CENTRAL BANK OF MONTENEGRO

FINANCIAL STABILITY REPORT 2013

Podgorica, 2014

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

ABBREVIATIONS

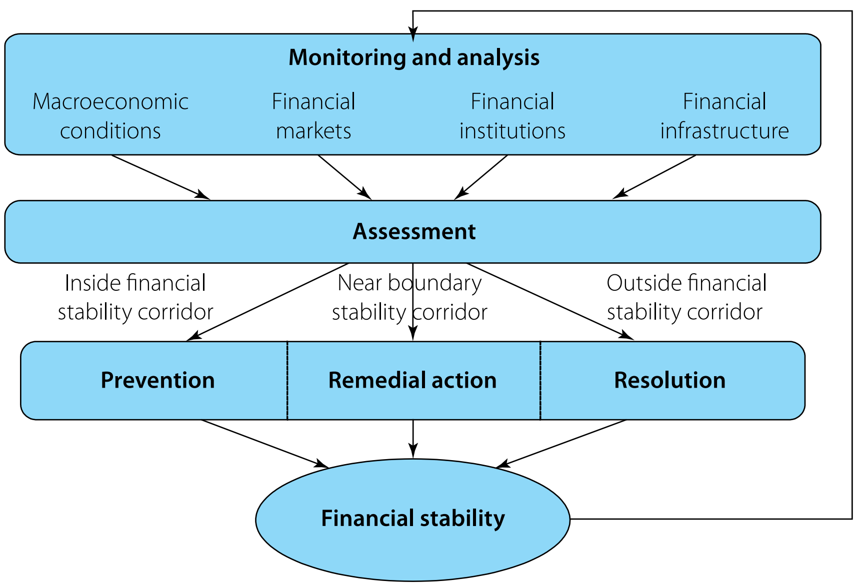
ARIMA model	Autoregressive integrated moving average model
AED	Dirham, United Arab Emirates currency
CBCG	Central Bank of Montenegro
CDS	Credit default swap
CHF	Swiss Franc
DNS	Deferred net settlement
EAM	Employment Agency of Montenegro
EBRD	European Bank for Reconstruction and Development
ECB	European Central Bank
EIB	European Investment Bank
EMU	Economic and Monetary Union
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
GBP	British Pound
GDP	Gross Domestic Product
(H)CPI	(Harmonised) Consumer Price Index
IMF	International Monetary Fund
JPY	Japanese Yen
KAP	Aluminium Plant Podgorica
KfW	Kreditanstalt für Wiederaufbau
LFS	Labour force survey
LIBOR	London interbank offered rate
MF	Ministry of Finance
MFI	Micro-credit financial institution
MSCI	Morgan Stanley Capital International
NOK	Norwegian Krone
OGM	Official Gazette of Montenegro
PIO	Pension and disability insurance
PPP	Purchasing power parity
RESET	Regression equation specification error test
ROAA	Return on average assets
ROAE	Return on average equity
RTGS	Real time gross settlement
USA	The United States of America
UK	The United Kingdom
USD	US Dollar
VAT	Value added tax
VIF	Variance inflation factor
VTB	Vneshtorgbank
WIIW	Wiener Institut für Internationale Wirtschaftsvergleiche

CONTENTS

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: a micro dimension that addresses risks from the aspect of individual financial institutions and a macro dimension that approaches risks from the aspect of the overall financial system. The objective of such a 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 in 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 some fluctuations or turbulences. Therefore, efforts should be put on minimizing the major risks and ensuring the 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

The global economy continued recovering in 2013 although at a slower pace, recording a 3% growth rate (as compared to 3.1% in 2012)[1]. The growth was relatively uneven throughout 2013 and the IMF estimated that the advanced economies grew at a rate of 1.3% at annual level, while emerging and developing economies grew at a rate of 4.7%. It was estimated that the global trade volume rose by 2.7% in 2013 (also 2.7% in 2012).

Table 1.1

Overview of main global indicators, y-o-y, %						
Indicators	2012	2013	Forecast		Difference from October 2013 projections (percentage points)	
			2014	2015	2014	2015
GDP growth						
World Output	**3.1**	**3.0**	**3.7**	**3.9**	**0.1**	**0.0**
Advanced economies	**1.4**	**1.3**	**2.2**	**2.3**	**0.2**	**-0.2**
Emerging and Developing Economies	**4.9**	**4.7**	**5.1**	**5.4**	**0.0**	**0.1**
USA	2.8	1.9	2.8	3.0	0.2	-0.4
Euro area	-0.7	-0.4	1.0	1.4	0.1	0.1
Germany	0.9	0.5	1.6	1.4	0.2	0.1
France	0.0	0.2	0.9	1.5	0.0	0.0
Italy	-2.5	-1.8	0.6	1.1	-0.1	0.1
Spain	-1.6	-1.2	0.6	0.8	0.4	0.3
Japan	1.4	1.7	1.7	1.0	0.4	-0.2
UK	0.3	1.7	2.4	2.2	0.6	0.2
Canada	1.7	1.7	2.2	2.4	0.1	-0.1
Advanced economies outside G7 and euro area	1.9	2.2	3.0	3.2	-0.1	-0.1
Central and Eastern Europe	1.4	2.5	2.8	3.1	0.1	-0.2
Russia	3.4	1.5	2.0	2.5	-1.0	-1.0
China	7.7	7.7	7.5	7.3	0.3	0.2
India	3.2	4.4	5.4	6.4	0.2	0.1
Latin America and the Caribbean	3.0	2.6	3.0	3.3	-0.1	-0.2
Middle East, North Africa, Afghanistan and Pakistan	4.1	2.4	3.3	4.8	-0.3	0.7
Sub-Saharan Africa	4.8	5.1	6.1	5.8	0.1	0.1
World trade volume (goods and services)	**2.7**	**2.7**	**4.5**	**5.2**	**-0.5**	**-0.3**
Consumer Prices						
Advanced economies	2.0	1.4	1.7	1.8	-0.1	0.0
Emerging and Developing Economies	6.0	6.1	5.6	5.3	0.0	0.1

Source: World Economic Outlook (WEO) Update, IMF, January 2014

[1] According to the IMF's *World Economic Outlook* report, updated in January 2014.

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 public finances in the USA, and still relatively high unemployment rates in the USA and the EU in particular, it may be noted that the global economy is still not on the path of a steady and sustainable growth and that the recovery period has not ended. It particularly refers to the advanced economies, while emerging and developing economies currently find themselves in a much better position as opposed to the one in pre-crisis period. For instance, China recorded a real GDP growth per capita (PPP)[2] of nearly 60% during the period 2008-2013.

