FINANCIAL STABILITY REPORT 2012

CENTRAL BANK OF MONTENEGRO

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ABBREVIATIONS

ARIMA	Autoregressive integrated moving average model
CBCG	Central Bank of Montenegro
CDS	Credit default swap
CHF	Swiss Franc
CPI	Consumer Price Index
DNS	Deferred net settlement
EAM	Employment Agency of Montenegro
EBRD	European Bank for Reconstruction and Development
ECB	European Central Bank
EIB	European Investment Bank
EONIA	Euro overnight index average
EPCG	Electric Power Company of Montenegro
EU	European Union
EUR	Euro
EURIBOR	Euro interbank offered rate
FDI	Foreign Direct Investments
FED	Federal Reserves
FOMC	Federal Open Market Committee
GBP	British Pound
GDP	Gross Domestic Product
KAP	Aluminium Plant Podgorica
KfW	Kreditanstalt für Wiederaufbau, German Development Bank
LIBOR	London interbank offered rate
MoF	Ministry of Finance
MFI	Micro-credit financial institution
IMF	International Monetary Fund
MSCI	Morgan Stanley Capital International
OGM	Official Gazette of Montenegro
PIO	Pension and disability insurance
ROAA	Return on average assets
ROAE	Return on average equity
RTGS	Real time gross settlement
UK	The United Kingdom
USA	The United States of America
USD	US Dollar
VAT	Value Added Tax
VTB	Vneshtorgbank
WIIW	Wiener Institut für Internationale Wirtschaftsvergleiche, Vienna Institute for International Economic Studies

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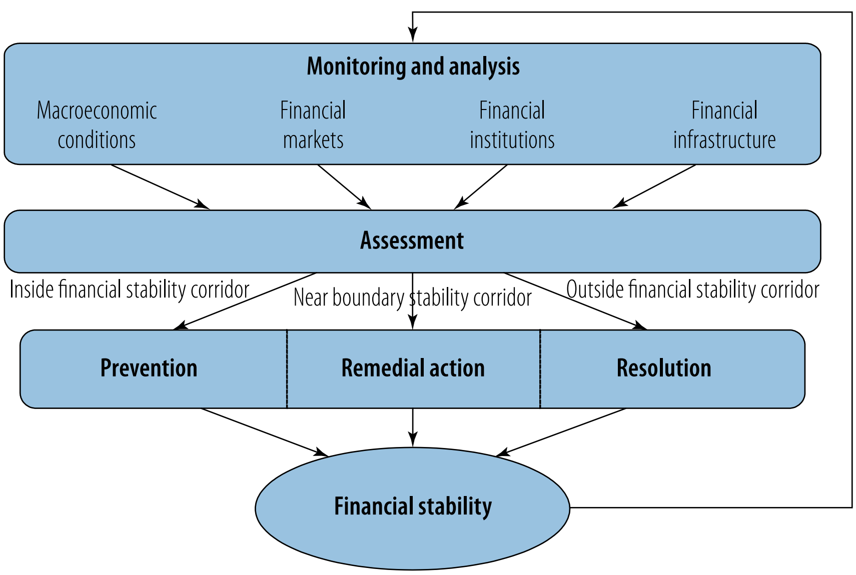
INTRODUCTORY NOTES

Financial stability is the fundamental prerequisite for economic development. In general, access to financial stability means that monetary policy creators analyse and prevent the emergence of all those events that may pose threat to financial stability via monetary and economic policy measures. This approach generally implies two dimensions of financial stability: micro dimension that addresses risks from the aspect of individual financial institutions and macro dimension that approaches risks from the aspect of the overall financial system. The objective of such two-dimensional approach is to properly assess systemic risk, i.e. the risk of spilling illiquidity or insolvency problem from an individual institution to the entire system. In general, the principle that is also applied by the CBCG may be presented through the following scheme.

Scheme 1 - Framework for maintaining financial system stability



Source: Schinasi, J., 2005, „Preserving Financial Stability"

With a view to achieving financial stability, it would be necessary to identify potential risks before they appear and result in a crisis or problems in the financial market functioning. This means implementing preventive and timely well-created policies. Of course, the objective cannot be the preventing of all potential problems in the financial market because it is impossible to manage all risks and uncertainties, and there is also no market that has not undergone fluctuations or turbulences. Therefore, efforts should be put on minimizing the biggest risks and ensuring system vitality in case of a crisis. Thus, the very objectives of the Financial Stability Report as well as activities of the CBCG in this area are preventive actions and identification of the most important risks before their materialisation.

1. INTERNATIONAL ENVIRONMENT

1.1. Overview of Macroeconomic Developments

Growth and imbalances

The global economy continued recovering in 2012although at a slower pace, recording a 3.2% growth rate (as compared to 3.9% in 2011)[1]. It was estimated that the global trade volume rose by 2.8% in 2012 (5.9% in 2011).

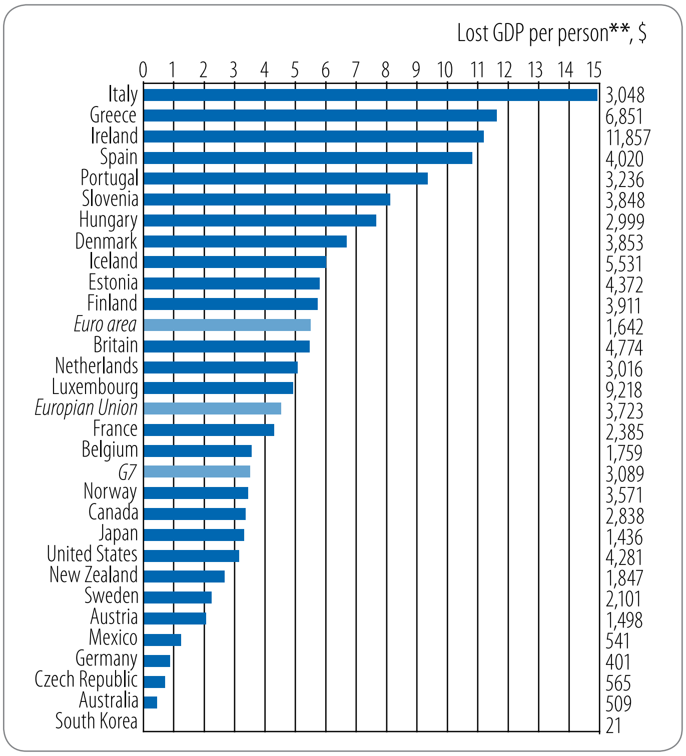
Table 1.1 – Overview of main global indicators, y-o-y, %

Indicators	2011	2012	Forecast		Difference from October 2012 projections (percentage points)	
			2013	2014	2013	2014
GDP growth						
World Output	**3.9**	**3.2**	**3.5**	**4.1**	**-0.1**	**-0.1**
Advanced economies	**1.6**	**1.3**	**1.4**	**2.2**	**-0.2**	**-0.1**
Emerging and Developing Economies	**6.3**	**5.1**	**5.5**	**5.9**	**-0.1**	**0.0**
USA	1.8	2.3	2.0	3.0	-0.1	0.1
Euro Area	1.4	-0.4	-0.2	1.0	-0.3	-0.1
Germany	3.1	0.9	0.6	1.4	-0.3	0.1
France	1.7	0.2	0.3	0.9	-0.1	-0.2
Italy	0.4	-2.1	-1.0	0.5	-0.3	0.0
Spain	0.4	-1.4	-1.5	0.8	-0.1	-0.2
Japan	-0.6	2.0	1.2	0.7	0.0	-0.4
UK	0.9	-0.2	1.0	1.9	-0.1	-0.3
Canada	2.6	2.0	1.8	2.3	-0.2	-0.1
Advanced economies outside G7 and Euro Area	3.3	1.9	2.7	3.3	-0.3	-0.1
Central and Eastern Europe	5.3	1.8	2.4	3.1	-0.1	0.0
Russia	4.3	3.6	3.7	3.8	-0.2	-0.1
China	9.3	7.8	8.2	8.5	0.0	0.0
India	7.9	4.5	5.9	6.4	-0.1	0.0
Latin America and the Caribbean	4.5	3.0	3.6	3.9	-0.3	-0.1
Middle East and North Africa	3.5	5.2	3.4	3.8	-0.2	0.0
Sub-Saharan Africa	5.3	4.8	5.8	5.7	0.0	0.1
World trade volume (goods and services)	**5.9**	**2.8**	**3.8**	**5.5**	**-0.7**	**-0.3**
Consumer Prices						
Advanced economies	2.7	2.0	1.6	1.8	0.0	0.0
Emerging and Developing Economies	7.2	6.1	6.1	5.5	0.3	0.2

Source: World Economic Outlook (WEO) Update, IMF, January 2012

[1] According to the IMF's World Economic Outlook report, updated in January 2013

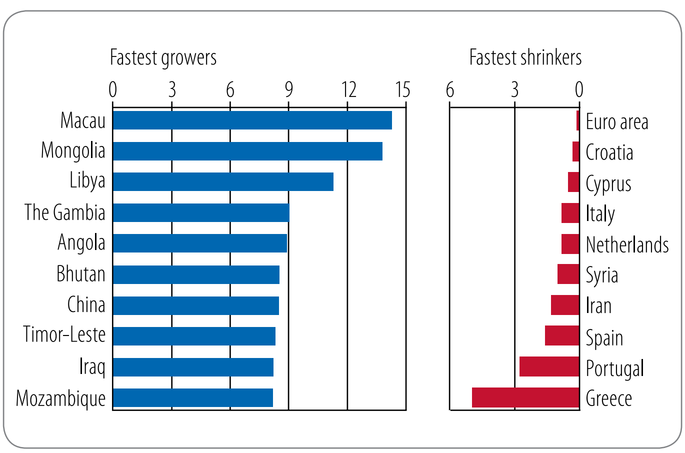
Graph 1.1
"Lost years" *



* Time to reach Q4 2011 GDP value predicted by pre-crisis trend, Based on forecast GDP growth 2013-17, years
** Difference between the trend determined value and real value (of annual) GDP from the fourth quarter of 2011, PPP

Source: The Economist

Graph 1.2
GDP growth forecast in 2013, %



Source: EIU

However, having in mind different results by selected countries/regions and taking into account the problem of the European sovereign debt crisis and slow economic recovery, as well as problems with the public finance in the USA, it may be noted that the global economy is still not on the path of a steady and sustainable growth and that the global crisis has not ended.

The growth was rather uneven during 2012, thus the IMF forecasted that advanced economies recorded growth of 1.3% and emerging and developing economies recorded growth as high as 5.1%. What was obvious in 2012 also characterised the entire crisis period, and thus China, observed through real GDP growth per capita, is supposed to record a spectacular growth of about 50% during the period 2007-2012. The general impression is that globally competitive and export oriented countries face crisis more easily and that current account deficits, especially if being notable and persisting over years, are a big problem, or to be more precise, they are a reflection of some long-term unsustainable imbalances. In other words, continuous maintaining of economic activity through borrowing cannot be a solution, and the resolution has to be sought in higher productivity, i.e. fundamental, structural and (eventually) institutional changes in an economic system.

Unemployment and current account deficit

For the countries on the periphery of the Euro area, the year 2012 brought the continuance of unemployment trends that started with the crisis. Thus, in the period after Q1 2008, the unemployment rate in Greece increased by 18.5 percentage points, in Spain 16.8 percentage points and in Ireland and Portugal by over 9 percentage points, and according to latest available Eurostat data (end of 2012), it reached 26.4%, 26.1%, 14.7% and 17.3%, respectively.

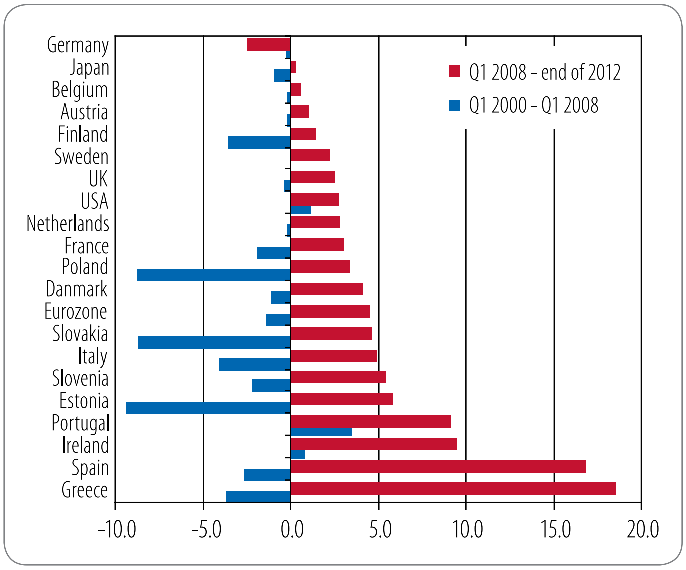
On the other hand, Germany was the only big European country that recorded unemployment decline in the period after the start of the crisis, of 2.5 percentage points. On the other hand, the unemployment rate in France grew by about 3 percentage points, being slightly below the Euro area average.

The unemployment rate in the USA also recorded a decline in 2012 (reaching the level of 7.8%), thus continuing a mild decline as of Q4 2009 when it had reached the level of 10.0%.

On the other hand, current account deficits of countries at the Euro area periphery that reached the highest levels in the period 2007-2008 started to recover. For example, Ireland has been recording a current account surplus since 2010 and it is forecasted that this could happen to Italy and Spain in 2013. Portugal and Greece have also been recording significant declines in their current account deficits. The current account surpluses come as the result of increased external competitiveness through a decline in labour costs

Graph 1.3

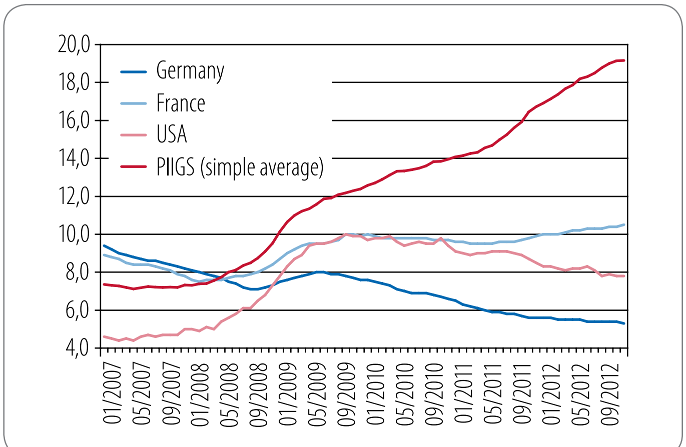
Change in unemployment rate in selected countries, in percentage points



Source: The Economist (source data: Haver Analytics)

Graph 1.4

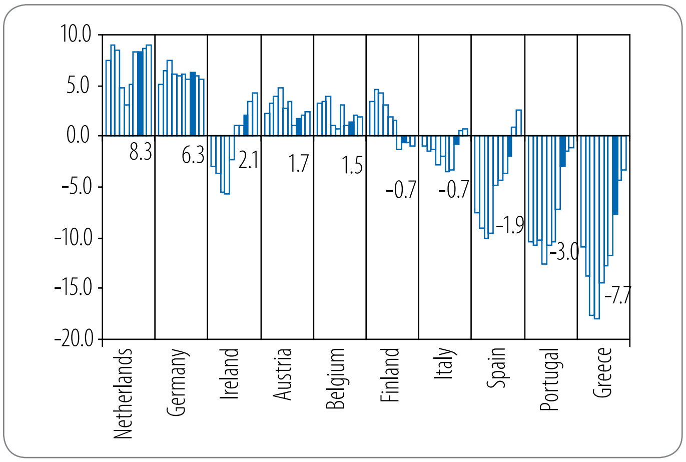
Monthly unemployment rates in selected countries, 2007-2012, by LFS, (PIIGS includes: Portugal, Ireland, Italy, Greece and Spain)



Source: Eurostat

Graph 1.5

Current account deficit in selected countries of the Euro area, GDP % (2005-2014; ranked according to values from 2012 (blue colour))*



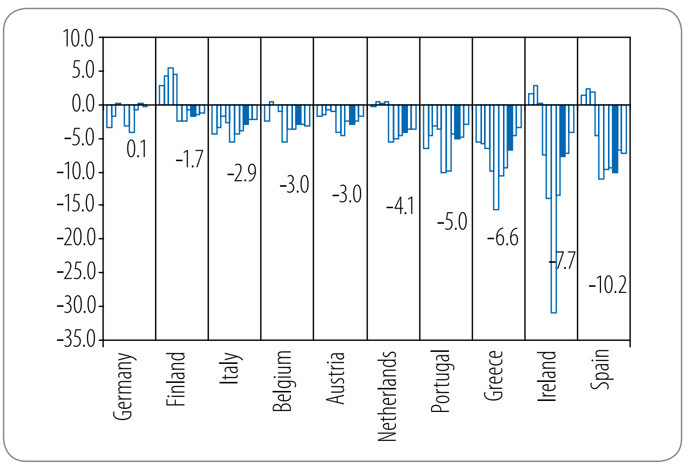
* Forecasts after 2011

Source: European Commission

(i.e. earnings) and specific structural reforms, as well as a decline in imports due to declines of the living standard and demand for imported products and services.

Graph 1.6

Budget deficit in selected countries of Euro area, GDP % (2005-2014; ranked according to values from 2012 (blue colour))*



* Forecasts after 2011

Source: European Commission

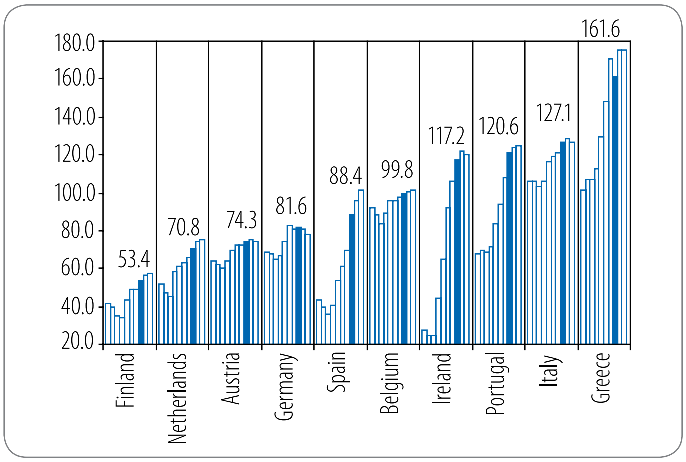
Public finance and financial markets

In general, 2012 was characterised by reduced jitters in the financial markets when it comes to the euro and public finances of countries at the Euro area periphery, especially in the second half of the reporting year. To wit, the painstaking austerity measures, structural reforms and the ECB expansion measures started to show results. However, the problems of weak growth (or decline) of economic activity remain. Also, the makers of economy policy measures still have a lot to do.

Graphs 1.6 and 1.7 show movements of public finances in the Euro area countries. It is clear that there is an ongoing process of strong fiscal adjustments and that the fiscal deficits are now considerably lower. Shortly after the start of the crisis the deficits have rapidly increased and reached very high levels – primarily due to problems in the finance sector and solving problems of troubled banks. However, even stronger consolidation is required as the level of public debt in some countries is extremely high, and every deficit, no matter how small, directly reflects on debt balance.

Graph 1.7

Public debt in selected countries of Euro area, GDP % (2005-2014; ranked according to values from 2012 (blue colour))*



* Forecasts after 2011

Source: European Commission

As already mentioned, the ECB had an important role in the market recovering and calming of the nervousness and the turning point was probably the speech of the ECB President in late July where he stated that the ECB would "do everything necessary to save the euro" and "that it will be enough". At the beginning of August, a couple of days after this statement, the ECB officially announced the program of the so-called direct monetary transactions (open market operations). If necessary and under specific conditions, this program would enable the ECB to be prepared to buy unlimited quantities of debt of the member states in the secondary market.

Except for the ECB measures and monetary policy, there was a significant progress in forming the Banking Union, which had a positive effect on financial markets. Namely, the first pillar of the Banking Union has been agreed. It will include the establishment of the common supervision of banks in the Euro area (or wider, in the EU), under the auspices of the ECB. After this, the common framework/fund for bank resolution would be added to the common supervision as well as the third pillar named the Common Deposit Insurance Scheme. Also, at the beginning of October 2012, the European Stability Mechanism (ESM) started working (as an integral successor of the European Financial Stability Facility and the European Financial Stabilisation Mechanism), which help the countries whose public finance/financial sector suffer financial problems, subject to specific conditions. One of the main ideas behind the Banking Union and the European Stability Mechanism is a further integration of financial markets of the Member States and "breaking the connection" between the public finance and financial sector (where the public finance suffered by helping/saving the financial sector), all for the purpose of strengthening the stability of the financial system of the Euro area/the EU.

In this way, during 2012, some of the countries at the Euro area periphery gained access to financial markets, and yields on their bonds have fallen dramatically compared to late 2011. As a consequence, CDS spreads on public debt of those countries demonstrated a similar trend in 2012[2].

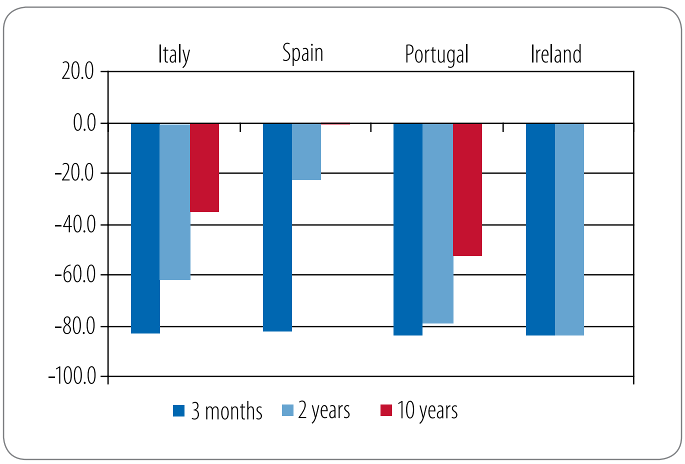
[2] Credit default swap (CDS) spread is a (market oriented) fee paid by debt owner as insurance against a debtor's default, shown as a percentage of the nominal value of a debt. As an example, a CDS of 500 base points (5%) on a debt of the nominal value of EUR 1 million means that the price of such insurance is EUR 50 thousand. A higher CDS logically makes the market believe that the probability of default is higher.

As for yields on the U.S., German and Swiss government bonds, they declined during H1 2012 when the period of their stagnation began. They began to grow during the last months of 2012 and at the beginning of 2013. The price of gold showed a different and unusual movement and after Q3 2012 it was recording obvious decline. These are all indicators of stabilisation in the financial markets.

Stock market indices are also at a higher level compared to the end of 2011. On 4 March 2013[3], the MSCI developed market index was 13% higher compared to end-2011, while the MSCI emerging market index for the same period recorded growth of 3.3%. The index growth started especially from June, after the indices` increase at the beginning of the year and declined towards June. The MSCI indices (as global indices) did not reach the highest levels recorded before the crisis but in mid-March 2013 some indices, for example DAX -Frankfurt, FTSE -London, and especially DJIA -New York, came close or exceeded their record maximums. On one hand, this represents a positive signal, while on the other it partially represents a matter of concern. This is because it is not quite clear where the optimism of financial markets comes from, i.e. there is a dilemma whether the speculative transactions dominated the observed period or whether this is just another "wave of irrationality".

Graph 1.8

Change of yields on public debt of the selected countries in the period 31 December 2011 – 4 March 2013, in percentage points*



* No data on the ten-year Ireland debt.
For the three-month Ireland debt in realtion to 6 July 2012.

Source: Bloomberg, CBCG calculations

Volatility indicators of financial markets (e.g. VIX), as well as indicators of credit and liquidity risk in the money markets (such as TED spread and LIBOR–OIS spread) recorded a decline in 2012 and first months of 2013 in comparison to 2011[4].

