	8.4	7.8	9.5	9.6	9.5	9.2
Italy	6.1	6.7	7.8	8.4	8.3	8.2
Cyprus	4.0	3.6	5.3	6.8	6.6	5.9
Luxembourg	4.2	4.9	5.1	5.5	5.6	5.6
Malta	6.4	5.9	7.0	6.6	6.6	6.5
The Netherlands	3.6	3.1	3.7	4.5	4.4	4.3
Austria	4.4	3.8	4.8	4.4	4.2	4.0
Portugal	8.1	7.7	9.6	10.5	11.1	11.2
Slovenia	4.9	4.4	5.9	7.2	7.2	6.6
Slovakia	11.1	9.5	12.0	14.5	14.2	13.4
Finland	6.9	6.4	8.2	8.3	7.8	7.2
Euro Area	7.5	7.5	9.5	10.1	10.0	9.6
Bulgaria	6.9	5.6	6.8	9.8	9.1	8.0
Czech Republic	5.3	4.4	6.7	7.3	7.0	6.7
Denmark	3.8	3.3	6.0	6.9	6.3	5.8
Latvia	6.0	7.5	17.1	19.3	17.7	16.2
Lithuania	4.3	5.8	13.7	17.8	16.9	15.1
Hungary	7.4	7.8	10.0	11.1	11.0	10.3
Poland	9.6	7.1	8.2	9.5	9.2	8.5
Romania	6.4	5.8	6.9	7.5	7.4	7.0
Sweden	6.1	6.2	8.3	8.3	8.0	7.5
Great Britain	5.3	5.6	7.6	7.8	7.9	7.8
EU	7.2	7.0	8.9	9.6	9.5	9.1
USA	4.6	5.8	9.3	9.6	9.4	9.0
Japan	3.9	4.0	5.1	5.1	4.9	4.8

Source: European Commission, Economic Forecast, Autumn 2010

Current account deficit – Q4 2010 was also characterized by significant adjustments and corrections in current and capital accounts of the EU Member States, primarily due to the increase in energy and food prices, as well as that of metals, which led to an increase in the EU current account deficit. Thus the estimated EU current account deficit in Q4 2010 was EUR 30.4 billion in comparison with EUR 19.7 billion in Q3. This means that the estimated share of the deficit in GDP amounted to 0.9%, which is more than the targeted level of 0.5%.

Table 1.4 – Current account deficit, % of GDP

	2007	2008	2009	2010	2011	2012
Belgium	3.9	1.1	2.0	1.7	2.0	2.0
Germany	7.6	6.7	5.0	4.8	4.6	4.3
Estonia	-17.2	-8.8	4.5	4.1	1.4	0.9
Ireland	-5.5	-5.6	-3.1	-1.1	1.5	2.7
Greece	-15.7	-16.4	-14.0	-10.6	-8.0	-6.5
Spain	-10.0	-9.6	-5.5	-4.8	-3.8	-3.6
France	-2.2	-2.7	-2.9	-3.3	-3.4	-3.5
Italy	-1.8	-3.1	-3.2	-3.2	-2.7	-2.4
Cyprus	-11.7	-17.7	-8.5	-6.1	-5.7	-5.4
Luxembourg	10.1	5.3	6.7	8.4	9.4	9.9
Malta	-6.2	-5.6	-6.1	-3.9	-2.9	-2.2
The Netherlands	8.4	4.8	3.4	5.2	6.8	7.9
Austria	4.0	3.7	2.6	3.0	3.5	4.1
Portugal	-10.2	-12.5	-10.4	-10.7	-8.0	-6.7
Slovenia	-4.5	-6.8	-1.3	-0.7	-0.6	-0.8
Slovakia	-5.1	-6.9	-3.4	-2.9	-1.9	-1.7
Finland	4.2	3.5	1.3	1.3	1.6	1.4
Euro Area	**0.2**	**-0.8**	**-0.7**	**-0.5**	**0.0**	**0.1**
Bulgaria	-20.1	-20.6	-8.4	-3.3	-2.5	-2.3
Czech Republic	-2.6	-0.8	-1.2	-1.9	-1.5	-1.1
Denmark	1.4	2.7	3.6	4.5	4.2	4.0
Latvia	-22.3	-13.1	8.6	3.9	-0.5	-2.9
Lithuania	-15.1	-13.1	2.6	2.6	1.3	1.0
Hungary	-7.0	-6.9	-0.4	0.8	0.4	-0.4
Poland	-5.1	-4.8	-1.9	-2.7	-3.3	-3.7
Romania	-13.6	-11.4	-4.5	-5.5	-5.6	-6.2
Sweden	8.6	8.9	7.3	6.6	6.5	6.1
Great Britain	-2.6	-1.6	-1.3	-2.2	-1.5	-0.2
EU	**-0.5**	**-1.0**	**-0.6**	**-0.5**	**-0.1**	**0.1**
USA	-5.1	-4.7	-2.7	-3.4	-4.0	-4.2
Japan	4.8	3.2	3.5	3.8	3.7	3.7

Source: European Commission, Economic Forecast, Autumn 2010

Inflation – The HICP inflation trended up in 2010. To wit, due to the increase in the consumer goods` prices, excise duties, as well as significant growths in energy and food prices, inflation in the Euro area and the EU respectively amounted to 2.2% and 2.6% at end-2010, which is much above the projected levels of 1.5% and 2%. The lowest inflation was recorded in Slovakia, 1.3%, whereas the highest rate of inflation was registered in Romania, 7.9%.

Table 1.5 – Projections of inflation in the EU and euro area until 2012

	Euro area					European Union				
	2008	2009	2010	2011	2012	2008	2009	2010	2011	2012
Personal consumption deflator	2.7	-0.2	1.7	1.7	1.6	3.0	0.3	2.1	1.9	1.7
GDP deflator	2.0	1.0	0.5	1.5	1.5	2.5	1.2	1.0	1.7	1.6
HICP	3.3	0.3	1.5	1.8	1.7	3.7	1.0	2.0	2.1	1.8
Unit labour costs	3.6	4.0	-0.6	0.6	0.9	3.8	4.3	-0.4	0.7	1.2
Import deflator	4.2	-7.4	5.9	1.3	1.8	5.2	-5.3	5.0	1.3	1.9

Source: Economic Forecast, European Commission, Autumn 2010

Table 1.6 – Projections of HICP in the EU and Euro area until 2012, %

	2007	2008	2009	2010	2011	2012
Belgium	1.8	4.5	0.0	2.3	1.9	1.9
Germany	2.3	2.8	0.2	1.1	1.8	2.0
Estonia	6.7	10.6	0.2	2.7	3.6	2.3
Ireland	2.9	3.1	-1.7	-1.5	0.4	0.6
Greece	3.0	4.2	1.3	4.6	2.2	0.5
Spain	2.8	4.1	-0.2	1.7	1.5	1.4
France	1.6	3.2	0.1	1.7	1.6	1.6
Italy	2.0	3.5	0.8	1.6	1.8	1.9
Cyprus	2.2	4.4	0.2	2.8	3.3	2.5
Luxembourg	2.7	4.1	0.0	2.8	2.1	1.6
Malta	0.7	4.7	1.8	1.9	2.0	2.3
The Netherlands	1.6	2.2	1.0	1.0	1.5	1.6
Austria	2.2	3.2	0.4	1.7	2.1	1.8
Portugal	2.4	2.7	-0.9	1.4	2.3	1.3
Slovenia	3.8	5.5	0.9	2.1	2.0	2.2
Slovakia	1.9	3.9	0.9	0.7	3.2	2.8
Finland	1.6	3.9	1.6	1.6	2.1	1.8
Euro Area	**2.1**	**3.3**	**0.3**	**1.5**	**1.8**	**1.7**
Bulgaria	7.6	12.0	2.5	2.9	3.2	3.1
Czech Republic	3.0	6.3	0.6	1.2	2.1	2.2
Denmark	1.7	3.6	1.1	2.2	2.1	2.0
Latvia	10.1	15.3	3.3	-1.3	1.1	1.8
Lithuania	5.8	11.1	4.2	1.2	2.3	2.8
Hungary	7.9	6.0	4.0	4.7	3.9	3.7
Poland	2.6	4.2	4.0	2.6	2.9	3.0
Romania	4.9	7.9	5.6	6.1	5.5	3.2
Sweden	1.7	3.3	1.9	1.8	1.4	1.9
Great Britain	2.3	3.6	2.2	3.2	2.6	1.4
EU	**2.4**	**3.7**	**1.0**	**2.0**	**2.1**	**1.8**
USA	2.8	3.8	-0.4	1.6	1.1	1.5
Japan	0.0	1.4	-1.4	-0.9	-0.7	0.0

Source: Economic Forecast, European Commission, Autumn 2010

Fiscal policy and external debt - Almost all EU and Euro area countries have implemented a wide range of expansive fiscal policy measures in both 2009 and 2010, which conditioned temporary derogations from the Maastricht criteria. A positive step forward is that the Euro area countries started adjusting their fiscal policies in 2010 towards more restrictive measures, which reflected on the deficit decline that amounted to 5.9% of GDP in Q3, in contrast to the projected level of 7.25%.

In parallel, the external debt of the Euro area was on an increase over the reporting year, reaching 82.7% at end-Q3, whereas the growth in 2011 (taking into account guarantees) is projected at the level of 86.5% of GDP.

Table 1.7 – Projections of fiscal expenditure and public debt in the EU and the Euro area, % of GDP

	Euro area					European Union				
	2008	2009	2010	2011	2012	2008	2009	2010	2011	2012
TOTAL REVENUES	44.9	44.5	44.4	44.8	44.8	44.5	44.0	43.9	44.1	44.2
TOTAL EXPENDITURES	46.9	50.8	50.8	49.4	48.7	46.9	50.8	50.6	49.2	48.4
BALANCE (3) = (1) – (2)	-2.0	-6.3	-6.3	-4.6	-3.9	-2.3	-6.8	-6.8	-5.1	-4.2
Interest expenditure (4)	3.0	2.8	2.9	3.0	3.2	2.8	2.6	2.7	2.9	3.0
Primary balance (5) – (3) + (4)	1.0	-3.4	-3.5	-1.6	-0.8	0.4	-4.2	-4.0	-2.2	-1.2
Cyclically-adjusted balance	-2.6	-4.4	-4.9	-3.5	-3.2	-3.0	-4.9	-5.3	-3.9	-3.4
Cyclically-adjusted primary balance	0.4	-1.6	-2.1	-0.5	0.0	-0.2	-2.3	-2.5	-1.0	-0.4
Gross public debt	69.7	79.1	84.1	86.5	87.8	61.8	74.0	79.1	81.8	83.3

Source: Economic Forecast, European Commission, Autumn 2010

USA

The USA recorded a significant year-on-year increase in economic activity in 2010, leading to a rise in the annual GDP estimate of 2.8%.

A slight slowdown in GDP growth in Q4 was primarily due to declining stocks and private sector spending. In parallel, exports declined and real estate prices remained stagnant, thus affecting the economic slowdown, whereby the creation of stock represented the main culprit for the slowdown.

As for the unemployment rate, it oscillated between 9.4% and 9.9%, displaying a declining trend and seeing the 2010 year-end at 9.4% and a further decline outlook of almost 0.8 percentage points by the end of 2011.

At end-2010, real wages declined by 0.4%. According to the US Department of Labour data, productivity increased by 1.9% in Q4 2010 in relation to the corresponding quarter in 2009. This represents a substantial growth at the annual level (of 3.9%).

Inflation pressures in the USA increased in the second half of 2010, primarily due to the growth in the energy and food prices, which affected inflation growth of up to 1.5% in relation to the period June-November, when it ranged from 1.1% to 1.2%.

The Federal Open Market Committee (FOMC) held a meeting at end-December 2010 and decided to keep interest rates low within the range from 0% to 0.25%, planning not to make long-term corrections, while the discount rate remained the same (0.75%).

Japan

In 2010, economy in Japan sent some recovery signals, mostly due to the growing external aggregate demand from the markets of China and the EU although domestic demand and public investments recorded slow recovery. However, the country saw a decline of 3.3% at the annual level in Q4 2010 due to reduced private consumption, instability in the industrial sector and further unemployment growth.

At end-2010, export substantially increased at monthly level (7.3%), whereby China, the USA and newly industrialized countries in Asia represent the most important exporting markets. On the other hand, import declined by 1%, mostly due to a decrease in the import of raw materials and low-processed products, which may affect a future downtrend in production.

Industrial production showed signs of the month-on-month recovery in December 2010 (3.1%). However, at quarterly level, production substantially declined. Thus, Q4 recorded a 1.7% decline in relation to Q3 or 1.8% at the annual level.

The Japanese market suffered abrupt deterioration in 2010, and subsequently the unemployment rate deteriorated by 0.4 percentage points only in the last quarter. This resulted in a 4.4% increase in unemployment at end-December.

Table 1.8 – Overview of selected macroeconomic indicators of Japanese economy

	2010.			
	Q1	Q2	Q3	Q4
Real GDP	**1.5**	**0.5**	**0.8**	**-0.3**
Domestic demand	**1.0**	**0.3**	**1.0**	**-0.2**
Private sector demand	1.1	0.3	1.0	0.0
Private consumption	0.3	-0.0	0.5	-0.4
Non-resident investments	0.1	0.4	0.2	0.1
Resident investments	0.0	-0.0	0.0	0.1
Private sector stocks	0.6	-0.1	0.3	0.2
Public demand	-0.1	0.0	-0.1	-0.2
Public investments	-0.1	-0.2	-0.1	-0.2
Net export of goods and services	**0.5**	**0.3**	**-0.1**	**-0.1**
Export	0.9	0.8	0.2	-0.1
Import	-0.4	-0.5	-0.4	0.0
Nominal GDP	**1.7**	**-0.6**	**0.6**	**-0.6**

Source: Monthly report of Bank of Japan, February 2011

However, it is certain that natural disasters will affect deep recession in 2011, and that recovery will take many years.

Impact of international environment on Montenegro

It is certain that international environment still negatively affected Montenegro in 2010, but with positive movements in the second half of the year, resulting in a gradual growth of external demand, recovery of employment and available income, which may have positive impact on production growth, increase of remittances and an easier access to the international capital market (foreign financing) in 2011.

However, it is important to note that as long as growth in economic activity remains slow, with the special emphasis on the EU countries, it will have a negative impact on Montenegro that will reflect on: construction, tourism, manufacturing industry, the banking system, the capital market and the like. In addition, expressed imbalance between the EU and the EMU countries` development represents a potential source of risk, with the special emphasis on the most important trading partners of Montenegro, such as Italy and Greece and which expect slower economic growth in 2011. General conclusion is that the remaining recession in certain segments of economy at the global level (weak recovery of private consumption and available income) and growing inflation pressures may have certain negative impact. Still, foreseen gradual recovery of the global economy in 2011 should have a positive impact on financial stability of Montenegro.

Uncertainty regarding the inflation pressure level and its impact on the prices in Montenegrin economy represents a potential growing risk. Namely, during the writing of this report, changed conditions in international real flows were recorded and they substantially affect the level of global prices and in Montenegro as well. Sudden natural disasters and deteriorated political situation in oil exporting countries will have a substantial impact on external factors which determine elements of imported inflation, in particular in the first half of 2011. The expected dominant channels of international impact on the prices in Montenegro are food and energy prices, both on the supply as well on the demand side. Unfavourable weather conditions affected a decrease in supply and an increase of food prices, while negative impact coming from the growing political instability in the oil exporting countries reflected through an increase in the energy prices, that is, the impact is transferred from the supply side, as well as from the inflexible demand side. In addition, recovery of the global aggregate demand will exert a pressure on the prices in the Montenegrin economy.