Table 1.2

GDP per capita and unemployment rate per selected countries (ranked by column "GDP per capita (PPP), $", part "2013/2008, %")

Country	BDP per capita (PPP), $		Unemployment rate, %	
	2013/2008, %	2013	2013/2008, %	2013
China	59.9	9,828	-2.4	4.1
India	37.0	3,991	/	/
Brazil	17.1	12,118	-26.6	5.8
Russia	14.2	18,083	-9.5	5.7
Australia	12.5	43,042	30.8	5.6
Germany	11.3	39,468	-26.4	5.6
Japan	10.2	37,135	5.5	4.2
USA	9.4	52,839	30.9	7.6
Serbia	7.7	11,085	70.1	25.0
Montenegro	**7.0**	**11,925**	**16.1**	**19.5**
Bosnia and Herzegovina	6.9	8,293	15.3	27.0
Switzerland	6.9	45,999	25.5	3.2
France	5.4	35,680	40.9	11.0
UK	2.3	37,299	39.3	7.7
Island	0.4	40,739	207.2	5.1
Portugal	-0.3	22,930	129.3	17.4
Ireland	-0.6	41,265	114.8	13.7
Spain	-1.1	30,128	137.8	26.9
Italy	-3.0	29,598	84.5	12.5
Luxembourg	-3.0	77,935	56.3	6.6
Croatia	-4.3	17,753	101.2	16.6
Cyprus	-13.7	24,522	367.9	17.0
Greece	-18.0	23,632	252.6	27.0
Appendix:				
Emerging and developing economies	28.9	7,285	/	/
Central and Eastern Europe	14.8	16,206	/	/
Advanced economies	8.4	41,520	39.4	8.1
Euro area	3.7	34,033	61.2	12.3

Source: World Economic Outlook (WEO) Update, IMF, October 2013, Monstat, CBCG calculations

---

2 The calculation of GDP based on purchase power parity tends to eliminate differences in prices between countries whose nominal GDPs are compared. Reference level of prices varies depending on the group of countries to be compared and statisticians selection. Thus, GDP calculated in this manner has no uniform value but serves for the purpose of more realistic comparison. For example, Table 1.2. takes as a benchmark U.S. dollar which impacts higher level of Montenegrin GDP compared to nominal as the level of prices in the USA is higher than the one in Montenegro.

The general impression is that globally competitive and export oriented countries faced crisis more easily and that the 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. structural and institutional changes in an economic system.

Unemployment and current account deficit

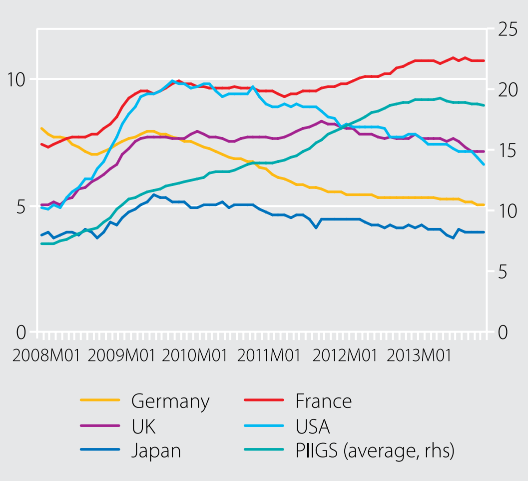
For countries on the periphery of the euro area, the year 2013 brought different results with regard to unemployment. Although they were still high in Ireland and Portugal (12.1% and 15.4% respectively) and extremely high in Spain (25.8%), the unemployment rates declined in these countries. On the other hand, unemployment rates additionally grew in Greece, Italy and Cyprus (by 3.6 percentage points) amounting to 28%, 12.7% and 17.5%, respectively at end-2013. These rates also deteriorated in Slovenia (by 0.4 percentage points) being 10.1% at end-2013. Croatia is ranked as the worst in the EU, after Greece and Italy. The unemployment rate in Croatia amounted to 18.6% at end-2013 after deterioration of 0.9 percentage points that occurred during 2013.

On the other hand, Germany was the only European country that recorded unemployment decline in period after the crisis outbreak. This decline continued also in 2013 (by 0.3 percentage points), and the unemployment rate amounted to 5.1% at end 2013, being only higher than the unemployment rate recorded in Austria (4.9%). Contrary to Germany, the unemployment rate in France grew about 3.4 percentage points, and after a period of stagnation of this rate during 2013, it amounted to 10.8% (which was below the euro area average).

The unemployment rate in the USA also recorded a decline in 2013 (reaching the level of 6.7%), thus continuing a gradual decline as of Q4 2009 when it had reached the level of 10%. The unemployment rate in Japan also declined by 0.3 percentage points amounting to 4%. However, the unemployment rate is not the primary problem of the Japanese economy but deflationary trends and weak economic growth, which is somehow untypically achieved with low unemployment rates.

Graph 1.1

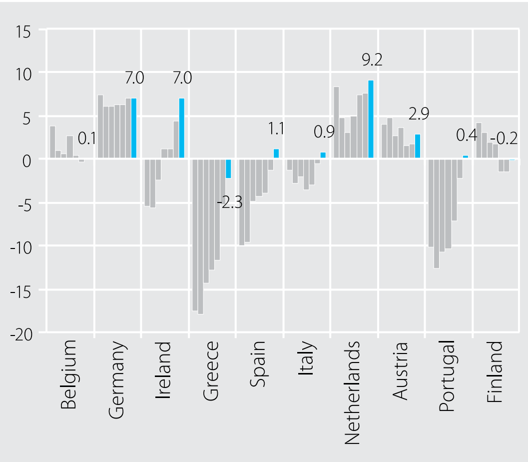
Change in unemployment rate in selected countries, 2008-2013, by LFS, % (PIIGS includes: Portugal, Ireland, Italy, Greece and Spain)



Source: Eurostat, CBCG calculations

Graph 1.2

Current account deficit in selected countries of the euro area, GDP % (2007-2013; 2013 presented in blue colour)

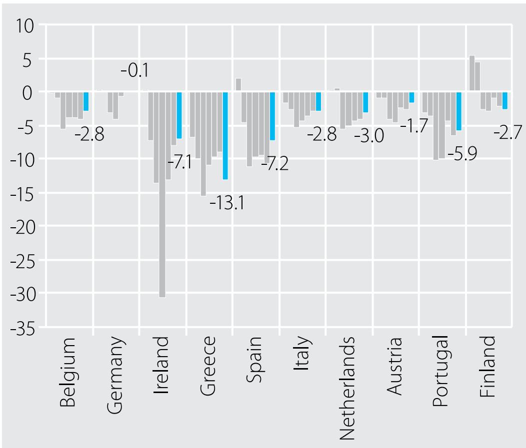


Source: European Commission – Winter forecast 2014 (February 2014)

On the other hand, the current account deficits of countries at the euro area periphery that reached the highest levels in the period 2007-2008 started to recover. It is estimated that all countries of the periphery, except Greece, recorded the current account surpluses in 2013 – Spain, Italy and Portugal for the first time, and Ireland for the fourth consecutive year. The current account surpluses come as a result of increased external competitiveness through a decline in labour costs (i.e. earnings) and specific structural reforms, as well as a decline in imports due to declines in the living standard and a demand for imported products and services.