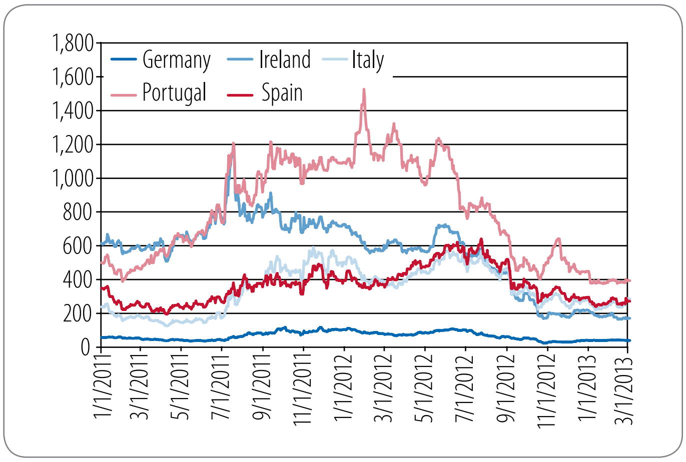
Talking about the exchange rate of the euro (EUR) against the U.S. Dollar (USD) and British Pound (GBP), EUR was losing its value from the beginning of 2012 until the end of July when it started to appreciate and at the beginning of March 2013 it reached levels similar to those on the onset of 2012. To wit, at the beginning of 2012 the EUR value was 1.2961 USD. On 24 July, EUR had reached the lowest value of 1.2061 USD after which it started to appreciate and reached the value of 1.2997 USD on 14 March 2013.

[3] The latest available information at the time of compilation of this report.

[4] VIX represents a measure of implied volatility options on the stock market index S&P 500, and thus a measure of expected volatility of stock prices (for the following 30 days). TED spread represents the difference between the quarterly USD LIBOR and USA treasury bills of the same maturity, while the LIBOR-OIS spread represents the difference between LIBOR and overnight swap (fixed) rate, which practically stands for expected market value of a reference overnight interest rate (in USA it usually represents effective "rate on federal funds") during a specific future periods.

Graph 1.9

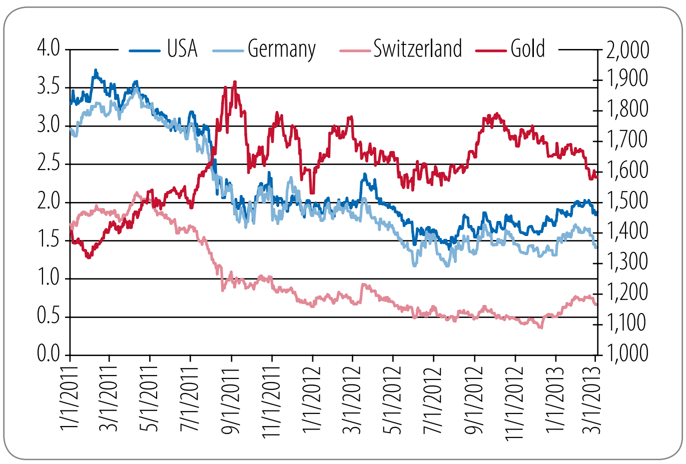
CDS spread (Credit Default Spread) on government bonds of selected countries at the Euro area periphery and Germany, 5-year contracts, in base points (1% = 100 base points)



Source: Bloomberg

Graph 1.10

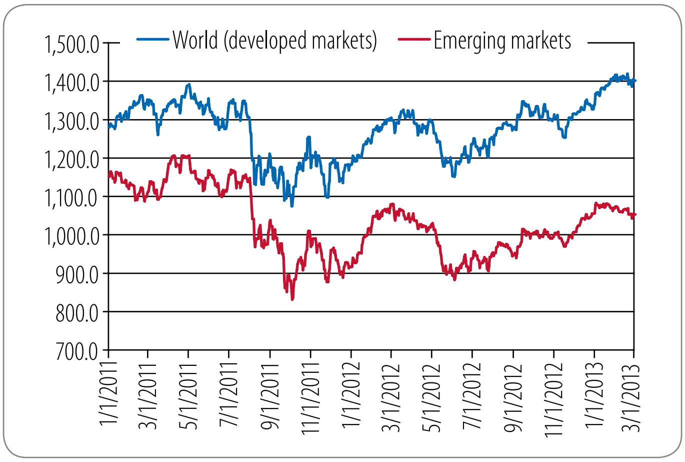
Yields on 10-year government bonds of the USA, Germany and Switzerland (left-hand scale and the price of a fine ounce of gold in US dollars (right-hand scale)



Source: Bloomberg

Graph 1.11

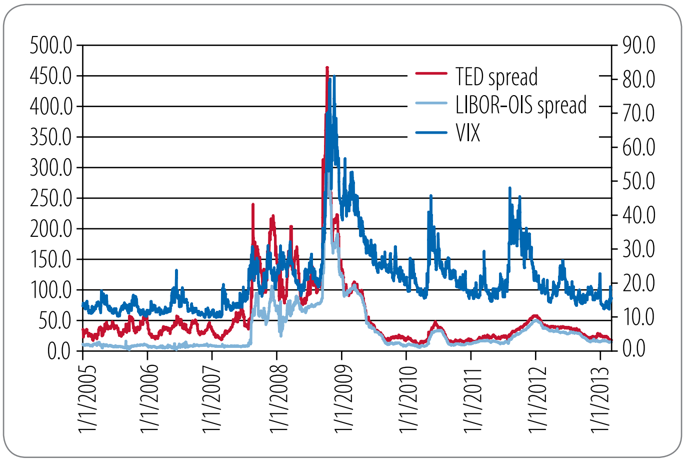
MSCI global indices, 1 January 2011 – 4 March 2013



Source: Bloomberg

Graph 1.12

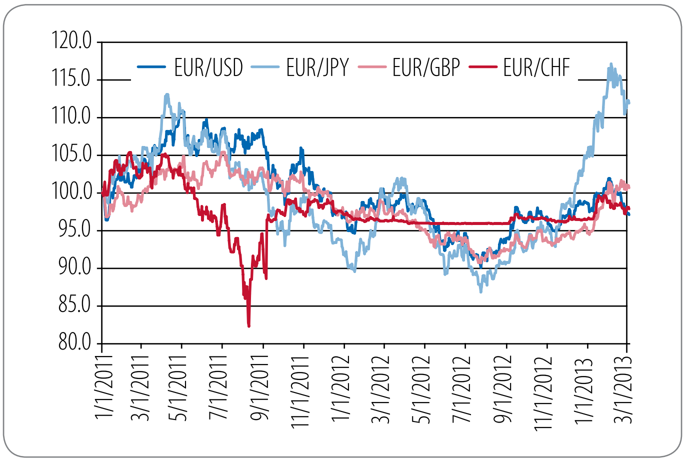
Volatility/stress indicators in financial markets (TED spread on the left-hand scale), 1 January 2005 – 4 March 2013



Source: Bloomberg

Graph 1.13

Euro against other currencies, 1 January 2011 =100
(rise/fall indicates euro appreciation/depreciation)



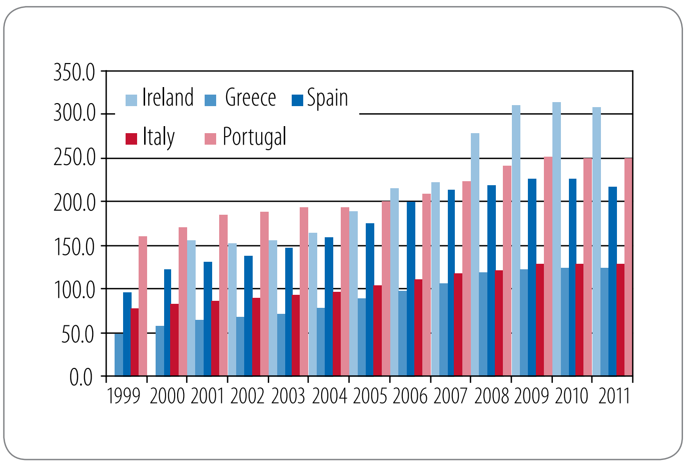
Source: Bloomberg, CBCG calculations

Private debt

Private debt is often one of the overlooked causes of the European debt crisis, since the public debt is often labelled as the main problem/cause, even though the public debt of the countries at the Euro area periphery did not significantly change during the period 2000-2010 (except for Portugal), while the debt of the private sector of those countries significantly increased. In the same period, the debt of the private sector of the "core" countries of the Euro area only slightly increased.

Graph 1.14

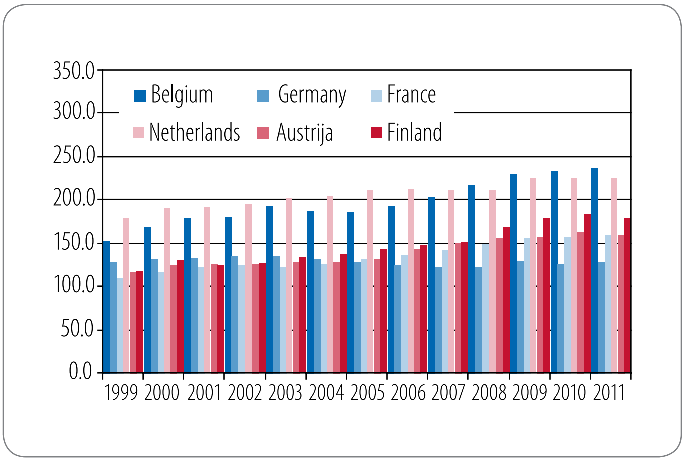
Debt of the private sector of peripheral countries of Euro area, GDP % (1999-2011; non-financial sector; unconsolidated)



Source: Eurostat

Graph 1.15

Debt of the private sector of the core countries of Euro area, GDP % (1999-2011; non-financial sector; unconsolidated)



Source: Eurostat

It is believed that the introduction of euro significantly reduced interest rates at which the private sector of the peripheral countries of the Euro area borrowed money, which the entities of that sector used and that consequently caused enormous, unsustainable levels of debt, which made the positions of the private sector and economy in general much more risky and vulnerable. In this regard, the European debt crisis must not be exclusively attributed to the public debt of the peripheral countries of the Euro area.

Monetary policy of leading central banks

Against the backdrop of continued and feeble economic recovery, and particularly taking into account expectations, central banks of leading economies mostly continued with the record low interest rate policies in 2012. For example, the Fed had kept its target federal funds rate unchanged since December 2008 (0-0.25%), and after the meeting of the FOMC held in January 2013 it was announced that the rates would remain at the same level for a long time. At the meeting held on 5 July 2012, the ECB Council reduced the ECB reference interest rate from 1% to 0.75% which represents the record low level. This was done due to easing of inflationary pressures and intensified risks of economic activity decline. The Bank of England and the Bank of Japan maintained their reference interest rates at the extremely low levels of 0.5% (since March 2009) and 0.1% (since December 2008), respectively. Reference interbank rates naturally followed the movement of reference rates of central banks, especially short-term rates such as the EONIA. In addition to the EONIA, quarterly EURIBOR recorded a decline during 2012 which reduced the mentioned rates to their lowest since the crisis levels in H2 2008.

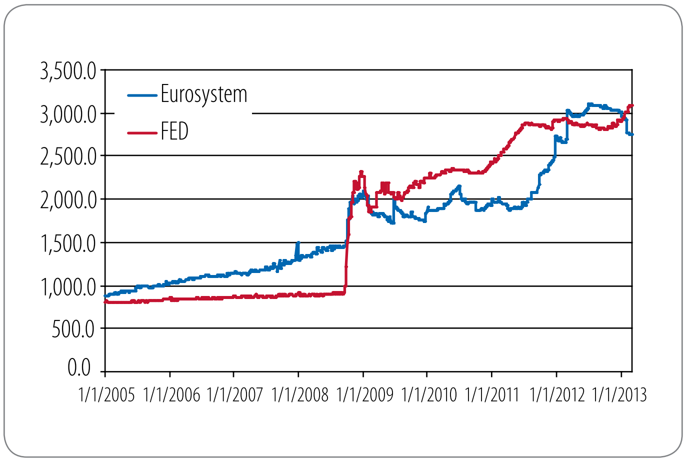
In 2012, the mentioned central banks have found resort in the so-called "quantitative easing" i.e. (electronic) money issue where through buying securities from banks they try to directly inject liquidity into the banking system and additionally decrease interest rates in the economy.[5] As a consequence, for the period 1 January 2012 – 4 March 2013, the total Euro system assets increased 0.5%, and the Fed`s assets rose 5.6 %. However, it has proved that not even these measures have given satisfactory results, since banks determine whether or not they would invest those funds in the real economy. There are assessments that the programs of quantitative easing take too much time, that they could

[5] The ECB does not use quantitative easing to the extent it is used by the FED or the Bank of England, but together with other expansive measures, the final effect is similar: an increased balance of the Euro system.

increase inflationary expectations. The issue of the manner of abandonment of those programs is especially sensitive. All things considered, it is clear that the quantitative easement cannot ensure long-term increase, i.e. that it can only be used to "buy time", until the other creators of economic and structural policies complete their part of work and the private sector finds a way to transform and increase productivity.

Graph 1.16

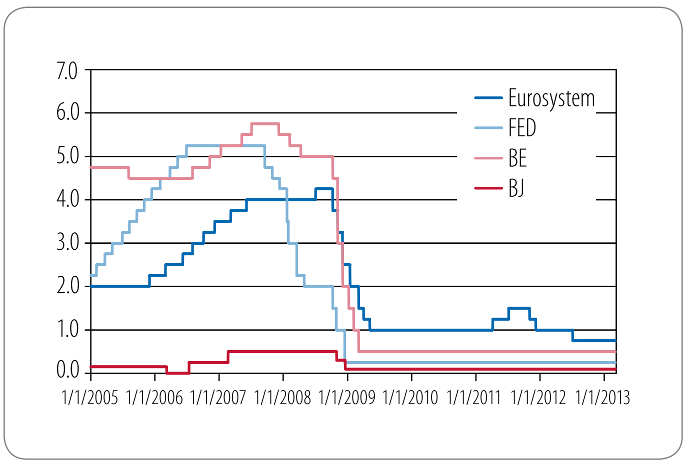
Total assets of the Euro system and the Fed, in EUR billion (1 January 2005 – 4 March 2013)



Source: Bloomberg

Graph 1.17

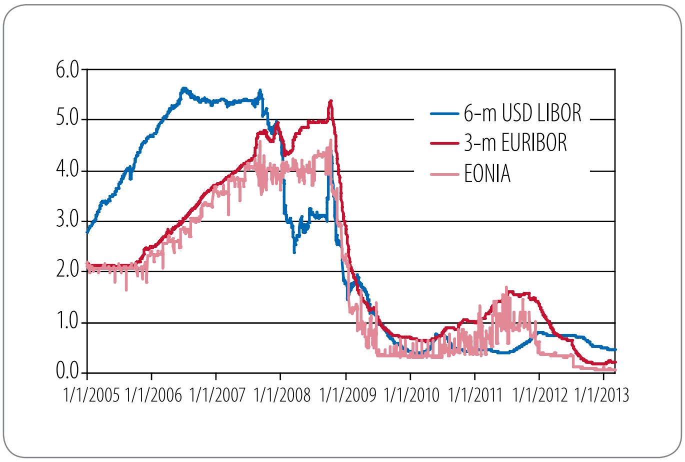
Reference interest rates of the central banks, (1 January 2005 – 4 March 2013)



Source: Bloomberg

Graph 1.18

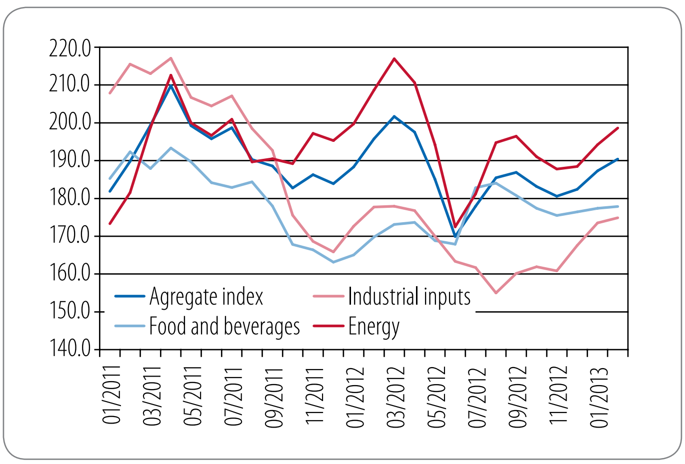
Reference market interest rates, (1 January 2005–4 March 2013)



Source: Bloomberg

Graph 1.19

Commodity prices (2005=100), (January 2011 – February 2013)



Source: IMF

Commodity prices[6]

According to the IMF's commodity price index (excluding precious metals), commodity prices recorded a 0.8% decline in 2012.[7] Although the prices of food and beverages and industrial inputs increased by 8.2% and 1%, respectively, the index value was largely affected by higher prices of energy products (3.5%), since the IMF's commodity price index assigns them the highest weight.[8] The prices of commodities also increased in January and February 2013 (4.4% in comparison to end-2012), this involving all indicated groups: food and beverages (0.8%), industrial inputs (4.4%), and energy (5.4%).

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[6] This refers to *commodities*, i.e. highly standardised market products, and not goods in the meaning of goods-services.

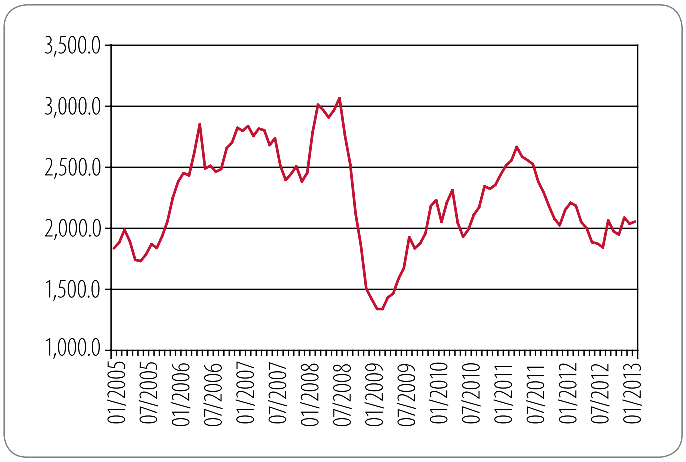
[7] Measured in December 2012 and compared to December 2011. If referring to an average change in prices (the 2012 average compared to the 2011 average), the decline rate is much higher (3.1%). We shall discuss the trend of the first index, since this was the most intuitive indicator, which is a widely accepted standard both globally and in Montenegro.

[8] This is the weight of 63.1% compared to 18.5% for beverages and food and 18.4% for industrial inputs. As expected, the most common weight refers to petroleum (53.6%). Nevertheless, the weights were derived from the global trade structure in the period 2002 – 2004.

Due to the importance of aluminium for the Montenegrin economy, we are presenting the price trending of this industrial input.

Graph 1.20

Price of aluminium tonne in the period January 2005 – February 2013, in USD (London Metal Exchange, monthly average)



Source: IMF

Expectations for 2013

According to the IMF January 2013 forecast, the global economic growth is expected to amount to 3.5%. Moreover, it should be noted that this forecast was revised downwards by 0.1 percentage points in relation to October 2012, primarily due to the ongoing problematic economic situation in the Euro area but also due to the USA problems concerning public finance. It is encouraging that the growth rate of 2% is forecasted for the USA, which is close to the one from 2011-2012. The US labour market was improving during 2012, but the persisting high level of long-term unemployment and a low share of active population in total population is still a matter of concern. A downtrend is also forecasted for the Japanese economy (1.2% compared to 2% in 2012).

Observed by groups of countries, it is forecasted that advanced economies would grow at the rate of 1.4%, emerging and developing economies at the rate of 5.5%, and the latter are estimated to give the major contribution to total growth in 2013. As expected, China and India will be the main drivers of growth. As regards advanced economies, the global growth contribution will mostly come from the USA, Japan, Canada, Britain and Germany.

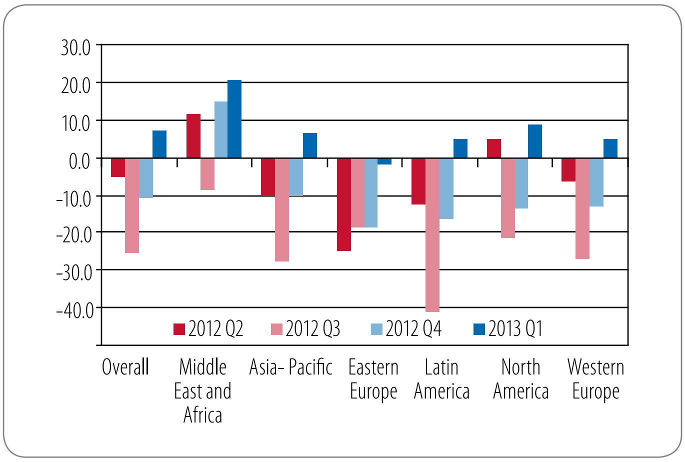
The 2013 growth in Central and Eastern Europe, according to the IMF forecast, will amount to 2.4%, which is a modest yet higher rate of growth than in 2012 (1.8%).

Briefly, the most encouraging fact is the higher growth rate in 2013 in comparison to 2012 and a significant improvement in financial markets. However, much remains to be done, and the announced structural/institutional reforms need to be implemented properly and as soon as possible. In addition, it seems that the efforts to change global regulations of the financial sector are taking too much time. As for Montenegro, the major concern is the announced decline in economic activity in the

Euro area (0.2%) i.e. weak growth of activities in the EU of 0.2%, since this is the region with which Montenegro has the strongest economic relations[9].

Graph 1.21

Global business barometer



Source: FT and The Economist survey

The FT-Economist Global Business Barometer showed rather optimistic expectations at the beginning of 2013 compared to the same survey from Q4 or even Q3 2012[10]. To wit, the balance between the top managers expecting improvement in business environment in the next six months as compared to those expecting the opposite is positive for the first time after Q2 2011, amounting to 6.9%. The expectations vary significantly from region to region: from 20.6% among managers from the Middle East and Africa to -2.1% among managers from Eastern Europe (which is the only negative result in the last conducted survey).

Position of the Montenegrin economy: Influence channels

Being a small and open euroised economy, Montenegro is highly exposed to global economic trends. Observed from the aspect of foreign trade, Montenegro is mostly connected with the Western Balkan region and the European Union. However, since the region itself is connected with the EU, thus Montenegro's relations with the EU market are more pronounced. Besides, there is a strong connection of the region with China but primarily on the imports side.

One of the most important influence channels at the international scene are prices, primarily those of food and energy. The IMF forecasts for 2013 show that the prices of oil and non-energy products would decrease on average by 5.1% and 3%, respectively. Of course, this forecast is largely based on the forecast of a slower economic recovery. However, factors that influence food and energy prices are really numerous and diverse, thus any forecast at this time would be the least appreciative.[11]

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[9] The acceleration of growth of the advanced economies from 1.3% (2012) to 1.4% (2013) should be interpreted in the similar context. This is attributed to countries outside G7, except for Britain, and countries of the Euro area (Austria, Czech Republic, Denmark, Hong Kong, Iceland, Israel, South Korea, New Zealand, Norway, Singapore, San Marino, Sweden, Switzerland and Taiwan), which are countries with week connections with Montenegro.

[10] This is a survey on business confidence which is done four times a year. It is based on the answers of more then 1,500 top managers around the world; the overall confidence/optimism level is measured as the balance of respondents who think business conditions will improve against those who expect them to get worse in the next six months. A neutral answer is also possible but it does not reflect on the main result (balance).

[11] For example, the prices of food and energy products were on an increase in January – February 2013 compared to end-2012.

An unavoidable segment of visible trade is aluminium. The price of aluminium in 2012 was 15.7% lower, on average, compared to the prices in 2011, ranging about 2.023 dollars per ton. (During 2012, the price of aluminium had been increasing until February and after that it declined until August when it recovered with certain variations). In general, a stronger recovery of the aluminium prices in 2013, as per current growth and activity forecasts, would be hard to expect.