2. MACROECONOMIC ENVIRONMENT IN MONTENEGRO

2.1. GDP movements

During the three-year period before the crisis, Montenegro's GDP recorded extremely high rates of real growth of around 8%. The effects of the crisis, being the most evident in Q4 2008 and 2009, the latter recording a negative real GDP growth rate of 5.7%, slowed down and halted in 2010, especially in the second half of 2010, when the first signs of recovery were registered. In the third and fourth quarter of 2010, Montenegrin economy entered a positive growth zone as the result of growing overall industrial output, tourism, trade, forestry and some segments in transport. Gross and net salaries increased in this period. Therefore, it would be realistic to expect that GDP growth would range between 1% and 2% in 2010. The recession factors have not only affected the supply side, but also the aggregate demand side, i.e. the national consumption. Slow recovery of aggregate demand resulted in low inflation. The previous year will be remembered for the lowest inflation rate ever recorded in Montenegro (0.7%).

Taking into account the depth of the crisis in 2009, obvious positive trends in 2010 were above expectations for some branches (industry, forestry, tourism, etc.).

In 2010, total indirect taxes were higher than in the previous year, as were household deposits, while corporate deposits and public spending declined, with the exception of Q4 when the public spending recorded increase. Still, these indicators did not have a strong effect on overall financial stability. It may be expected that the upcoming period of economic revival will be additionally supported by improved availability of pre-accession funds owing to the granted status of the EU candidate country. Potential risks that remain and that may affect GDP include: illiquidity in the real sector and the established borrower-creditor relations, reduced propensity of banks to new lending to the real sector, reduced opportunities for new capital sources to initiate economic activity through new investments, and the like.

Estimate of GDP movements in 2011 and their impact on financial stability

Considering the depth of the crisis in 2009, most international financial institutions dealing with GDP forecasts have forecasted a negative rate of growth for Montenegro's GDP in 2010. The reasons for such an assessment are negative economic trends recorded in Q1 and to a great extent over the first half of 2010. The correction of negative trends at the beginning of 2010 happened after the end of the tourist season which indicated the recovery of the tourism sector and complementary activities (trade and some segments of transport). The additional correction factor was the output growth, especially in the energy sector. The real GDP rate for 2010 was revised several times, thus the lowest one (-1.8%) given by the IMF (World Economic Outlook, October 2010) was corrected after the IMF mission in February 2011 (to 1.1%). Data clearly show that the Montenegrin economy left the recession, yet exiting the crisis will require a longer time period, especially when it comes to the labour market. Should an improved economic activity lead to lower unemployment, then it might be said that the economy exited the crisis. Movement of the main indicators in the upcoming period might confirm this statement, especially knowing that highly praised institutions estimated that the real GDP growth in 2011 could range between 2% and 4%. After their mission in February 2011, the IMF corrected the former real GDP growth forecast (4.5% in 2011) for the Montenegrin economy to a lower value.

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

Institution	Estimated rate of growth in 2011
IMF	2.0
EBRD	3.1
UN DESA	3.0
Business Monitor Online	4.0

Table 2.2 – Montenegro: selected economic indicators, 2009-12[1]

	2009	2010	2011	2012
		EIU assessment	Projection	
Real GDP growth	-5.7	0.5	2.5	4.5
Industrial production, growth	-32.7	19.0	3.0	5.0
Consumer prices (average)	3.4	0.6	2.3	2.7
Consumer prices (end of period)	1.5	1.8	2.6	3.0
Fiscal deficit (% of GDP)	-4.5	-4.4	-3.6	-2.0
Current account deficit (% of GDP)	-30.1	-17.9	-13.8	-10.9

[1] Source: Country Report - Montenegro, Economist Intelligence Unit, January 2011

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

	2008	2009	2010 Prelim.	2011	2012	2013	2014	2015
				Projection				
	in Eur million							
Current account balance	-1,584	-896	-775	-383	-348	-341	-366	-394
Trade balance	-2,102	-1,372	-1,315	-1,123	-1,188	-1,273	-1,402	1,542
Exports	450	296	357	420	475	511	550	582
Imports	-2,552	-1,668	-1,671	-1,544	-1,663	-1,784	-1,951	-2,124
Services balance	399	385	446	670	751	836	930	1,036
Receipts	751	680	747	893	991	1,099	1,219	1,352
Expenditure	-351	-296	-301	-223	-240	-263	-289	-316
Net factor income	46	5	-21	-26	-14	-14	-14	-14
Compensation of employees	137	150	150	144	156	167	179	191
Investment income	-91	-144	-171	-170	-170	-182	-193	-205
Current transfers, net	73	85	114	96	104	112	119	127
Government	9	5.	16.	...	...	...	...	......
Remittances	64	80	98	...	...	...	...	...
Capital and financial accounts	1,325	528	368	459	434	432	463	496
Capital account	0	2	0	0	0	0	0	0
Financial account	1,325	526	368	459	434	432	463	496
FDI, net	582	1,066	542	199	251	270	288	307
In Montenegro, net	656	1,099	564	...	...	...	...	...
Abroad, net	-74	-33	-22	...	...	...	...	...
Portfolio investment, net	-16	-42	188	0	0	0	0	0
Other	604	-414	-345	259	183	162	175	189
General government	-7	143	8	...	...	...	...	...
Commercial banks	551	-303	-176	-93	-6	-3	-2	-1
Other non-bank sectors	61	-283	-177	352	189	165	177	190
Net errors and omissions	258	368	406	53	58	62	66	70
Change in official reserves	155	-85	-17	-22	-28	-30	-30	-32
Memorandum items	in percent of GDP							
Current account balance	-51.3	-30.1	-25.6	-12.2	-10.3	-9.4	-9.4	-9.5
Merchandize trade	-68.1	-46.0	-43.5	-35.9	-35.1	-35.0	-36.0	-37.2
Exports	14.6	9.9	11.8	13.4	14.0	14.0	14.1	14.0
Imports	-82.7	-56.0	-55.2	-49.4	-49.2	-49.0	-50.2	-51.3
Services balance	12.9	12.9	14.8	21.4	22.2	23.0	23.9	25.0
Receipts	24.3	22.8	24.7	28.6	29.3	30.2	31.3	32.6
Payments	-11.4	-9.9	-9.9	-7.1	-7.1	-7.2	-7.4	-7.6
Foreign direct investment	18.9	35.8	17.9	6.4	7.4	7.4	7.4	7.4

Sources: Central Bank of Montenegro and IMF projections

Table 2.4 – Vienna Institute projections[2]

	2008	2009	2010P	2011P	2012P
Real GDP growth (%)	6.9	-5.7	-1.0	2.0	3.0
Consumer prices (% y-o-y change)	7.4	3.4	1.0	3.0	3.0
Unemployment rate (as per Labour Force Survey)	17.2	19.3	20.0	20.0	20.0
Current account (% of GDP)	-50.7	-30.1	-22.6	-21.2	-20.0

Table 2.5 – EBRD projections

	Real GDP growth (%)									
	GDP growth year over year percent change						Memorandum items GDP growth within year			
			EBRD forecast in January 2011		EBRD forecast in October 2010			Forecast (January 2011)		
	2008	2009	2010	2011	2010	2011	2008	2009	2010	2011
Central Europe and Baltic states										
Croatia	2.4	-5.9	0.6	2.0	-1.5	1.9	0.2	-4.9	0.8	2.7
Estonia	-3.6	-14.7	-1.8	2.7	2.4	3.2	-9.2	-12.7	2.4	2.6
Hungary	0.6	-6.7	-0.6	2.0	0.8	1.7	-2.5	-5.3	0.4	2.5
Latvia	-4.6	-17.9	-2.0	2.5	-1.0	2.6	-10.3	-15.7	1.2	3.2
Lithuania	2.8	-15.2	-0.5	2.3	0.5	4.0	-2.2	-13.7	-0.7	3.2
Poland	5.0	1.4	2.3	3.0	3.3	3.5	2.6	1.9	2.1	3.6
Slovakia	6.2	-5.3	2.8	3.7	4.0	3.5	1.6	-5.3	2.2	4.0
Slovenia	3.5	-7.5	1.9	2.7	1.1	2.1	-0.8	-4.2	1.7	3.0
Average	**3.5**	**-3.3**	**1.4**	**2.8**	**2.2**	**3.0**	**0.3**	**-2.3**	**1.6**	**3.3**
South-eastern Europe										
Albania	7.0	4.3	2.0	3.9	3.0	2.2	6.9	2.1	3.2	4.1
Bosnia and Herzegovina	5.4	-4.4	0.6	1.9	0.8	2.2	…	…	…	…
Bulgaria	6.0	-4.8	0.0	2.7	0.4	2.4	3.5	-4.9	0.7	3.5
Macedonia	4.8	-1.2	2.0	3.8	0.8	2.3	1.0	-0.6	3.2	4.0
Montenegro	7.0	-4.3	0.4	2.0	-0.6	2.5	…	…	…	…
Romania	7.1	-7.0	1.3	2.3	-2.0	0.9	2.9	-6.1	2.2	2.8
Serbia	5.4	-3.1	2.4	3.2	1.6	2.9	2.8	-1.7	1.9	3.7
Average	**6.5**	**-5.4**	**1.2**	**2.6**	**-0.6**	**1.6**	**2.9**	**-4.4**	**1.8**	**2.9**

The estimate of Montenegro's real GDP growth in 2011 that was based on model and expert assessments ranges between 2.7% and 3%.

Positive trends of some economic indicators in Q3, and especially in Q4 2010 indicate the halting of the recession in Montenegro. Assuming that negative trends in sectors which contribution is of high importance for total GDP shall not repeat (industry, tourism (the latter due to the multiplication effects on some industries), trade, real estate activities, and the like), higher growth rate is to be

[2] Source: wiiw (November 2010), Eurostat. Forecasts by wiiw and European Commission (Interim Forecast, September 2010) for EU.

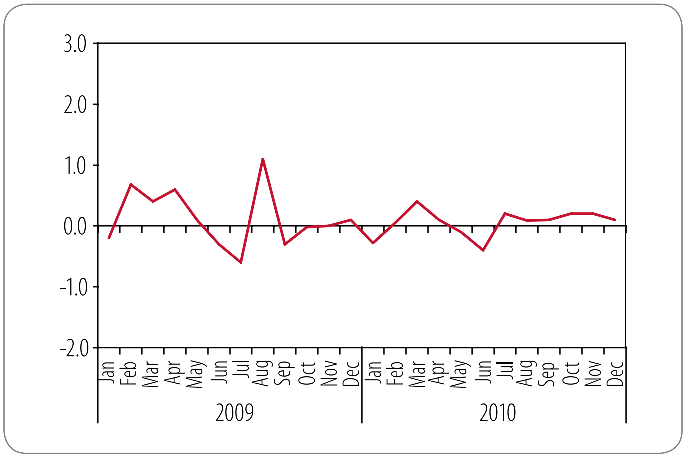
expected in 2011. In addition, all relevant international institutions forecasted that Montenegro should record higher rate of growth in 2011, as compared to the previous year. Therefore, it may be concluded that GDP growth would have a positive effect on preserving financial stability.

2.2. Inflation

In December 2010, CPI inflation in Montenegro amounted to 0.7%, which is the lowest inflation rate ever recorded in Montenegro, either measured by the retail price index or the cost-of-living index. Lower CPI inflation was the result of lower prices under "dwelling" by 7.5% (mostly due to the lower price of electricity - correction in early 2010) and a bit modest fluctuations in some categories of the total consumer prices basket ("clothes and footwear", "education", "other goods and services") and the recorded high base from previous years under the category "food and non-alcoholic beverages".

Graph 2.1

Consumer prices, monthly rate of growth



Source: Monstat

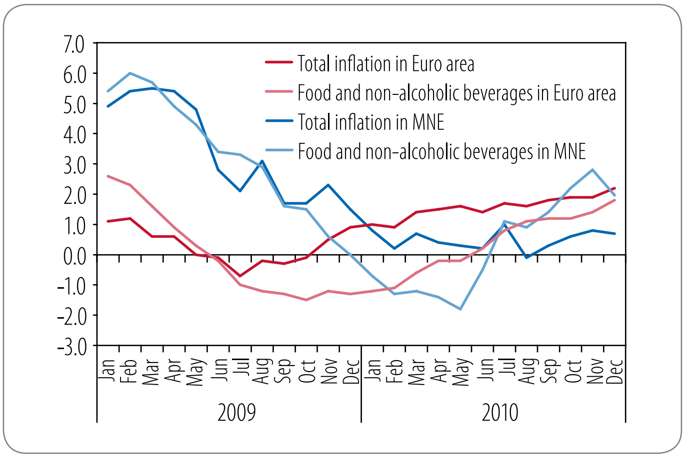
Prices under "food and non-alcoholic beverages" recorded annual growth of 2%. Within this category, products under milk, cheese and eggs and fish recorded decline by 3.5% and 4.6%, respectively, whereas the prices of oils and fats, fruit, vegetables, bread and cereals and non-alcoholic beverages recorded respective increases of 19.7%, 7.6%, 7.9%, 1.3% and 5.1%. The prices under "transport" recorded a 6% growth, mostly as the result of the higher prices of fuels and lubricants (13%), as well as the prices under "health care" (5%). The increase was recorded in prices under "restaurants and hotels" (2.1%), "housing and household appliances" (1%), "footwear and clothes" (0.3%), "education" (0.1%) and "other goods and services" (0.7%). The highest price decline was recorded in the category "dwelling" (-7.5%), due to the lower price of electricity by 11.3% (corrected price in January 2010) and lower prices of rents – fees for dwelling by 13.8% (product introduced in the consumer basket in January 2010). The price decline was recorded under "alcoholic beverages and tobacco" (-1%) as the result of the lower prices of alcoholic beverages (-2.3%), while the prices under "culture and recreation" fell by 2.2%.

The annual **core inflation** rate amounted to 0.41% in December 2010, being 0.33 percentage points lower than total annual inflation. During the reporting year (except in August and November), the annual core inflation was lower than total inflation, and had negative sign in the first five months, as well as in July.

As of the crisis emergence, food prices dictated inflation to a great extent, as shown in Graph 2.2. After a decline in the food prices (at the annual level) in the second half of 2009 and moderate changes in the first months of 2010, the food prices started to increase again. According to the Food and

Graph 2.2

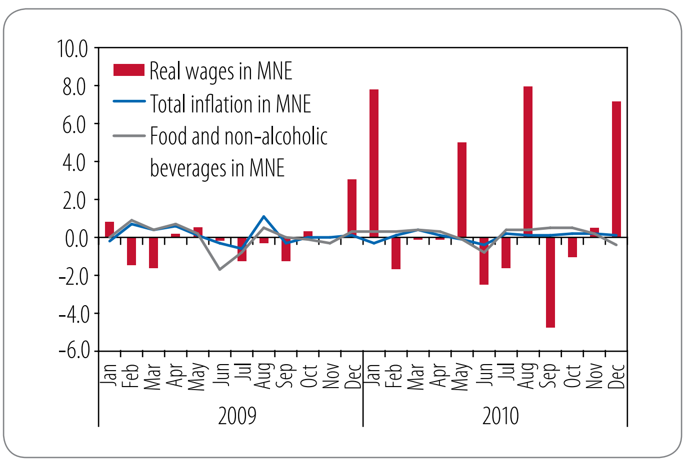
Comparison of total inflation and food prices in Montenegro and the Euro area (annual change)



Source: Monstat and Eurostat

Graph 2.3

Movement of inflation, food and non-alcoholic beverages prices and real wages (monthly change in %)



Source: Monstat

Agriculture Organization of the United Nations (FAO), in December 2010 and at the beginning of 2011, the food prices reached their record highs that exceeded the prices from the pre-crisis years (2007 and 2008). Taking into account the expected increase in the oil and food prices at the global market, a significant increase in the food prices may be expected in Montenegro, which could strongly affect an increase in overall inflation in 2011.