Graph 1.3

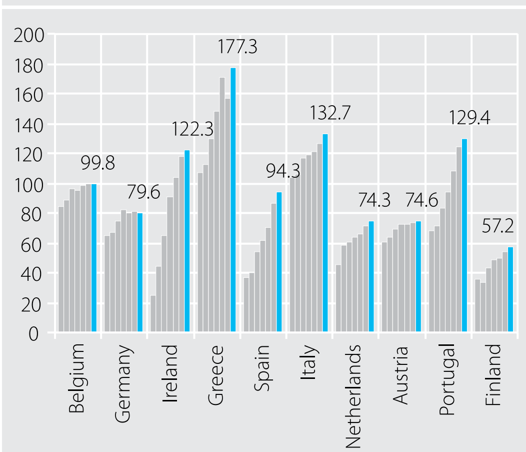
Budget deficit in selected countries of euro area, GDP % (2007-2013; 2013 is shown in blue colour)



Source: European Commission – Winter forecast 2014 (February 2014)

Graph 1.4

Public debt in selected countries of euro area, GDP % (2007-2013; 2013 is shown in blue colour)



Source: European Commission – Winter forecast 2014 (February 2014)

Public finance and financial markets

In general, 2013 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. 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 1.3 and 1.4 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 fiscal deficits are now considerably lower. Shortly after the start of the crisis, deficits rapidly increased and reached very high levels – primarily due to problems in the finance sectors and solving problems of troubled banks. However, even stronger consolidation is required as the level of public debt in some countries is extremely high. In other words, every deficit is much smaller thereby decelerating the public debt growth or reducing it to a minimum. However, but public debt decline is missing, except in the case of Germany.

The peak of the financial crisis and public finance crisis in Cyprus was in the centre of attention in 2013, particularly in H1 2013. Excessiveness of the banking sector, whose total assets exceeded GDP of Cyprus by several times, was the centre of the problem. Bank has become very exposed to the domestic real estate market, domestic and Greek government bonds, and other Greek entities. On the other hand, assets were substantially funded by large volatile foreign deposits. When the real estate bubble burst, and in particular when Greek public debt was restructured, banks and the Government (mostly as a result of bailouts) become insolvent.

Cyprus did not have a choice and it had to ask for the support from the Three – ECB, the European Commission and the IMF. The agreement was reached on 25 March on the assistance worth 10 billion euros, whereby 9 million euros would be provided through the European Stability Mechanism (ESM) and the IMF would provide 1 billion euros. The second largest bank (Laiki Bank) was divided into two parts: the "good" bank (containing performing assets and insured deposits) was absorbed by the largest bank (Bank of Cyprus), while the "bad" part was to be liquidated. The agreement included some problems as it implied enforced recapitalisation, i.e. uninsured deposits and other debts of Bank of Cyprus to equity swap in substantial percentage. Moreover, the remaining portion of uninsured deposits was temporarily frozen or their use was restricted in some other way. Limits for cash withdrawals and payments were introduced in the system as well as capital controls to overseas. A certain number of analysts and makers of economic policy measures viewed this as risky precedent and were concerned that this could trigger deposit runs in other euro area member states, which however, did not occur.

The second half of 2013 brought the completion of the legal framework for the first stage of the project Banking Union in the euro area/EU as the EU Council adopted a regulation which gives the mandate to the ECB for the banking sector supervision. In that respect, the ECB started the overall assessment of the banking sector in the context of assuming the supervisory role. This assessment will cover the assessment of all key risks, asset quality and stress testing. It will last one year and the results will be communicated before the ECB starts working as the banking supervisor (4 November 2014).

During 2013, some of the countries at the euro area periphery gained access to financial markets, and yields on their bonds fell dramatically compared to late 2012. As a consequence, CDS on public debt of those countries demonstrated a similar trend in 2013.

The yields on the U.S., German and Swiss government ten-year bonds grew during 2013 which was not in any material connection with the situation of economies of these countries, but primarily due to expectations of a gradual withdrawal from the FED quantitative easing programme. The price of gold dropped in 2013 by 28.3% to 1.202 U.S. dollars for a fine ounce of gold at the end of 2013. These are all indicators of stabilisation in the financial markets, i.e. stabilisation of the global economic activity.

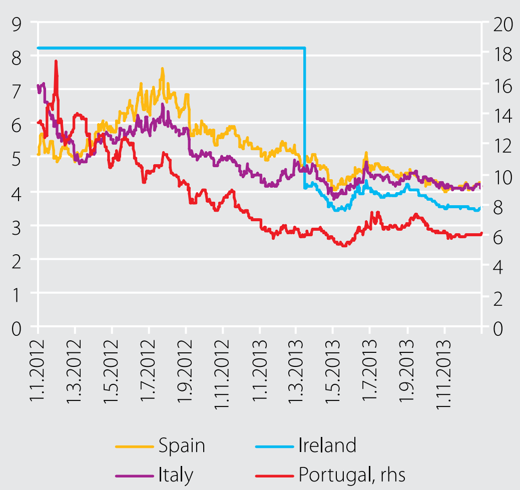
Stock market indices were also at a higher level compared to the end of 2012. They grew throughout 2013. The MSCI developed market index was 24.1% higher compared to end-2012, while the MSCI index covering all markets for the same period recorded somewhat lower values yet very strong growth of 20.3%, and due to the decline of the MSCI emerging market index of 5%. The MSCI indices (as global indices) did not reach the highest levels recorded before the crisis (although the developed market index is close to its record maximums), but some indices, for example DAX-Frankfurt or DJIA-New York came close to their record highs at end-2013. On one hand, this represents a positive signal, while on the other hand it partially represents a matter of concern. This is because it is not quite clear where the optimism of financial markets comes from, taking into account still incomplete recovery and economic recovery perspectives at the global level.

Volatility indicators of financial markets (e.g. VIX), as well as indicators of credit and liquidity risks in the money markets (such as TED spread and LIBOR – OIS spread) recorded declines in 2013 in comparison to 2012[3].

Euro appreciated against major currencies during 2013. The exchange rate of the euro (EUR) mildly appreciated against U.S. Dollar (USD), British Pound (GBP) and Swiss Franc (CHF) by 4.2% (from 1.3192 to 1.3741 USD against 1 EUR), 2.2% and 1.6%, respectively. The fluctuation of the exchange rate of the euro against these three currencies was small, 2%, 1.4% and 0.7%, respectively. The appreciation of the EUR against the Yen was most evident, 26.4%. It was clear that the Yen depreciated also against other major currencies (primarily due to the measures of the Bank of Japan).