As regards the USD/EUR exchange rate, although being an undisputable factor affecting the state of affairs in the Montenegrin economy, it should not be worth any particular attention, at least not in 2013.

As regards revenues from tourism, the announced uncertain global economic growth may come as a threat. Still, with some good internal organization and preparation of the summer tourist season, as well as effective advertising activities, good results are not be unreasonable to expect, primarily since tourism has proved to be a very resistant sector to the crisis in the previous period.

Finally, a far important transmission channel from the international environment to Montenegro is capital flows which are directly in connection with the level of general economic activity and situation in financial markets. Taking into account the not-so-low external debt, it is evident that a potential vulnerability of Montenegro's economy lies here.

As regards foreign direct investments, the situation is not encouraging having in mind the conditions of an uncertain global growth with relatively high general risk sensitivity. Sensitivity to risk, as regards foreign borrowings, will be particularly important for new government borrowings. The policy of a balanced public finance shall thus be of crucial importance for attracting investors.[12] As regards banks' borrowings, they will dominantly be affected by financial position of their parent banks and their willingness to potentially finance their subsidiaries. More significant support of parent banks for improving lending activity should not be expected in 2013, and the daughter banks will have to look for funds for lending in the domestic market or via credit lines granted during the previous period.

[12] Of course, this refers to: 1) possible new borrowings of the state under more favourable conditions in comparison to the existing contracts; this would ensure less expensive refinancing of the existing debt, i.e. 2) borrowings that would be used exclusively for capital purposes. Any other forms of borrowing of the state other than the aforementioned are generally undesirable and would generate additional pressure on the financial system stability.

2. MACROECONOMIC ENVIRONMENT IN MONTENEGRO

2.1. GDP movements

According to the official statistics, GDP in 2011 grew by 3.2%. Observed by the structure of activities, the key drivers of growth in 2011 were trade, construction, agriculture (with forestry and fishery) and manufacturing industry.

The indicators determining total economic growth in Montenegro showed different trends in 2012. In this manner, tourism and trade will have a small positive influence on the total economic growth while the industry and construction will have a negative influence on the total economic growth in 2012.

Table 2.1 - Trends of selected activities, 2012/2011, in %

Tourism	
Arrivals	4.8
Overnights	4.3
Turnover in retail sale	6.7
Construction	
Value of performed works	-13.2
Effective construction hours	-9.2
Forestry, physical volume (weighted index)	-16.1
Manufacturing output, physical volume	-10.1
Mining and quarrying, physical volume	-21.0
Electricity, gas, steam and air conditioning supply	1.4

Source: Monstat

According to the Ministry of Finance's estimates, the real GDP growth in 2012 amounted to 0.5%. According to the model estimate of the CBCG, the estimated growth of GDP in 2012 ranged from -0.5% to 0.3%, while the estimates of the IMF and the European Commission show that the Montenegrin economy recorded a growth rate of 0.2%, and according to the EBRD estimates, the growth rate amounted to 0.3%.

The year 2012 was characterised by an increased number of employees and a decline in registered unemployment, as well as a modest increase in gross and net salaries of 0.8% and 0.7%, respectively. Still, these were obvious slight movements in the labour market, and general position of the household sector is still relatively "fragile". Namely, looking at the trends of average earnings and inflation, it can be said that the earnings of the population have not realistically increased during the past two years; instead, they recorded a modest decline due to the fact that the prices increase exceeded the growth in earnings, especially in 2012.

This should be accompanied by the information from the labour market according to the Monstat's Labour Force Survey. It shows that the unemployment rate remained high, amounting approximately to 19%, with continued low employment rates (ratio of employment towards working age population) of about 40% and activity rate (ratio of labour force (i.e. active) towards working age population) of about 50%. However, this is a segment where Montenegro continued to be better in comparison to the regional average.

Table 2.2 – Main labour market indicators (annual average)

	2010	2011	2012	Change (2012/2011) %
Employed	161,742	163,082	166,531	2.1
Unemployed	31,864	30,869	30,182	-2.2
Gross salaries, EUR	715	722	727	0.8
Net salaries, EUR	479	484	487	0.7

Source: Monstat; Employment Agency of Montenegro

In 2012, the economy was still facing significant illiquidity. Observed through enforced collection indicators, the position of the economy further deteriorated in 2012. The share of persons[13] with frozen accounts in total number of persons performing an activity declined by 2.9 percentage points during 2012, thus it amounted to 23.5% at end-2012[14]. On the other hand, frozen amounts reached their record levels. In the end of 2012, the amount of persons with frozen accounts for a period longer than 1 year amounted to EUR 384 million and the total frozen amount reached EUR 445.1 million, increasing 17.9% during 2012.

Table 2.3 – Unemployment in the region, Labour Force Survey, %

Country	Unemployment rate, 2012
Slovenia	8.9
Croatia	15.7
Montenegro	20.0
Serbia (excluding Kosovo)	24.0
Bosnia and Herzegovina	28.0
Macedonia	31.0

Source: WIIW, March 2013

Table 2.4 – Basic statistics of enforced collection, end -period

	2011	2012	Change in %
Number of entities with frozen accounts	15,186	12,247	-19.4
as a % of total entities	**26.43**	**23.5**	(percentage points) -2.9
entities with frozen accounts up to 1 year, EUR	88,281,907	61,140,135.84	-30.7
entities with frozen accounts over 1 year, EUR	289,311,928	383,956,101.84	32.7
Total, EUR	**377,593,836**	**445,096,237.68**	**17.9**

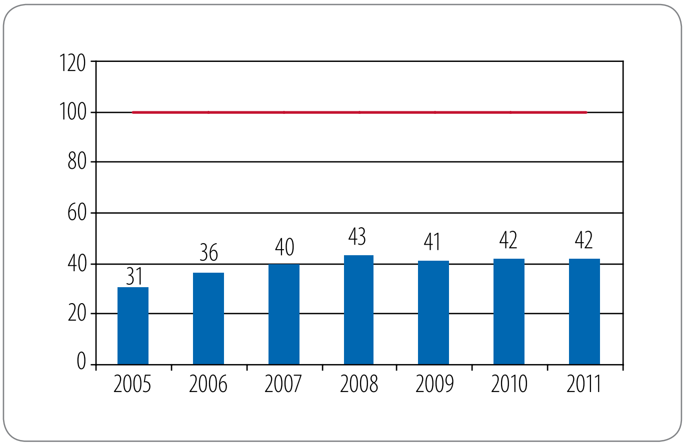
Source: CBCG

[13] Includes legal persons and entrepreneurs.

[14] The decline is significantly attributed to the harmonisation of the records on the Central Registry of Accounts (CBCG) with the records on the Central Registry of Commercial Entities (Commercial Court), which was completed in mid-2012.

Graph 2.1

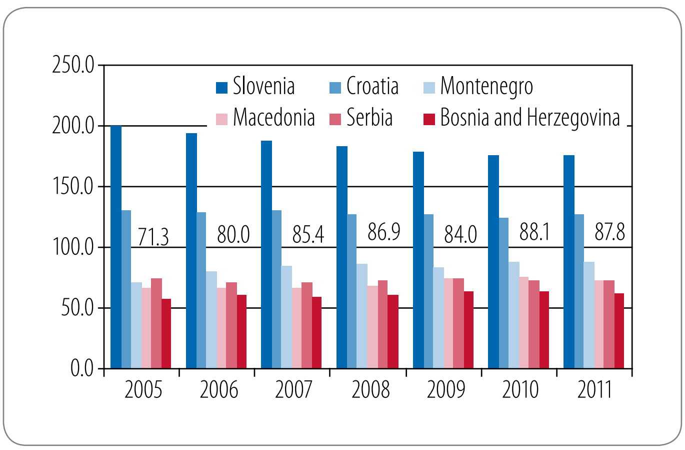
Montenegrin GDP per capita at purchasing power parity, EU27=100



Source: Eurostat

Graph 2.2

Montenegrin GDP per capita at purchasing power parity, EX YU=100



Source: Eurostat, rescaling CBCG

Table 2.5 – The latest Montenegro's GDP official estimates for 2013 given by the international financial institutions (in %)

Institution	Estimated growth rate in 2013, %
IMF	1.5
EBRD	0.8
European Commission	2.2

Estimate of GDP movements in 2013 and their impact on financial stability

Growth in 2013 will primarily depend on three factors: inflow of foreign capital, credit supply (and the overall situation in the banking sector) and the situation in the metal industry. It is difficult to make forecasts regarding the movement of all of these factors. The inflow of capital, the main driving force of the economy during the several past years, will depend on the situation in the international markets, i.e. on the willingness of foreign investors to invest (to lend money), but also on indebtedness of the domestic sectors and their credit demand (state and banks). Speaking about the purchasing of real estates, the extent to which the unsold real estates attract foreign buyers remains an issue. When it comes to the willingness of banks to extend loans, it is unreasonable to expect that they will make any significant changes to their prudent policies during 2013, which is largely attributed to a relatively high share of non-performing loans. The situation in the metal industry will, of course, remain dependent on further developments in KAP, which is very difficult to predict.

As Table 2.5 shows, international financial institutions forecasted a slight growth in 2013. However, the growth rate of 1.5% (if we take the IMF's forecast as a representative one) is not satisfactory for the Montenegrin economy, having in mind the difference in the level of the living standard compared to the EU countries, to which the Montenegrin society strives, although in comparison to the region Montenegro records good results.

The document titled "Montenegro Pre-accession Economic Programme 2012 – 2015", published by the Ministry of Finance in January 2013, contains two macroeconomic scenarios, whereby the baseline scenario envisages real GDP growth rate of 2.5% in 2013, while the lower growth scenario, which also includes the abovementioned problems, envisages a 1.0% growth.

Table 2.6 – Montenegro: selected economic indicators, 2007-13 (under current economy policies)

	2007	2008	2009	2010	2011	2012	2013
					Assessment	Projection	
Real economy							
Nominal GDP (in EUR million)	2,680	3,086	2,981	3,104	3,260	3,334	3,449
Gross national savings (as % of GDP)	-5.1	-10.0	-3.1	-2.6	-1.2	-0.6	-0.4
Gross investments (as % of GDP)	33.8	40.7	27.1	22.8	19.4	20.3	20.9
	(change in %)						
Real GDP	10.7	6.9	-5.7	2.5	2.5	0.2	1.5
Industrial output	0.1	-2.0	-32.2	17.5	-10.3	…	…
Tourism							
Arrivals	18.8	4.8	1.6	4.6	8.7	…	…
Overnights	22.9	6.9	-3.1	5.5	10.2	…	…
CPI (annual average)	3.5	9.0	3.6	0.7	3.1	2.0	1.1
CPI (period end)	6.3	7.2	1.7	0.7	2.8	1.7	1.3
GDP deflator	12.7	7.7	2.4	1.6	2.5	2.1	1.9
Average net salary (12 months average)[1]	19.9	23.1	11.3	3.5	1.0	…	…
Cash and loans (12 months average)							
Loans to private sector	180.5	25.0	-15.1	-8.9	-13.0	…	…
Corporates	199.3	21.3	-18.0	-11.2	-17.6	…	…
Households	153.5	31.2	-10.7	-5.7	-2.6	…	…
Private sector deposits	102.7	-14.2	-4.1	5.9	1.2	…	…
	(as a % of GDP)						
General Government finance, by invoiced realisation[2]							
Revenues and grants	47.7	48.4	42.6	41.3	37.9	38.0	38.0
Expenditures (including discrepancy)	40.9	51.5	47.9	46.0	44.2	43.2	42.3
Deficit/surplus	6.7	-3.1	-5.3	-4.7	-6.3	-5.2	-4.3
Primary deficit/surplus	7.8	0.5	-4.4	-3.7	-4.6	-3.3	-2.1
Domestic financing (net)	-7.7	2.1	-3.2	-1.4	2.4	0.4	-0.7
Revenues from privatization	4.0	1.2	4.4	0.9	0.5	0.5	0.5
	(as a % of GDP)						
Gross general government debt (end of period)	27.5	31.9	40.7	42.4	46.9	50.2	52.1
	(as a % of GDP)						
Balance of payments							
Current account balance	-39.5	-50.6	-29.6	-24.6	-19.4	-19.7	-20.0
Foreign direct investments	21.2	18.9	35.8	17.8	11.9	11.4	12.4
External debt (end of period)	74.1	90.8	93.5	96.4	99.9	107.3	114.5
of which: private sector[3]	56.9	75.2	70.0	67.0	67.3	71.1	75.0
Real effective exchange rate (based on CPI, average change in %) (minus refers to depreciation)	-2.3	1.6	6.4	0.0	-3.2	…	…
Additionally:							
Aluminium price (EUR/tonne)	1,926	1,752	1,198	1,638	1,725	1,785	1,878

1) Data on salaries for 2009 were adjusted in order to comply with a change in the Monstat methodology, starting from 1 January 2010.
2) Including state funds and municipalities, but not state owned companies.
3) Assessments, because private debt statistics is not published.
Taken from the Report of the IMF Mission within consultations pursuant to Article IV of the IMF Articles of Agreement, April/May 2012. (Original source: MoF, CBCG, Monstat, EAM and the IMF assessments and forecasts)

Table 2.7 – Montenegro: selected economic indicators, 2011-14

Indicator	2011	2012	2013	2014
		Projection		
Real GDP growth	3.2	0.2	2.2	3.0
Unemployment rate (as a % of total labour force)	19.7	20.0	19.7	19.4
CPI	3.1	4.1	2.7	2.5
Current account deficit (% of GDP)	-19.6	-20.0	-20.6	-20.6
Fiscal deficit (% of GDP)	-5.4	-4.0	-3.0	-2.0
Public debt (%GDP)	45.9	52.0	53.4	53.0

Source: European Commission, Winter Forecast 2013 (February 2013)

Table 2.8 – Montenegro, Vienna institute projections, March 2013

Indicator	2011	2012	2013	2014	2015
			Projections		
Real GDP growth (%)	3.2	-1.0	1.0	2.0	3.0
Consumer prices (% y-o-y change)	3.1	4.1	3.0	3.0	3.0
Unemployment rate (as per Labour Force Survey)	19.7	20.0	20.0	19.0	19.0
Current account (% of GDP)	17.7	-15.5	-15.5	-15.5	-15.5

Table 2.9 – Real GDP growth, EBRD projections, %

Country/Region	2011	Forecast for January 2013		Forecast for October 2012	
		2012	2013	2012	2013
Central Europe and Baltic states					
Croatia	0.0	-1.9	0.8	-1.9	1.2
Estonia	8.3	3.3	3.1	2.3	2.5
Hungary	1.6	-1.5	-0.1	-1.5	0.4
Latvia	5.5	5.4	3.0	4.2	2.7
Lithuania	5.9	3.2	2.9	2.7	2.4
Poland	4.3	2.0	1.5	2.5	2.2
Slovakia	3.2	2.2	1.7	2.7	2.3
Slovenia	0.6	-2.1	-2.0	-2.5	-2.0
Average	**3.5**	**1.3**	**1.2**	**1.4**	**1.7**
Southeast Europe					
Albania	3.1	1.8	2.0	0.6	1.3
Bosnia and Herzegovina	1.0	-0.5	0.6	0.1	0.4
Bulgaria	1.7	1.1	1.9	1.2	1.7
Macedonia	2.9	-0.5	1.8	0.3	2.0
Montenegro	3.2	0.3	0.8	0.3	0.8
Romania	2.5	0.3	1.4	0.5	1.9
Serbia	1.6	-1.9	2.1	-0.7	1.1
Average	**2.2**	**0.1**	**1.5**	**0.4**	**1.6**

The CBCG model estimate showing Montenegro's GDP dependence on the Euro area GDP, salaries, employment, industrial output and tourism trending indicates that real GDP in 2013 could record growth from 0.7% to 1.9%, with the central projection of 1.5%. The weighting of estimated real GDP growth rate of international institutions and institutes shows that Montenegro's GDP growth in 2013 will amount to 1.4%.

2.2. Inflation

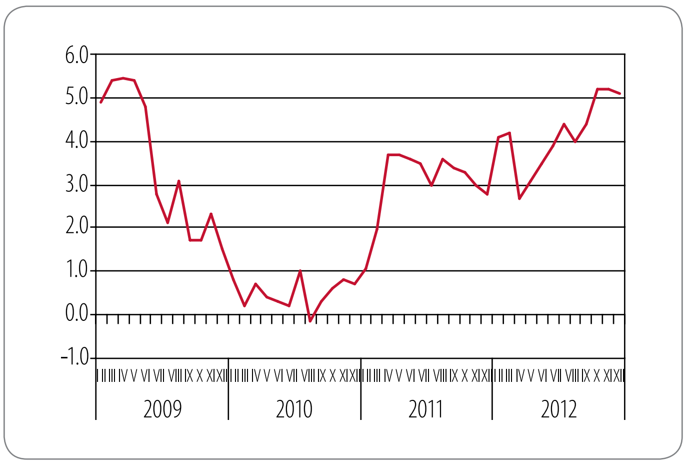
In December 2012, the annual inflation rate amounted to 5.1%, being significantly higher in comparison to December 2011, when it amounted to 2.8%. This represents a significant deviation from the inflation rate in the EU and the Euro area which amounted to 2.3% and 2.2%, respectively. The higher inflation rate was a result of an increase in the prices of "food and non-alcoholic beverages" 6.9% (mostly due to of higher prices of fruit and vegetables) and the prices under the category "housing" of 11.6% (mostly due to higher prices of electricity). The higher inflation rate was also a result of the higher prices under the category "alcohol and tobacco" of 10.7% (primarily tobacco) and "clothing and footwear" of 3.9% (mostly due to the higher prices of clothes).

The prices from the category "furnishing and household equipment" and "miscellaneous goods and services" had a negative impact on the inflation, generating respective declines of 1.5% and 2.6% mostly due to lower prices of furniture and household items, i.e. personal care.

Table 2.10 shows the share of changes of the main categories of goods and services in the change of the general price level.

Graph 2.3

Consumer prices, annual growth rate



Source: Monstat

Table 2.10 – Share of individual categories in total inflation

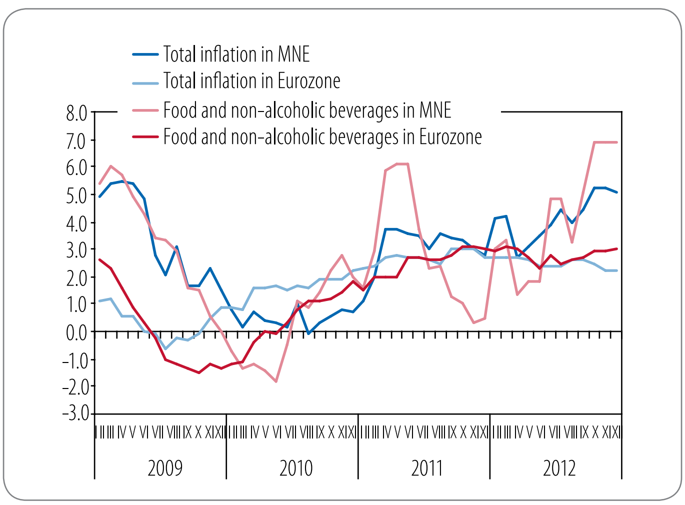
	Weight	Growth rate DEC 12 / DEC 11	Share in percentage points	Share in %
TOTAL	10,000	5.1	5.1	100.0
Food and non-alcoholic beverages	3,755	6.9	2.6	51.7
Alcoholic beverages and tobacco	372	10.7	0.4	7.9
Clothes and footwear	761	3.9	0.3	5.9
Housing	1,287	11.6	1.5	29.7
Furnishing and household equipment	494	-1.5	-0.1	-1.5
Health	280	0.7	0.0	0.4
Transport	1,216	0.5	0.1	1.3
Communication	558	3.3	0.2	3.7
Recreation and culture	321	3.2	0.1	2.1
Education	218	0.0	0.0	0
Restaurants and hotels	296	2.0	0.1	1.2
Miscellaneous goods and services	442	-2.6	-0.1	-2.2

Source: Monstat and CBCG calculations

The average monthly rate of **core inflation** during 2012 amounted to 0.21% and it was two times lower (i.e. 0.21 percentage points) than the average monthly (total) inflation. Monthly core inflation recorded positive values only in four months (June, July, November and December), while monthly (total) inflation, recorded negative values only in two months (November and December).

Graph 2.4

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



Source: Monstat and Eurostat

Since the crisis emergence, the food prices have been "dictating" total inflation. After a decline in the prices of food (observed via the y-o-y rate) in H2 2009 and moderate changes during 2010, the food prices were on an ongoing uptrend in H1 2011, yet showing a downward trend in H2 2011. However, during 2012, the food prices in Montenegro exhibited strong growth trend, with certain fluctuations. This growth was much greater in comparison to the trends in the Euro area, causing stronger influence of the higher food prices in Montenegro where the inflation rate is much more "sensitive" to the changes of the food prices in comparison to the inflation rates in the Euro area, mainly due to the higher weights of food products for the calculation of the total inflation.

Noticeable climate changes and insufficient investments in agriculture may always provoke changes leading to disruptions in the global food markets. It is assumed that in 2013, the prices of food will not record any significant growth as in previous years, and also their significant decline is not to be expected.[15] As regards Montenegro, volatility of the global food prices will inevitably affect the prices under the food and non-alcoholic beverages category, due to the country's large dependence on imports. Moreover, volatility of the oil prices in the global market strongly contributes to inflation trending in Montenegro.

The Fan Chart showing the inflation in Montenegro, based on the ARIMA model assessment and Tramo/Seats simulation for 2013, shows 90% probability that CPI inflation, depending on the month, will range between 2.2% and 4.5%. Also, the inflation ranging between 2.7% and 4.1% is forecasted for end-2013. Namely, as the time span for forecasting increases, uncertainty increases as does the forecast span for projections.

Assumptions referring to inflation forecast for 2013 include:

1. The prices of oil and oil derivatives will not exceed 5% of the prices in December 2012;
2. The price of aluminium will not grow more than 3% in relation to that in June 2012;
3. The real estate prices will remain stagnant in relation to end-2012;
4. The price of electricity will increase up to 5%;
5. Real wages increase in 2013 will be at the 2012 level;
6. There will be no significant increase in the prices of food products in relation to September 2012;
7. VAT increase is not planned nor is growth of other tax liabilities.

Any deviation of the parameters would require correction of the forecast.

On the other hand, the expert assessment is similar to the model forecast although slightly lower, and we expect that the inflation rate in 2013 will range between 1.5% and 3.5%.

2.3. Fiscal deficit/surplus

The impact of the global economic crisis on Montenegro in 2012 resulted in the non-implementation of fiscal projections as per the planned volume and dynamics. Thus in 2012, the budget of Montenegro was characterized by a larger deficit than planned, partially as a result of under-collection of taxes and other revenues on one hand, and higher levels of some categories of public expenditures on the other hand[16].

[15] According to the Food and Agriculture Organisation of the United Nations (FAO)

[16] The Budget includes the aggregate of the Central Budget and state funds, and this reference will be consistently applied throughout the entire chapter.

Table 2.11 – Fiscal surplus/deficit

Description/Period	2007	2008	2009	2010	2011	Forecast for 2012	Plan for 2013
Current revenues (in million €)	1,128.3	1,287.2	1,169.3	1,140.4	1,129.1	1,118.8	1,161.8
Consolidated expenditures (in million €)	952.2	1,272.1	1,301.4	1,252.6	1,318.8	1,282.6	1,257.1
Deficit/surplus (in million €)	176.1	15.1	-132.1	-112.2	-189.7	-163.8	-95.3
Deficit/surplus% share in GDP)	6.6	0.5	-4.4	-3.6	-5.9	-4.9	-2.7

Source: Ministry of Finance

Source (current) budget revenues in 2012 amounted to EUR 1,118.8 million or 33.7% of the estimated GDP[17]. These revenues were 2.7% lower than planned due to the lower collection of taxes, primarily VAT, excise duties and taxes on international trade and transactions. These revenues recorded the y-o-y decline of 0.9%.