The increase in global oil prices and the growing prices of crops, the latter induced by poor weather and fires in 2010, will reflect on the movement of prices of other food products. Since Montenegro is highly dependent on the import of food, and since the category "food and non-alcoholic beverages" holds the highest weight in the consumer basket, an increase in the prices of some groups or individual products within this category could largely determine the movement of total inflation in the following period. Although the prices of agricultural products in Montenegro recorded extremely high levels over the previous two years, it is evident that together with an increase in the prices of liquid fuels they would exert the pressure on the annual inflation growth. Since a very low inflation rate was recorded in 2010 and the market trends indicate nothing else but an increase in prices, inflation in Montenegro is expected to range between 3.50% and 5.75% by 2011 year-end, which is not the level that could pose a threat to financial stability, still it aggravates the macroeconomic environment.[3] Moreover, there is a high level of uncertainty due to the transmission of negative shocks from the international market, which indicates that this forecast should be taken with a slight reservation. Taking into account that this is the external inflation it can be hardly affected by monetary policy instruments, even in case when all monetary policy instruments are available (which is not the case in Montenegro).

[3] For more information on assumptions behind the inflation forecast see the Price Stability Report.

2.3. Fiscal deficit/surplus

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

Table 2.6 – Movement of fiscal surplus/deficit

Description/Period	2009				2010			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Current Revenues	216.7	501.6	833.6	1169.3	213.6	498.4	803.80	1106.5
Consolidated Expenditures	224.6	482.8	841	1301.4	250.2	510.3	803.82	1191.1
Montenegro budget surplus (in million €)	-7.9	18.8	-7.4	-132.1	-36.6	-11.9	-0.02	-84.6
% Share in GDP*	-0.3%	0.6%	-0.2%	-4.4%	-1.1%	-0.4%	-0.001%	-2.8%

* Surplus/deficit ratio in the reported quarter and estimated GDP in 2009 (EUR 2,981 million) and 2010 (EUR 3,025.0 million).

Source: Ministry of Finance

Current budget revenues in 2010 amounted to EUR 1.106.5 million or 36.6% of the estimated GDP. These revenues were 2% lower than planned due to the lower collection of taxes, duties, fees and other revenues. Compared to 2009, these revenues fell by 5.4%.

Table 2.7 – Source revenues of the Budget and Funds

Description	Plan 2010 in mil €	Realization in 2010 in mil €	% of realization	Deviation in absolute terms in mil €
TAXES	**746.27**	**675.80**	**90.56**	**-70.47**
Personal income tax	83.63	89.75	107.32	6.12
Corporate profit tax	49.58	20.27	40.88	-29.31
Real estate turnover tax	5.65	4.94	87.43	-0.71
VAT	398.86	364.18	91.31	-34.68
Excise tax	149.89	134.26	89.57	-15.63
International trade and transactions tax	48.87	50.81	103.97	1.94
Other Republic taxes	9.79	11.59	118.39	1.80
Contributions	**288.23**	**347.61**	**120.60**	**59.38**
Contributions for pension and disability insurance	176.69	213.73	120.96	37.04
Contributions for health insurance	103.02	118.90	115.41	15.88
Contributions for unemployment	8.52	9.29	109.04	0.77
Other contributions	0.00	5.69		5.69
DUTIES	**22.04**	**20.54**	**93.19**	**-1.50**
FEES	**32.45**	**27.43**	**84.53**	**-5.02**
OTHER REVENUES	**33.36**	**31.48**	**94.36**	**-1.88**
Receipts from loan repayment	**6.84**	**3.62**	**52.92**	**-3.22**
CURRENT REVENUES	**1,129.19**	**1,106.48**	**97.99**	**-22.71**

Source: Ministry of Finance

The collected budget revenues provided the regular payout of wages and salaries, pensions and social contributions, servicing of all state liabilities to its citizens and the international community, as well as the continued implementation of initiated investment projects.

Preliminary data of the Ministry of Finance show that total budget revenues, together with the state-owned Funds, amounted to EUR 1,337.0 million or 44.2% of the estimated GDP in 2010.

In 2010, consolidated budget expenditures[4] amounted to EUR 1,191.1 million or 39.4% of the estimated GDP. In comparison with 2009, this is a decrease of 8.5%, but they were 5.7% lower than planned for the reporting year, which is in compliance with the plan and additional austerity measures adopted by the Government. The highest deviation from the plan was recorded in the expenditures for gross salaries and social security contributions.

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

DESCRIPTION	Plan 2010 in mil €	Realization in 2010 in mil €	% of realization
Current expenditures	525.78	493.96	93.95
Gross salaries and contributions charged to employer	243.66	251.53	103.23
Other personal earnings	25.48	18.84	73.94
Expenses for material and services	135.45	112.90	83.35
Current maintenance	28.94	28.02	96.82
Interest	32.14	30.16	93.84
Lease	9.43	8.24	87.38
Subsidies	44.07	39.04	88.59
Other expenditures	6.61	5.23	79.12
Transfers for social protection	406.86	423.17	104.01
Transfers to institutions, individuals, NGOs and public sector	173.78	174.64	100.49
Total capital expenditures	142.24	82.65	58.11
Borrowings and loans	4.26	4.07	95.54
Provisions	9.5	12.59	132.53
CONSOLIDATED EXPENDITURES	1,262.42	1,191.08	94.35
Repayment of debts to residents	17.84	56.82	318.50
Repayment of liabilities from previous period	66.68	113.66	170.46
Repayment of debts to non-residents	43.34	45.34	104.61
TOTAL EXPENDITURES	1,390.28	1,406.90	93.95

Source: Ministry of Finance

According to the Ministry of Finance's estimate, the Budget of Montenegro, ran a deficit in 2010 of EUR 84.6 million or 2.8% of GDP.[5] The existing level of deficit does not pose a threat to financial stability and it is lower than deficits recorded in most EU countries. Still, euroised economies pay

[4] Total expenditures less debt repayment.

[5] According to preliminary conclusions of the IMF mission, it is assessed that the fiscal deficit in 2010, as per the accrual accounting method, will amount to 3.9% of GDP.

more attention to fiscal policy than those economies with their own national currency, and it would therefore be necessary to provide budget balancing.

2.4. Public Debt

Situation - At the 2010 year-end, the public debt of Montenegro, according to Ministry of Finance data, amounted to EUR 1,270.7 million or 42.0% of the estimated GDP[6] for 2010. In relation to end-2009, it increased by 11.4%.

Domestic public debt amounted to EUR 358.3 million or 11.8% of GDP, while external public debt amounted to EUR 912.4 million or 30.2% of GDP.

Table 2.9 – Public debt, 2009 – 2010

	Public Debt	% of GDP	External public debt	% of GDP	Domestic public debt	% of GDP
Q1 2009	1,016.2	33.8	550.4	18.3	465.8	15.5
Q2 2009	1,003.6	33.4	553.3	18.4	450.3	15.0
Q3 2009	1,071.2	35.7	645.2	21.5	426.0	14.2
Q4 2009	1,140.2	38.0	699.9	23.3	440.3	14.7
Q1 2010	1,130.1	35.3	719.8	22.5	410.3	12.8
Q2 2010	1,115.3	34.8	737.8	23.0	377.5	11.8
Q3 2010	1,279.2	42.3	917.7	30.3	361.5	12.0
Q4 2010	1,270.7	42.0	912.4	30.2	358.3	11.8

Domestic public debt

Situation – In 2010, the domestic debt recorded an ongoing decline and it was EUR 82 million lower than at end-2009. The domestic public debt was reduced due to the lowering of debt arising from restitution by EUR 22.3 million, reduced municipal indebtedness by some EUR 14.4 million, the repayment of loans with commercial banks, T-bills and non-financial institutions by EUR 56.8 million, as well as the repayment of the fourth and fifth regular instalment of the debt to pensioners of EUR 3.05 million and the repayment of regular instalment for frozen foreign currency savings to the amount of EUR 9.8 million. On the other hand, domestic public debt increased due to continued realization of the Transport Directorate projects aimed at solving traffic bottlenecks to the amount of about EUR 33.1 million, issuing of T-bills valued some EUR 9.0 million, borrowing EUR 6.0 million for the realization and completion of investments into public administration business premises, and EUR 5.0 million for the restoration of cultural monuments in Cetinje.

[6] Forecasted GDP for 2010 amounts to EUR 3,025.0 million – Source: Ministry of Finance

External public debt

Situation – At 2010 year-end, external public debt amounted to EUR 912.4 million or 30.2% of GDP. In relation to 2009 year-end, it increased by EUR 212.5 million or 30.4%. The external debt increased due to the issue of Eurobonds to the amount of EUR 200.0 million, the withdrawal IBRD loan for the project "Health" of EUR 0.6 million, the project "LAMP"[7] (EUR 0.6 million), the project "Energy Efficiency" (EUR 0.9 million), the project "MIDAS"[8] (EUR 1.3 million), a loan from Hungary (EUR 1.6 million), the EBRD loan for the railway (EUR 2.1 million), the IDA loan (EUR 2.4 million), loan for financing the project "Supply of special vehicles for extinguishing fire and rescue" from the Austrian Steiermärkische bank und Sparkassen AG (EUR 12.9 million), the EIB loan for the railway (EUR 7.0 million), the EIB loan for the waste water disposal project for the Niksic municipality (EUR 1.0 million), the EIB loan for the project "Roads and bridges" (EUR 3.0 million), the commodity loan from the Spanish Government for the recycling centre in Podgorica (EUR 3.5 million), a loan from Poland (EUR 0.2 million), the KfW loan for the water supply project (phase II and III) (total amount of EUR 3.0 million) and the loan from Exim Bank Hungary for financing projects of building a school in Bar (EUR 0.3 million). In addition, the withdrawal of funds for a commodity loan from Erste Bank Austria for the Health Fund project of EUR 6.0 million was also recorded. The external public debt partially increased as the result of a higher value of the US Dollar as compared to the Euro, conditioning a higher value of EUR loans in US dollars. The external debt declined on the basis of regular repayment of principal of EUR 45.3 million.

Guarantees

At the end of 2010, foreign guarantees of the Government were EUR 313.4 million or 10.4% of GDP, i.e. 24.7% of the public debt.

If domestic guarantees are added to the amount, the total guarantees amounted to EUR 355.5 million at 2010 year-end or about 11.7% of GDP.

[7] Land Administration and Management Project (LAMP) is focusing on the improved efficiency in spatial planning, issuing licences and registering of real estates. The project is partially funded through a World Bank Loan (IBRD), and partially from the Government funds.

[8] Montenegro Institutional Development and Agriculture Strengthening project (MIDAS) is focusing on strengthening agriculture and the rural development as well as on promoting environmental protection in compliance with the EU standards.

Table 2.10 – Issued foreign Government guarantees

Creditor	Loan	Borrower	Year of signing	Signed amount	Withdrawn until 31 December 2010	Debt as at 31 December 2010
EIB	European Roads project	Monteput	2004	24,000,000	24,000,000.00	24,000,000.00
EIB	Power Sector Reconstruction	EPCG	2002	11,000,000	8,023,090.00	7,578,942.12
EIB	Airports Modernisation	Airports of Montenegro	2004	12,000,000	11,000,000.00	10,800,000.00
EIB	Montenegro Loan for SMEs	Commercial banks	2009	91,000,000	56,132,000.00	56,132,000.00
EIB	Montenegro Rail Infrastructure Rehabilitation	Railway Infrastructure of Montenegro	2010	7,000,000	0.00	0.00
EBRD	Airports Modernisation	Airports of Montenegro	2003	11,000,000	10,235,127.00	6,820,094.68
EBRD	Regional Water Supply Project – Phase I of the Construction of the Southern Branch	Regional Water supply	2007	8,000,000	8,000,000.00	7,666,666.67
EBRD	Regional Water Supply Project – Phase II of the Construction of the Southern Branch	Regional Water supply	2008	7,000,000	7,000,000.00	6,708,333.33
EBRD	Montenegro Rail Infrastructure Rehabilitation Project III	Rail company of Montenegro	2009	4,000,000	1,395,860.27	1,395,860.27
EBRD	Montenegro Emergency Rail Infrastructure Rehabilitation Project II	Railway Infrastructure of Montenegro	2009	15,000,000	650,000.00	650,000.00
EBRD	Project of supply electromotor units and diagnostic equipment	Railway transport	2010	13,550,000	0.00	0.00
EBRD	Credit line for deposit protection	Deposit protection fund	2010	30,000,000	0.00	0.00
KfW	Hydro Power Plant Perucica	EPCG	2003	3,580,000	3,531,897.31	1,672,831.97
KfW	Hydro Power Plant Piva	EPCG	2007	16,000,000	2,572,039.37	2,572,039.37
KfW	Substation Ribarevine	EPCG	2007	5,400,000	536,000.00	536,000.00
KfW	Replacement of filters in TE Pljevlja and the Expansion of the substations Podgorica - Ribarevine	EPCG	2008	15,000,000	8,863,740.00	8,863,740.00
KfW	Opportunity bank	Opportunity bank	2009	15,000,000	15,000,000.00	15,000,000.00
KfW	NLB	NLB	2009	16,000,000	5,000,000.00	5,000,000.00
OTP	KAP	KAP	2009	49,680,000	49,680,000.00	49,680,000.00
EXIM China	Purchase and repair of ships	Crnogorska plovidba	2010	47,396,000.00	0,00	
WTE Wassertechnik	Waste water project	Municipality of Budva	2010	29,250,000.00	0,00	
Abu Dhabi Fund for Development	Water supply project	Regional Water Supply	2010	18,977,884.37	0,00	
Credit Suisse	Support to Steel Factory Niksic	Steel Factory Niksic	2010	26,300,000.00	26,300,000.00	26,300,000.00
Deutsche Bank	Support to KAP	KAP	2010	22,000,000.00	22,000,000.00	22,000,000.00
VTB	Support to KAP	KAP	2010	60,000,000.00	60,000,000.00	60,000,000.00
as of 31 December 2010					319,919,753.95	313,376,508.41

Source: Ministry of Finance

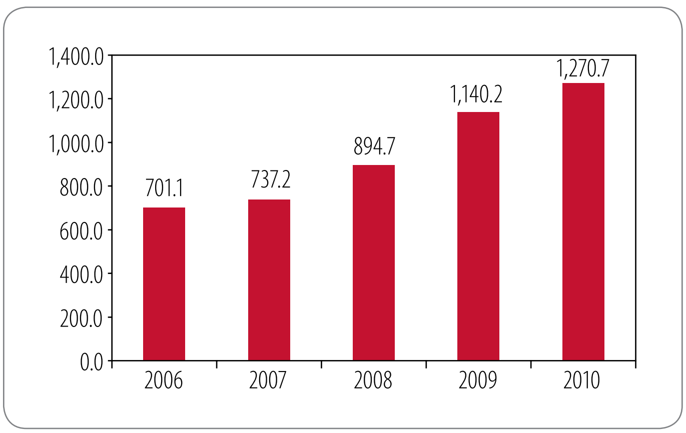
Table 2.11 – Domestic guarantees issued in 2009 and 2010

Creditor	Borrower	Amount
NLB Montenegrobanka	Bauxite Mines AD Niksic	5,000,000.00
Podgorička banka	Pobjeda AD Podgorica	2,970,000.00
Hipotekarna banka	Montenegro Airlines	2,700,000.00
NLB Montenegrobanka	Montenegro Airlines	1,800,000.00
Erste Banka	The Montenegrin Fund for Solidarity Housing Development	3,800,000.00
Erste Banka	Rail transport of Montenegro	7,000,000.00
Erste Banka	Pobjeda AD Podgorica	3,500,000.00
Erste Banka	Regional Water Supply	7,000,000.00
Hipotekarna banka A.D.	MI-RAI GROUP DOO Nikšić	800,000.00
NLB Montenegrobanka	Gradir Montenegro doo Nikšić	900,000.00
NLB Montenegrobanka	Gradir Montenegro doo Nikšic	700,000.00
NLB Montenegrobanka	Gradir Montenegro doo Nikšic	2,000,000.00
NLB Montenegrobanka	Melgonia - Primorka	4,000,000.00
TOTAL AS AT 31 December 2010		42,170,000.00

Source: Ministry of Finance

Graph 2.4

Public debt trend in the period 2006 – 2010 (in million EUR)



In the following period, as per the projected GDP movement and in accordance with macroeconomic trends, it is expected that the public debt will increase by 2012, to be followed by a decline afterwards. The public debt increase will largely be the result of the external public debt, while domestic debt shall decline due to higher repayment over newly incurred obligations.