Graph 1.5

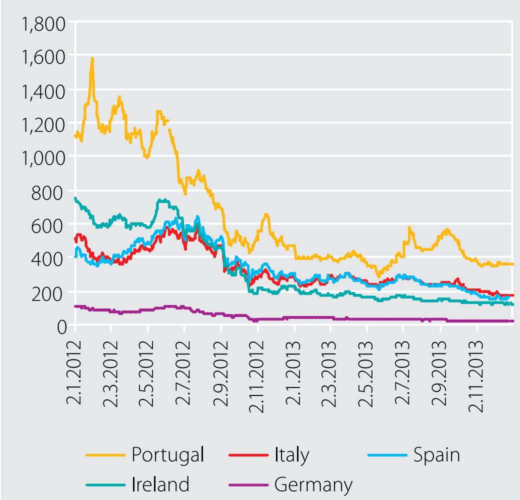
Yields on ten-year government bonds, %, 2012-2013



Source: Bloomberg

Graph 1.6

CDS on government bonds in basis points, 5-year contracts, 2012-2013

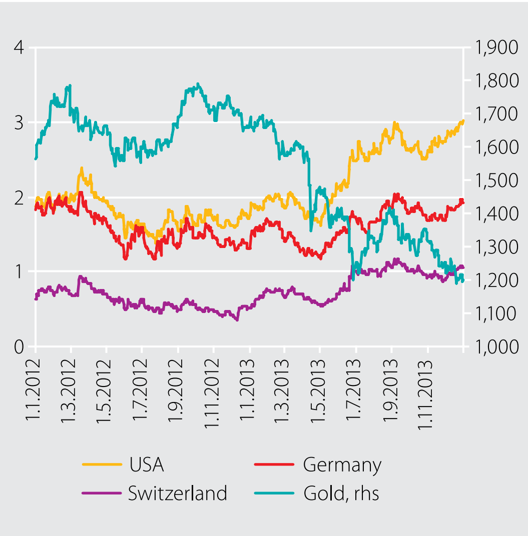


Source: Bloomberg

[3] 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 the USA it usually represents an effective "rate on federal funds") during specific future periods.

Graph 1.7

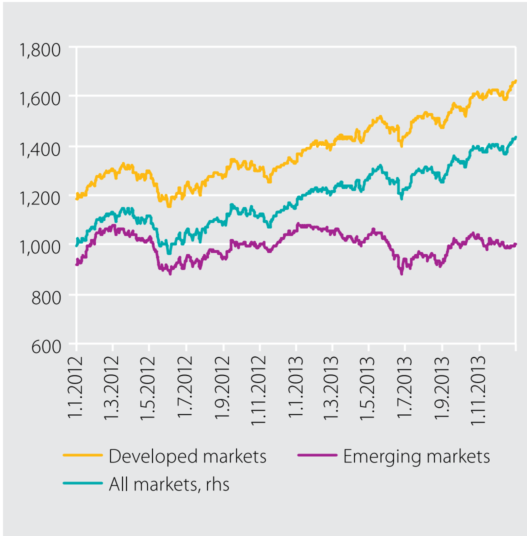
Yields on 10-year government bonds of the USA, Germany and Switzerland (%) and the price of a fine ounce of gold in US dollars, 2012-2013



Source: Bloomberg

Graph 1.8

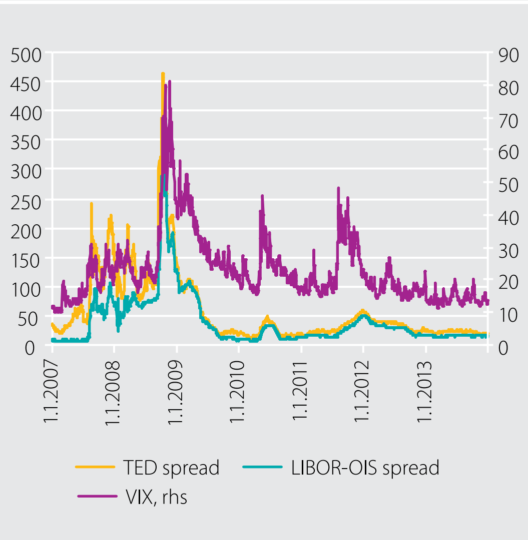
MSCI global indices, 2012-2013



Source: Bloomberg

Graph 1.9

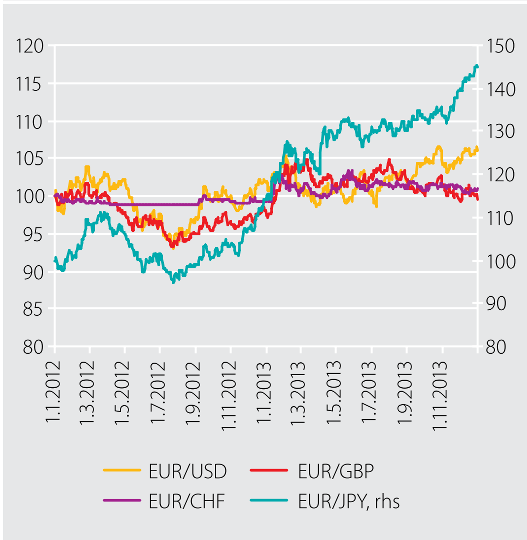
Volatility/stress indicators in financial markets, 2007-2013



Source: Bloomberg

Graph 1.10

Euro against other currencies, 2012-2013, 1 January 2012=100 (rise/fall indicates euro appreciation/depreciation)

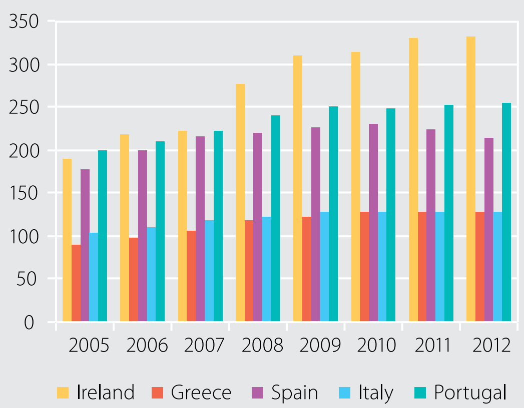


Source: Bloomberg, CBCG calculations

Graphs below show private debt[4] trending in selected countries of the core and periphery euro area countries. 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. The introduction of euro largely contributed to the increase in private debt, resulting in the reduction of interest rates in that period (particularly in the euro area peripheral countries) and it was used by the entities of that sector used. This consequently caused enormous, unsustainable levels of debt, which made the positions of the private sector and economy in general much more risky and vulnerable.