Table 2.12 – Source revenues of the Budget in 2012

Type of revenue	Realization in 2012 in million €	Share in GDP %	Share in revenues* %	Plan for 2012 in million €	Realization in relation to plan	Realization in 2011 in million €	Realization in 2012/2011
Taxes	**687.5**	**20.7**	**61.4**	**725.6**	**94.7**	**704.1**	**97.6**
Personal income tax	82.3	2.5	7.4	81.5	100.9	81.6	100.8
Corporate profit tax	64.0	1.9	5.7	46.9	136.6	36.1	177.3
Real estate turnover tax	1.4	0.0	0.1	1.5	98.0	1.2	116.1
VAT	354.7	10.7	31.7	381.2	93.0	392.2	90.4
Excise tax	151.8	4.6	13.6	163.1	93.1	143.4	105.9
International trade and transactions tax	29.0	0.9	2.6	47.3	61.2	45.3	63.9
Other Republic taxes	4.3	0.1	0.4	4.2	103.1	4.2	103.1
Contributions	**362.3**	**10.9**	**32.4**	**352.0**	**102.9**	**353.6**	**102.5**
Contributions for pension and disability insurance	216.5	6.5	19.4	211.8	102.2	213.5	101.4
Contributions for health insurance	125.7	3.8	11.2	120.2	104.6	120.9	104.0
Contributions for unemployment	10.0	0.3	0.9	11.1	90.2	10.8	92.8
Other contributions	10.0	0.3	0.9	8.9	112.5	8.5	118.3
Duties	**17.8**	**0.5**	**1.6**	**27.1**	**65.9**	**16.0**	**111.4**
Fees	**12.7**	**0.4**	**1.1**	**15.5**	**82.3**	**25.7**	**49.5**
Other revenues	**34.1**	**1.0**	**3.0**	**25.7**	**132.4**	**24.8**	**137.6**
Receipts from loan repayment and funds transferred from the previous year	**4.5**	**0.1**	**0.4**	**4.2**	**107.7**	**5.0**	**89.6**
CURRENT REVENUES	**1,118.8**	**33.7**	**100.0**	**1,150.1**	**97.3**	**1.129.2**	**99.1**
Borrowings and loans from domestic sources	62.6	1.9	4.3	16.4	380.8	47.0	133.2
Borrowings and loans from abroad	258.1	7.8	17.8	291.8	88.5	187.7	137.6
Donations	5.0	0.2	0.3	0.0	---	4.0	125.2
Revenues from privatization	2.8	0.1	0.2	10.0	28.3	3.4	84.5
TOTAL BUDGET REVENUES	**1,447.4**	**43.5**	**100.0**	**1,468.3**	**98.6**	**1,371.2**	**105.6**

* As a share in current revenues and for other types of revenues (revenues from privatisation, donations and borrowings and loans) as a share in total revenues
Source: Ministry of Finance

[17] Estimated GDP for 2012 amounts to EUR 3,324 million

The estimates of the Ministry of Finance show that the total budget revenues amounted to EUR 1,447.4 million or 43.5% of the estimated GDP in 2012.

Consolidated budget expenditures[18] amounted to EUR 1,282.6 million or 38.6% of the estimated GDP. When it comes to expenditures, there is a decrease of 2.7% as compared to 2011. Compared to the plan, the expenditures were 1.8% higher and the deviation is mainly the result of higher expenditures under "expenses for material and services" and "subsidies".

Table 2.13 – Budget expenditures in 2012

Type of expenditures	Realization in 2012 in million €	Share in GDP %	Share in expenditures* %	Plan for 2012 in million €	Realization in relation to plan	Realization in 2011 in million €	Realization in 2012/2011
Current expenditures	666.2	20.0	51.9	654.2	101.8	632.0	105.4
Gross salaries and contributions charged to employer	374.7	11.3	29.2	377.7	99.2	371.3	100.9
Other personal earnings	10.1	0.3	0.8	10.4	96.4	12.8	78.4
Expenses for material and services	150.4	4.5	11.7	141.9	106.0	104.0	144.6
Current maintenance	22.6	0.7	1.8	23.2	97.3	23.5	95.8
Interest	56.0	1.7	4.4	54.9	102.0	45.1	124.2
Lease	7.2	0.2	0.6	7.7	93.6	7.4	97.8
Subsidies	25.9	0.8	2.0	20.7	124.9	45.4	56.9
Other expenditures	6.1	0.2	0.5	6.4	94.5	5.5	109.6
Capital expenditures of current budget and state funds	13.4	0.4	1.0	11.3	118.8	17.0	78.7
Transfers for social protection	481.6	14.5	37.6	477.9	100.8	454.8	105.9
Transfers to institutions, individuals, NGOs and public sector	31.5	0.9	2.5	29.1	108.4	87.9	35.8
Total capital expenditures	58.7	1.8	4.6	65.5	89.7	67.1	87.5
Borrowings and loans	1.8	0.1	0.1	1.7	104.7	2.1	85.2
Reserves	18.1	0.5	1.4	8.5	213.7	11.8	153.4
Net increase of liabilities	0.0	0.0	0.0	0.0	---	29.2	0.0
Repayment of guarantees	24.7	0.7	1.9	23.4	105.5	33.9	72.9
CONSOLIDATED EXPENDITURES	1,282.6	38.6	100.0	1,260.2	101.8	1,318.8	97.3
Repayment of debts to residents	77.9	2.3	5.4	48.9	159.5	32.0	243.9
Repayment of liabilities from previous period	35.9	1.1	2.5	44.8	80.1	41.3	86.9
Repayment of debts to non-residents	54.9	1.7	3.8	54.5	100.8	59.5	92.2
TOTAL EXPENDITURES	1,451.3	43.7	100.0	1,408.3	103.1	1,451.6	100,0

* As a share in consolidated expenditures, and regarding other types of expenditures (repayment of debts) as a share in total expenditures.
Source: Ministry of Finance

According to the Ministry of Finance's estimates, the Budget of Montenegro ran a deficit in 2012 of EUR 163.8 million or 4.9% of GDP, being 1.6 percentage points higher than planned. This was the fourth subsequent year of fiscal deficit, while the average level of deficit during these four years amounted to 4.7% of GDP. In addition, this is the fourth year in a row of the primary budget deficit (balance between deficit and interest expenditures).

[18] Total expenditures less debt repayment and guarantees

Moreover, the repayment of debt amounted to EUR 168.7 million (this amount is not included in the 2012 deficit), thus total lacking funds in 2012 amounted to EUR 332.5 million, or 10% of GDP. This amount was financed from foreign borrowings and loans (EUR 258.1 million), borrowings and loans from domestic sources (EUR 62.6 million), donations (EUR 5.0 million), use of state deposits (EUR 3.9 million) and the sale of state property (EUR 2.8 million).

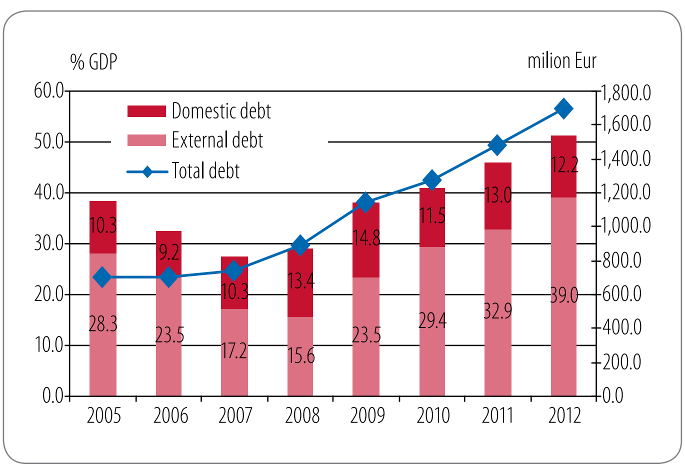
The year 2013 started rather good as regards tax collection (primarily VAT). There was a significant increase in inflows based on health insurance contributions. On the other hand, the expenditures were lower, mostly based on lower expenses for material and services and lower subsidies. In January - February 2013, current budget revenues recorded a growth in the amount of EUR 13.7 million, and consolidated expenditures recorded a decline in the amount of EUR 9.8 million in comparison with the same period of 2012. In this way, two-month budget deficit was reduced from EUR 36.2 million, to EUR 12.7 million, i.e. 2.8 times. However, we will have to wait for the rest of the year in order to reach more comprehensive conclusions.

2.4. Public Debt

Since fiscal deficits automatically spill over to debt and thus increase it, the public debt of Montenegro also increased in 2012 and, according to the Ministry of Finance data, reached nearly EUR 1.7 billion at end-2012 or 51.1% of the estimated GDP for 2012. In relation to end-2011, the public debt grew by 14.6%, and the public debt is expected to grow in 2013. Thus, it may be noted that the public debt's trending upward was a matter of concern in the previous period, and now the level of the public debt has also become a matter of concern. In addition to this, some guarantees bear high risk of being called or transferred into public debt. Thus, the policy of balanced budget revenues and expenditures should be implemented with a view to avoiding risk to financial stability.

Graph 2.5

Movement of public debt, end- period (external and domestic debt– left-hand scale, total debt– right-hand scale)



Source: Ministry of Finance

Domestic public debt amounted to EUR 404.5 million or 12.2% of GDP, while the external debt amounted to EUR 1,295 million or 39% of GDP.

In 2012, there were no significant changes in the structure of the domestic debt. In addition to this, the debt recorded a slight decline in comparison to end-2011, of 3.6%. Bonds of the Labour Fund (debt in the amount of EUR 6 million) represent a new item in the structure, and they are used by the Government to accelerate the process of certain claims by beneficiaries of the Labour Fund, in relation to losing of jobs due to bankruptcy or redundancy.

Table 2.14 – Domestic debt structure, 31 December 2012 (as per debt balance)

Creditor	Domestic debt, in million €	GDP %	public debt %
Liabilities for indemnification	83.3	2.5	4.9
Frozen foreign currency deposits	80.3	2.4	4.7
Municipal debt	79.4	2.4	4.7
Treasury bills	73.0	2.2	4.3
Loans with commercial banks	48.3	1.5	2.8
Loans with non-financial institutions	32.4	1.0	1.9
Labour Fund bonds	6.0	0.2	0.4
Accrued pensions	1.8	0.1	0.1
TOTAL	**404.5**	**12.2**	**23.8**

Source: Ministry of Finance

At 2012 year-end, the external public debt amounted to EUR 1,295 million or 39% of GDP. In relation to end-2011, it increased by EUR 231.3 million or 21.7%, mostly due to the additional credit arrangements with Credit Suisse, in the (net) additional amount of approximately EUR 190 million, and the World Bank, in the (net) additional amount of approximately EUR 65 million.

Table 2.15 – External debt structure, 31 December 2012 (as per debt balance)

Creditor	Foreign debt, €	Undrawn funds, €	GDP %	Public debt %
EUROBOND	380,000,000	0	11.4	22.2
Credit Suisse	250,000,000	0	7.5	14.6
International Bank for Reconstruction and Development (IBRD)	237,589,686	26,952,052	7.1	13.9
Member countries of the Paris Club of Creditors	104,925,854	0	3.2	6.1
European Investment Bank (EIB)	79,901,876	58, 500,000	2.4	4.7
International Development Association (IDA)	65,196,952	1,062,542	2.0	3.8
EUROFIMA	24,834,000	0	0.7	1.5
Czech Republic's EXIM	24,094,788	0	0.7	1.4
EBRD	21,642,499	9,547,285	0.7	1.3
Steiermarkische Sparkassen	18,701,454	0	0.6	1.1
German development bank (KfW)	12,619,600	53,466,397	0.4	0.7
Hungarian loan	11,805,218	0	0.4	0.7
Erste	11,250,000	30,000,000	0.3	0.7
Erste – Health Fund (Austrian loan)	9,834,366	0	0.3	0.6
Polish loan	9,725,124	0	0.3	0.6
Council of Europe Development Bank	9,079,160	0	0.3	0.5
French loan – Natixis	8,471,132	0	0.3	0.5
The European Community	5,500,000	0	0.2	0.3
ICO – Landfill	4,981,741	0	0.1	0.3
International Finance Corporation (IFC)	2,460,967	0	0.1	0.1
EXIM Hungary - Ante Đedović	2,415,933	0	0.1	0.1
Societe Generale - Education IT	5,772	0	0.0	0.0
TOTAL	**1,295,036,119**	**179,528,277**	**39.0**	**75.8**

Source: Ministry of Finance

Guarantees

At end-2012, foreign guarantees of Montenegro amounted to EUR 347.5 million or 10.5% of GDP, i.e. 20.4% of the public debt. We should also take into account the amount of funds that have not been withdrawn yet and which will be guaranteed by the Government in the case of withdrawal. This refers to the amount of EUR 116.5 million (3.5% of GDP), i.e. 6.9% of total public debt.

Table 2.16 – Foreign guarantees as at 31 December 2012, in EUR (as per debt balance)

Creditor	Loan	Borrower	Year of signing	Contracted amount	Withdrawn until 31 December 2012	Debt balance per loan
EIB	Montenegro Loan for SMEs	Commercial banks	2009	90,000,000	90,000,000	80,037,987
VTB	Support to KAP	KAP	2010	60,000,000	60,000,000	60,000,000
OTP	KAP	KAP	2009	49,680,000	49,680,000	42,198,235
EXIM Kina	Purchase and repair of ships	Crnogorska plovidba	2010	35,954,606	35,954,606	35,954,606
EIB	European Roads project	Monteput	2004	24,000,000	24,000,000	22,813,347
KfW	EPCG-Replacement of filters in TE Pljevlja and the Expansion of the substations Podgorica - Ribarevine	EPCG	2008	15,000,000	12,900,445	12,900,445
KfW	NLB	NLB	2009	16,000,000	16,000,000	11,636,364
EBRD	Montenegro Rail Infrastructure Rehabilitation Project II	Rail company of Montenegro	2009	15,000,000	10,885,523	10,885,523
EIB	Airports Modernisation	Airports of Montenegro	2004	12,000,000	11,000,000	9,600,000
KfW	Erste banka	Erste banka	2009	15,000,000	15,000,000	9,545,455
EBRD	Regional Water Supply Project – Phase II of the Construction of the Southern Branch	Regional Water supply – first tranche	2007	8,000,000	8,000,000	6,666,667
EIB	Power System Reconstruction	EPCG	2002	11,000,000	8,023,090	6,511,641
EBRD	Regional Water Supply Project – Phase I of the Construction of the Southern Branch	Regional Water supply – second tranche	2008	7,000,000	7,000,000	6,125,000
EBRD	Airports Modernisation	Airports of Montenegro	2003	11,000,000	10,235,127	5,112,579
Czech Export Bank	Completion of the railroad Podgorica-Nikšić	Rail company of Montenegro	2011	5,000,000	4,978,102	4,978,102
Abu Dhabi Fund for Development	Water supply project	Regional Water Supply	2010	9,004,890	4,874,181	4,874,181
KfW	EPCG - Substation Podgorica -Ribarevine	EPCG	2007	5,400,000	4,038,396	4,038,396
KfW	EPCG- Hydro Power Plant Piva	EPCG	2007	16,000,000	3,616,553	3,616,553
EBRD	Montenegro Rail Infrastructure Rehabilitation Project - Phase III	Rail company of Montenegro - third tranche	2010	4,000,000	3,146,346	3,146,346
EBRD	Project of purchasing electromotor units and diagnostic equipment	Railway transport	2010	13,550,000	3,098,372	3,098,372
EBRD	Regional Water Supply Project – Annex to the Phase I of the Construction of the Southern Branch	Regional Water supply – expansion of the second tranche	2010	3,000,000	3,000,000	2,625,000
KfW	EPCG- Hydro Power Plant Perucica	EPCG	2003	3,580,000	3,422,388	1,036,388
EBRD	Montenegro Rail Infrastructure Rehabilitation Project – annex to the Phase III	Rail company of Montenegro	2012	10,000,000	100,000	100,000
EIB	Montenegro Rail Infrastructure Rehabilitation	Rail company of Montenegro	2010	7,000,000	0	0
EBRD	Credit line for deposit protection	Deposit protection fund	2010	30,000,000	0	0
WTE Wassertechnik	Waste water project	Municipality of Budva	2010	29,250,000	0	0
UKUPNO				505,419,495	388,953,129	347,501,185

Source: Ministry of Finance

If domestic guarantees are added to the amount, the total guarantees amounted to EUR 378.3 million at 2012 year-end or about 11.4% of GDP. Thus the sum of total public debt and total guarantees amounted to 62.5% of the estimated GDP for 2012.

Table 2.17 – Domestic guarantees as at 31 December 2012, in EUR (as per debt balance)

Creditor	Borrower	Year of signing	Contracted amount	Debt balance per loan
NLB Montenegrobank	Bauxite Mines AD Niksic	2009	5,000,000	5,000,000
NLB Montenegrobank	Melgonia-Primorka	2010	4,000,000	4,000,000
Erste bank	Pobjeda	2010	3,500,000	3,500,000
Erste bank	Željeznički prevoz Crne Gore	2011	3,500,000	3,500,000
Hipotekarna bank	Montenegro Airlines	2009	2,700,000	2,700,000
Hipotekarna bank	Montenegro Airlines	2011	2,000,000	2,000,000
NLB Montenegrobank	Montenegro Airlines	2010	1,800,000	1,800,000
Podgorička bank	Pobjeda	2009	2,970,000	1,728,963
Erste bank	Fabrika elektroda „Piva"	2011	1,500,000	1,500,000
NLB Montenegrobank	Montenegro Airlines	2011	2,400,000	1,130,000
Crnogorska komercijalna banka	Adratic Shipyard	2012	1,050,000	1,050,000
Investment Development Fund	Crnogorska plovidba	2011	1,500,000	852,192
Hipotekarna bank	MI-RAI GROUP DOO	2010	800,000	777,976
Hipotekarna bank	MI-RAI GROUP DOO	2011	700,000	700,000
Hypo Alpe Adria bank	„Lenka"	2011	525,000	525,000
TOTAL			33,945,000	30,764,131

Source: Ministry of Finance

As the CBCG pointed earlier, some guarantees proved to be highly risky and there is a serious risk regarding a potential calling of the issued guarantees in 2013. Thus the restrictive approach in issuing new guarantees initiated after 2011 has proved to be positive and needs to be continued in the upcoming period.

Assessment of the public finance sustainability

It may be stated that the current public debt of Montenegro is lower than in many EU countries, but it is still within the limits of the Maastricht Criteria. Still, the level of debt, i.e. the debt to GDP ratio is not the only indicator of public finance; it is also confirmed by credit ratings of some countries and by interest rates that countries pay for their debt, which may be very different although the two compared countries have the same debt to GDP ratio. What credit agencies and investors assess is a country's ability to repay borrowings. On the other hand, both credit rating and interest rate indirectly give opinion on the situation in the economy. And only if the private sector is strong, it is reckoned that the state would be able to tax it easily and thus repay the debt. Thus, a relatively lower level of public debt in Montenegro is a matter of significant concern.

In the case of public debt of Montenegro, a matter of concern is its growing tendency on one hand, and the level of issued guarantees on the other hand. From end-2007 to end-2012, debt increased by

23.6 percentage points (from 27.5% to 51.1% of GDP) and the amount of guarantees by 11.4 percentage points (from 0% to 11.4% of GDP). Moreover, a significant concern represents a high risk of calling of some of the issued guarantees.

Finally, this dynamics of deficit and debt increase will have to be solved, i.e. the budget will sooner or later have to be balanced. If we assume that all other factors remain unchanged, this may be done by increasing revenues or decreasing expenditures, i.e. using a combined approach. It should be noted that an increase in public revenues (which would result in the private sector's purchasing power decline) and a decline in expenditures (which would largely reflect on the labour market either as layoffs or a decline in the public sector salaries) would exert pressure on the financial sector, i.e. the banking sector as its key segment, primarily by affecting defaults in loan repayments.

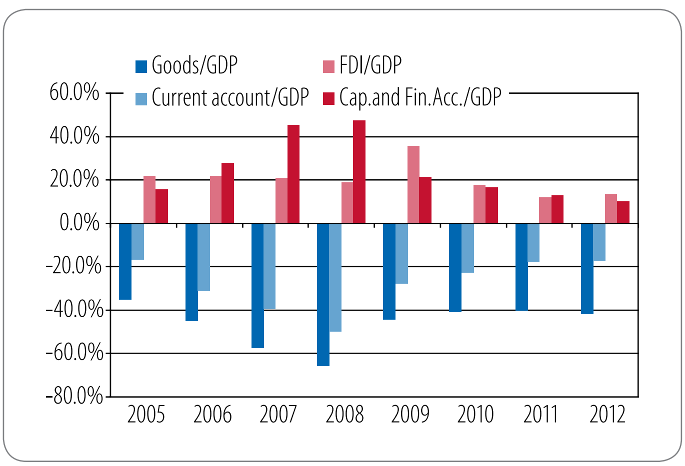
2.5. Balance of payments with a special overview of the current account deficit

The current account deficit recorded a slight increase in 2012. Observed through the structure of the current account, the increase in deficit was mostly a result of negative trends when it comes to imports, i.e. increased trade deficit that could not be compensated by increased surpluses in other sub-accounts of the current account.

Preliminary data show that the current account deficit amounted to EUR 587.2 million, which is 2.4% more than in 2011. The current account deficit's share in GDP amounted to 17.7%, which represents a significant decline in view of high levels recorded prior to the crisis (39.5% in 2007 and 50.6% in 2008) and after the main crisis impact (29.6% in 2009 and 24.6% in 2010). The main reason behind the deficit's trending downward is the year-on-year decline in capital inflows used to finance this deficit in 2012, primarily due to a negative net inflow to the portfolio investments account and, in general, due to a decline in FDI in comparison to the situation before the crisis.

Graph 2.6

Balances of different BoP accounts



Source: CBCG

Foreign trade recorded a greater decline in export (17.8%) in comparison to a decline in the import of goods (0.1%). In terms of the structure, the decline in export of goods was largely affected by the decline in export of the most important export products – aluminium (due to lower production and lower aluminium prices in comparison to 2011), iron and steel. On the other hand, the structure of the import in 2012 was almost identical to 2011. The coverage of imports by exports amounted to 22%, representing a decline of 4.7 percentage points in relation to 2011. However, a still moderate export/import ratio points to the necessity of further promotion and stimulation of investments in export-oriented and/or import substitution production, i.e. above all, the necessity of the increase in competitiveness of domestic producers and productivity of the domestic labour force.

An increase in external demand positively affected trends in the services account which recorded a surplus increase of 3.9% (EUR 612.3 million), primarily due to higher travel-tourism revenues (by 3.8%, i.e. EUR 23.7 million) and transport (10.6%, i.e. EUR 15.9 million). The coverage of foreign trade deficit with surpluses recorded in other sub-accounts amounted to 57.7% in 2012, which is 1.6 percentage points higher in relation to the previous year.

Capital inflows in the capital and financial account continued their downtrend that had started in 2009. In 2012, due to positive trends in the international capital markets and larger interest of foreign investors, FDI net inflow recorded an increase of 16.6% in comparison to the previous year (mostly as a result of an increase in the inflow based on equity investments in companies and banks, as well as investments in real estate). FDI net inflow thus amounted to EUR 453.6 million or 13.6% of GDP. The portfolio investments account recorded a net outflow of EUR 24.7 million, which is EUR 188.3 million less in comparison to EUR 163.6 million net outflow in 2011 (Eurobond issues were making significant inflows during 2010-2011), while at the same time, the account of other investments recorded a net outflow of EUR 55.4 million, which represents EUR 192.2 million decline, or 77.6% (mostly due to inflows from the borrowing of the state).