It may be stated that the current public debt[9] is lower than in many EU countries but the dynamics of new indebtedness in the post-crisis period is the matter of concern. Therefore, it may be concluded that there are some risks in this area that still do not aggravate the level of financial stability. Moreover, there is some discomfort regarding a potential danger of activating issued state guarantees.

[9] There is a risk that the statistical coverage of liabilities, especially in municipalities, may be inadequate and thus increase the amount of total domestic dent, arising from the unsettled liabilities at the local level the need for their servicing.

Table 2.12 – Projection and sustainability of public debt of Montenegro, 2011 - 2014

	2011 Projection	2012 Projection	2013 Projection	2014 Projection
External debt (in EUR million)	1,054.02	1,134.66	1,166.86	1,113.86
External debt (% of GDP*)	33.25%	33.74%	32.55%	29.14%
Domestic debt (in EUR million)	325.22	258.72	190.92	151.62
Domestic debt (% of GDP)	10.26%	7.69%	5.33%	3.97%
Total debt (in EUR million)	1,379.24	1,393.38	1,357.78	1,265.48
Total debt (% of GDP)	43.51%	41.43%	37.87%	33.11%

* Forecasted GDP: EUR 3,170.0 mil in 2011, EUR 3,363.0 mil in 2012, EUR 3,585.0 mil in 2013, and EUR 3,822.0 mil in 2014

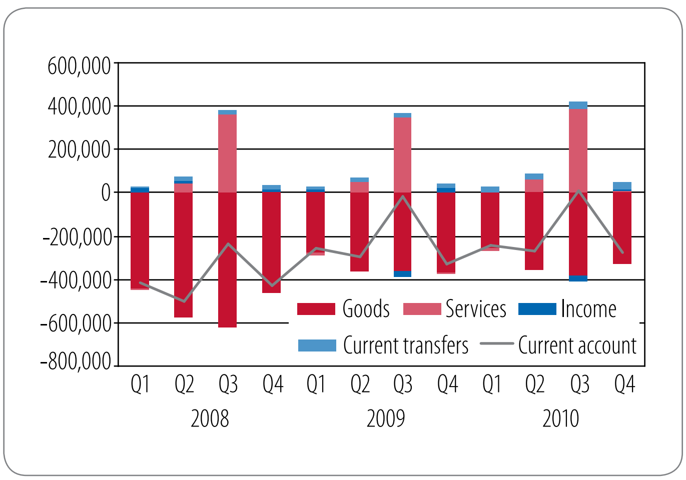
Source: Ministry of Finance

2.5. Balance of payments with the special focus on the current account deficit

The current account deficit in 2010, according to preliminary data, amounted to EUR 774.6 million and it was 13.6% lower in relation to 2009 due to a decrease in the external trade deficit of 4.2%. The deficit decline was a result of the positive balance in the services subaccount (EUR 446.4 million), mostly contributed by an increase in revenues from tourism. Positive trend at goods and services account resulted in a reduced year-on-year deficit of goods and services of 12%. A positive trend was recorded in the current transfers subaccount, which recorded a surplus increase of 34%. Still, it should be noted that the lower current account deficit was mostly a result of the crisis adjustment (lower aggregate demand) and of some positive external circumstances (higher aluminium prices in the global market), and not the result of improved competitiveness of the Montenegrin economy.

Graph 2.5

Trends in current account sub-accounts, EUR thousand



Source: CBM

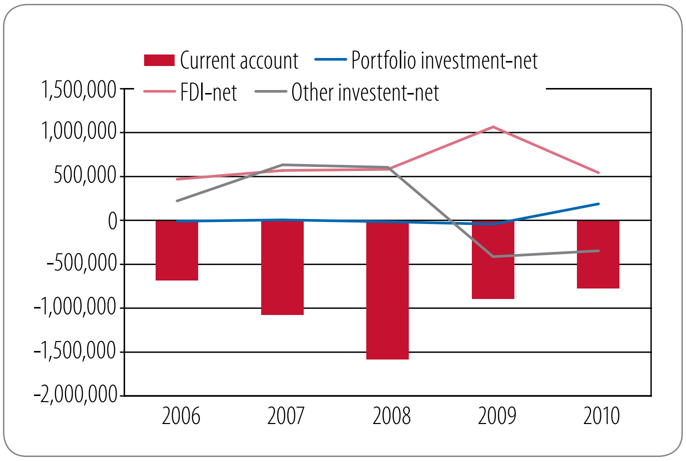
Commodities exchange recorded a positive trend. Faster decline of imports at the crisis outset and its slower recovery in 2010, together with faster recovery of exports lead to the improvements in the commodities exchange account. The export of commodities, according to the balance of payments data, increased 20.3% in relation to 2009, whereby increased aluminium exports (17.3%) mostly resulted in exports increase. As a result of domestic demand standstill, the import of goods recorded approximately the same volume as in 2009. The coverage of imports with exports was still low, 21.3%.

A very low exports/imports ratio indicates the need of promoting and stimulating export-oriented or import-substituting production and an increase in competitiveness of domestic producers. The coverage of external trade deficit with the surplus recorded at other sub-accounts was 41% in 2010, or 6.4 percentage points higher in relation to 2009.

In 2010, a remarkable net FDI inflow was recorded, EUR 542.4 million or 17.9% of GDP. Foreign investments into domestic companies and banks amounted to EUR 260.2 million (40.5% of total inflow), while inflow from intercompany debt amounted to EUR 163.9 million (25.5%). Total investments into real estates amounted to EUR 186.8 million (29%). Although FDI declined in relation to 2009, they have a significant share in financing the current account deficit (70%). Other investments subaccount recorded a decline in the banks and general government obligations for foreign borrowing, whereas the private sector's debt (companies) increased. Obligations for portfolio investments substantially increased due to the state's borrowing in the international market through the issuing of Eurobonds to the amount of EUR 200 million. High interest in Montenegro's Eurobonds in the international market points to the still high trust of foreign investors in Montenegrin economy.

Graph 2.6

Net FDI, other investments and current account deficit



Source: CBM

However, it is not reasonable to expect any significant decline in the current account deficit due to the announced capital and infrastructural projects. Potential risks that may negatively affect the current account deficit in the upcoming period are deteriorated conditions in the metal industry (lower prices of metals and reduced output of KAP), which would lead to a decline of goods exports. Moreover, potential risks lie in an increase in the prices of fuel and raw material (as important inputs for the domestic production) and an increase in the food prices, which may affect an increase in the value of imports, i.e. the external trade deficit. One of potential risks is a decline of foreign capital inflow, as a result of negative external factors, low interest of foreign investors in the implementation of capital projects and delays in the privatization of state companies. Possible problems include inadequate privatization and delays in the implementation of contracted investments. As a result of lower capital inflow, a potential risk of financing the current account deficit may appear. Still, this risk does not pose a threat to financial stability at the moment.

2.6. Real estate market

The real estate market is still one of the most sensitive segments of the Montenegrin economy, which decline of prices conditioned by the demand decline lead to the most important negative results to the financial flows (lower FDI inflow), as well as to the flows of the real economy in 2009 and Q1 2010. For the first time in Q2 2010, the real estate market recorded an increase of 5.6%, but the figure inevitably indicates that any further downtrend in the real estate prices that started in Q2 2008 was finally stopped.

In Q3 2010, the price of a residential space per square meter amounted to EUR 1,117, which is a decline of 1.17% in relation to June, when the assessed price was EUR 1,191, while in December it was kept at the level of 1,185.2 EUR/m2 (the minimum price increase of 0.7% in relation to Q3), and it may be concluded that the prices were on the standstill since Q2 2010 (Table 2.13) and that this market stabilized. In particular, the real estates prices recorded the annual decline in 2010 of a mere 3.76%, with a noticeable recovery after Q2 2010. In relation to March 2008, when the prices of real estates reached their maximum, a cumulative decline in the real estates prices at 2010 year-end amounted to 31.8%.

Table 2.13 – Summary statistics of the average value, standard deviations, minimum and maximum housing prices in Podgorica, in EUR

Period	Price in EUR	Chain index	Base index
September 2007	1697.56	100	100
March 2008	1738.3	102.40	102.40
September 2008	1525.5	87.76	89.86
March 2009	1402.1	91.91	82.60
September 2009	1223.1	87.23	72.05
March 2010	1128.3	92.25	66.47
June 2010	1191.5	105.60	70.19
September 2010	1177.1	98.79	69.34
December 2010	1185.2	100.69	69.82

Source: CBM, 2010

Observed in relation to the region (Table 2.14), it may be noticed that Montenegro recorded the lowest decline in the housing prices. Thus the annual decline of 3.76% in 2010 may be considered as moderate in relation to that recorded in Croatia (-4.85%) or Bulgaria (-8.79%), which may be explained by the fact that the most evident price adjustments in Montenegro was in the period March 2008 – Q4 2009, when the annual adjustment was above 20%.

Table 2.14 – Real estate prices in selected countries, September 2010

Country	Annual growth Q3 2009/Q3 2008	Assessment of trend	Annual growth Q3 2010/Q3 2009	Q-O-Q (%) Q3 2010/Q2 2009
LATVIA	-59.07	+	24.59	1.95
SINGAPORE	-10.96	+	22.88	2.93
HONG KONG	3.19	+	20.52	4.62
ISRAEL	14.26	+	16.41	4.39
AUSTRALIA - 8 TOWNS	6.56	+	11.5	0.13
TAIWAN	9.37	+	7.37	-0.99
FINLAND	0.52	+	7.26	0.4
NORWAY	3.78	+	6.68	-0.5
SOUTH AFRICA	-4.14	+	5.07	-1.34
GREAT BRITAIN	-3.04	+	4.49	-0.81
CHINA - SHANGHAI	2.63	+	4.3	-1.06
JAPAN-TOKIO	-3.8	+	4.23	1.98
AUSTRIA	2.91	+	3.68	-0.9
DENMARK	-10.77	+	3.32	0.97
INDONESIA – 14 TOWNS	2.1	+	2.93	0.47
CANADA	-2.98	+	2.82	0.21
GERMANY	-3.03	+	2.78	1.13
THAILAND	-18.42	+	2.43	-9.78
SWITZERLAND	3.27	+	1.27	0.26
NEW ZEALAND	3.71	+	1.19	-0.89
FRANCE	-4.82	+	0.62	1.07
RUSSIA	-10.82	+	0.38	0.41
ICELAND	-12.54	-	-0.15	0.24
PORTUGAL	-1.72	-	-0.35	-1.81
THE NETHERLANDS	-5.07	-	-0.59	0.13
POLAND – 6 TOWNS	-7.04	-	-0.73	1.13
SLOVAKIA	-14.27	-	-1.36	0.85
GREECE - ATHENS	-5.4	-	-3.14	-2.91
USA	-4	-	-3.18	-1.59
SPAIN	-8.02	-	-3.73	-0.92
CROATIA	-4.17	-	-4.85	-2.86
BULGARIA	-27.98	-	-6.04	-1.17
UNITED ARAB EMIRATES	-47.22	-	-6.14	-6.14
LITHUANIA	-29.44	-	-8.79	0.49
UKRAINE - KYEV	-34.41	-	-10.56	-1.25
IRELAND	-13.8	-	-14.78	-1.32
MONTENEGRO - PODGORICA	**-19.82**	-	**-3.7**	**1.2**

Source: Global property Guide 2010, CBM, 2010

It is assumed that there should be a slight recovery of the real estate market in the upcoming period, primarily due to the expected mild growth in available income, lower unemployment rate, implementation of the programme “1000+ apartments”, and potential FDI inflow in real estates. This is indicated through the following:

1. According to the 2010 CBM survey, the largest real estate agencies expect an increase in the real estate prices in 2010 (5% - 10%), as well as a growing demand (10%-15%), with the special accent on domestic demand.
2. The analysis of the biggest construction companies – debtors in the system, taking into account their financial statements for 2009 and their borrowings in 2010, points that despite a large exposure of the banking sector to the construction sector (the second largest exposure after that to tourism and trade), the concentration of (very dispersive) debt is not present, which reduces the risk of construction companies` insolvency.
3. In 2010, the share of housing loans in the estimated GDP amounted to 11.6% and was on a standstill in relation to 2009, with a potential future growth since the recorded share was still significantly lower than the average in the EU countries, ranging up to almost a third of the value of their forecasted GDP.

Table 2.15 – Housing loans in 2010

	GDP, in mil. EUR	real growth	Housing loans, amount in thous. EUR	Population	Housing loans	
	I-XII				Share in GDP	Per capita (in EUR)
2000	1,065.7			612,496		
2001	1,295.1	1.10%		614,791		
2002	1,360.4	1.90%		617,085		
2003	1,510.1	2.50%		620,279		
2004	1,669.8	4.40%		622,118		
2005	1,815.0	4.20%	11,259	623,277	0.6%	18
2006	2,149.0	8.60%	63,790	624,241	3.0%	102
2007	2,680.5	10.70%	222,592	626,188	8.3%	355
2008	3,085.6	6.90%	264,073	628,804	8.6%	420
2009	2,981.0	-5.70%	349,042	630,095	11.7%	554
2010	3,025.0*	0.50%	350,874	632,922	11.6%	554

* EFT forecast 2010

Source: CBM, Ministry of Finance and Monstat, 2010

On the other hand, although a mild recovery of the real estate market in 2011 was projected, this segment of the economy may still be a potential source of risk if the stagnation or a further decline in the prices would appear as a result of extremely low realization of sale agreements due to the disproportion of supply and demand, real wages standstill or unexpected further growth in unemployment. This may deepen the illiquidity of construction companies, and may be effectuated by the activation of mortgages in the banking sector. Such a scenario would lead to further pressures on decreasing real estate prices and, in parallel, increasing credit risk, treatment of collaterals and a significant decline in lending activity of banks. At present, it is assessed that this risk is not high.