Graph 1.11

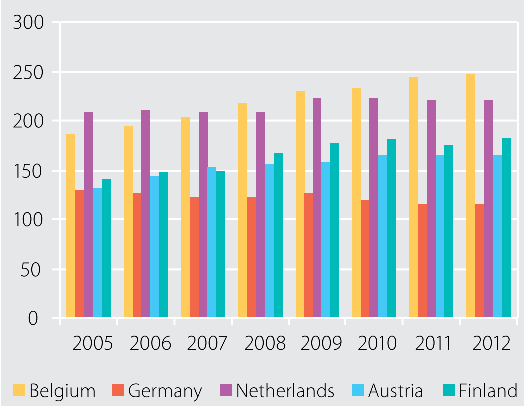
Debt of the private sector of peripheral countries of euro area, GDP %



Source: Eurostat

Graph 1.12

Debt of the private sector of the core countries of euro area, GDP %



Source: Eurostat

Box 1.1 – Single supervision: the first step towards banking union

The ECB will take the role of the main supervisor for banks in euro area as of 4 November 2014, which will be a starting date for the functioning of the single supervisory mechanism. This was laid down in the Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions. This will contribute, together with the projected creation of the single resolution mechanism and the common deposit insurance and the uniform set of regulations for financial services, to the creation of the banking union as one of the missing dimensions of the Economic and Monetary Union.

The notion of the banking union tends to unify this part of the EMU so that it becomes uniform as other components are integrated in the EMU system. Governing structures and makers of the economic policy measures are of the opinion that this would create the level playing field, avoid biasness towards national

[4] Data referred to the non-consolidated debt of the private sector – non-financial sector companies and households – in relation to other entities, either domestic or foreign.

institutions and problems inherent to cross-border coordination and cooperation by preventing the spilling over of problems among countries. Moreover, the tendency is to reduce, to the greatest extent, the connection between the governments (states) and banks, where the situation in banks in the future would, to lesser extent, reflect the situation in the public sector and entire economy; i.e. less money of taxpayers would be spent for bank resolution.

The ECB supervision will cover the euro area countries (18 countries as of 1 January 2014), while the ECB can sign the memoranda of understanding with other EU countries. The ECB will directly supervise significant banks in cooperation with the competent national authorities which will continue to supervise less important banks. However, the ECB has the possibility to directly supervise less important banks when it deems necessary. The ECB will directly supervise banks:

1. whose total assets exceed 30 billion euros;
2. whose assets exceed 20% of GDP of the originating country unless it is lower than 5 billion euro;
3. which are engaged in significant cross-border activities, and
4. which obtained support from the European Stability Mechanism or at least requested assistance.

Separately from the listed criteria, the ECB will directly supervise at least three significant banks in each euro area country. Specifically, it is expected that 130 banks whose assets will comprise about 85% of total assets of euro area banks will be subject to supervision.

From the governing aspect, a new body of the ECB will be formed – the Supervisory Board which will include the Chair (appointed for an unrenewable term of office of five years), a Vice-chair (chosen from among members of the ECB Executive Board), four ECB representatives and one representative of the national competent authority of each participating country. The Supervisory Board will be a body separated from the ECB Governing Council with a view to better performing its supervisory function and adequately separating supervisory and monetary policy function without potential conflict between them.

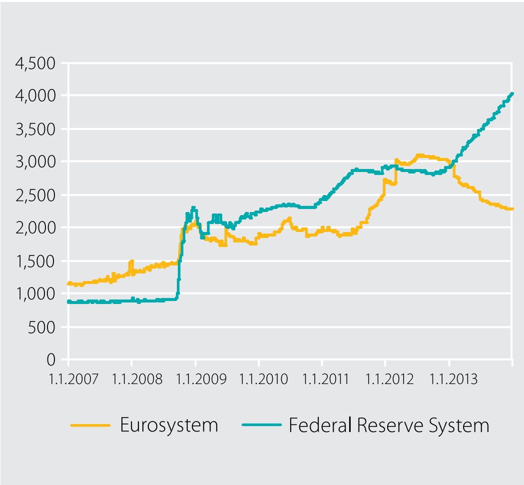
With regard to the organisation, four new sectors will be set up within the ECB: two of them will be set up for a direct supervision of important banks, one will perform indirect supervision of less important banks and one will perform mutual and specialised tasks together with the secretariat which will provide legal and other types of support to the Supervisory Board.

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 2013. For example, the Fed had kept its target federal funds rate unchanged since December 2008 (0-0.25%), and after the last meetings of the FOMC in 2013 it was announced that the rates would remain at the same level for a long time. Due to the easing of inflationary pressures and intensified risks of economic activity decline, the ECB Council reduced the ECB reference interest rate twice, from 0.75% to 0.5% at the meeting held on 2 May, and from 0.5% to 0.25% at the meeting held on 7 November, which represents the record low level. 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 were at record low levels: the EONIA was around 0.09%, while the 3M EURIBOR was around 0.22%.

Graph 1.13

Total assets of the Euro system and the Fed, 2007-2013 (in EUR/USD billion)

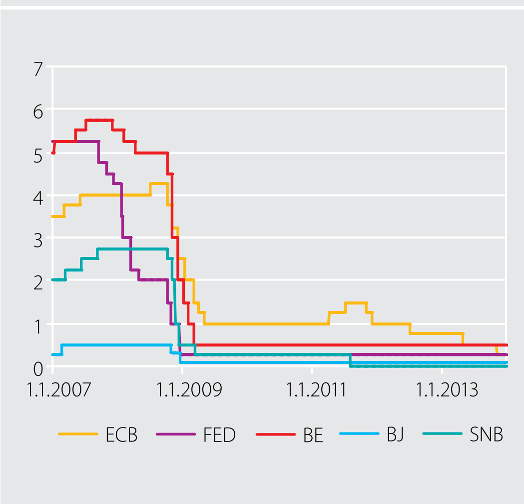


Source: Bloomberg

In 2013, the mentioned central banks have found resort in the so-called "quantitative easing" i.e. (electronic) money issue where they tried directly to inject liquidity into the banking system and additionally decrease interest rates in the economy by buying securities from banks[5]. As a consequence, during 2013, the Fed's assets rose by 38.6% and those of the Bank of Japan by 41.6%. However, after the FOMC meetings held in December 2013 and January 2014, the Fed decided to reduce monthly purchase of agency bills, i.e. long-term Treasury bills, from 40 to 30 billion U.S. dollars or from 45 to 35 billion U.S. dollars, respectively. The Fed did this as additional signals arrived that the labour market and economic activity in general are on the way to stronger recovery.

Graph 1.14

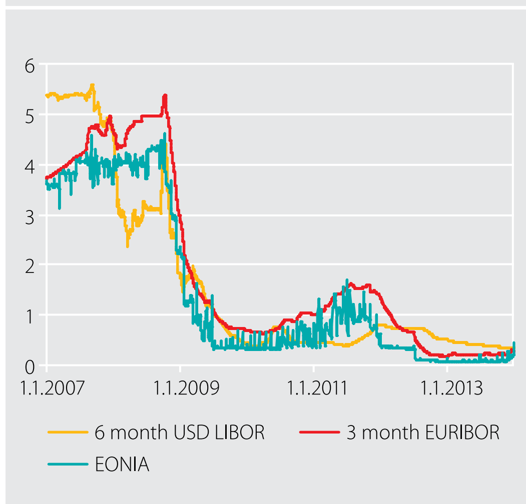
Reference interest rates of central banks, %, 2007-2013



Source: Bloomberg

Graph 1.15

Reference market interest rates, %, 2007-2013



Source: Bloomberg

[5] The ECB/Eurosystem 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 in particular in the period before 2013.