Trends in the balance of payments in the following period will depend on the trends in the international capital markets and financial soundness of the real sector. Considering that considerable FDI inflow in the past years came from EU countries, negative trends in these countries may influence a further decrease in capital inflows. Inad-

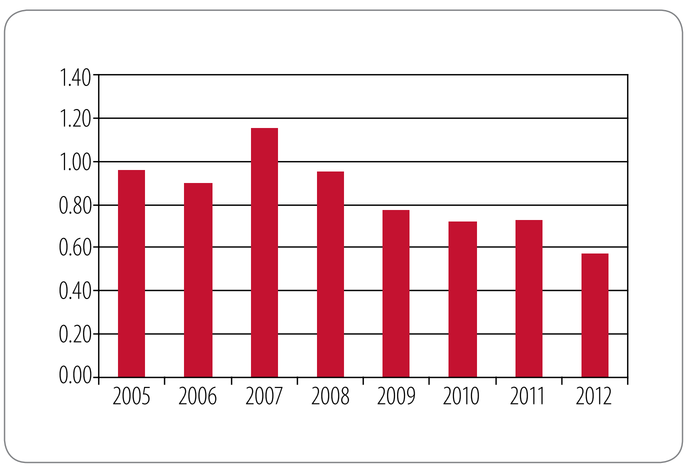
Graph 2.7

Export/import coverage

Source: CBCG

Graph 2.8

Coverage of current account deficit by the surplus in the capital and financial account



Source: CBCG

equate privatisations and stagnation in the implementation of contracted investments, i.e. their deferment, represent potential risks, as does the overall situation in the global market - trends in the prices of aluminium, electricity, oil and food. Deepening of the crisis in the emissive tourist markets may negatively influence the realisation of tourism revenues, but currently there is no high risk. Considering high correlation between capital inflow and economic growth, a decrease in capital inflows represents a threat to sustainability of the Montenegro's growth model which is based on large consumption and imports. The balance of payments trends alone do not represent a threat to financial stability, but in case of Montenegro they point to the urgent need for structural reforms and changes in the country's growth model.

2.6. Real estate market

The real estate market was one of the most sensitive segments of the Montenegrin economy in 2012 although its direct influence on the risk of financial instability decreased due to a long-term stagnation of prices in this market (from June 2010 until end-2012). The stagnation in this segment of the market led to deleveraging within the banking sector for the segment related to the mortgage credits, causing further deceleration of the real economy during 2012.

Table 2.18 – Summary statistics of the average value of dwellings in Podgorica, per m^2

Period	Price in EUR	Chain index	Base index
September 2007	1,697.6	100.0	100.0
March 2008	1,738.3	102.4	102.4
September 2008	1,525.5	87.8	89.9
March 2009	1,402,1	91.9	82.6
September 2009	1,223.1	87.2	72.1
March 2010	1,128.3	92.2	66.5
June 2010	1,191.5	105.6	70.2
September 2010	1,177.1	98.8	69.3
December 2010	1,185.2	100.7	69.8
March 2011	1,171.2	98.8	69.0
June 2011	1,163.0	99.3	68.5
September 2011	1,174.0	100.9	69.2
December 2011	1,151.2	98.1	67.8
January 2012	1,168.3	101.5	69.0
June 2012	1,179.6	102.5	69.5
September 2012	1,172.3	99.4	69.1
December 2012	1,171.6	99.9	69.0

Source: CBCG

In Q4 2012, an average price of 1 m^2 property in Podgorica amounted to EUR 1,171.6[19] which is an increase of 1.8% in relation to December 2011. Analysis of the chain index of real estate price trends shows that the prices have been stagnant since September 2010, with upward or downward fluctuations up to 5%.

In 2012 the situation continued, there was a considerable supply of dwellings with the price that did not go bellow a certain threshold on one side, while on the other there was a demand relying on a further decline in prices. The demand was highly differentiated (there is a demand for specific objects) and aware that the liquid assets for the purchase of real estate are limited. Consequently, we have a very exigent yet limited demand and extensive supply that is slow in adjusting to the demand. According to estimates of real estate agencies, the market turnover declined in 2012 in relation to 2011 and only 32.8% of the surveyed agencies recorded the same turnover as in 2011, while 61 % of them recorded a decline in turnover.

[19] According to the hedonic index obtained from the CBCG survey, where the prices do not reflect the real, realized prices, but essentially represent subjective prices of the real estate owners, i.e. prices below which they would not be willing to sell their property.

Table 2.19– Trends in nominal real estate prices in selected countries, December 2011 (ranked per the annual growth rate in Q3 2012)

Country	Annual growth, Q3 2011, %	Trend grade	Annual growth, Q3 2012, %	Quarter growth, Q3 2012, %
Brazil - Sao Paulo	28.9	↓	18.4	4.0
India	33.9	↓	15.6	3.5
Turkey	5.9	↑	14.5	6.1
UAE - Dubai	-1.2	↑	14.4	3.6
Hong Kong	20.2	↓	14.2	4.6
Austria	5.1	↑	10.1	0.7
Philippines	5.4	↑	8.3	1.8
Malaysia	9.8	↓	7.3	-1.8
Norway	8.3	↓	7.0	0.6
Island	6.0	→	6.7	1.3
Estonia	14.3	↓	6.4	2.6
Taiwan – Taipei	9.1	↓	5.3	1.4
Latvia - Riga	4.1	↑	5.2	0.4
Germany	3.1	↑	5.1	0.6
New Zeeland	0.1	↑	5.0	-0.4
Indonesia	4.5	←	4.3	1.0
Canada	5.5	↓	4.2	1.9
USA (FHFA)	-3.6	↑	4.0	1.1
USA (S&P)	-3.5	↑	3.7	1.1
Finland	2.5	→	3.3	1.4
Switzerland	3.7	↓	2.7	0.3
South Africa	4.1	↓	2.6	3.0
Israel	4.8	↓	2.6	0.2
Thailand	3.9	↓	2.1	4.1
Russia	0.6	↑	1.8	0.0
Singapore	8.5	↓	1.2	0.6
Australia	-3.4	↑	0.4	0.4
China	2.0	↓	-0.6	0.3
Slovakia	-4.3	↑	-0.6	1.1
Lithuania	2.6	↓	-1.3	-0.5
UK	-0.5	↓	-1.6	-0.6
Bulgaria	-6.1	↑	-2.2	-0.5
Japan - Tokyo	-1.9	←	-2.3	0.0
Sweden	0.9	↓	-2.6	0.2
Croatia - Zagreb	-3.2	↓	-4.3	-0.7
Poland – Warsaw	-4.2	←	-4.3	-1.5
Puerto Rico	-6.6	↑	-4.4	-6.3
Ukraine	-7.0	↑	-4.4	-9.5
Romania	-7.9	↑	-6.4	-2.7
Portugal	-3.8	↓	-7.1	-1.7
Holland	-1.8	↓	-9.2	-2.9
Spain	-5.6	↓	-9.4	-2.5
Greece	-4.1	↓	-11.3	-2.5
Ireland	-13.5	↑	-11.7	0.1
Montenegro -Podgorica (Q4)	-2.9	↑	1.8	-0.1

Source: Global Property Guide, CBCG

Table 2.19 shows the trends of real estate prices in selected countries. As you can see, 2012 was characterised by different trends, the highest extremes were recorded in Brazil – Sao Paolo (18.4% increase) i.e. in Ireland (11.7%decline).

When it comes to Montenegro, the year 2013 is characterised by major uncertainties in the real estate prices trend in view of uncertainty regarding the available income trend, possibility of activation of a number of collaterals, as well as the announced loan restructuring in the construction sector. However, stagnation of real estate prices is to be expected in 2013 as well. In addition to this, according to the survey conducted by CBCG in the beginning of 2013, the biggest real estate agencies predict stagnation in the real estate prices as well as a slight increase in demand (10% - 15%) in 2012, with emphasis on the growth of demand from abroad.

The analysis of the biggest construction companies – borrowers in the system, considering the balance in their annual financial statements for 2011, as well as the level of their indebtedness in 2012, implies that despite a relatively large banking sector's exposure to the construction sector (the second highest after tourism and trade sectors), there is no obvious debt concentration as the debt is dispersed and thus lowers the risk.

The share of housing loans at end-2012 amounted to some 9.3% of the estimated GDP, being lower than in 2010 and 2011. There is a considerable deleveraging and decline of lending activity, both in absolute and relative terms. Despite the low activity in the segment of mortgage loans, this market has a considerable potential, considering that the recorded share is still significantly below the average in the EU countries (about one third of GDP).

Table 2.20 – Housing loans, 2005-2012

Year	GDP, EUR million	Housing loans in EUR thousand, end-year	Population*	Housing loans, end-year	
				in % of GDP	Per capita (in EUR)
2005	1,815.0	11,259	623,277	0.6	18
2006	2,149.0	63,790	624,241	3.0	102
2007	2,680.5	222,592	615,875	8.3	361
2008	3,085.6	264,073	616,969	8.6	428
2009	2,981.0	349,042	618,294	11.7	565
2010	3,104.0	350,880	619,428	11.3	566
2011	3,234.0	325,793	620,029	10.1	525
2012	3,324.0	309,729	620,029	9.3	500

* The estemates regarding the population from 2007 until 2010 were revised based on the results of the 2011 census (mid-year population) source: Monstat, Statistical Yearbook 2012.

Source: CBCG, Ministry of Finance and Monstat

The real estate agencies estimated that the real estate market will remain stagnant in 2013 in terms of prices as well as the level of demand. It is likely that this segment of the economy will continue to represent a potential risk, however not as much as it was in 2012, having in mind a low number of sales agreements in the first months of 2013, as well as the stagnation in nominal and a decline in real wages. Increased in demand by foreign buyers could recover this market, having in mind that there was an increase in demand and turnover by foreign investors in 2012, which reflected in the inflow of FDI in the real estate.

In parallel, there was an increase in illiquidity of construction companies and the corporate sector effectuated by the activation of the banking sector's mortgages in the reporting year. A continuation of this trend would lead to further pressures on the prices reduction in the real estate market and a reverse negative effect on the financial sector's stability through an increase of credit risk, treatment of collaterals, and a significant decrease in lending activity of the banking system. However, this risk remains low to moderate for 2013.

3. FINANCIAL SYSTEM

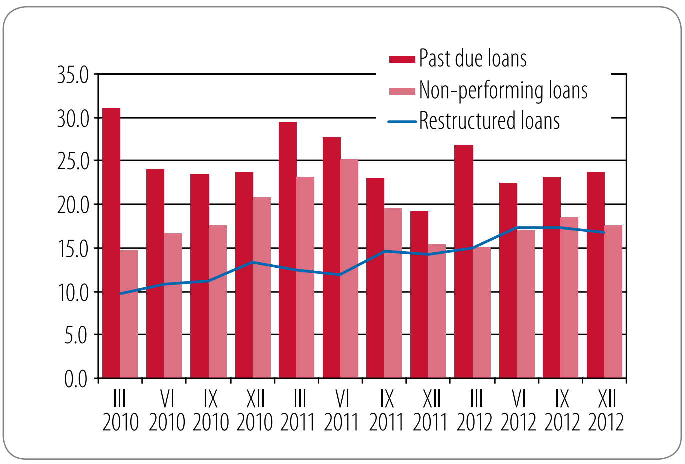
3.1. Banking System

3.1.1. Credit risk

Credit risk remained the most prominent risk in the Montenegrin banking system in 2012. The main parameters of quality of the loan portfolio of banks slightly deteriorated in comparison to 2011. The banks continued to suffer the consequences of relaxed lending policies that existed before the crisis, and continued to write off and sell parts of their loan portfolios. It is not reasonable to expect further deterioration of quality of loans, primarily due to large and growing insolvency of the Montenegrin economy. Therefore, it is to be expected for banks to continue pursuing prudent lending policy in 2013.

Graph 3.1

Share of certain loan categories in total loans, in %, end-period



Source: CBCG

The amount of total (gross) loans continued its downward trend that started after Q4 2008. In 2012, total loans declined 4.8% and amounted to EUR 1,862.5 million. Even new loans (EUR 702.6 million) extended during 2012 could not greatly improve the overall situation[20].

Banks ended 2012 with a 17.6% share of non-performing loans (NPLs) in total loans, which is an increase of 2.1 percentage points in relation to the end of the previous year[21]. The share of past due loans also recorded an increase, from 19.3% to 23.8%. Over the year, the share of non-performing loans increased until end-Q3, yet it declined at the end of the year. This was primarily the result of the sale of a part of the loan portfolio by one bank. In

[20] The information regarding newly approved loans refers to the contracted loans and not neccesarily the amounts paid, which are certainly lower in comparison to the contracted ones. Also, a number of loans was used to refinance/close old loans.

[21] NPLs cover categories C, D and E.

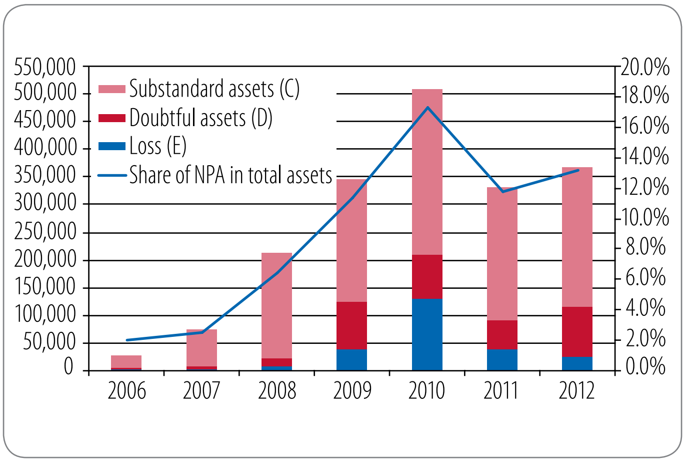
2012, banks continued to maintain a considerable level of restructured loan portfolios; therefore the share of restructured loans in total loans at end-2012 amounted to 16.8%, which is the year-on-year increase of 2.6 percentage points (total amount of restructured loans increased by 12.8%, from EUR 277.4 million to EUR 312.7 million).

On the other hand, the ratio of non-performing loans coverage[22] although somewhat higher in relation to 2011 year-end (0.40 against 0.33), remained relatively low.

The real economy is the main source of credit risk and thus at end-2011, the share of past due loans in the corporate sector remained quite high in relation to the household sector, i.e. 34.5% against 14.6%. A higher level of past due loans in the corporate sector in relation to households is not uncommon. This is due to the fact that the household sector needs to be more disciplined because they secure loans in a different way and have no "limited liability". In addition to this, when it comes to the current situation in Montenegro, the reasons behind it should be sought in the structure of the economy (which is import and Montenegrin market oriented), i.e. in the problems of certain sectors of the economy which operate mainly based on the inflow from the balance of payments financial account, paying attention to the fact that these flows have been on a downtrend in the past four years. On the other hand, there are a considerable number of employees working in the public sector, which position has not been so destabilised mostly due to it's possibility to borrow from abroad.

Graph 3.2

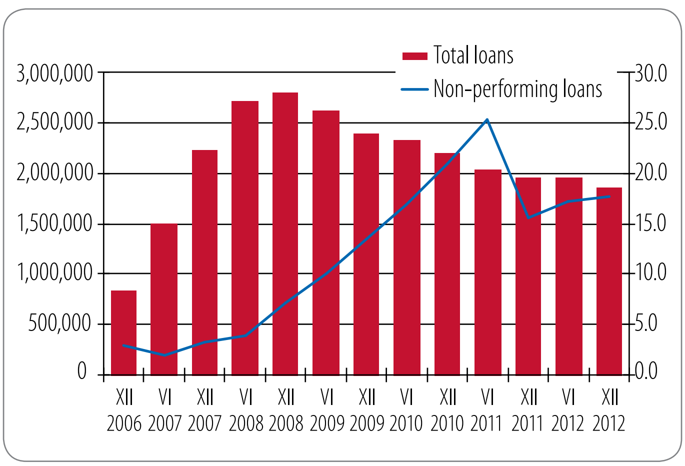
Non-performing assets categories (left-hand scale, in EUR thousand) and its share in total assets (right-hand scale), end-period



Source: CBCG

Graph 3.3

Total loans (left-hand scale, in EUR thousand), share of NPLs in total loans (right-hand scale, in %), end-period

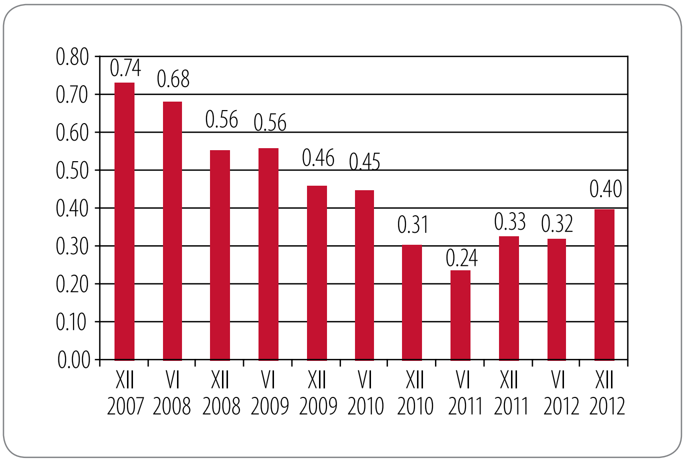


Source: CBCG

[22] Loan loss provisions (for all categories of loans) to non-performing loans

Graph 3.4

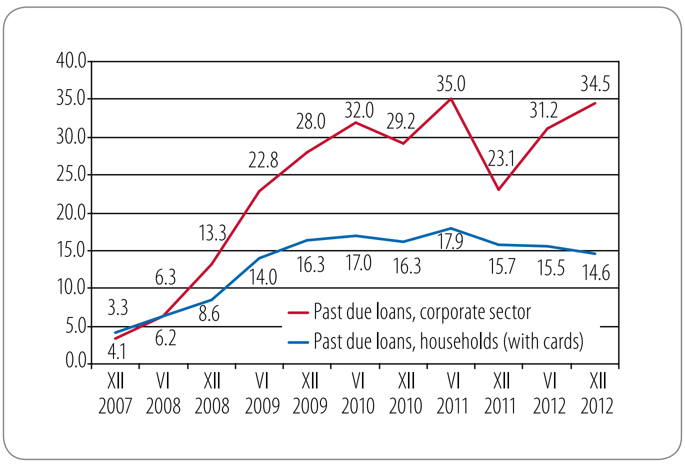
Coverage ratio, end-period



Source: CBCG

Graph 3.5

Share of past due loans by sectors, end-period



Source: CBCG

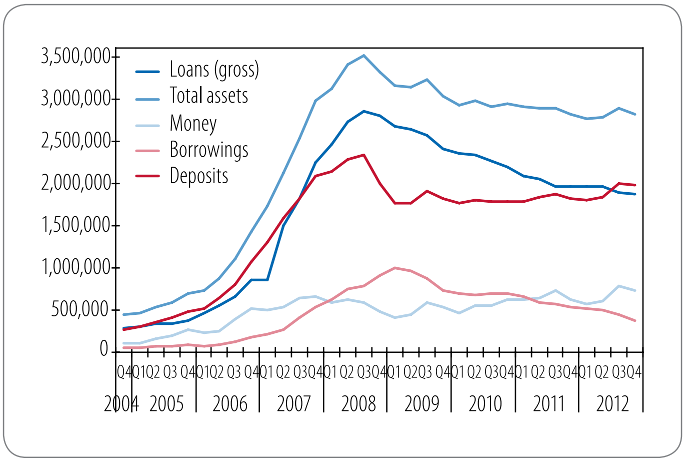
Credit cycle: 2004-2012

The graphs 3.6, 3.7 and 3.8 show the main trends in the banking system for 2004-2012. In Graph 3.6 we can see that credit growth in the period 2005-2006 was mainly financed by increases in deposits. The following year (2007) marks a significant change in that relation: namely, the demand for loans was so high that the banks borrowed even more in order to issue loans. Of course, the supply of loans was the "other side of the coin": the banks increased lending activity in pursuit of their own best interests. This trend continued until the end of Q3 2008, followed by a significant withdrawal of deposits, due to a (partially justified) loss of trust in the system, mainly due to bad news regarding the results of certain banks, as well as the global situation. Let us remind you that a gradual "bubble burst" of domestic stock market happened in mid-2007 and the real estate "bubble burst" followed shortly after it. Although borrowings continued to grow until the end of Q1 2009, loans recorded a significant decline, while the new/larger borrowings during that interim period primarily came as liquidity support from parent banks.

Although it is undeniable that the global crisis influenced a decline in loans, it is clear that the banks engaged in excessive lending: with relaxed crediting standards, the banks issued too many loans during a relatively short period, without paying attention to endogenous risks of the system. The stabilisation and gradual growth of deposits started from Q1 2009, and lasted until the end of 2012. The period of strong bank deleveraging started at about the same time and lasted until the end of 2012. The loans continued to decline in 2012 (although at much slower pace after Q3 2012), and after the Q3 2012 the loans-to-deposits ratio dropped below 1 for the first time after five years. Also, after Q1 2009 there was a gradual "accumulation" of liquidity by banks, so the monetary assets to total assets ratio of banks at end-2012 came very close to the pre-crisis levels. However, in terms of system stability, it seems that the exaggerated prudence by banks now begins to deviate from the optimum.

Graph 3.6

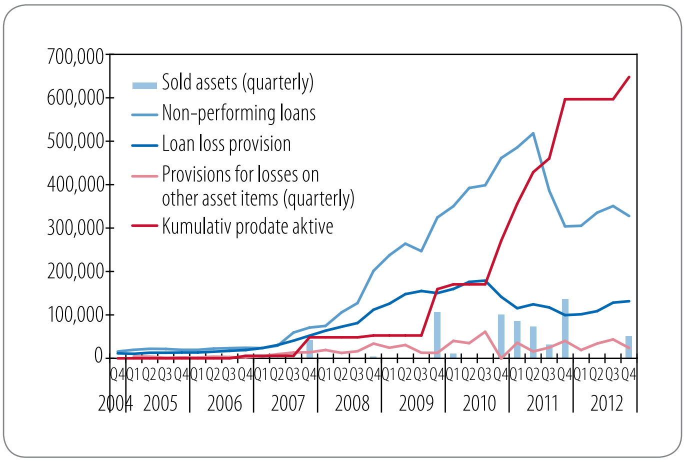
Trends of key balance categories, end-Q, in EUR thousand



Source: CBCG

Graph 3.7

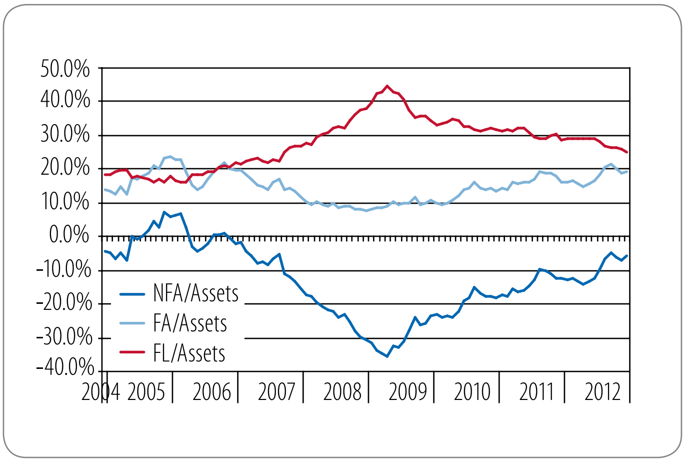
Sale of loans and other balance sheet categories, end-Q (except for cash flows), in EUR thousand



Source: CBCG

Graph 3.8

Foreign assets and liabilities and net foreign assets as a percentage of total assets, end- period



Source: CBCG

When it comes to credit balance, in addition to being significantly reduced in the situation where new loans were not low enough to prevail over repayments, and especially write-offs of the existing loans, it has been reduced on the basis of factoring, i.e. sale of (mostly non-performing) loans, which became especially obvious in 2011. Factoring was performed mainly via companies that were founded by parent companies, and arrangements often included proportionate debt release of the subsidiaries by their parent banks.