3. FINANCIAL SYSTEM

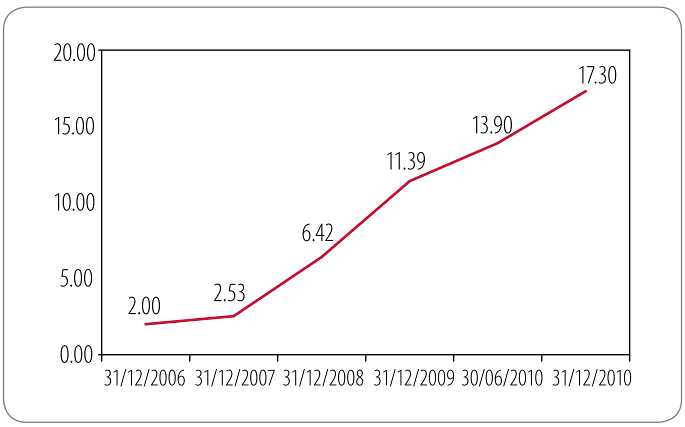
3.1. Banking system

3.1.1. Credit risk

Credit risk is the most important risk in Montenegrin banking system. Two causes influenced the increase in credit risk in 2010: 1) expansive growth in loan portfolios of banks in 2006 and 2007, when individual banks multiplied their assets, and (2) the global financial crisis impact from Q4 2008, which accentuated all weaknesses in credit risk management in the previous period and additionally worsened banks' asset quality through deterioration of the financial position of the real and household sectors.

Graph 3.1

Non-performing assets to total assets ratio, 2006 – 2010

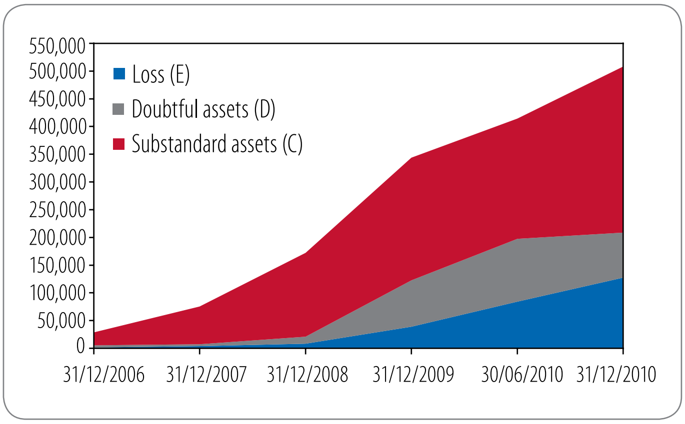


The assessment of the quality of credit risk management is based, inter alia, on the assessment of adequacy of classification of risk assets items and off-balance sheet items and the allocation of loan loss provisions pursuant to the regulations.

Overall condition in the real sector, illiquidity of the economy, unemployment growth and aggravated collection of claims led to deterioration of all asset quality indicators, which reached their highs at end-2010. Credit risk growth influenced the maintenance of conservative credit policy by banks and a decline in lending activity in 2010.

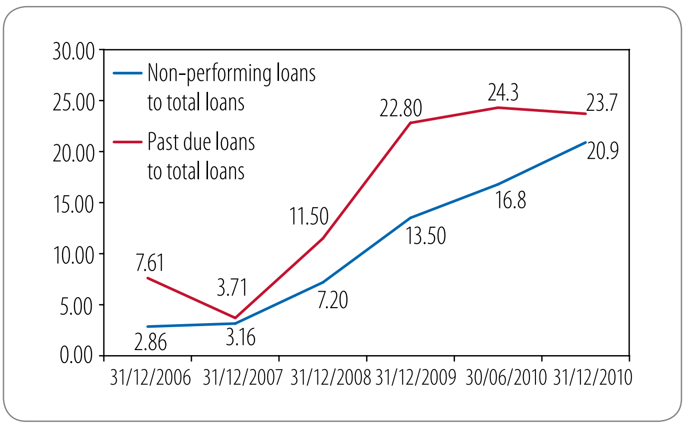
Graph 3.2

Non-performing assets, 2006 – 2010



Graph 3.3

Non-performing loans and past due loans to total loans ratio, 2006 – 2010



Banks' loan portfolio analysis disclosed that most of them do not perform fair classification of assets exposed to risk, and consequently, they do not calculate adequate provisions for asset items.

Credit risk stress testing of banks was performed under the following assumptions:

1. reclassification of the structure of classified loans,
2. increase in non-performing loans (C, D, E) and required amount of provisions,
3. bankruptcy of one debtor – borrower, (real exposure),
4. Bankruptcy of the largest – top 1 borrower of the bank (real exposure).

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

Stress testing was performed using data submitted by banks as at 31 December 2010, and the banks reported solvency ratio above the legally prescribed minimum of 10%.

a) Shock 1 – reclassification of the structure of classified loans

Reclassification of the structure of classified loans showed an increase in the share of aggregate non-performing loans from 21% to 22.5%, which resulted in the solvency ratio decline from 15.85% to 8.96% at the aggregate level. This was below the statutory minimum of 10%. Three banks in the system did not pass stress testing requirements since their solvency ratio dropped below 10%, which required additional capital injection.

b) Shock 2 - Increase in non-performing assets and required amount of provisions

It has been assumed that non-performing assets (C, D and E) would increase by 20% and the level of required provisions by 30% at the level of individual banks as well as at the system level. The solvency ratio at the aggregate level decreased from 15.85% to 14.67%, due to a decrease of this indicator in all eleven banks ranging from 0.06 to 1.93 percentage points. One bank recorded the solvency ratio below the statutory minimum of 10%.

c) Shock 3 – Bankruptcy of one of the 20 largest borrowers of a bank (real exposure)

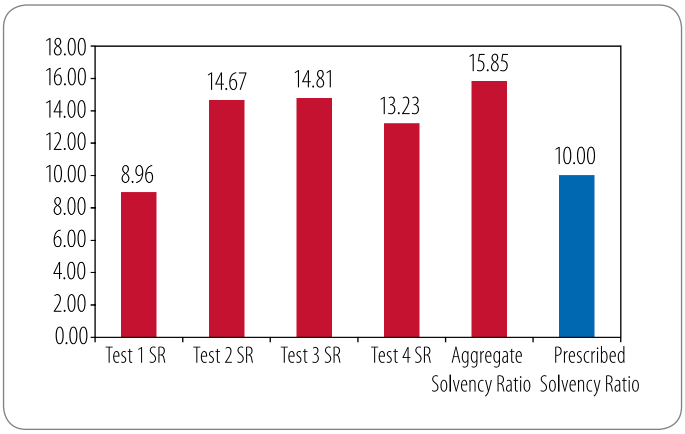
The shock of deterioration in large exposures of the banks was based on the assumption that one of the 20 largest borrowers in the system of each individual bank was unable to meet its liabilities, whereby the amount of real exposure of banks was calculated by using the mean value. Shock 3 resulted in a decrease in the solvency ratio from 15.85% to 14.81% at the aggregate level. The decrease in solvency ratio of all eleven banks ranged from 0.65 to 1.84 percentage points. The solvency ratio in all banks in the system was above the legally prescribed minimum of 10%.

d) Shock 4 – Bankruptcy of the largest, top 1 borrower of a bank (real exposure)

The shock of deterioration of large exposures of banks was based on the assumption that the largest borrower in the system of each individual bank was unable to meet its obligations, from the aspect of its total exposure to the bank. Shock 4 resulted in a decrease in the solvency ratio from 15.85% to 13.23% at the aggregate level. A decrease in the solvency ratio of all eleven banks ranged from 1.49 to 6.13 percentage points. Two banks reported the solvency ratio below the statutory minimum, which required additional capital injection.

Graph 3.4

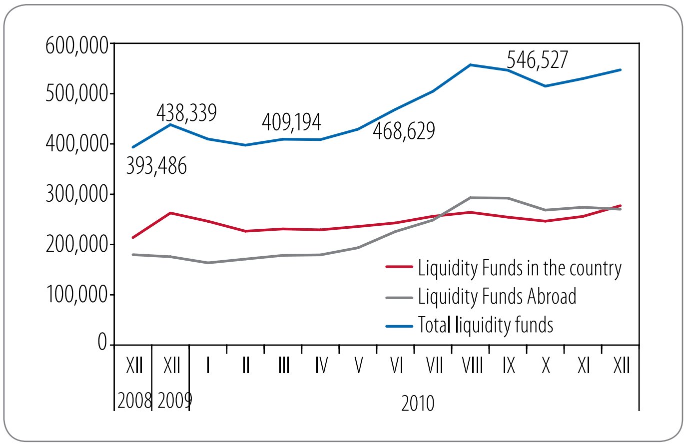
Credit risk stress testing – aggregate solvency ratio as at 31 December 2010



The CBM will closely monitor the solvency ratio movements in the following period, and demand recapitalisation from individual banks, if needed.

Graph 3.5

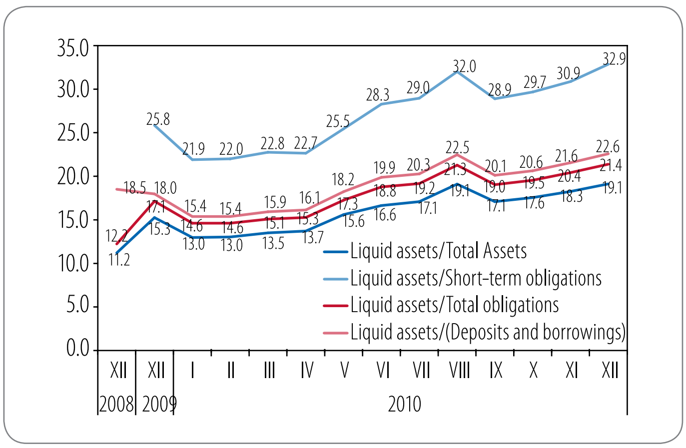
Average liquid funds in the country and abroad



Source: Banks' daily reports

Graph 3.6

Selected liquidity indicators, %



3.1.2. Liquidity risk management

Liquidity risk management corresponded to the level of banks' exposure to this risk during 2010. All key liquidity indicators grew and ten-day liquidity indicators doubled as compared to the prescribed amounts.

The banks' average liquid funds amounted to EUR 547.3 million at 2010 year-end, showing the year-on-year increase of EUR 108.9 million or 24.9%. Liquid funds increased due to the annual increase in liquid funds in the country (by EUR 14.5 million) and liquid funds abroad (by EUR 94.5 million).

Liquidity risk stress testing

Cash and deposits with depository institutions to deposits ratio at the aggregate level amounted to 35.18%. However, two banks significantly diverged from the aggregate average, having this ratio at only 19.94% and 20%, which will negatively reflect on the stress testing results of these banks.

The testing of banks' sensitivity referred to the following:

a) withdrawal of 30% of the total amount of deposits,
b) withdrawal of 30% of demand deposits,
c) withdrawal of 40% of households' demand deposits and 30% of legal persons' deposits,
d) withdrawal of 30% of households' time deposits and 25% of time deposits of legal persons,
e) withdrawal of deposits of the largest depositor,
f) withdrawal of deposits of ten largest depositors,
g) withdrawal of 100% of state deposits.

The banks' ability to cover losses incurred based on the abovementioned was tested through the following:

1) available liquid funds (the difference between cash and deposits with depository institutions and allocated amount of reserve requirements as at 31 December 2010),
2) available liquid funds (free liquid funds increased by 50% of the reserve requirements),

a) Shock 1: Withdrawal of 30% of total deposits

Loss of depositors' confidence in the banking system was simulated and it resulted in the withdrawal of 30% of total deposits with all banks. In these conditions, four banks in the system would show the lack of liquid funds that would result in the banking system illiquidity of EUR 41.3 million. If the reserve requirement of 50% was used, four banks would still be illiquid, but not the entire banking system.

b) Shock 2: Withdrawal of 30% of demand deposits

Demand deposits' share in total deposits amounted to 40.94%. If 30% of these deposits were withdrawn, the banking system would still be liquid, as well as all banks.

c) Shock 3: withdrawal of 40% of households' demand deposits and 30% of legal persons' demand deposits

Simulation of withdrawal of 40% of households' demand deposits and 30% of legal persons' demand deposits would result in the lack of liquid funds with one bank. Despite the use of reserve requirements, this bank would still be illiquid.

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

Simulation of withdrawal of 30% of households' time deposits and 25% of legal persons' time deposits would result in lack of liquid funds with two banks, while the banking system would have a surplus of liquid funds. Despite the use of reserve requirements in amount of 50%, two banks would still be illiquid.

e) Shock 5: Withdrawal of deposits by the largest depositor

The concentration of deposits of one depositor (top 1) in seven banks was lower than 10%, while in two banks it exceeded 25%. If the withdrawal of these deposits would occur, stress testing results showed that one bank would still have liquidity problems that could not be solved by using the reserve requirements.

f) Shock 6: The withdrawal of 50% of deposits by the ten largest depositors

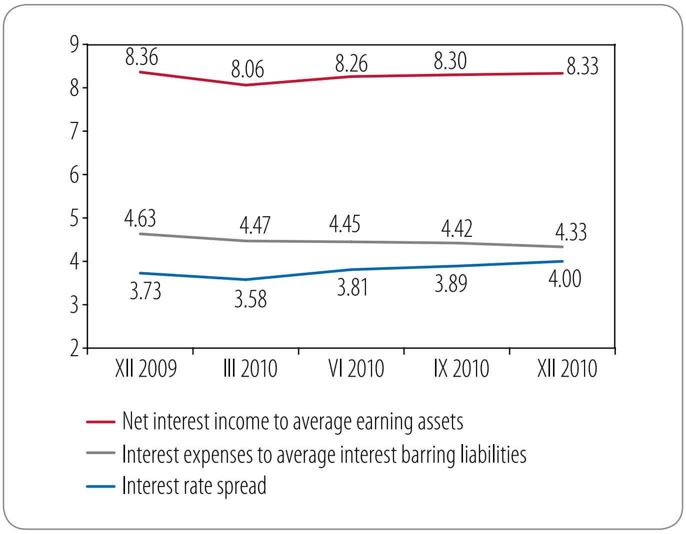
The concentration of deposits of the ten largest depositors was evident with all banks, ranging from 12.37% to 93.12%. If these deposits were withdrawn in the amount of 50%, one bank would be illiquid. Despite the use of reserve requirements, this bank would still be unable to provide funds needed.

g) Shock 7: Withdrawal of 100% of state deposits

High concentration of the state-related deposits in relation to total deposits was evident with three banks, ranging from 12.48% to 24.77%. Stress testing of banks' liquidity was performed assuming that the state-related deposits (deposits of the Government of Montenegro, its agencies, state funds, municipalities and state companies) would be withdrawn to the amount of 100%. In this situation, one large bank would become illiquid. That bank would still be illiquid, despite the use of its reserve requirements.

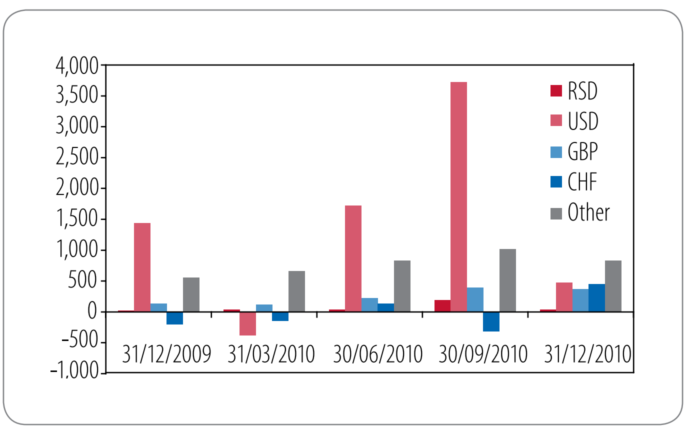
Graph 3.7

Interest rate spread



Graph 3.8

Aggregate exposure to FX risk



3.1.3. Market risk management

Overall level of market risks was low. FX risk in Montenegrin banks was low due to euroised Montenegrin economy, but its importance was higher in the real sector, the export-oriented companies which sell their products in USD. Interest rate risk was evident due to an increase in risk premiums and losses in individual banks, but it still affected the corporate and household sectors more than banks.