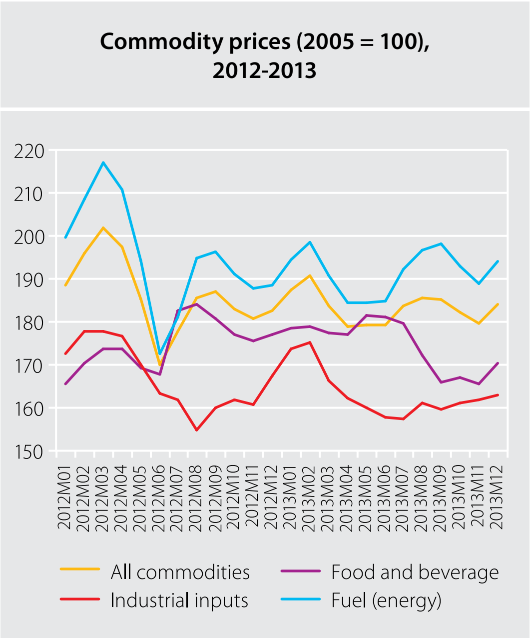
However, although financial markets expect gradual abandonment of quantitative easing programme, the Fed announced that there is no pre-determined plan of the programme withdrawal. Instead, it will be decided step by step based on continuous monitoring of the overall economic situation. In general, it is clear that quantitative easing still meets its main objective – "buying time", until other creators of economic and structural policies do their part of work and the private sector finds a way to transform and increase productivity.

Commodity prices

According to the IMF's commodity price index (excluding precious metals), commodity prices recorded the y-o-y 0.8% decline in December 2013. However, observed through an average of 12-month indices, the prices dropped by 1.6%, which did not represent any major change. Although the prices of food and beverages and industrial products fell by 3.6% and 2.7% respectively, the index value in December 2013 was largely affected by higher prices of energy products (3%), since the IMF's commodity price index assigns them the highest weight[6]. Observed through the average, the energy product prices fell during 2013 by 1.8%.

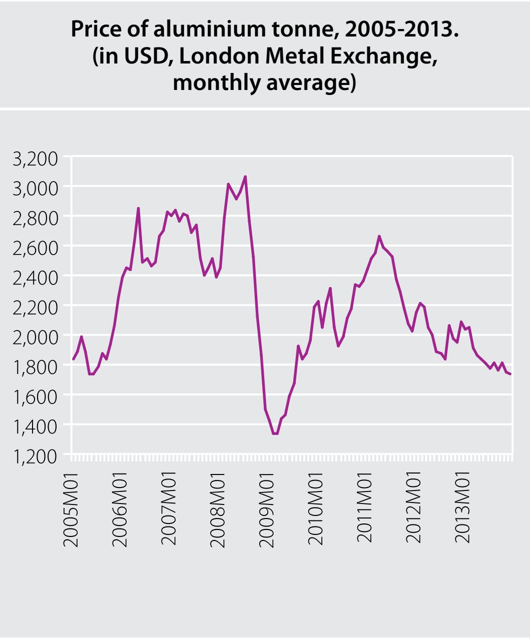
Due to the importance of aluminium for the Montenegrin economy, we are presenting the price trending of this industrial input. The aluminium price declined y-o-y 16.6% in December 2013, amounting to 1.739.81 USD/t, while the average annual decline amounted to 8.7%.

Graph 1.16



Source: IMF

Graph 1.17



Source: IMF

[6] 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.

Expectations for 2014.

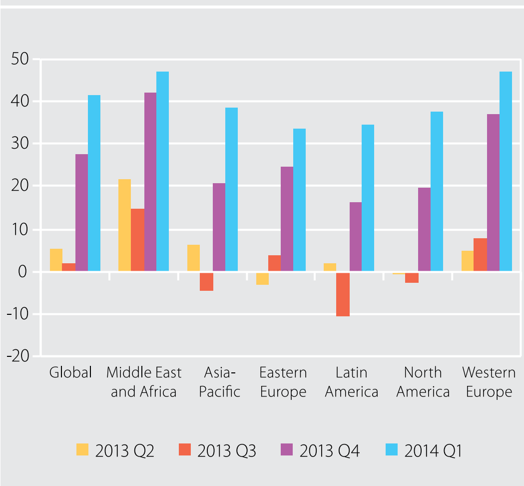
According to the IMF January 2014 forecast, the global economic growth is expected to amount to 3.7%. Moreover, it should be noted that this forecast was revised upwards by 0.1 percentage points in relation to October 2013, due to the forecast revisions upwards for several countries: the USA, Japan, the UK, Germany and Spain. It is encouraging that the growth rate of 2.8% is forecasted for the USA, which is close to the one from 2012 and almost 1 percentage point higher relative to the growth rate from 2013. The US labour market additionally recovered during 2013, 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. Maintaining of solid growth rate is also forecasted for the Japanese economy (1.7% as recorded in 2013).

Observed by groups of countries, it is forecasted that advanced economies would grow at the rate of 2.2%, emerging and developing economies at the rate of 5.1%, and the latter are estimated to give the major contribution to total growth in 2014. As expected, China and India will be the main drivers of growth (with Mexico, Brazil and Russia). As regards advanced economies, the global growth contribution will mostly come from the USA, Japan, Canada, Britain and Germany. However, the intensified tensions in Ukraine could have negative effects on economic growth.

The 2013 growth in Central and Eastern Europe, according to the IMF forecast, will amount to 2.8%, which is a modest yet higher rate of growth than in 2013 (2.5%).

Graph 1.18

Global business barometer, percentage points



Source: FT and The Economist survey

Briefly, the most encouraging fact is higher growth rate in 2014 in comparison to 2013 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 encouraging fact is the announced increase in economic activity in the euro area (1%) after the contraction that occurred in two consecutive years, since this is the region with which Montenegro has the strongest economic relations.

The Financial Times and the Economist's Global Business Barometer showed the most optimistic expectations at the beginning of 2014 since the beginning of the survey (Q2 2011)[7]. To wit, the balance between the top managers expecting im-

[7] This is a survey on business confidence which is done four times a year. It is based on answers of more than 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).

provement in business environment in the next six months as compared to those expecting the opposite amounted to 41.5 percentage points. The expectations by regions: from 46.9 percentage points among managers from the Middle East and Africa to 46.8 percentage points among managers from Western Europe, and to 33.6 percentage points among managers from Eastern Europe.