Graph 3.8 reaffirms what was previously stated, only from the perspective of receivables/liabilities of banks towards non-resident entities. Foreign liabilities increased as we approached end-March 2009, as a result of an increase in borrowings (by parent banks and other foreign financial institutions) and deposits by non-residents (natural persons and financial institutions, including parent banks), generating the foreign liabilities to total liabilities ratio of almost 45%. On the other hand, although the foreign assets increased in absolute terms, its share in total assets declined because they increased at a slower pace in comparison to total assets. At end-March 2009, the share of foreign assets in total assets amounted to a mere 8% whereas the net side of the assets at reached its record minimum.

The already mentioned process of deleveraging started after March 2009, from over EUR 0.9 billion to below EUR 0.35 billion at 2012 year-end. Deposits of foreign banks with domestic banks declined during the same period, from over EUR 150 million to practically zero at end-2012. The increased decline in deposits by non-residents, and to some extent a decline in liabilities, was enabled by deposits of non-residential natural entities that continued to increase after the Q3 2008-Q1 2009 crisis period and reached their record high of EUR 287.2 million at 2012 year-end. On the other hand, foreign assets started to increase, spurred by an increase of balances in correspondent and deposit foreign accounts, by around EUR 250 million. As a result of those trends, the foreign assets/foreign liabilities converged (towards the share of 20-25% in total assets/liabilities). In this way, net foreign assets at 2012 year-end reached the highest level during the last five or six years.

Thus, this imbalance was practically closed, which is very positive, but now from the system aspect we have a situation where domestic banks keep enormous amounts of liquidity with foreign banks. On the other hand, the banks intentionally choose this type of policy, having in mind the bad experiences during the ascending phase of the cycle, as well as creditworthiness of domestic entities which continues to be relatively poor, i.e. in general, looking at the relatively limited economic growth in the following period.

Credit risk stress testing

The following assumptions (shocks) were applied in credit risk stress testing:

1. The reclassification of classified loans and application prescribed and average provisioning rates as follows:

   - category A – "pass" - calculated in the amount of 90%, and category B increased by 10% for loans from category A;
   - category B – "special mention" – calculated in the amount of 95% of the increased category B;
   - category C – "substandard" – calculated in the amount of 5% from category B, whereby 95% of category C was kept;
   - category D – "doubtful" – calculated in the amount of 5% from category C, while 95% from category D was kept;
   - category E "loss" – amount increased by 5% of the amount of category D.

   The following rates for categories (A, B, D and E), i.e. the following average provisioning rates (category C) were applied to thus calculated categories of reclassified loans:

   - category A – "pass" - 1%
   - category B- "special mention" - 3%
   - category C – "substandard" -30%
   - category D – "doubtful"- 75%
   - category E – "loss"- 100%

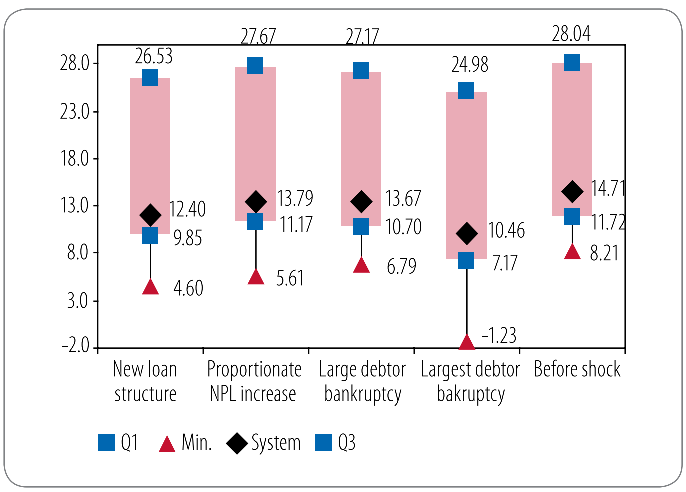
2. An increase in non-performing loans (C, D and E) of 20% and, therefore an increase in required provisions of 30 %;

3. Default of one borrower whose exposure is calculated based on the arithmetic mean of a bank's 20 largest borrowers decreased by the arithmetic mean of provisions for given exposures (real exposure);

4. Default of the largest borrower, the amount of debt decreased by the amount of provisions for given exposures (real exposure).

Graph 3.9

Credit risk stress testing, results, 31 December 2012



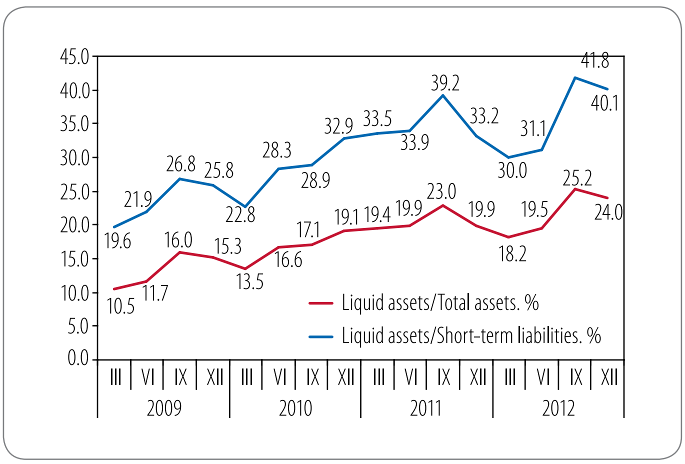
Source: CBCG

In general, the testing confirmed the banks' sensitivity to credit risk, whereby the results differed greatly from bank to bank[23]. Stress testing showed that the banks are most sensitive to the first and fourth shock, whereby the system level adequacy ratio decreased by 2.31 percentage points and 4.25 percentage points, respectively (remaining above the prescribed minimum, in terms of the system level). Four banks did not pass the first test, as they showed a shortfall of capital of EUR 20.5 million and six banks failed the fourth test, with the shortfall of capital of EUR 50.7 million. When it comes to fourth test, the capital of one bank would be completely "consumed" if one of its largest debtors went bankrupt and its capital adequacy ratio would drop below zero. Two banks did not pass the second and third test (the same banks), with a shortfall of capital of EUR 14.7 million for the second test and EUR 10.7 million for the third test.

3.1.2. Liquidity risk management

Graph 3.10

Selected liquidity indicators, end-period



Source: CBCG

In 2012, restrictive lending policies of banks also affected an increase in their monetary assets and the overall level of liquidity. At 2012 year-end, the share of liquid assets[24] in total assets amounted to 24%, increasing again up to (and above) the level from Q3 2011. The coverage of short-term liabilities by liquid assets recorded a similar trend, amounting to 40.1% at 2012 year-end. Liquid assets recorded an increase over the first three quarters, but slightly declined in Q4, mostly due to a decline in the banks` positions held abroad (correspondent accounts and deposit accounts) of over EUR 50 million.

As for the ten-day liquidity indicator, it remained substantially above the prescribed minimum during 2012, with a strong growth after Q1.[25]

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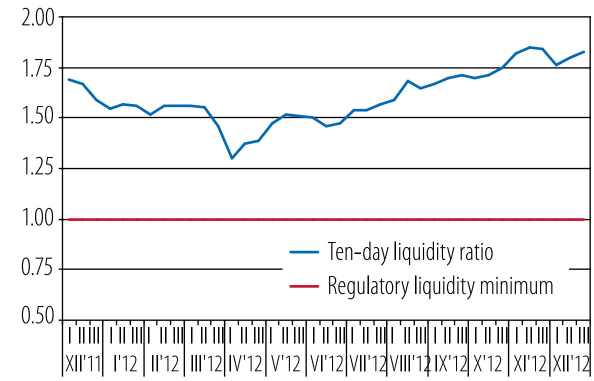
[23] At 2012 year-end, one bank had the capital adequacy ratio below the regulatory 10%. (The bank was recapitalised during the first months of 2013 so the adequacy radio is back above the regulatory minimum). We note that for every shock, when testing the credit risk (as well as testing market risks, bellow) it was formally considered that the bank did not pass the shock, although the adequacy ratio remained below the regulatory minimum even before the shocks.

[24] Monetary assets and deposit accounts with depository institutions reduced by 50% of allocated reserve requirements.

[25] The liquidity indicator represents the liquid assets to claim payables ratio, the prescribed ten-day minimum being 1, pursuant to the Decision on Minimum Standards for Credit Risk Management in Banks (OGM 60/2008). Definitions of liquid assets and due liabilities is given in the Decision.

Graph 3.11

Aggregate ten-day liquidity indicators



Source: CBCG

Liquidity risk stress testing

The aggregate ratio of cash and deposit accounts with depository institutions (assets side) and deposits (liabilities side) amounted to 37.32 %. However, three banks significantly deviated from the aggregate ratio, with achieved the ratio ranging from 13.99 to 19.13, which had a negative effect on stress testing of these banks.

The ability of banks to cover different types of deposit outflows (by the amount, maturity and depositors) was tested through the amount of:

1. available liquid assets (cash and deposit accounts with depository institutions) decreased by the total amount of reserve requirements,
2. available liquid assets, decreased by 50% of the reserve requirements amount, i.e. free liquid funds increased by 50% of the reserve requirement amount.

Regardless of positive trend of certain liquidity parameters at the system level, the stress tests showed that the position of certain banks was not satisfactory from the aspect of liquidity risk. (Although, truth to be told, certain shocks were quite extreme, i.e. their realisation is not very likely.)

The banks showed the worst results in the first and fourth test, whereby the system itself “suffered” mostly after the first test. In addition, more banks passed the fourth test and the lacking amounts are significantly lower in relation to the first test.

Table 3.1 – Liquidity risk stress testing, results as at 31 December 2012

No:	Test/ Coverage (EUR thousand)	By free liquid assets			By available liquid assets		
		Lacking amounts in the system	Number of banks which failed the test	Lacking amounts in banks which failed the test	Lacking amounts in the system	Number of banks which failed the test	Lacking amounts in banks which failed the test
1	Withdrawal of 30% of total deposits	16,262	6	-121,195	80,637	5	-86,797
2	Withdrawal of 30% of demand deposits	382,609	2	-4,530	446,984	0	0
3	Withdrawal of demand deposits (30% households, 50% legal persons)	299,287	2	-23,036	363,662	2	-8,366
4	Withdrawal of time deposits (households and legal persons 40% each)	80,284	5	-98,696	144,659	3	-74,659
5	Largest depositor's deposits withdrawal	453,301	3	-45,147	517,676	3	-36,988
6	Withdrawal of 50% of 10 largest depositors' deposits	381,475	4	-49,237	445,850	4	-33,498
7	Withdrawal of 100% of state deposits*	420,462	2	-29,702	484,837	1	-21,487

* Here: Deposits by the Government and its agencies, state funds, municipalities and state companies with majority state ownership

Source: CBCG

Banks showed the best results in the second and seventh test. In the second test, only two banks showed the lack of available liquidity to cover the outflow (a relatively small amount), but the problem can be solved by using 50% of reserve requirements (a small percentage of reserve requirements is needed to cover the outflow, not the entire 50%). In the seventh test, two banks were not able to cover the public sector's deposits outflow, even after using 50% of their reserve requirements.

3.1.3. Market risk management[26]

The risk of interest rate change in the sense of trading activities hardly exists in the Montenegrin banking sector because the trading positions that would be potentially affected by the interest rate change are insignificant. The non-trading activities interest rate risk is most certainly present, but the banks have successfully transferred it on to their clients.

In 2012, the interest rate spread[27] at the banking sector level increased in relation to 2011, which was mostly a result of a decrease in interest expenses in relation to the average interest-bearing liabilities. At end-2012, the spread at the system level amounted to 4.39% (compared to 4.25% at end-2011), while it differed significantly by banks, ranging from 2.45 to 6.46 percentage points.

[26] This part relates to two market risks: interest rate risk and FX risk.

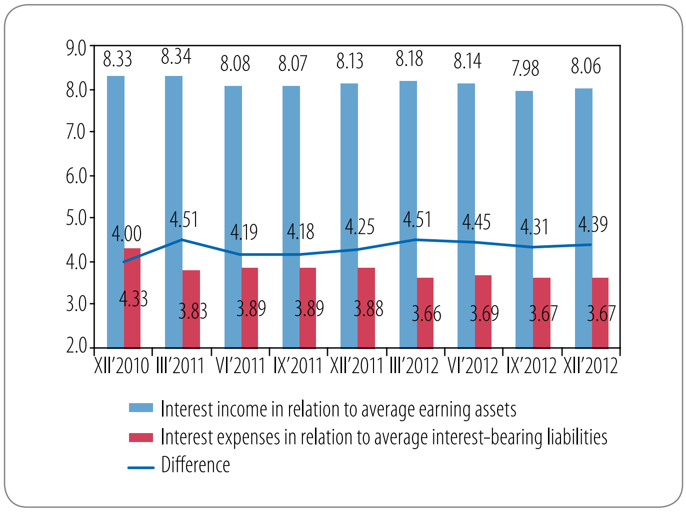
[27] Interest spread is calculated as the difference between the interest income in relation to average earning assets and the expenditures based on interest in relation to average interest-bearing liabilities.

Low FX risk was mostly a result of the euroised economy as well as of proper management of this risk. Aggregate open net FX position at end-2012 amounted to EUR -2.1 million or 0.84% of core capital[29]. The most frequent foreign currency was US dollar, with the open net position of EUR -3.2 million.

The majority of loans were EUR denominated. Only one bank showed a significant share of foreign currency loans (18.2%) in its loan portfolio, while at the system level this share was a mere 1.9%.

Graph 3.12

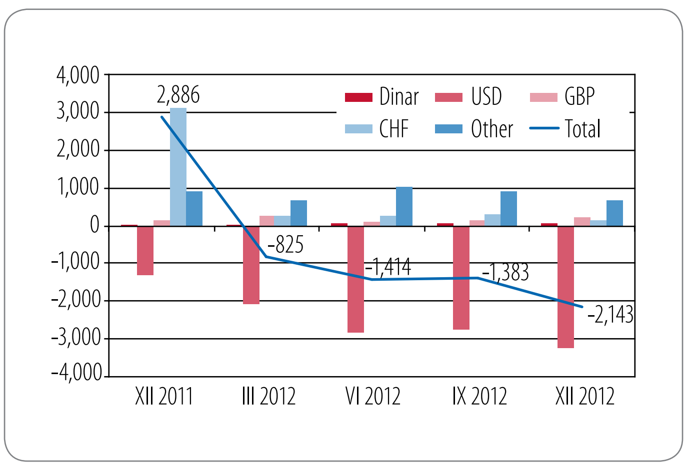
Margin analysis, aggregate level, in % (percentage point for differences)[28]



Source: CBCG

Graph 3.13

Aggregate open net position, EUR thousand, end-period



Source: CBCG

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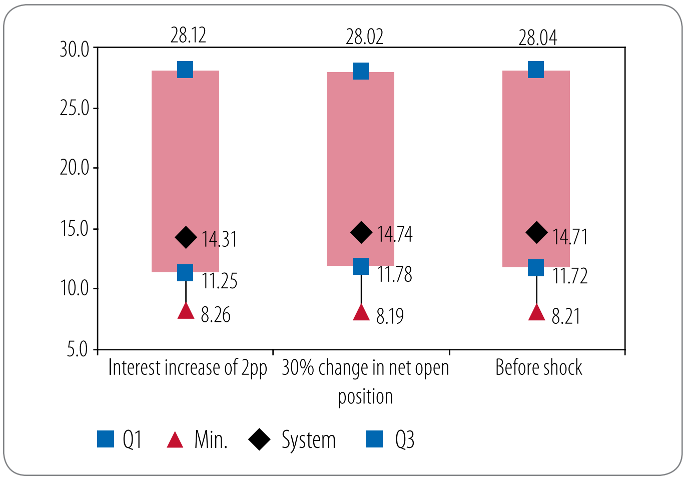
[28] Income/expenses are given cumulatively as at the beginning of the year, therefore, data for e.g. June 2012 relate to the trend as of the beginning of the year until end-June, not just Q2 2012 or June 2012.

[29] For details on the composition of core capital see the Capital Adequacy Decision, OGM 38/2011 and 55/2012.

Graph 3.14

Market risk stress testing, results, 31 December 2012



Source: CBCG

Market risk stress testing

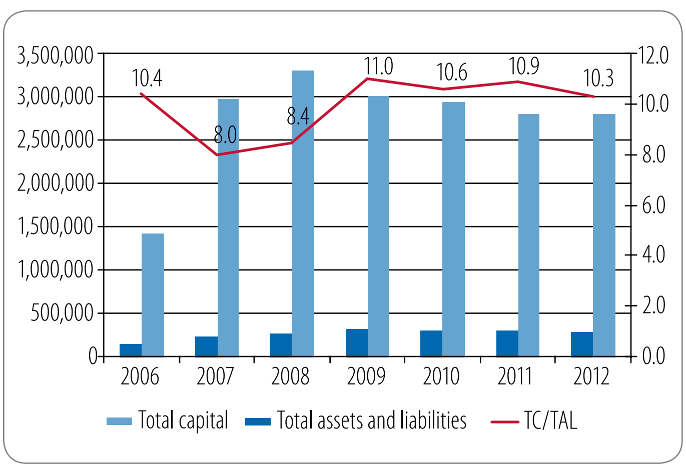
The sensitivity of assets and liabilities positions to interest rate risk was tested through the application of the increased level of interest rate of 2 percentage points applied to the cumulative difference (gap) between assets and liabilities positions, sensitive to the change of interest rate.

Stress testing of direct FX risk was based on the net open FX position (spot position) i.e. on the assumption that own funds would be corrected by 30% of the value of net open position.

Stress test results showed that the exposure to interest rate and FX risks was not significant. After the application of interest rate change, the system responded with a decline in the capital adequacy ratio of 0.4 percentage points (i.e. 2.7% with somewhat more intense declines in certain banks). During the FX risk test, there was an increase in the adequacy ratio of 0.03 percentage points (0.2% with somewhat larger oscillations in certain banks). After the first test, the adequacy ratio remained below the regulatory minimum in two banks, while after the second test the adequacy ratio remained below the regulatory minimum in one bank.

Graph 3.15

Capital and total assets and liabilities (left-hand scale, EUR thousand) and the share of capital in total assets and liabilities (right-hand scale), end-period



Source: CBCG

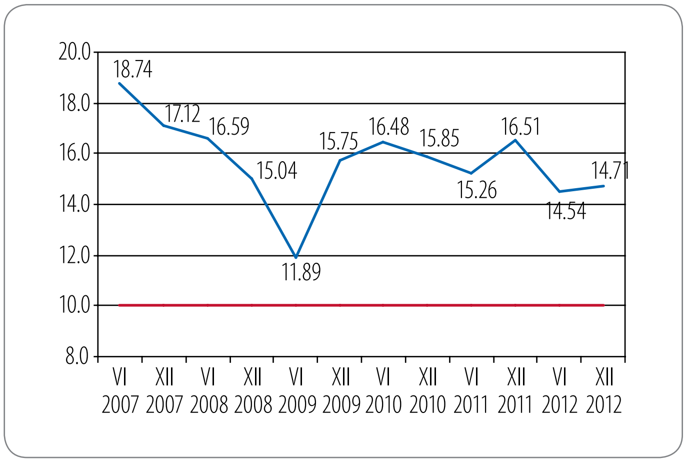
3.1.4. Capital of the Banking Sector

At end-2012, banks' capital accounted for 10.3% of total assets and liabilities, which is 0.6 percentage points lower in relation to end-2011, mostly as a result of a more intense decline in capital in relation to a decrease in assets (5.4% against 0.1%). In 2012, two banks were recapitalised in the total amount of EUR 46.5 million, but regardless of the recapitalisation, total capital declined by EUR 16.5 million, primarily as a result of financial results amounting to EUR -56.5 million and negative changes in the accumulated profit/losses from the past period (EUR 11.2 million).

At the 2012 year-end there was the year-on-year decline in the capital adequacy ratio of the banking sector. The capital adequacy ratio amounted to 14.71 % but it remained above the prescribe minimum of 10% in all banks (except for one). The bank whose adequacy ratio dropped below 10% was requested to recapitalise, which was done during the first months of 2013, consequently raising its adequacy ratio above the regulatory minimum[30].

Graph 3.16

Solvency ratio at the aggregate level, in %, end-period (prescribed minimum is 10%)



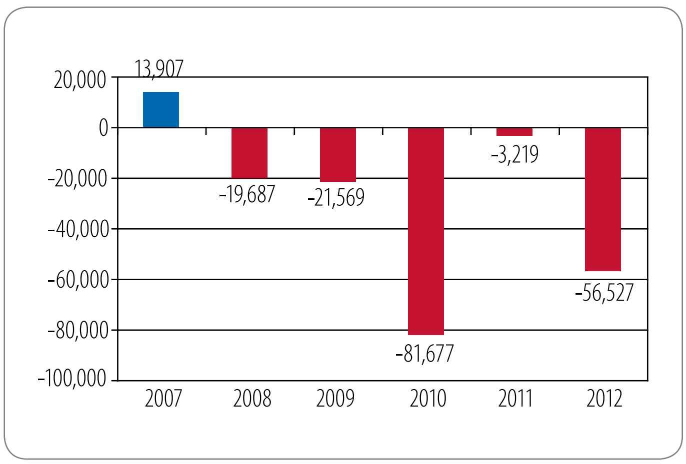
Source: CBCG

3.1.5. Profitability of the Banking Sector

The loss during 2012 was significantly increased in comparison to the previous year. Also, it is necessary to note that eight banks concluded 2012 with profit and that loss was concentrated in the two largest banks in the system. Consequently, the deterioration is also evident through the deterioration of ROAE and ROAA results.

Graph 3.17

Financial result, in EUR thousand

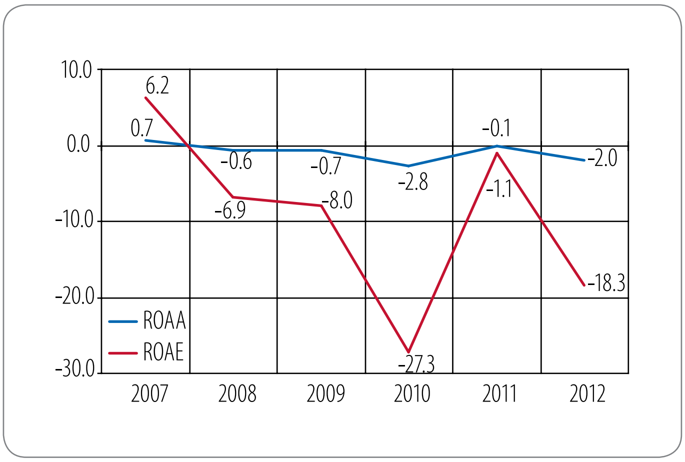


Source: CBCG

[30] Recapitalisation was actually implemented a few days before 2012 year-end, but for technical/accounting reasons it was included in the reports in January 2013.

Graph 3.18

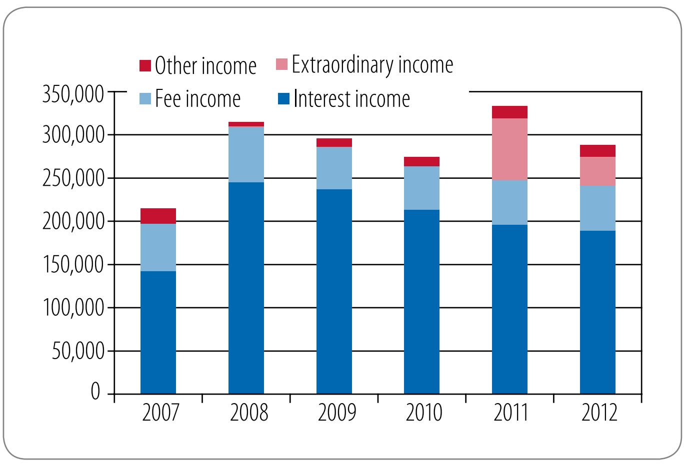
ROA and ROE trends, in %



Source: CBCG

Graph 3.19

Income by categories, in EUR thousand



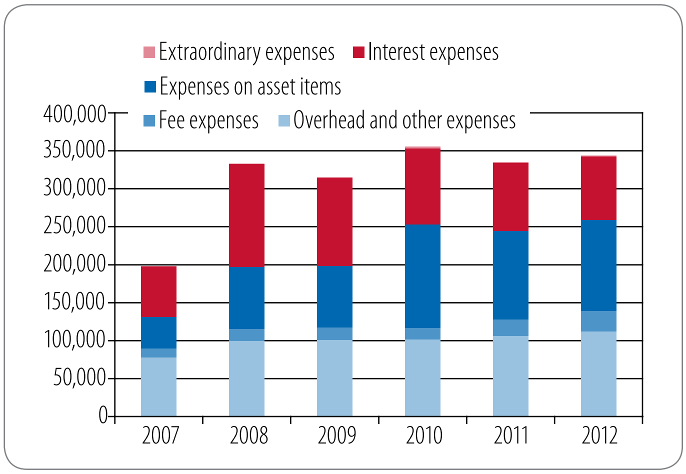
Source: CBCG

If we exclude the impact of extraordinary revenues, income and expenditures were on similar levels and of similar structures both in 2011 and 2012. The biggest change came as a result of decline in extraordinary revenues, from EUR 71 million to EUR 33.6 million in 2012. (Of course, by definition, extraordinary revenues are not a type of income that can be seriously taken into consideration.) In addition, the only significant change is reflected by the slightly higher level and share of fee expenses in the overall expenses.