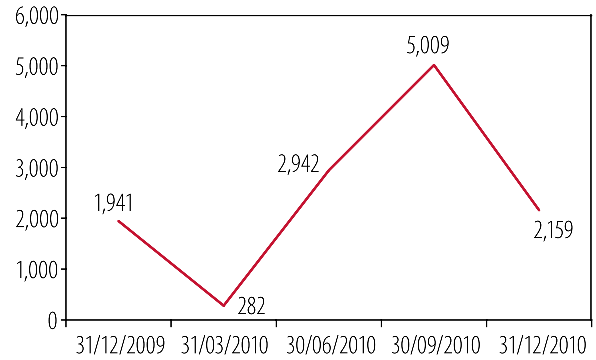
The aggregate interest rate spread oscillated in the one-year period. As at 31 December 2010, the interest rate spread amounted to 4%, while it was 3.73% in the same period of 2009. The interest rate spread at individual banks' level was different, ranging from 1.64 to 9.14%.

FX risk was low. The mostly used currency was USD. As at 31 December 2010, the banking system had more assets than liabilities in the USD currency (corresponding to EUR 475 thousand).

The aggregate balance sheet in all foreign currencies (except in EUR) amounted to EUR 2.2 million or 0.78% of core capital at the 2010 year-end.

Graph 3.9

Aggregate balance in all currencies



Market risk stress testing

Although the total level of market risks was low, mostly due to the limited market, interest rates and FX position were the main sources of market risks in the Montenegrin banking system. Thus, stress testing included interest rate risk and FX risk.

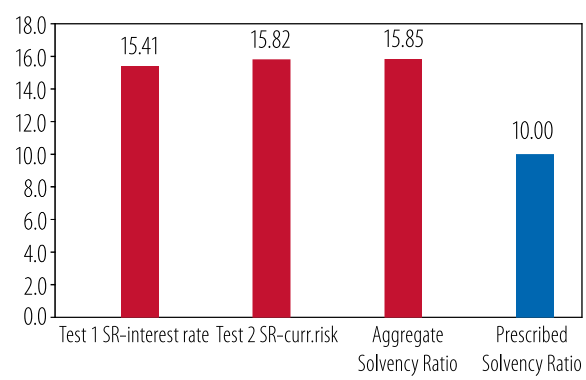
The sensitivity of assets and liabilities positions to interest rate risk was tested through the application of the increased level of interest rate of 2 percentage points to cumulative difference (gap) between assets and liabilities positions, sensitive to the interest rate change at the level of individual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

Stress testing results of a direct impact of interest rates' change to sensitive assets and liabilities positions showed a slight decrease in the solvency ratio at system level. To wit, the aggregate solvency ratio declined from 15.85% to 15.41%, while the ratio's decrease in all banks ranged from 0.05 to 1.06 percentage points.

The exposure of the Montenegrin banking system to direct FX risk was limited since euro is the official payment currency. Only 6.22% of assets at the aggregate level were denominated in a foreign currency, with the largest exposure of one to the amount of 27.39%. FX exposure of other banks ranged from 0.06% to 5.57%. Net open FX position at the system level was positive, amounting to EUR 2.2 million.

Graph 3.10

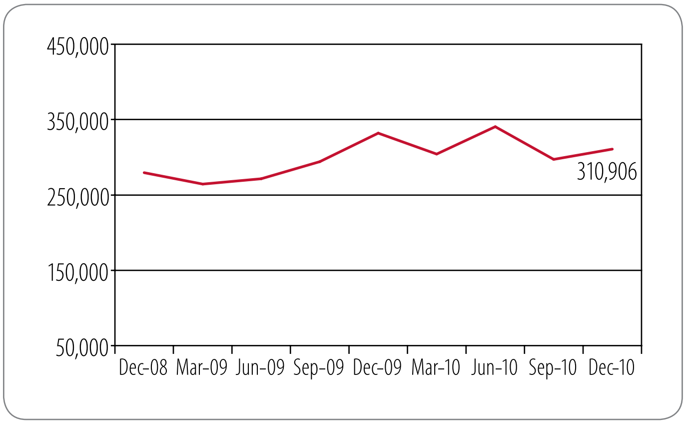
Market risk stress testing – aggregate solvency ratio as at 31 December 2010



Stress testing of direct FX risk was based on the net open FX position (so-called spot position), i.e. on the assumption that own funds would be corrected by 30% (+) of the value of the net open position both at the individual bank level and at the system level. The aggregate solvency ratio would slightly decrease after stress tests, by 0.03%, while in ten banks it would decrease by 0.01 to 0.50 percentage points.

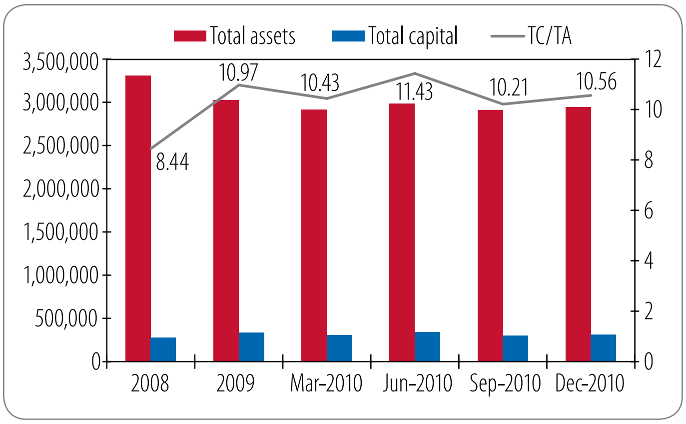
Graph 3.11

Capital movement, 2008- 2010 (in thousand EUR and in %)



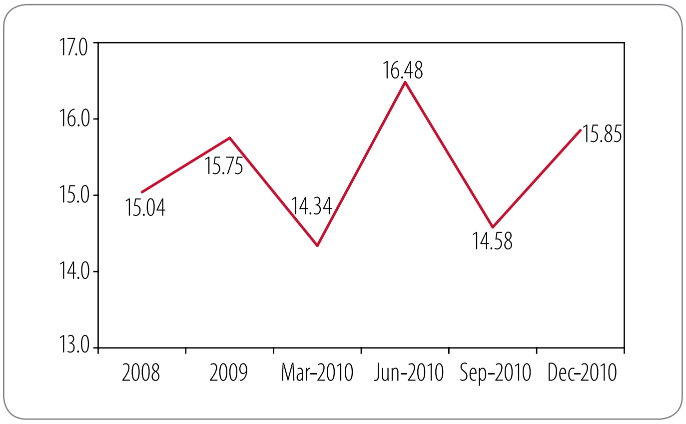
Graph 3.12

Capital and total assets and liabilities, 2008- 2010 (in thousand EUR)



Graph 3.13

Solvency ratio



3.1.4. Capital of the banking sector

As at 31 December 2010, the banks' capital was EUR 310.9 million. In the one-year period, total banks' capital declined by EUR 20.8 million or 6.28%. Negative financial result of banks influenced the decrease in capital, which annulled the effects of recapitalisation that occurred during 2010.

Total capital to total assets and liabilities ratio increased in the past two years, as a result of the decline in total assets and liabilities and growth in capital.

The aggregate solvency ratio amounted to 15.85%. All banks in the system reported the solvency ratio significantly above the legally prescribed minimum of 10%.

3.1.5. Profitability of the banking sector

Although the Montenegrin economy exited recession, the crisis effects on the banking sector are still evident.

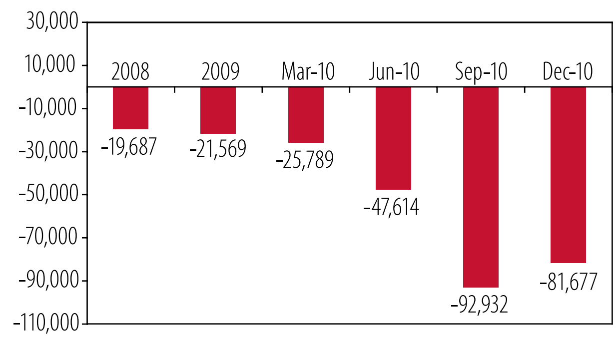
The negative trend in profitability of the banking sector stemmed from crisis in Q4 2008 was evident also in 2010. The banking system reported the total loss of EUR 81.7 million.

Several factors influenced the negative profitability of the banking sector. Total interest income has declined in the last three years due to a decrease in total loans and other interest-bearing items. On the other hand, high provision expenses and overhead and other expenses were extremely high. In 2010, the CBM adopted counter-cyclical measures to define favourable criteria for assets classification and a reduction in loan loss provisions.

However, in spite of the evident reliefs, past due loans and non-performing loans were above the 2009 amount, since the household and corporate sectors, as the largest loan beneficiaries, defaulted in repaying their obligations to banks in the approximately same dynamics.

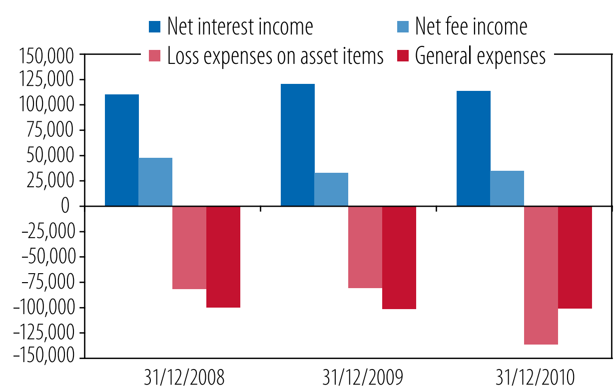
Graph 3.14

Aggregate financial result, 2008- 2010 (in thousand EUR)



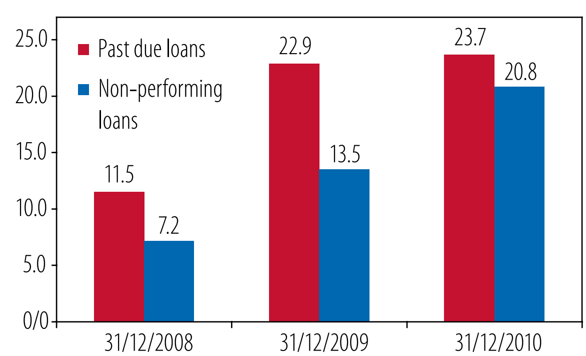
Graph 3.15

Selected balance sheet indicators, 2008-2010 (in thousand EUR)



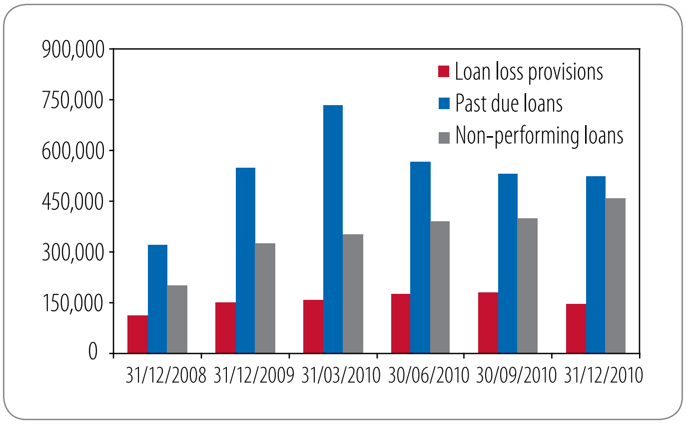
Graph 3.16

Past due and non-performing loans percentage



Graph 3.17

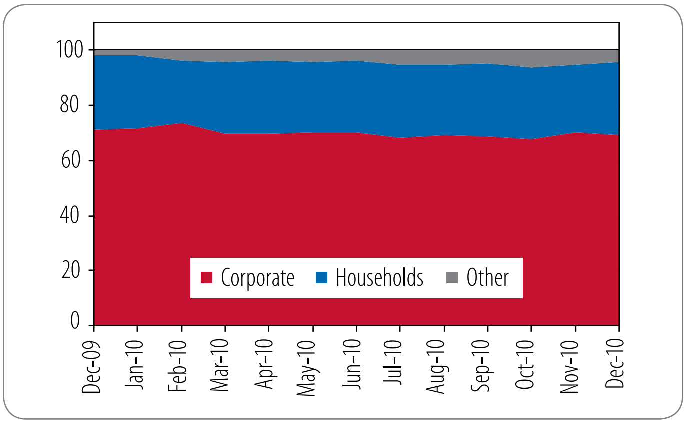
Quality of loan portfolio and loan loss provisions



The negative financial result consequently led to negative ROA and ROE at the aggregate level. The graph 3.19 shows the level and trend of these indicators.

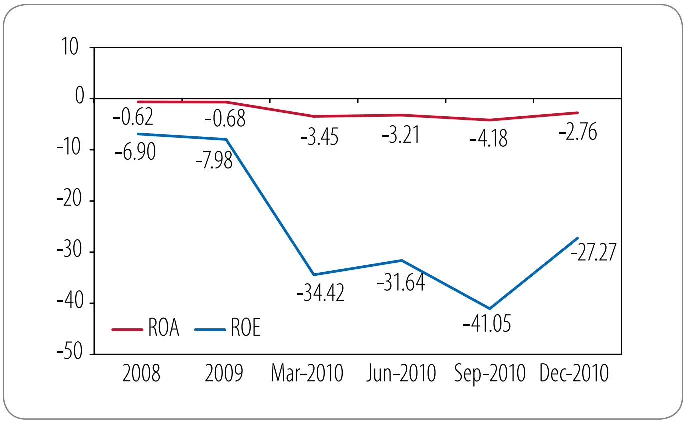
Graph 3.18

Past due loans by sectors



Graph 3.19

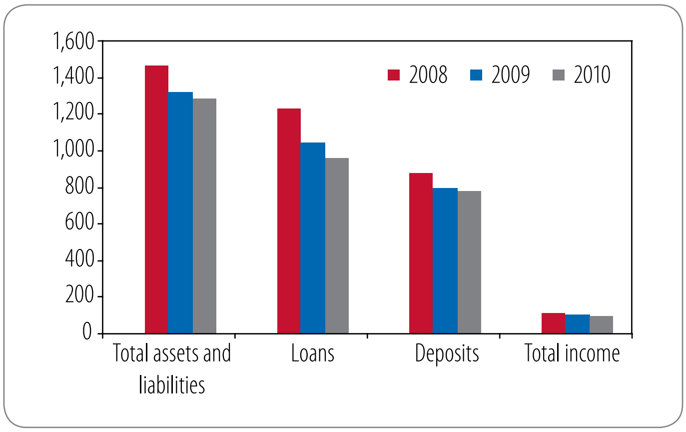
Aggregate ROA and ROE, 2008- 2010



An uptrend in the banks' performance indicators per employee was terminated in 2008.

Graph 3.20

Bank's performance indicators per employee, 2008- 2010



3.2. Micro-credit financial institutions

Total assets of micro-credit financial institutions (MFIs) amounted to EUR 58.7 million at end-2010. Total assets declined by 22.1% in relation to 2009 year-end.

Net loans were dominant in MFIs` asset structure (68.2%). Cash made up 25.6% and other assets 4.2% of total assets.

Total MFIs loans amounted to EUR 43.5 million reporting a decline of 33.9% at the annual level. Loan loss provisions to total loans ratio amounted to 7.9%.

Observed by industries, loans to the agriculture sector (52.4%) were dominant in the loan portfolio structure, while loans to services, tourism and hotel management sectors made up 26.1%, loans to trade sector were 11.5% and households loans accounted for 8.6% of total MFI loans. Long-term loans (93.6%) were dominant in the maturity structure of MFI loans.

The most significant share in the structure of liabilities was of borrowings (65.1%), amounting to EUR 38.2 million at end-2010. Foreign capital was mainly the source of financing of MFI which is directed through micro credit lines to agriculture producers, entrepreneurs from services, retail manufacturing and trade sectors.