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 products. The IMF forecasts for 2014 show that the prices of oil and non-energy products would decrease on average by 0.3% and 6.1%, respectively. This forecast is largely based on the forecast of growth of oil stock with non-OPEC countries and the recovery from problems in oil productions with the OPEC countries. However, factors that influence food and energy product prices are really numerous and diverse, thus any forecast at this time would be the least appreciative.

An unavoidable segment of visible trade is aluminium. The aluminium price, according to the IMF, will amount on average to 1.823 U.S. dollars per tonne in 2014 or they will decline by 1.3% compared to the price in 2013.

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 2014.

As regards revenues from tourism, the continued recovery of global economy is good news. Still, with some good internal organization and preparation of the summer tourist season, as well as effective advertising activities, better results are expected in 2014 compared to 2013.

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 a relatively high level of external debt, it is evident that a potential vulnerability of Montenegro's economy lies here.

As regards foreign direct investments, the situation is encouraging having in mind the expected acceleration of global growth, while the potential increase of risk sensitivity to emerging and developing economies represents a matter of concern. Sensitivity to risk, as regards foreign borrowings, will be particularly important for new government borrowings. The policy of balanced public finances shall thus be of crucial importance for attracting investors.[8] As regards banks' borrowings, they will dominantly be affected by financial positions of their parent banks and the latters` willingness to po-

[8] 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 and threats on the financial system stability.

tentially finance their subsidiaries. More significant support of parent banks for improving lending activity should not be expected in 2014, and the subsidiaries will have to look for funds for lending in the domestic market or via credit lines granted during the previous period.

2. MACROECONOMIC ENVIRONMENT IN MONTENEGRO

2.1. Economic activity developments

The indicators determining total economic growth in Montenegro showed rather upward trends in 2013. In this manner, manufacturing industry and the mining and quarrying will have negative effects on total growth rate in 2013.

Table 2.1

Trends of selected activities, 2013/2012, %	
Retail trade, turnover (permanent prices)	9.5
Tourism	
Arrivals	3.6
Overnights	2.8
Manufacturing output, physical volume	-5.0
Construction	
Value of performed works	9.7
Effective construction hours	31.5
Electricity, gas and steam supply	38.7
Mining and quarrying, physical volume	-1.4
Forestry, physical volume (weighted index)	9.7

Source: Monstat

According to the Ministry of Finance's estimates, the real GDP growth in 2013 amounted to 2.6%. According to the CBCG model estimate, the estimated growth of GDP in 2013 amounted to 3%, while the latest IMF and EBRD estimates show that the Montenegrin economy recorded a growth rate of 1.5% in 2013, and according to the European Commission`s estimates, the growth rate amounted to 2.4%.

The year 2013 was characterised by an increased number of employees (3%) and registered unemployed persons (6.7%), as well as slight decline in gross and net salaries of 0.2% and 1.7% respectively. 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 earnings of the population have not realistically increased during the past three years; instead, they recorded a decline due to the fact that the prices increase exceeded significantly 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 20%, with continued low employment rates (the 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)				
	2011.	2012.	2013.	Change (2013/2012), %
Employed	163,082	166,531	171,474	3.0
Unemployed	30,869	30,182	32,190	6.7
Gross salaries, EUR	722	727	726	-0.2
Net salaries, EUR	484	487	479	-1.7

Source: Monstat, Employment Agency of Montenegro

Table 2.3

Unemployment in the region, Labour Force Survey, %	
Country	Unemployment rate, 2013
Slovenia	10.8
Croatia	17.5
Montenegro	**20.0**
Serbia	23.6
Bosnia and Herzegovina	27.5
Macedonia	29.2

Source: WIIW, February 2014

In 2013, the economy was still facing significant illiquidity. Observed through enforced collection indicators, the position of the economy remained almost unchanged compared to 2012. The share of persons[9] with frozen accounts in total number of persons performing an activity remained the same in 2013 and it accounted for 23.5% at the end of 2013. Frozen accounts suffered some changes in their structure. At the end of 2013, the amount of entities with frozen accounts for a period longer than 1 year amounted to 401.6 million euros (an increase of 4.6%), while the total frozen amount amounted to 437 million euros declining by 1.8%.

Moreover, the fact that the Montenegrin economy showed only a slight increase in period 2009-2013 remained as a concern, i.e. the 2013 GDP was insignificantly higher than the 2008 GDP due to the fact that the pre-crisis growth did not create any significant number of jobs (although a remarkable progress was made) so growth benefits were distributed rather unevenly.

[9] Includes legal persons and entrepreneurs.

Table 2.4

Basic statistics of enforced collection, end -period			
	2012.	2013.	Change in, %
Number of entities with frozen accounts	12,247	12,981	6.0
As a % of total entities	23.5	23.5	(percentage points) 0.0
Entities with frozen accounts up to 1 year, EUR	61,140,135.84	35,384,040.03	-42.1
Entities with frozen accounts over 1 year, EUR	383,956,101.84	401,636,556.82	4.6
Total, EUR	**445,096,237.68**	**437,020,596.85**	**-1.8**

Source: CBCG

Estimate of GDP movements in 2014 and their impact on financial stability

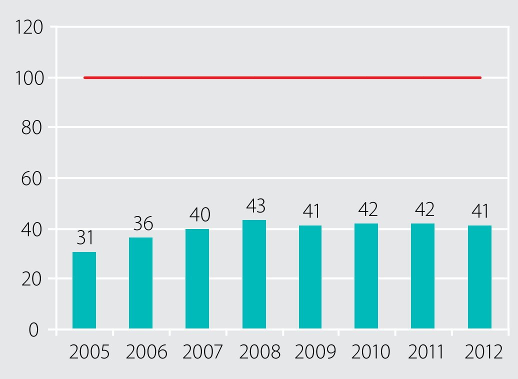
Growth in 2014 will primarily depend on four factors: inflow of foreign capital, credit supply (and the overall situation in the banking sector), the situation in industry and realisation of the announced investment projects in 2014. The inflow of capital, the main driver of the economy during the past several 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 unsold real estate attract foreign buyers remains an issue. Still, it should be noted that there are some important announcements when it comes to FDI inflows.

When it comes to the willingness of banks to grant loans, it is unreasonable to expect that they will make any significant changes to their prudent policies during 2014, 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. Direct and indirect effects of the investment projects (three at the Coast, together with the first section of the highway Bar-Boljare, and other projects) will be present in 2014 to the extent in which their implementation will start/continue.

As Table 2.5 shows, international financial institutions forecasted growth in 2014. However, the growth rate of 2.2% (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.