As for other trends characteristic for the years following the crisis impact, the most prominent were a decline in interest income, as well as an increase in provision expenses – both of these categories primarily as a result of deterioration of the loan portfolio and writing-off of a considerable portion of loans. A decline in interest expenses in volume and structure was also evident as a consequence of the combination of lower deposit interest rates and a decline in interest-bearing liabilities.

Graph 3.20

Expenses by categories, in EUR thousand



Source: CBCG

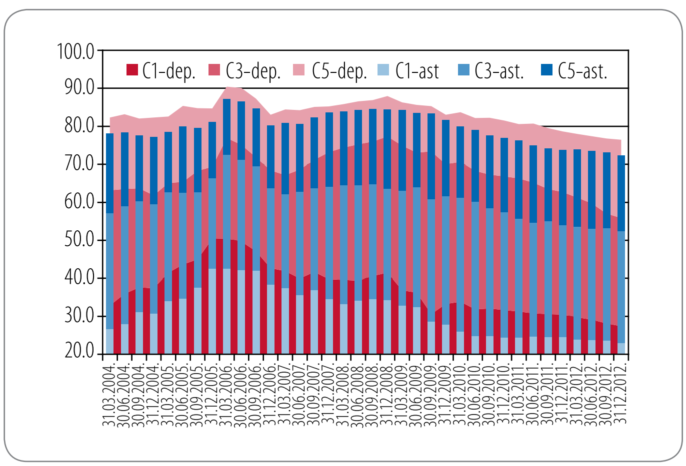
Concentration in the banking sector: 2004 - 2012

Concentration in the banking sector at end-2012 was lower in comparison to 2011 year-end, after declining from quarter to quarter during 2012. Measured by assets, three, i.e. five of the largest banks in the system at 2012 year-end had a market share of 52.4% i.e. 72.3% which is a decline of 1.6 percentage points i.e. 1.5 percentage points in comparison to 2011 year-end. The Herfindahl-Hirschman Index recorded a decline of 79.5 index points, from 1,430.69 at end-2011 to 1,351.16 at end-2012.

The decline of concentration was even more evident if we look at the share in deposits. The concentration ratio of deposits C3 and C5 declined by 6.8 percentage points and 2.2 percentage points in comparison to 2011 year-end, and amounted to 55.9% and 76.4%, respectively. The Herfindahl-Hirschman Index for deposits recorded a decline of 198.5 index points, from 1,727.23 at 2011 year-end to 1,528.71 index points at 2012 year-end. With HHI level of 1.500 points or below, we can say that the Montenegrin banking systems belongs to a fairly moderate concentration zone, i.e. stronger competition in comparison to the previous period.

Graph 3.21

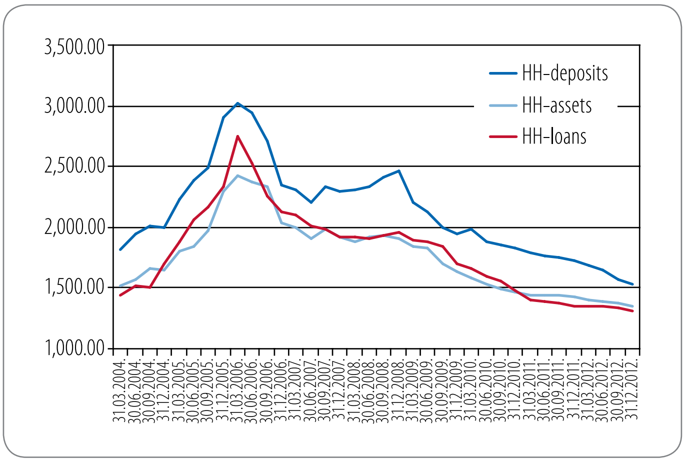
Concentration ratio by assets and deposits, in %



Source: CBCG

Graph 3.22

Herfindahl-Hirschman Index by assets, loans and deposits



Source: CBCG

Looking at the past periods, from 2004 until Q1 2006 the concentration increased primarily as a result of increase in the market share of the largest bank in the system, where there are over 50% of the total system deposits at end–Q1 2006. After Q1 2006 there was a decline of concentration over the next few quarters after which there was a period of gradual increase of concentration until end-2008. That was actually a period when the market share of the largest bank in the system declined while the market share of other banks increased. As the Herfindahl-Hirschman Index gives the larger weight to the market share of the largest bank, the HHI did not recover during the mentioned period as much as the concentration ratio. However, banks that recorded the fastest growth until end-2008 began to suffer because of the excessive lending which made them the biggest losers in the system after 2008. From then on, primarily due to the write-off and sale of non-performing loans, i.e. increased (share of) deposits in smaller banks in the system, there has been a steady decline in the market shares of both assets and deposits. However, the HHI shows a larger decline in comparison to decline in the simple concentration ratios.

3.1.6. Interest rates

At end-2012, the weighted average lending effective interest rate (WALEIR) amounted to 9.47% at the system level and it was 0.22 percentage points lower in comparison to end-2011. Observed by the average of 12-month data (from the end of the month), in comparison to 2011 the WALEIR declined by 0.12 percentage points, from 9.68% to 9.56%. For the same period, the weighted average deposit effective interest rate (WADEIR) recorded a slight decline, from 3.25% to 3.23%, i.e. observed by the average of 12-month data, the WADEIR increased by 0.13 percentage points (3.26% in comparison to 3.13%).

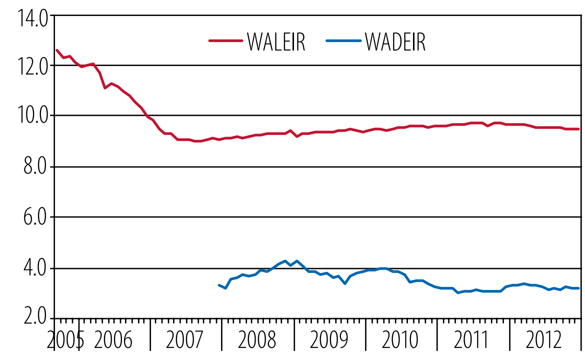
Looking at the past periods, the lending interest rates continued to decline in 2012, which is a trend that started after November 2011. This happened after they increased during the period half-2007 – end-2011 by about 0.7 percentage points (increasing almost continuously during this period, from 9% to around 9.7%). On the other hand, the trends of the lending interest rates in 2012 signalled the end of the declining trend that started after Q1 2010. When it comes to changes in lending and depositing interest rates in 2012, compared to 2011, it can be easily noticed that this is a very slight change[31].

[31] The reasons behind the trends of the interest rates that have been described in the first two paragraphs of this section should not be commented because data on lending interest rates apply to all active loans (underpaid principal) on the observed date, while the data on deposit interest rates, similarly, apply to all active (approved) deposits on the observed date.

In December 2012, the WALEIR on new loans[32] amounted to 9.38%, which is 0.26 percentage points lower in comparison to 9.64% from December 2011. However, during the rest of 2012, the WALEIR on new loans was considerably higher in comparison to December 2011 (simple average 10.8%, weighted average 10.7%). Looking at the structure, the decline of the lending interest rates in December 2012, compared to the rest of the year, was primarily affected by the amount of new loans extended to the public sector, which was considerably above the average during the rest of the year (32.6 thousands in December, in comparison to the 11-month average of EUR 3.8 thousand), that were approved by using the interest rate which was significantly below the average that was applied during the rest of the year (7.2% in comparison to the simple average of 11.2%, i.e. weighted average of 9.7% during the first 11 months 2012). In that sense, the change of WALEIR on new loans in December 2012 and in relation to December 2012 needs to be interpreted with caution.

Graph 3.23

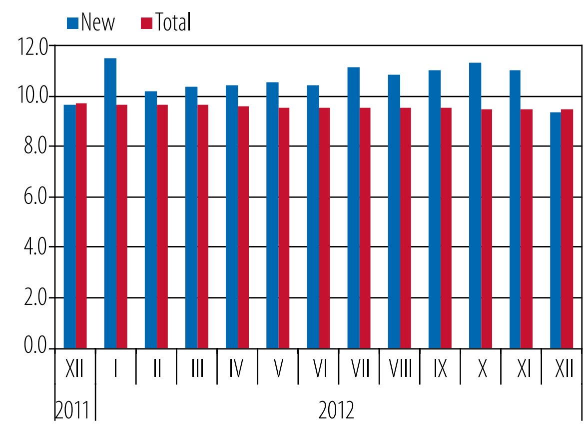
Weighted average lending/deposit effective interest rate, month-end, in %



Source: CBCG

Graph 3.24

Weighted average lending effective interest rate, on new loans (during month) and total loans (month-end), in %



Source: CBCG

[32] The amounts of new loans (which ultimately have the role of weight for determining the aggregate interest rates) represent the agreed and not repaid amounts, which are considerably lower in comparison to the agreed amounts.

3.2. Micro-Credit Financial Institutions

Total assets of micro-credit financial institutions (MFIs) amounted to EUR 36.2 million at end-2012, recording a decline of 18.4% in relation to 2011 year-end.

Net loans were dominant in the MFIs` assets structure, 77.5%, followed by cash that accounted for 15.1% and other assets accounted for 7.4% of total assets of MFIs.

Total MFIs` (gross) loans amounted to EUR 29.7 million, recording an annual decline of 11.5%. The loan loss provisions to total loans ratio amounted to 5.4% at 2012 year-end.

Observed by industries, most of the loans were granted to the services, tourism and hotel management sectors - 30.6%, while the loans granted to the agriculture sector, amounted to 28.2%, loans to the trade sector accounted for 14.4%, and those to households made up 21.4% of total MFI loans. Long-term loans (83.3%) were dominant in the maturity structure of MFI loans.

In the structure of MFIs' liabilities, total capital accounted for the main share (59.5%), amounting to EUR 21.5 million at end-2012. Of total MFIs` capital, 65.5% referred to donated capital, retained profit made up 25.5% of total capital, and common shares made up 9.0% of total capital. On the other hand, expenses accounted for 40.5% of liabilities, i.e. EUR 14.7 million.

MFIs reported a positive financial result of EUR 2.4 million at the end of the reporting year.

Interest rates on MFI loans were on a slight downtrend in 2012. The weighted average effective interest rate (WALEIR) was 28.48% and it declined by 0.06 percentage points in relation to the previous year-end. When it comes to interest rates on new loans, the WALEIR amounted to 28.9% on loans approved in December 2012, which is 0.48 percentage points lower in comparison to the WALEIR on loans approved in December 2011.

Micro-credit financial institutions account for a small share of total loans and assets in the financial system in general, therefore, their risk to financial stability is small. In addition, MFIs are not allowed to accept deposits, so there is no threat of panic spread, which additionally minimizes the risk to financial stability.

Table 3.2 – Key indicators at the Montenegro Stock Exchange in 2012

MONEX 20, 31 December 2012	9,849.92
Annual index change	5.6%
Total turnover in 2012, in EUR	32,669,370
Turnover change, 2012 to 2011	-44.6%
Market capitalisation, in EUR, 31 December 2012	2,902,823,247
Annual market capitalisation change	6.1%

Source: Montenegro Stock Exchange

3.3. Capital market

Negative trends in the capital market also marked 2012. The turnover declined by 44.6% in comparison to 2011, and amounted to only EUR 32.7 million, which is the lowest level of the annual turnover since 2002. At end-2012, the main Montenegro Stock Exchange index, the MONEX 20, recorded an increase of 5.6% in comparison to end-

2011. However, it remained at the levels recorded at end-2005, while in relation to the end of April 2007 (the peak of the stock exchange activities) this index plummeted by almost 80%.

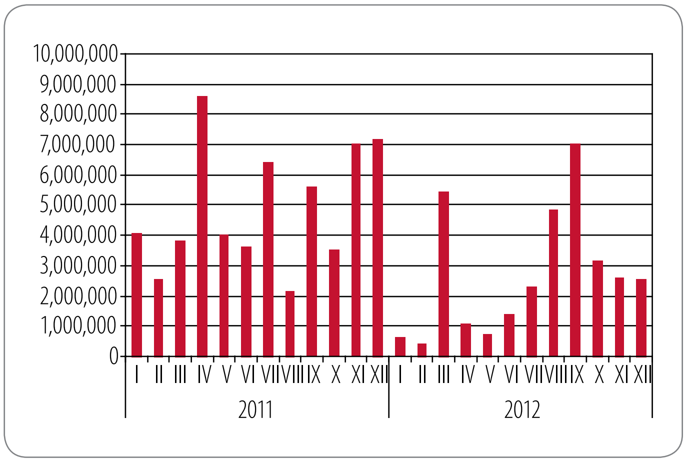
Average monthly turnover in 2012 amounted to a mere EUR 2.7 million (compared to EUR 4.9 million in 2011), while the MONEX PIF index declined during the year by 19.3%, remaining at the levels from 2005.

The global crisis caused a significant decrease of available assets for investments and growing sensitivity to risk of all investors, not disregarding the highly unrealistic expectations of investors before the impact of the crisis and unrealistic values of shares. Nevertheless, it appears that the share prices of some companies are currently unrealistically below their intrinsic values, which is also undesirable from the aspect of financial stability.

The Montenegrin capital market is still showing numerous weaknesses, the most important being very low liquidity and poor protection of proprietary rights, especially the protection of minority shareholder's rights and the observance of basic principles of corporate management. Issuers' information on their finances, which are not always accurate and regular, represents but another problem. Considering the previous assessments and a sharp decline of the indices` values in the past few years, a considerable number of investors have lost the confidence in the market.

Graph 3.25

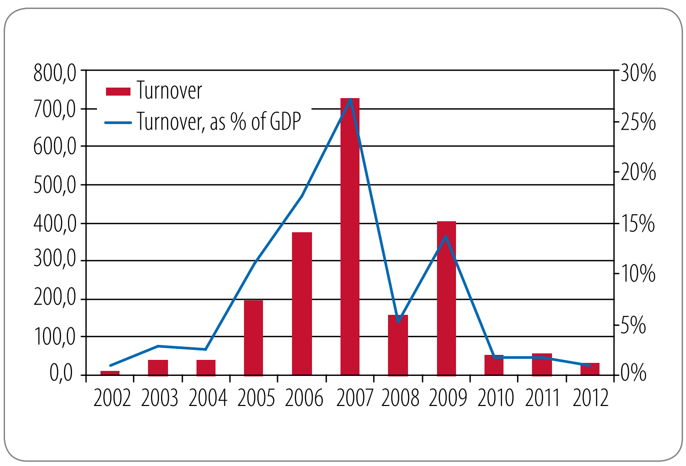
Total turnover, monthly, in EUR million



Source: Montenegro Stock Exchange

Graph 3.26

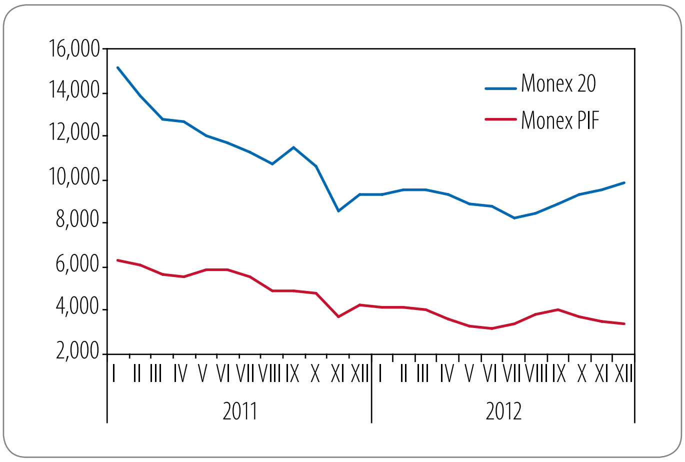
Turnover in relation to GDP (right-hand scale) and turnover in EUR million (left -hand scale)



Source: Montenegro Stock Exchange

Graph 3.27

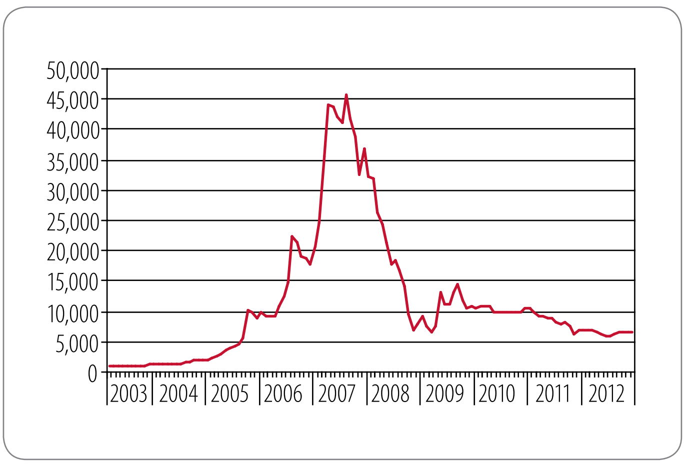
Indices trend, end-month



Source: Montenegro Stock Exchange

Graph 3.28

Simple average of the MONEX 20 and MONEX PIF indices for the period March 2003 – 2012, end-month



Source: Montenegro Stock Exchange

However, looking from the aspect of financial stability, it is encouraging that the capital market plays a relatively small role in relation to banks regarding the financing of the economy: Montenegro applies the bank-centric model, characteristic for Europe (in comparison to the USA), in which the economy is financed mostly through banking loans, and much less through capital market. Thus the amounts of capital collected through primary share issues in Montenegro remains insignificant in relation to capital that the economy borrows from banks.

The signing of an agreement on a common platform for trading between Sarajevo (SASE), Banja Luka (BLSE) and Montenegro stock exchanges can be seen as a positive step forwards. However, looking at a wider context that has been previously explained, we should not expect too much from this agreement.

3.4. Insurance Market[33]

Growth of the gross insurance premium, increase of insurance sector's total assets and a positive financial result recorded in 2012 were the main characteristics of the trends in the Montenegrin insurance sector.

Total gross premium recorded at insurance market amounted to EUR 66.8 million in 2012, recording the year-on-year increase of 3.1%. Gross premiums on non-life insurances of EUR 57.3 million accounted for the main share (85.9%) in the structure of gross premiums of insurance companies. Written life insurance premiums amounted to EUR 9.5 million, recording the annual increase of 4.3%, with a slight decline in the share of life insurance premium in total premiums.

The analysis of the non-life insurance gross premium structure in 2012 shows that compulsory insurance accounted for the main share (58%), recording a 1.4 percentage points higher share in relation to the previous year.

In the life insurance gross premium structure, life insurance accounted for the main share of 83.7% and together with supplementary insurance comprised 96.1% of total written life insurance premium. The impact of the crisis on the insurance companies' operations regarding life insurance, primarily reflected in hindered collection of premiums of insurance companies in 2012, which resulted in the reversal of a large number of policies (3.403 policies) and intensified requests for policy surrenders (817 policies were surrendered). Nevertheless, during 2012, a total of 8,110 new policies have been concluded, so in comparison to end-2011 there was an increase in the number of active policies of 12.3%, reaching 35,442 policies.

In 2012, 11 companies offered insurance services in the Montenegrin insurance market, of which six engaged in life insurance, while five insurance companies engaged in non-life insurance.

The insurance market concentration measured by the Herfindahl-Hirschman Index by gross premiums, declined from 2,620.95 points in 2011 to 2,341.87 in 2012.

Total equity capital of the insurance companies in Montenegro amounted to EUR 46 million at end-2012. Some 66.8% or EUR 30.7 million of total share capital of the insurance companies referred to foreign capital, while domestic capital amounted to 33.2% or EUR 15.3 million. Foreign capital accounted for the major share in seven companies, while other companies were characterised by mixed equity structure.

The solvency margin of insurance companies amounted to EUR 17.5 million while guarantee reserves amounted to EUR 33.7 million. The guarantee reserve to solvency margin ratio at the Montenegrin insurance sector level amounted to 193.1% (compared to 153.1% at 2011 year-end), which indicates that the insurance companies in Montenegro were solvent. The liquidity ratio amounted to 4.26 percentage points (liquid assets to short-term liabilities) recording an increase in comparison to end 2011, when it amounted to 3.05.

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[33] All the data related to the insurance market in 2012 are preliminary.

The financial result at the insurance sector level was positive and it amounted to EUR 2.6 million (compared to EUR 1.7 million in 2011).

These figures lead to a conclusion that the insurance market continued to stabilise in 2012 and that it currently does not impose a threat to financial stability.

In general, due to its size, the insurance sector does not have too much of an influence (about EUR 143 million of total assets at end -2012). However, as with the capital market, development possibilities should be sought in this market as well. The higher gross premiums and balances of insurance companies mean more money (capital) in the system, since the insurance companies are entities which perform further placement of a large portion of capital mostly towards other financial intermediaries (usually banks) or directly into the market, together with the provision of unavoidable type of financial service. Low income of the population and the troubled economy are stated as the main reasons for such a small insurance market. In addition, the lack of awareness of importance of this sector most certainly plays a role.

4. FINANCIAL INFRASTRUCTURE

A set of institutional arrangement/systems in Montenegro comprise the financial infrastructure which provides the legal and regulatory framework for effective and safe performance of financial intermediation. The following two important segments of the financial infrastructure in Montenegro are examined here: the payment system and the regulatory credit registry.

4.1. Payment system

The Central Bank of Montenegro is the owner and operator of the interbank payment system consisting of two sub-systems, RTGS and DNS.[34] The main objectives of operating in this domain are payment system safety and efficiency, which provides adequate support to the process of financial intermediation as well as to the resilience of other parts of the financial system.

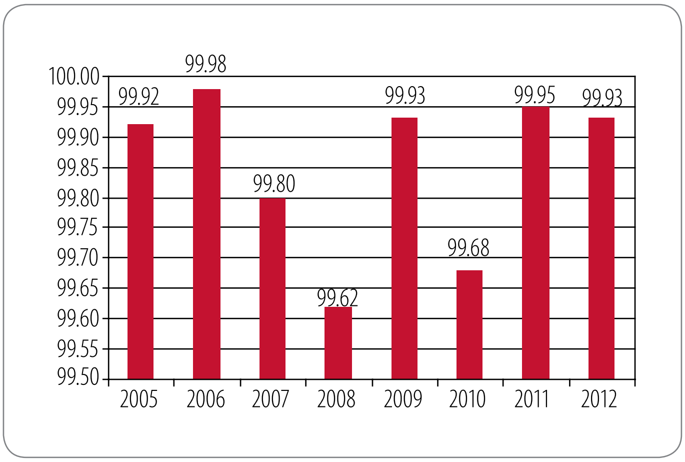
Table 4.1 – RTGS and DNS system availability

Period	Working			Extension in min	Production in min	Suspension in min	System availability, in %
	days	hours	minutes				
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	99.93
2010	256	2176		6	130,566	414	99.68
2011	255	2,165	30	29	129,959	62	99.95
2012	255	2,167	30	15	130,065	86	99.93
January 2012	20	170			10,200	60	99.41
February 2012	21	178	30		10,710		100.00
March 2012	22	187		15	11,235		100.00
April 2012	21	178	30		10,710		100.00
May 2012	19	161	30		9,690		100.00
June 2012	21	178	30		10,710		100.00
July 2012	21	178	30		10,710		100.00
August 2012	23	195	30		11,730	9	99.92
September 2012	20	170			10,200		100.00
October 2012	23	195	30		11,730		100.00
November 2012	22	187			11,220		100.00
December 2012	22	187			11,220	17	99,85

Source: CBCG

[34] Basic characteristics: RTGS sub-system: payments are processed individually, in real time, on gross basis and in line with the FIFO principle for major payments (over EUR 1,000); DNS sub-system: used for minor payments, understands multilateral schematics of resuming payables to the net level, while net positions settlement is done through RTGS sub-system. (There are three clearing cycles per day).