Total MFI capital amounted to EUR 18.5 million or 31.5% of total liabilities at end-2010. Of total MFI capital, 76.2% referred to donated capital, while undistributed profit made up 23.8% of total capital. MFIs reported a negative financial result of EUR 1.6 million at the end of the reporting year.

Lending interest rates were on an uptrend in 2010. At end-December 2010, the average weighted effective interest rate (AWEIR) was 27.96%. It increased by 0.49 percentage point in relation to the previous year-end. We assume that the existing interest rates are too high. Therefore, in the upcoming period, the CBM will consider available instruments aiming to limit their movement.

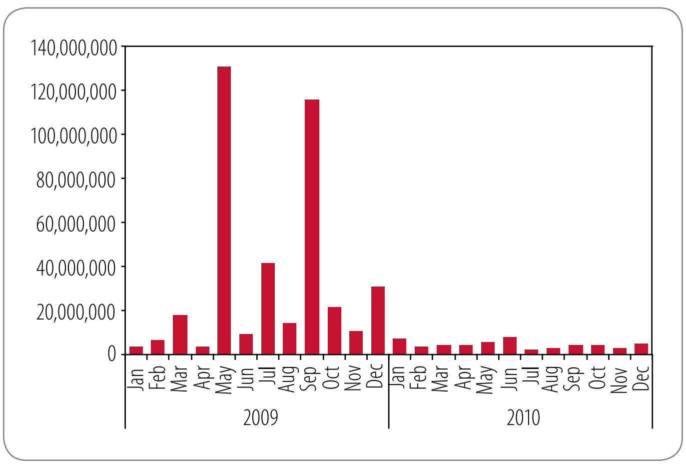
Micro-credit financial institutions accounted for a small share in total loans and assets of the financial system (2.0% at end-2010). Therefore, their risk to financial stability is small. In addition, considering the fact that MFIs cannot accept deposits in accordance with the law, there is no threat of spreading panic, which additionally minimises the risk to financial stability.

3.3. Capital Market

Although some evident signs of recovery of the capital market existed in 2009, when the key recovery factor was recapitalization of EPCG, 2010 saw negative indices trends and substantially lower turnover and transactions, which indicates that the Montenegrin capital market is still venerable. This is evidenced by the fact that Montenegrin stock exchanges recorded the highest turnover decline in the region. Some improvement signs can be expected in the forthcoming period, which implies investors' portfolio transition to company shares. In 2010, the share of turnover with different bonds in total turnover increased, which points to the fact that investors invest in safer "investment material". However, market risks should also be taken into consideration such as low market liquidity, fear from a further market decline, poor protection of ownership rights, especially those of smaller shareholders, and accepting core principles of corporate governance. The global financial crisis affected a substantial decline in available investment funds and a substantial growth of investors` sensitivity to risk. Therefore, future investors' decisions will probably be induced by the safe investment principle, in addition to the potential profit increase.

Graph 3.21

Total turnover at Montenegrin stock exchanges, by months



Source: Montenegro Stock Exchange and Nex Montenegro Stock Exchange

An average monthly turnover in 2010 was only EUR 4.6 million, being substantially below the average reported in 2009 (EUR 33.8 million).

In 2010, stock exchange indices of both stock exchanges recorded monthly declines, while in December 2010 they recorded a substantial monthly increases. In relation to the previous year, turnover at both stock exchanges substantialy declined. Capitalization declined at the annual level, as well as liquidity measured by the asset turnover ratio. Table 3.1 shows the changes of the main indicators of the stock exchanges:

Table 3.1 – Indicators of Montenegrin stock exchanges, December 2010 (%)

Indices	MOSTE	NEX 20	NEXPIF
Value as at 31 December 2010	523.69	14.522.53	6.777.76
Relative change in index % (annual)/ monthly	(-18.0) / (8.2)	(-0.5) / (3.4)	(-3.5) / (24.1)
	Montenegro SE		Nex Montenegro SE
Total turnover, in EUR – 2010	**31,344,169**		**23,452,245**
Relative change in turnover % (in relation to 2009)	-87.1		-85.6
Capitalization (31.12.2010.)	**2,672,709,114**		**2,011,231,643**
Relative change in capitalization % (annual)/ monthly	(-9.3) / (1.2)		(-1.6) / (1.8)
Turnover coefficient (31.12.2010.)	**0.001488**		**0.0005115**
Relative change in turnover coefficient % (annual)/ monthly	(-84.6) /(186.5)		(-56.9) / (-30.4)

Source: Montenegro Stock Exchange and Nex Montenegro Stock Exchange

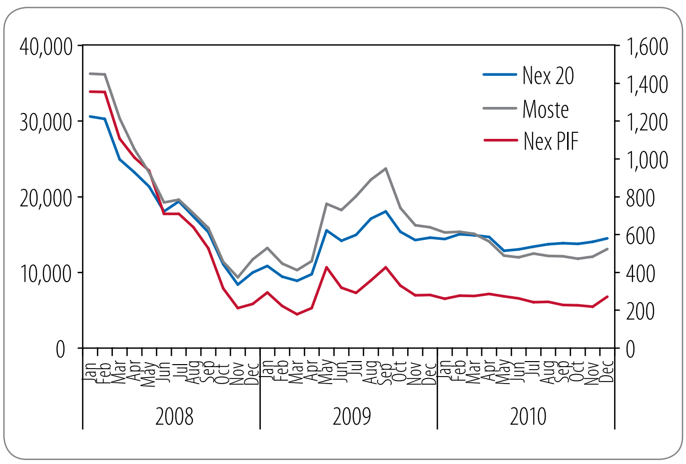
All three indices reported annual declines, with slight oscillations. Moste index recorded the year-on-year decline of 18%, whereas NEX PIF and NEX 20 fell by 0.5% and 3.5%, respectively.

Observed by their record highs reached in 2007, the following decline in indices was reported at end-2010: Moste – 78.7%, NEX PIF – 86.7%, and NEX20 – 70.1%.

Despite negative trends, deceleration of decline at the Montenegrin stock exchanges is obvious. However, final recovery will depend on the volume of investments by big investment funds and individual portfolio investors. Even though the influence of the capital market on the financial system is not critically important, the fact that good portion of loans was granted for the purchase of shares at the capital market should not be neglected. In parallel, inflow of funds from this market can affect favourable trends in the banking system. On the other hand, growth in borrowings by both investment funds and individual investors (Lombard loans) contributed significantly to the growth of credit risk in the banking sector over the past period. However, it is not expected that this market will pose any substantial threat to financial stability considering its small share in overall financial system and the fact that the real sector does not use the capital market to finance their operations.

Graph 3.22

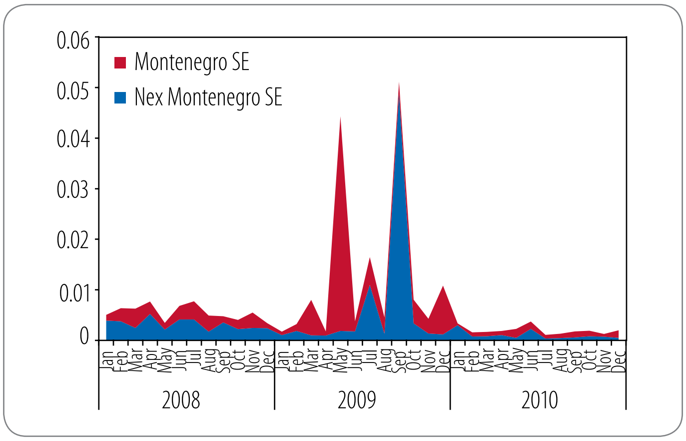
Indices of Nex Montenegro SE and Montenegro SE (NEX20 and NEX PIF at left-hand scale and MOSTE at right-hand scale)



Source: Montenegro Stock Exchange and Nex Montenegro Stock Exchange

Graph 3.23

Turnover coefficient



Source: Montenegro Stock Exchange, Nex Montenegro Stock Exchange

3.4. Insurance Market

A decline of the gross insurance premium, that is, insurance payouts in 2010, being one of the expected effects of the crisis, was particularly obvious in non-life insurance. At the same time, an increase in the life insurance premium, as well as satisfactory liquidity and solvency of insurance companies represent a positive sign of the insurance sector development in Montenegro.

Twelve insurance companies operated in the Montenegrin insurance market in 2010, of which seven were engaged in life insurance and five in non-life insurance.

Table 3.2 – Insurance companies operating in Montenegro, 2010

	Type of insurance
Lovćen osiguranje A.D.	Non-life
Sava Montenegro osiguranje A.D.	Non-life
Swiss osiguranje A.D.	Non-life
Grawe osiguranje A.D.	Life
Atlas life A.D.	Life
Uniqa neživotno osiguranje A.D.	Non-life
Uniqa životno osiguranje A.D.	Life
Delta generali osiguranje A.D.	Non-life
Delta generali životna osiguranja A.D.	Life
Merkur osiguranje A.D.	Life
Winer Städtische životno osiguranje A.D.	Life
Lovćen životno osiguranje A.D.	Life

Source: Insurance Supervision Agency

Total share capital of the insurance companies amounted to EUR 39.1 million at end-2010 and it showed the year-on-year increase of 13.1%. This increase resulted from the establishment of two new insurance companies and recapitalisation of the existing ones. Some 83.1% or EUR 32.5 million of total share capital of the insurance companies referred to foreign capital. The share of foreign capital in total capital grew by 1% over the one-year period. With regard to the ownership structure of insurance companies, six of them are foreign-owned, while the ownership structure of other insurance companies was mixed.

According to preliminary data, total gross premium reported in the insurance market at end-2010 was EUR 62.8 million, showing the year-on-year decline of 4.4%. Gross premiums of non-life insurance of EUR 54.3 million prevailed in the structure of gross premiums of insurance companies (86.5%). The year-on-year decline in gross premium of non-life insurance was 5.5%. Written life insurance premium amounted to EUR 8.5 million, recording the annual increase of 4.7%.

With regard to the structure of gross premiums in non-life insurance in 2010, the majority share was of compulsory insurances (55.9%), which rose by 6.7 percentage points over the one-year period.

Life insurance showed the largest share of 86.4% in gross premiums of life insurance, which together with supplementary insurance made up 96.4% of total written premiums in life insurance. Some 2,477 new life insurance policies were concluded during the first six months of the reporting year. Effects of the financial crisis in the observed period primarily reflected in hindered collection of premiums by insurance companies, which resulted in the reversal of large number of policies (4,847 policies), decrease of number of new policies (5,873) and intensified request for policy surrenders (578 policies were surrendered). This reflected in a decrease in the total number of active policies at the end-year as compared to their number at the beginning of 2010.

Growing competition in Montenegro's insurance market resulted in a decrease of the market share at end-2010. Three companies with the highest premium recorded 77.5% of market share, which is 1.4% less than at end-2009.

Solvency margin of insurance companies was EUR 21.8 million and guarantee reserves amounted to EUR 23.9 million at end-2010. Guarantee reserve to solvency margin ratio on the insurance sector level was 109.4% at end-2010, which indicates that the insurance companies in Montenegro were solvent. The liquidity ratio was 3.5, which shows that liquid assets of the insurance companies were 3.5 times higher in relation to their short-term liabilities.

The aforementioned indicates that the insurance sector does not pose a threat to financial stability at this moment.

4. FINANCIAL INFRASTRUCTURE

The financial infrastructure in Montenegro is comprised of a set of institutions that provide the legal framework for effective and safe performance of financial intermediation. A safe and efficient financial infrastructure contributes to financial stability and, based on the current technical and technological development, it becomes crucial for successful operations of a modern, internationally integrated financial market.

4.1. Payment system

In small economies, due to a limited market and reduced interest, central bank is usually the owner and operator of payment system, which is the case in Montenegro. The key business goals of the CBM in this domain are the payment system safety and efficiency, which at the same time guarantees safety of the financial sector.

The Central Bank of Montenegro focuses on reaching these goals due to several reasons:

- Maintenance of systemic stability of the payment system;
- High level of the payment system efficiency;
- High level of safety of publicly used payment instruments in, that is, the confidence in the payment system;
- Normal functioning of the economy.

The RTGS and DNS system of the Central Bank of Montenegro, the interbank payment system, operated for 11.220 minutes in 2010 and it was some 414 minutes suspended. Average system availability was 99.71% in 2010, in comparison with 99.87% in 2009, which can be assessed as extremely high availability level.

Table 4.1 – RTGS and DNS CBM system availability in period 2005-2010

Month	Business days	Business hours	Business minutes	Extension in min	Production in min	Delay in min	System availability
2005	254	2,151	22	34	129,116	98	99.92%
2006	255	2,167	30	60	130,110	24	99.98%
2007	254	2,159		96	129,636	261	99.80%
2008	254	2,159		462	130,002	491	99.62%
2009	254	2,159		37	129,577	96	99.87%
2010	256	2,176		6	130,566	414	99.71%
I-2010	20	170			10,200		100.00%
II-2010	20	170			10,200		100.00%
III-2010	23	195	30		11,730		100.00%
IV-2010	22	187			11,220		100.00%
V-2010	19	161	30		9,690		100.00%
VI-2010	22	187			11,220	107	99.46%
VII-2010	20	170			10,200	172	98.31%
VIII-2010	22	187			11,220	113	98.99%
IX-2010	22	187			11,220		100.00%
X-2010	21	178	30		10,710		100.00%
XI-2010	22	187			11,220		100.00%
XII-2010	23	195	30	6	11,736	22	99.81%

Total national payment system transactions amounted to EUR 20,407.4 million in 2010. They showed the year-on-year decrease of 7%.

These ratios indicate the presence of extended effect of the crisis that resulted in a decline in economic activity in Montenegro, which reflected on cash flows in the payment system.

Although systemic risks which could arise from the payment system are diminished or eliminated by the technical and legal solutions, there is room to additionally reduce operational risk by constructing the backup location, improving technological platform for the system functioning, and investing in IT of the CBM.

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

Period	Total payment transactions	Chain Index	Business days	Daily average	Interbank transactions	Daily average	Share of interbank transactions	Internal payment transactions	Daily average	Share of internal payment transactions
2005	10,968,099,128		254	43,181,493	5,372,998,880	21,153,539	48.99%	5,595,100,248	22,027,954	51.01%
2006	15,649,251,222		255	61,369,613	7,073,777,227	27,740,303	45.20%	8,575,473,995	33,629,310	54.80%
2007	25,242,585,660		254	99,380,259	10,425,634,941	41,045,807	41.30%	14,816,950,718	58,334,452	58.70%
2008	26,715,281,627		254	105,178,274	10,546,453,000	41,521,469	39.48%	16,168,828,627	63,656,806	60.52%
2009	22,033,220,193		254	86,744,961	8,900,719,570	35,042,203	40.40%	13,132,500,623	51,702,758	59.60%
I-10	1,062,103,329	45	20	53,105,166	418,029,249	20,901,462	39.36%	644,074,080	32,203,704	60.64%
II-10	1,348,058,127	127	20	67,402,906	575,029,019	28,751,451	42.66%	773,029,109	38,651,455	57.34%
III-10	1,738,167,222	129	23	75,572,488	723,526,791	31,457,687	41.63%	1,014,640,431	44,114,801	58.37%
IV-10	1,627,079,634	94	22	73,958,165	712,105,541	32,368,434	43.77%	914,974,093	41,589,732	56.23%
V-10	1,531,727,590	94	19	80,617,242	642,477,815	33,814,622	41.94%	889,249,775	46,802,620	58.06%
VI-10	1,878,204,541	123	22	85,372,934	820,642,037	37,301,911	43.69%	1,057,562,505	48,071,023	56.31%
VII-10	1,860,375,690	99	20	93,018,785	763,282,104	38,164,105	41.03%	1,097,093,586	54,854,679	58.97%
VIII-10	1,894,240,363	102	22	86,101,835	765,878,819	34,812,674	40.43%	1,128,361,544	51,289,161	59.57%
IX-10	1,795,829,105	95	22	81,628,596	753,626,148	34,255,734	41.97%	1,042,202,957	47,372,862	58.03%
X-10	1,786,383,390	99	21	85,065,876	782,353,059	37,254,908	43.80%	1,004,030,331	47,810,968	56.20%
XI-10	1,639,875,694	92	22	74,539,804	685,650,824	31,165,947	41.81%	954,224,871	43,373,858	58.19%
XII-10	2,245,320,005	137	23	97,622,609	1,031,175,688	44,833,726	45.93%	1,214,144,317	52,788,883	54.07%
2010	20,407,364,691		256	79,716,268	8,673,777,093	33,881,942	42.50%	11,733,587,598	45,834,327	57.50%
Monthly average	1,700,613,724				722,814,758			977,798,966		
Index 2010/2009	93				97			89		

4.2. Regulatory credit registry

The Credit Registry of the CBM became operational in 2008. It aims at gathering data on retail and corporate loans and providing information which contribute to a better assessment and better credit risk management in banks. In the beginning of its functioning, the information obtained from banks were used in the Central Bank for the purpose of conducting more efficient bank inspections, while later on the information from the credit registry was made available to banks and micro-credit financial institutions. As of 2010, this information is used also by the Investment and Development Fund. Besides information on loans, banks are obliged to submit information on all issued guarantees, credit cards, lease operations, overdrafts and other receivables that expose a bank to risk.

Banks have the possibility to verify credit histories in the registry when a client is applying for a new loan through identification number for companies or uniform identification number of natural persons. The report obtained from database of credit registry includes all credit obligations of legal or natural persons with all banks in Montenegro, as well as the balance of interest and regularity of repayment and/or servicing of debt. Also potential clients' indebtedness can be verified on the basis of reports, reflecting the number of guarantees or pledges issued by a client for other legal and natural persons. This shows that banks can find information which is relevant for adequate assessment of the client's solvency.

Number of clients – users as per **active loans in the banks' systems recorded in the Regulatory Credit Registry (RCR)**

	31.12.2007	31.12.2008	31.12.2009	31.12.2010
Natural persons	123,729	133,961	117,047	107,414
Legal persons	5,193	5,603	5,207	5,031
Total:	**128,922**	**139,564**	**122,254**	**112,445**

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

	31.12.2007	31.12.2008	31.12.2009	31.12.2010
Natural persons	165,465	184,872	171,153	160,161
Legal persons	8,594	6,137	5,787	6,483
Total:	**174,059**	**191,009**	**176,940**	**166,646**

Table 4.3 - Number of inquiries from the Regulatory Credit Registry

	Period		
	September -December 2008	January - December 2009	January - December 2010
No. inquiries	26,910	119,576	188,165

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

The new Central Bank of Montenegro Law sets up the legal base for further development of the credit registry. A Decision on the Collection and Use of Data from the Credit Registry of the CBM, which adoption is expected by mid-2011, will improve the system of reporting loans and other types of indebtedness of legal and natural persons. In this way, the reporting system will cover (beside banks and financial institutions) other entities in the financial sector (lease and insurance companies) and legal persons outside the financial sector but with whom citizens and natural persons have substantial indebtedness (companies for electricity distributions, tax authorities and other). In addition, in order to provide better data on indebtedness, the Decision prescribes daily reporting on new loans and other exposures of banks and financial institutions which will additionally increase the quality of information in the Credit Registry. Citizens' data in the credit registry will provide detailed information on indebtedness of legal and natural persons in banks and financial institutions as well as on the level of liabilities of these persons to other persons in the Montenegrin system. Efforts of the CBM are focused on getting the opportunity to fully examine creditworthiness of potential clients of banks and financial institutions, and on better credit risk management which will have positive effects on financial stability.

5. CONCLUDING REMARKS

International environment – Being a small and highly open economy, Montenegro operates as a part of the global economy and largely depends on global trends, particularly those in the EU countries and neighbouring countries (CEFTA countries). Global recovery has already started, however it is largely uneven and slower in those regions that are important for Montenegro, as the table below shows. Less noticeable growth in these economies shall result in growth deceleration in Montenegro.

Table 5.1 – Comparative overview of recovery of selected countries

Forecast	Real GDP growth (annual change, %)	
	2010	2011
EU 27	1.8	1.8
EU 15	1.8	1.6
CEFTA		
Bosnia and Herzegovina	0.8	2.2
Croatia	-1.5	1
Serbia	1.5	2.5

Source: wiiw

Significant fiscal and monetary stimuli applied in the previous period largely contributed to global recovery. However, there remains a dilemma whether they would have adverse effect on public finances and lead to inflation growth on the global scale. Still, their premature withdrawal threatens to absorb still vulnerable economies in the double-dip (w-shaped) crisis. As regards the Montenegrin recovery forecasts, the macroeconomic environment is still uncertain and does not give any clear signal for great expectations.

National macroeconomic environment – The effects of the crisis were the most apparent in 2009, while the first signs of recovery and entering a positive growth zone appeared in 2010. Still, we should be careful with conclusions on the exhausted effects of the recession caused by the global crisis since positive growth embarked upon a quite low basis from the previous year, yet it is still modest to allow speaking in favour of optimistic expectations.

A significant increase in industrial output, especially in the energy sector, and positive trends in tourism and trade, resulted in real growth of GDP between 1% and 2%. In the upcoming year, economic growth is expected to amount to some 3% and it may positively influence financial stability.

The standstill in the real estate market is still present, although there are some weak signs of recovery, especially after the implementation of the Government's "1000+ apartments" programme. Negative market trends and a decline in both the prices and demand hinder the position of the construction sector, which is reflected in a further decline in activities of this sector and irregular fulfilment of obligations to the banking sector.

The annual CPI inflation in Montenegro amounted to 0.7% in December 2010, being the lowest inflation rate ever recorded in Montenegro, either measured by the retail price index or the cost-of-living index. Such a low inflation rate was the result of the low aggregate demand in 2010, as well as higher propensity of households for saving, but consequently less propensity of the trade sector to increase prices. It points to the conclusion that profit margins, calculated on retail prices in the previous period, were sufficiently high, thus not posing the need for their correction. Growing prices of food and fuels in the global market will affect the price increase in Montenegro, taking into account large dependence on the export of these products. In 2011, inflation in Montenegro is expected to range between 3.50% and 5.75% and this movement does not jeopardize financial stability. Taking into account that the inflation will mostly be induced by external factors, monetary policy instruments cannot efficiently affect inflation drop in such cases. The increasing inflationary forecasts of the international community are causing uneasiness that may affect a higher increase in the prices than that initially forecasted.

Due to a greater external demand in 2010, economic and external trade activity recovered in 2010, resulting in positive trends in the current account. A faster pace of recovery of the export of goods and services than of imports led to a decrease in the deficit. This primarily reflected in a significant decline in the current account deficit from 50.7% of GDP (2008 - the largest level) to 30.1% of GDP in 2009 and consequently to 25.6% of GDP in 2010[10]. Still, although a positive trend was recorded, the lower external misbalance was not the result of improved competitiveness of the Montenegrin economy, but mostly the result of the crisis adjustments. Potential risks in the medium term that could adversely influence the current account deficit are deterioration of conditions in the aluminium industry (KAP) and growing prices of fuels and food products. One of the potential risks is a decline in foreign capital inflow, as the result of negative external factors, low interest of foreign investors in the implementation of capital projects and delays in the privatization of state companies.

[10] The CBM expresses some reservations regarding the registered value of exports and imports. Similar reservations were also pointed by the IMF after the consultations on Article IV of the IMF Articles of Agreement.

In 2010, the fiscal deficit was lower than the maximum criterion defined under the Maastricht Criteria (2.8% of GDP) although the plan envisaged the crossing of the upper threshold. The fiscal deficit in 2011 is expected to be within the limits defined by the Maastricht Criteria.

The external debt continued to increase in 2010, amounting to 30.2% of GDP at the 2010 year-end. The internal public debt amounted to 11.8% of GDP, thus total public debt amounted to 42% of the estimated GDP. The debt increase was also the result of the first Montenegro issue of Eurobonds in the international financial market. Additional increase of the external debt due to the Eurobonds and taking over some debts is planned in the coming period. It has to be noted that the share of the Montenegrin public debt in GDP was lower than in the EU countries, and that creation of the fiscal deficit and the public debt increase were necessary in the fight against the crisis striving to mitigate the effects of recession to the population standard. Still, the rapid public debt uptrend is a matter of concern.

However, besides the existing level of the public debt, total amount of issued guarantees of 11.8% of GDP[11] that may become potential public debt should also be taken into account. The largest threat to the public debt sustainability would be its further growth based on economically unsustainable overindebtedness of the state during the implementation of large capital projects. In these circumstances, the public debt would pose a special risk to financial stability, particularly if negative GDP growth rates and the fiscal deficit would continue after 2012. Risks are not so high in the short-term, while they are much higher in the medium- and long-term. All these indicators point to the necessity of further fiscal adjustment and providing a balanced budget in 2012.

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

Extended recession impact contributed to an increase in past due and non-performing loans during 2009 and 2010. This increase was evident in almost all banks, reaching the respective shares of 23.7% and 20.9% in total loans. Overall banking system recorded a negative financial result at end-2010.

With respect to risks prevailing in the Montenegrin banking system, credit risk is the dominant one. In 2010, banks performed necessary recapitalization, thus increasing the solvency of the banking sector and its resistance to negative impacts. Stress testing showed the resistance of banks, but some shocks would have stronger effect on certain banks. An increase in defaulting clients significantly reflected on overall result of the banking sector at end-2010. Although the result was negative, most banks operated with profit.

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

---

[11] Guarantees as at end-2010

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

Negative trends in the Montenegrin capital market indicate that the crisis is still present, but the situation in this financial market segment still does not have a large impact on financial stability. However it indirectly affects the level of economic and population wealth and financial stability as well. It is expected that the establishment of a single stock exchange market, which became operational in January 2011, would enable simpler monitoring of trends in the market, as well as opportunities for more efficient technical analysis and the centralization of the capital market, better oversight by the supervisor and growing investors' trust. The capital market in Montenegro is still shallow, representing a very limited source of financing for the Montenegrin companies since the issuing of new shares and corporate securities are very rare. The economy is directed to the banking system as the main source of financing. It may be concluded that the global capital market, as well as that in Montenegro, pays a high price for all anomalies in the financial sector regulation and supervision opened by the global financial crisis, especially due to a high sensitivity to market risks.

The insurance market is small, but growing part of Montenegrin economy. This market shares the fate of the real economy. Although the insurance market indicators point to a slowdown of this segment of the financial market, currently there are no threats from this sector to financial stability.

Global economy

- Recovery is uneven and slower at most important partners of Montenegro
- The appearance of post-debtor crisis in the EU
- Higher inflation at the global level, especially in the EU countries
- Increase in prices of fuels and food
- Overstrained finances are the source of risk
- Mild aggregate demand recovery

Montenegrin macroeconomic environment

- Economy in mild but uncertain and sector uneven recovery
- Fiscal deficit
- Higher inflation expectations
- Higher unemployment and standstill of real salaries
- Lower operation revenues and increased economic illiquidity
- Accelerated public debt growth

Montenegrin financial system

- Still present uncertainty in the capital market
- Threats to banking system stability are present
- Operational standstill in the insurance market
- Private pension funds are at initial stage of operations

Banking system

- High credit risk
- Significant loan delinquency
- Negative financial result
- High level of liquidity and low market risks

Financial stability

- Moderate level or risk

5.1. Recommendations for maintaining financial stability

Real sector

Although the economic activity recovered, this has still not affected positive trends at the labour market, i.e. to the increased stability of this market. Special attention has to be paid to this segment of market since trends at the labour market are directly or indirectly reflected on trends in productivity, which is one of the indicators of the level of economic growth and population standards.

The economic activity growth should be directed towards the real growth of productivity and not dominantly to increased productivity as the result of statistic decrease in employment (although the problem of redundancies should not be neglected). Positive economic trend in the coming period has to be encouraged by increased contribution of the labour force by increasing the share of active population in the labour force and decreasing unemployment.

Fiscal deficit/surplus

As for the fiscal policy, it would be important to ensure that the public spending matches the public revenues. It would be necessary to continuously rationalize public expenditures and to limit further growth in the key items of public spending. Moreover, the possibilities to increase public revenues have to be reconsidered.

Public Debt

In the area of public debt, it would be necessary to adequately execute the foreign borrowing policy, in order to prevent the exposure of the state to the public debt crisis, considering the pace of the debt growth. In the upcoming period, it would be necessary to pay attention to the volume and structure of issuing guarantees, as well as to the creditworthiness of guarantee beneficiaries, in order to prevent the risk of additional debt increase.

Balance of payments

The external trade deficit, and consequently the current account deficit, is still extremely high, but the trust shown by foreign investors and creditors to Montenegro does not question the deficit sustainability. Moreover, we should have in mind that the deficit was largely generated by the significant FDI inflow, so it partially contains the self-balancing component.

Still it is necessary to perform activities on decreasing the current account deficit.[12] To that end, it would be necessary to primarily work on increasing competitiveness of the domestic products. Therefore, we should continue to promote and encourage investments in the export-oriented output and the production dedicated to imports substitution and to increasing the share of products with higher processing degree in exports. Moreover, we should work on promoting Greenfield investments, especially in the branches where Montenegro has competitive advantage (energy, tourism, agriculture,

---

12 For more details, see Recommendations to the Government of Montenegro on Economic Policy in 2011.

food industry, and the like) and thus affect the FDI inflow increase. In addition, it is important to intensify additional efforts on the promotion of tourism potentials of Montenegro and improving the tourist offer by constructing better quality accommodation facilities in order to increase revenues from tourism which highly contribute to the current account deficit decline. It would be important to make a lot of efforts on adopting international quality standards.

Banking system

In the following period, more attention will have to be paid to credit risk. The supervision of systemically important banks is important. In banks where non-performing assets` increase endangers the solvency ratio, the CBM shall insist on recapitalization or moving of bad assets.

Microcredit financial institutions

Although the financial stability risk borne by MFIs is negligible, the risk of MFIs` interest rates is high. Extremely high interest rates, which reached their peak in 2010, raised the issue of possibility of their limiting. Although the CBM has very limited capacities, all mechanisms for affecting the MFIs` interest rate trends will be examined during the following year.

Capital market

With regard to the capital market, with a view to preventing the asymmetric information to investors that may lead to other negative events (like the appearance of negative selection and moral hazard), it would be necessary to fully implement and respect the European and the International Financial Reporting Standards and to publicly disclose all financial statements and relevant data needed for taking investment decisions. It would be necessary to improve the quality of corporate governance and awareness of all participants in the capital market, primarily regarding the risk level indicators of stocks, so that the risk/yield ratio would be at the real level.

Insurance market

Although the situation in the insurance market is stable, the remaining main risk is the underdevelopment this market. Therefore, we should work on further development and stabilization of the insurance market so that this segment could become one of the key sources of financing the capital market. Accordingly, it would be necessary to work on a further improvement and adoption of legal framework compliant with the EU acquis communautaire and the Core principles of the International Association of Insurance Supervisors (IAIS). In addition, it would be necessary to strengthen the cooperation among financial supervisors in order to ensure better stability of the overall financial system. It would be useful that the Insurance Supervision Agency performs stress testing of the insurance market.