Graph 4.1
RTGS and DNS systems availability, in %



Source: CBCG

In 2012, total production of interbank payment system, i.e. RTGS and DNS sub-systems, amounted to 130,065 minutes, with 86 minutes of suspension of the system; therefore the system availability amounted to 99.93% continuing the trend of especially high availability recorded in the previous years.

In 2012, the value of total payment system transactions in the country amounted to EUR 20.8 billion, i.e. 1.3% more in relation to 2011. On the other hand, the number of transactions increased by 1.7%, to EUR 24.1 million. These indicators point to the persisting effects of the crisis and uncertain recovery of the economy, all of which reflected on the cash flows in the payment system.

Table 4.2 – Comparative indicators of total national payment system transactions, in EUR

	2012	2011	2010	2009	2008	2012/2011
Interbank	**9,103,468,406**	**9,069,817,107**	**8,673,777,093**	**8,900,719,570**	**10,546,453,000**	**100.4**
RTGS	8,553,655,836	8,519,229,139	8,140,415,076	8,392,787,439	10,019,615,322	100.4
DNS	549,812,570	550,587,969	533,362,017	507,932,131	526,837,678	99.9
Internal	**11,710,512,566**	**12,009,464,651**	**11,733,587,598**	**13,132,500,623**	**16,168,828,627**	**97.5**
cashless	8,682,132,662	8,952,110,113	8,741,589,307	9,993,633,299	12,352,961,765	97.0
cash	3,028,379,904	3,057,354,538	2,991,998,291	3,138,867,324	3,815,866,862	99.1
Total	**20,813,980,972**	**21,079,281,758**	**20,407,364,691**	**22,033,220,193**	**26,715,281,627**	**98.7**

Source: CBCG, commercial banks

Table 4.3 – Comparative indicators of the volume of national payment system transactions, number of transactions

	2012	2011	2010	2009	2008	2012/2011
Interbank	**7,405,773**	**7,780,970**	**8,809,445**	**8,644,923**	**9,100,708**	**95.2**
RTGS	3,520,051	3,999,616	5,136,534	5,099,093	5,166,259	88.0
DNS	3,885,722	3,781,354	3,672,911	3,545,830	3,934,449	102.8
Internal	**16,648,750**	**15,862,001**	**16,483,085**	**17,215,483**	**17,208,545**	**105.0**
cashless	11,602,066	10,805,920	11,275,833	11,895,934	12,015,581	107.4
cash	5,046,684	5,056,081	5,207,252	5,319,549	5,192,964	99.8
Total	**24,054,523**	**23,642,971**	**25,292,530**	**25,860,406**	**26,309,253**	**101.7**

Source: CBCG, commercial banks

In addition to the existing room for further reduction of payment system operational risk, with the completion of the ongoing construction of the remote location and improvement of the technological/IT platform for the system operations, other potential risks arising from the payment system were minimized through technical and legal solutions.

4.2. Regulatory Credit Registry

The Regulatory Credit Registry, operating within the Central Bank of Montenegro since 2008, aims at gathering data on retail and corporate loans and providing information which contribute to better assessment and better credit risk management in banks. Information obtained from banks were first used in the Central Bank for the purpose of conducting more efficient inspections, while the information from the credit registry was later made available to banks and micro-credit financial institutions and, as of 2010, to 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 a client's credit history in the registry when the client applies for a new loan, through the identification number for companies or personal identification number of natural persons. The report obtained from the credit registry database includes all loan obligations that legal or natural persons have with all banks in Montenegro, as well as interest and regularity in repayment, i.e. the quality of debt servicing. Contingent borrowing of a client, i.e. guarantees or collaterals that the client issued for other legal or natural persons, can be determined based on the report. All the above indicates that banks can obtain valuable information on their clients' creditworthiness through the credit registry.

Table 4.4 – Number of clients by active loans, year-end

	2007	2008	2009	2010	2011	2012
Natural persons	123,729	133,961	117,047	107,414	104,158	102,212
Legal persons	5,193	5,603	5,207	5,031	4,830	4,771
Total	**128,922**	**139,564**	**122,254**	**112,445**	**108,988**	**106,983**

Source: CBCG

Table 4.5 – Number of clients by total receivables (loans, lease operations, credit cards and overdrafts), end-year

	2007	2008	2009	2010	2011	2012
Natural persons	165,465	184,872	171,153	160,161	146,132	150,260
Legal persons	8,594	6,137	5,787	6,483	6,261	6,355
Total	**174,059**	**191,009**	**176,940**	**166,644**	**152,393**	**156,615**

Source: CBCG

Table 4.6 - Number of searches from the Regulatory Credit Registry for the observed period

September – December 2008	2009	2010	2011	2012
26.910	119,576	188,165	198,722	143,990

Source: CBCG

The new Central Bank of Montenegro Law established the legal basis for further development of the credit registry and its functioning was later regulated in more detail in the Decision on Credit Registry[35]. The implementation of this decision, where in addition to monthly, daily reporting on newly approved loans and other exposures of credit and guarantee institutions was introduced as of 1 November, additionally enhanced the quality of information obtained from the credit registry, and, at the same time, it enabled the issuing of reports to residents – legal and natural persons – on their current and contingent liabilities.

Apart from eleven banks, six MFIs and the Investment and Development Fund (IDF), and based on the contract concluded with the Central Bank, other financial sector participants can be included into the reporting system: lease companies and insurance companies, as well as legal persons outside the financial sector with whom legal and natural persons are heavily indebted (electricity distribution companies, tax authorities, etc.).

Finally, since the credit registry increases the credit and guarantee institutions' level of information on credit and guarantees` history and position of (potential) clients, and thereby influences better credit risk management, as the main risk in the system, the credit registry consequently makes a significant contribution to the stability of the Montenegrin financial sector.

[35] Before, the participation in the registry was regulated exclusively by contracts. Law: OGM 40/2010, 46/2010, and 6/2013. Decision: OGM 27/2011 and 64/2012.

5. CONCLUDING REMARKS

Reflections on certain threats and vulnerabilities given in this chapter, as well as in the rest of the Report, are only intended *to point* to threats and imbalances. That *does not mean* that threats will realise.

International environment

Even though it seems that the pressures regarding the European debt crisis have weakened, the global economic environment remains quite uncertain and the definite recovery is expected to be prolonged: it will take some time to reach new, sound balances.

Since a decline in economic activity is forecasted for Europe in 2013 (the latest official forecast of the IMF for the Euro area and the EU are -0.2% and 0.2%, respectively), Montenegro, being a small and open and relatively fragile economy which is directly or indirectly tightly connected to Europe, is expected to have a rather uncertain 2013. Regarding the channels of influence and bearing in mind the current system functioning model, the most important channel is the balance of payments` financial account (decline in the capital inflow/capital outflow). Therefore, the public as well as the private sector remain quite vulnerable, based on investments in debt securities and equity investments.

National macroeconomic environment

In the period 2010-2012, the Montenegrin economy recorded moderate growth. However, position of the economy has not significantly improved – moreover, liquidity deteriorated. Situation in the household sector showed no significant improvements in relation to the previous three or four years. Growth was maintained mostly due to the new public sector's borrowings (Eurobond issues and bilateral credit arrangements) and, of course, foreign direct investments.

In other words, growth was more of a discontinuation of negative trends and consequences from the end-2008 and 2009 crisis than an exit towards the road of a long-term sustainable and steady recovery. Domestic capital market is maybe the best reflection of the aforesaid. Total annual turnover in 2012 was only EUR 32.7 million, while the MONEX 20 index, as an expectation indicator, although increasing in this period by a couple of percentage points, is still close to 80% decline in comparison to the boom from the spring 2007 (in a situation when some of the global indices completely recovered or even surpassed their forecasted values).

Measured by the consumer price index, prices increased by 5.1% in 2012, which is a significant increase in relation to 2.8% recorded in 2011 and considerably higher in comparison to the 2.2% increase of prices in the Euro area. In terms of the structure, the growth of the prices is mainly the result of an increase in the prices of vegetables, fruit and electricity. Also, the annual growth in prices of 5.1% is above the desirable level, and it has generated a slight pressure on the financial position of the household sector in a situation where nominal salaries have only slightly increased (0.7%).

As for the expectations in 2013, Montenegro will most certainly be exposed to the global price movements, with the largest influence of food and oil prices. Nevertheless, according to the IMF forecasts, the global inflation pressure will be relaxed in 2013 (in line with the slow acceleration of the global economic activity), therefore this threat is not so conspicuous, although this type of forecasts are quite uncertain and could fail.

As already pointed out, trends in the balance of payments are perhaps the indicators of the most significant imbalances in the Montenegrin economy. In 2012, the current account deficit remained without significant changes in comparison to 2011 (the deficit slightly increased and its share in GDP slightly declined), while the coverage of import by export significantly declined, by 4.7 percentage points and amounted to a mere 22%. The increase in the deficit is mostly the result of negative trends in exports, i.e. larger trade deficit (primarily due to a significant decline in the export of aluminium, iron and steel), which could not be compensated by larger surpluses in other sub-accounts. The growth of services account surplus of 3.9% is identified as a positive trend. Nevertheless, the most important to mention is the continuation of capital inflow decline.

The fiscal deficit in 2012 exceeded the plan and amounted to 4.9% of GDP as a result of lower income as well as due to expenditures which were higher than planned. The repayment of debt amounted to EUR 168.7 million (this amount is not included in the deficit); therefore, the total shortfall in funds in 2012 amounted to EUR 332.5 million or 10% of GDP. The 2012 deficit, in general, represents a continuation of trends started in the 2009-2011 period; therefore, the average deficit in the period 2009-2012 amounted to some 4.7% of GDP. Deficit planned for 2013 amounts to 2.7% of GDP, although, given the current situation, it is going to be a big challenge to keep it at that level.

The deficit consequently increased the public debt, which at end-2012 amounted to almost EUR 1.7 billion, of which EUR 1.3 billion referred to external debt. On the other hand, issued guarantees (foreign and domestic) amounted to EUR 378.3 million. The public debt is still not too high in relation to GDP; however, the debt growing tendency and the provision of sources for its repayment are the matters of concern. In the period 2007-2012, the share of public debt in GDP increased by 23.6 percentage points (from 27.5% to 51.1%), while the share of guarantees increased to 11.4% of GDP[36]. In addition to the above, conditions in the private sector point to the vulnerability of this sector which levying provides the funds for debt repayment.

Growth of the economy in the period 2010-2012 was most certainly furthered by the Government borrowing, however, it is necessary to balance the budget and restrain the public debt growth, or the problem will only be delayed and become incomparably harder to absorb later. The balancing, which

[36] According to the Pre-accession Economic Program (Ministry of Finance), the debt will amount to EUR 1,904 million or 54.5% of GDP at the 2013 year-end.

has to start in 2013, will have a recurring effect on the financial position of all domestic sectors, putting more pressure on the financial system (banks).

The real estate market trends recorded worst results in relation to 2011. According to Monstat, an average price per square meter in a new building amounted to EUR 1,116 i.e. 14.6% less than in 2011, while a new-building apartment sale declined by 35.2%. According to the CBCG survey, an average real estate price in Podgorica (old and new real estate) increased by 1.8% in December 2012 in relation to December 2011. In view of the outlook for the Montenegrin economy and cautious and rather restrictive banking policy, it is not unreasonable to expect a downward movement of prices in 2013. This would put a pressure on the construction sector (to which banks are significantly exposed) and potential activation of new mortgages, and above all, a decline in the market value of collaterals for a large portion of banking loans (granted to construction companies as well as to the household sector).

Financial system

Consequences of very relaxed bank lending policies in the pre-crisis period were also felt in 2012, so banks continued to write-off and sell loans. Total assets and loans thus declined 0.1% and 4.8%, respectively. However, six of the smaller and medium-sized banks increased their gross balance of loans by EUR 32.5 million in relation to end-2011 (by 4.8%). However, they were outweighed by the amount of write-offs/sales with (previously) largest banks in the system. The loss at the system level amounted to EUR 56.5 million, which is significantly worse in comparison to the previous year. Looking at the level and structure of income and expenditure, the mentioned loss comes primarily from the extraordinary income (partly expected, because they accounted for over one fifth of the system income in 2011), and partially due to an increase of fee expenses. If it had not been for this, both the level and the structure of income and expenditure would have remained almost identical to those in 2011.

Mostly as a result of deteriorated financial position of the economy, the share of non-performing loans and past due loans in total loans increased in relation to end-2011 (17.6% in relation to 15.5% and 23.8% in relation to 19.3%, respectively). However, the amount of loan loss provisions is worrying. Provisions to bad loans ratio, although somewhat improved in relation to 2011 year-end, remained at the low 0.40. Finally, stress testing showed that certain banks are still sensitive to credit risk.

Liquidity of the banking sector is satisfactory. Stress testing showed that liquidity problems do not occur at the system level, however when certain shocks are applied, this problem could arise in individual banks.

Stress testing showed that interest and FX risks are insignificant both at the system level and individual levels.

As for the capital market, 2012 was perhaps even worse than 2011. Although total turnover recorded a decline of as much as 44.6% in relation to 2011, it amounted to EUR 32.7 million and marked the lowest level of annual turnover since 2002. Furthermore, the MONEX 20 increased by 5.6%, while the MONEX PIF declined during 2012. Simply, there are other substantial defects of the market and, above all, relatively poor outlook/expectations for the economy. However, it seems that a significant number of shares was underestimated, which is undesirable from the aspect of financial stability but opens a possibility of restarting the capital market in the future after stabilisation. In addition, individual perceptions of personal wealth moves downward unrealistically causing the contraction of their consumption and, consequently, the general level of economic activity.

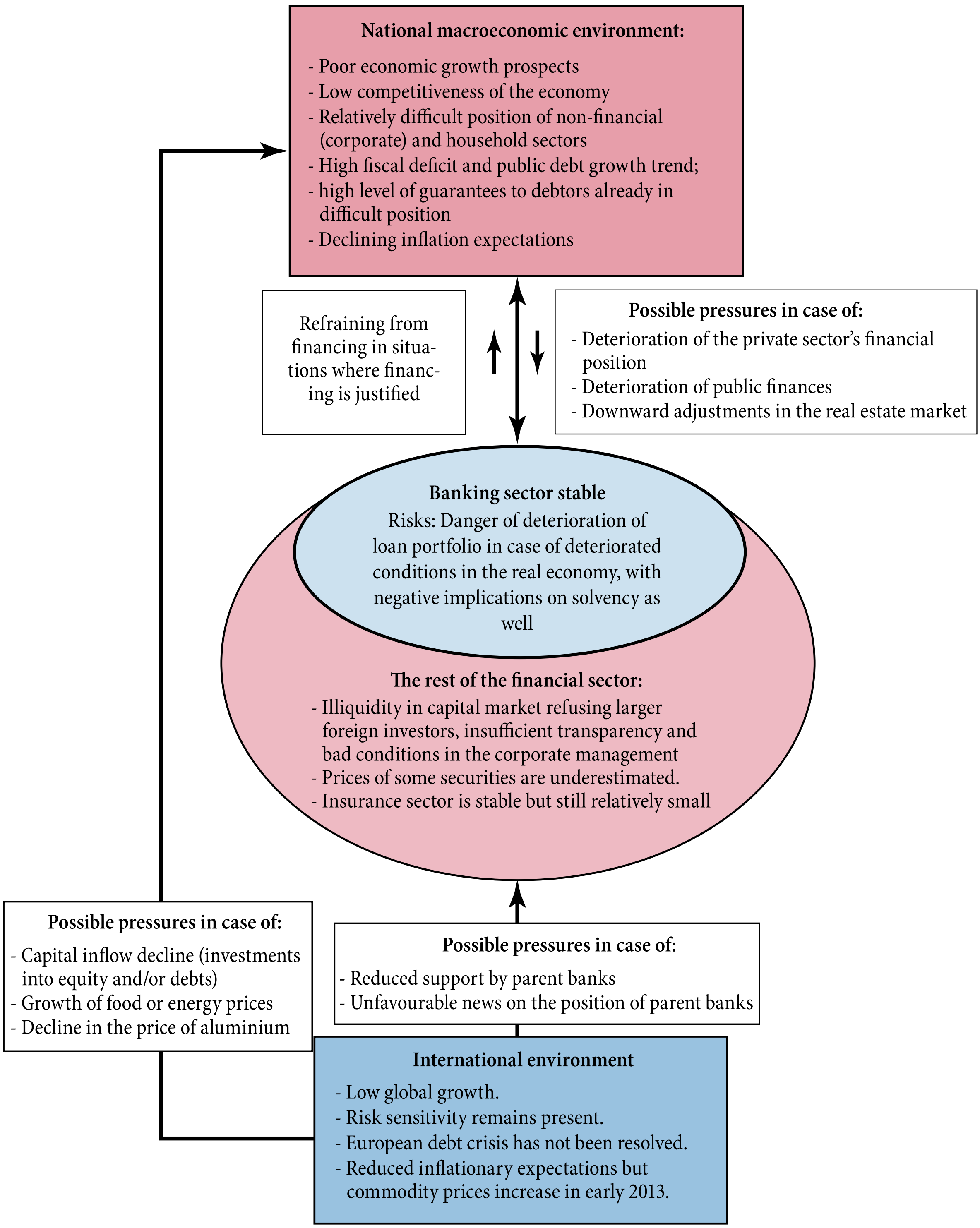
As for the insurance companies position, preliminary business results show that this sector further stabilised in 2012. Potential influence of this sector on the rest of the financial system and/or the real economy is limited by its relative size. Nevertheless, a greater and stronger insurance sector would be desirable: it would mean more capital in the financial system.

Table 5.1 shows the key risks.

Table 5.1 – Key risks in the system

Type of risk	Level of risk	Movement direction
Fiscal sustainability	Moderate to high	Increasing
Credit risk	Moderate to high	Stable to incising
Liquidity risk	Moderate	Stable to declining
Market risk	Low	Stable
Financial infrastructure	Low	Stable
International environment	Moderate	Stable
Insurance Market	Low	Stable
Capital market	Moderate	Stable to increasing

Chart 5.1 – Key risks and influence directions



5.1. Policies for preservation of financial stability

Real sector / balance of payments

The real/private sector remains very vulnerable. Only a strong and competitive private sector enables stable state finances, does not threaten the banking sector (which is exposed to it) and provides jobs and salaries for the household sector. Undoubtedly, the public and banking sectors may themselves be a part of the problem (as is the case of Montenegro). In other words, a strong real sector is not *sufficient*, but it is a *necessary* precondition for a good position of both the state and banks.

It is necessary to work on building the private sector on a sound, competitive basis, and on the principles of comparative advantages. Montenegro has comparative advantages in the development of tourism, agriculture, food industry and energy industry – and those sectors should be recording significant surpluses in foreign trade. This would lead to the balancing of the current account which is, as the current global crisis has shown, a desirable and normal condition for maintaining economic activity through borrowing or real estate inflows. Firstly, because the capital flows are quite "sensitive" to instability and secondly because capital inflows (debt or equity) cannot last forever.

Debt is not necessarily bad in all circumstances; however, artificial maintaining of standard through borrowing is impermissible. The situation is similar with capital inflows: the best are those through which the situation has actually changed for the better, and where capital is used for productive and not consumption purposes. This has not been the prevailing practice in Montenegro so far when it comes to capital inflows, real estate trading (households) or the selling of state-owned companies (privatisations). Without a doubt, the "appetite" for capital/higher standard in the household sector and certain real problems the state was facing, only partially justify this situation. The type of equity investments needed in Montenegro is Greenfield investments (ideal for import-oriented activities), so far underrepresented.

Although the private sector should make a turn towards the above mentioned activities, it cannot be done without the support from the state. The state needs to provide a stable and foreseeable environment (legal, administrative and judicial) and in communication with the private sector, to create an umbrella strategy, which will be gradually implemented afterwards.

Fiscal deficit (surplus) / public debt

The public sector remains the key risk in 2013. In that sense, the measures of fiscal consolidation from the beginning of 2013 are very encouraging (introduction of progressive taxation on personal income, lowering of expenses for materials and services as well as measures for reducing gray economy). Although this type of measures are often "painful" and with pronounced negative effects on the living standard, any delay in the application of these measures will generate significantly higher costs in the future. We can see how excessive debt can become a factor of limitation of growth and prosperity in case of the neighbouring or the EU countries.

The fiscal deficit in 2013 needs to be lower in relation to the previous year, and lower in comparison to the level prescribed by the Maastricht Criteria. Stopping the public debt upward trending would also be desirable, but realistically, it cannot happen in 2013 and it should be regarded as a medium-term objective. Efforts should be made to keep the public debt permanently below the critical level of 50% of GDP. Nužno je uvođenje i fiskalnih pravila, a najbolje bi bilo primijeniti nova fiskalna pravila dijela zemalja EU na dobrovoljnoj osnovi The introduction of fiscal rules is also necessary, and the new fiscal rules on voluntary application applied in a part of the EU countries would be desirable.[37]

The financial market may see a surge in the public debt and a high fiscal deficit as factors which may threaten regular financing of government obligations. In such conditions, capital inflows are interrupted or significantly decreased, portfolio investments are withdrawn, risk premium increases (public debt financing becomes more expensive), credit rating is downgraded, the banking system operations are threatened, etc. The question of public debt is inevitably accompanied by the question of guarantees: new guarantees must be stopped, which was very well implemented in 2012.

Banking sector and the rest of the financial system

The banking sector acquired a painful, however precious experience from the pre-crisis credit boom and later from the period of recovery from its consequences. Since this period is not yet over and under the pressure of expectations for 2013, the banks need to continue to clean their balance sheets with all means available: sale, restructuring and finally write-offs. Adequate provisioning policy remains inevitable in credit risk management. In addition, all possibilities for borrowing and recapitalisation need to be examined as a precaution. All these processes will be monitored by the Central Bank, which will continue, within its possibilities, to support the banking sector.[38] The banks` manoeuvring space is rather narrow due to euroisation; therefore, the most important lever is undoubtedly the banking supervision. Although the concept of financial stability and macroprudential inspection defers from microprudential approach, an efficient banking supervision is the key for achieving financial stability because the prevention is the best policy.

As for the capital market, efforts need to be made to achieve greater transparency (especially in regular disclosure of accurate financial statements of issuers, as well as information on business activities of all other market participants: the stock exchange, brokers, etc.), a stronger protection of equity rights (primarily of minority shareholders), and the promotion, support and protection of core principles of corporate governance. The insurance market also requires an increased level of transparency and the "reinforcement" of supervision. In addition, it is necessary to intensify efforts to promote the significance of services provided to the society by the insurance companies.

The system's ability to absorb shocks was significantly reinforced with the adoption of institutional and national contingency plans. Occasional updates of these plans as well as the testing of their application in practice will be necessary.

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[37] New organic Budget Law (so-called Law on Budget and Fiscal Responsibility, currently in the draft form) is a very good step forward.

[38] The CBCG has the role of a mediator and catalyst when it comes to the current program of restructuring of non-performing loans, which is conducted together with the experts of the World Bank.

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