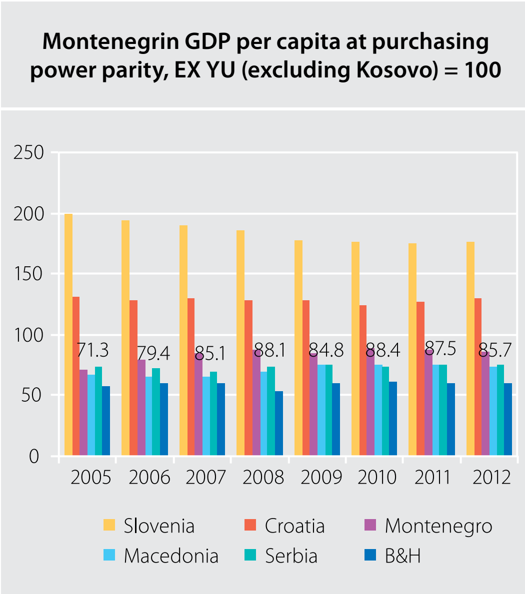
Graph 2.1

Montenegrin GDP per capita at purchasing power parity, EU28=100



Source: Eurostat

Graph 2.2



Source: Eurostat, CBCG rescaling

The document titled "Montenegro Pre-accession Economic Programme 2013-2016", published by the Ministry of Finance in January 2014, contains two macroeconomic scenarios, whereby the baseline scenario envisages real GDP growth rate of 3.6% in 2014, while the lower growth scenario, which also includes the abovementioned problems, forecasts a 1.6% growth.

Table 2.5

The latest Montenegro's GDP official estimates for 2014 given by the international financial institutions

Institution	Estimated growth rate in 2014, %
IMF	2.2
EBRD	2.0
European Commission	2.7

Table 2.6

Montenegro: selected economic indicators, 2012-2015

Indicator	2012	2013	2014	2015
		Projection		
Real GDP growth	-2.5	2.4	2.7	3.0
Unemployment rate (as a % of total labour force)	19.6	19.6	19.2	18.5
CPI	4.1	2.2	2.3	2.6
Current account deficit (% of GDP)	-18.6	-15.1	-15.3	-15.8
Fiscal deficit (% of GDP)	-5.6	-4.1	-2.5	-1.1
Public debt (%GDP)	54.0	56.8	57.9	59.0

Source: European Commission – Winter forecast 2014 (February 2014)

Table 2.7

Montenegro: selected economic indicators, 2008-2014 (projections under the assumption on the validity of current economic policy and for the future period)							
	2008	2009	2010	2011	2012	2013	2014
						Projection	
Real economy							
Nominal GDP (in EUR million)	3,086	2,981	3,104	3,234	3,276	3,411	3,567
Gross national savings (as % of GDP)	-10.0	-3.1	-2.6	-2.0	-1.5	0.3	1.8
Gross investments (as % of GDP)	40.7	27.1	22.8	19.5	20.3	21.0	21.9
(change in %)							
Real GDP	6.9	-5.7	2.5	3.2	-0.5	1.5	2.2
Industrial output	-2.0	-32.2	17.5	-10.3	-7.1	…	…
Tourism							
Arrivals	4.8	1.6	4.6	8.7	4.8	…	…
Overnights	6.9	-3.1	5.5	10.2	4.3	…	…
CPI (annual average)	9.0	3.6	0.7	3.1	3.6	3.4	2.9
CPI (period end)	7.2	1.7	0.7	2.8	5.1	3.3	2.3
GDP deflator	7.7	2.4	1.6	0.9	1.9	2.5	2.4
Average net salary (12 months average)[1]	23.1	11.3	3.5	1.0	0.6	…	…
Cash and loans (12 months average)							
Loans to private sector	25.0	-15.1	-8.9	-13.0	-3.1	0.2	1.0
Corporates	21.3	-18.0	-11.2	-20.3	-4.9	…	…
Households	31.2	-10.7	-5.7	-3.2	-1.1	…	…
Private sector deposits	-14.2	-4.1	5.9	1.2	7.2	…	…
(as a % of GDP)							
General Government finance, by invoiced realisation[2]							
Revenues and grants	48.4	42.5	41.3	38.5	38.4	38.9	39.0
Expenditures (including discrepancy)	51.6	47.8	45.9	43.8	42.7	41.2	42.1
Deficit/surplus	-3.2	-5.4	-4.6	-5.2	-4.3	-2.3	-3.2
Primary deficit/surplus	-2.4	-4.5	-3.6	-3.8	-2.5	-0.1	-0.5
Domestic financing (net)	2.1	-3.1	-1.4	0.7	-2.7	-4.7	0.0
Revenues from privatization	1.2	4.4	0.8	0.5	0.4	0.6	0.5
(as a % of GDP)							
Gross general government debt (end of period)	29.0	38.2	40.9	46.0	51.9	55.3	54.1
(as a % of GDP)							
Balance of payments							
Current account balance[3]	-49.8	-27.9	-22.9	-17.7	-17.9	-16.9	-16.4
Foreign direct investments	18.9	35.8	17.8	12.0	14.1	14.6	15.2
External debt (end of period)	90.8	93.5	96.4	101.4	108.4	113.3	113.6
of which: private sector[4]	75.2	70.0	67.0	68.5	68.9	68.9	68.6
Real effective exchange rate (based on CPI, average change in %)							
(minus refers to depreciation)	-3.1	5.2	2.8	-3.2	0.9	…	…
Additionally:							
Aluminium price (EUR/tonne)	1,892	1,143	1,644	1,822	1,533	1,495	1,542

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) Balance of payment data were revised at end 2012 for correcting non registered revenues from tourism which resulted in an average annual improvement of the current account of 1.7% of GDP for period 2009-2011.
4) Assessments, because private debt statistics is not published

Source: Taken from the Report of the IMF Mission within consultations pursuant to Article IV of the IMF Articles of Agreement, August 2013. (Original source: MF, CBCG, Monstat, EAM and the IMF assessments and forecasts)

Table 2.8

Montenegro, Vienna institute projections, February 2014					
Indicator	2011	2012	2013	2014	2015
				Projections	
Real GDP growth (%)	3.2	-2.5	2.5	2.1	2.9
Consumer prices (% y-o-y change)	3.1	4.1	2.2	3.8	3.0
Unemployment rate (as per Labour Force Survey)	19.7	19.7	20.0	19.0	19.0
Current account (% of GDP)	-17.7	-18.7	-15.0	-15.4	-15.4

Table 2.9

Real GDP growth, EBRD projections, %					
Country/Region	2012	Forecast for January 2014		Forecast for October 2013	
		2013	2014	2013	2014
Central Europe and Baltic states					
Croatia	-2.0	-0.7	1.0	-0.8	1.5
Estonia	3.9	1.2	2.8	1.2	2.5
Hungary	-1.7	1.2	1.7	0.5	1.2
Latvia	5.2	4.4	4.1	4.2	3.2
Lithuania	3.7	2.8	3.3	3.0	3.5
Poland	1.9	1.3	2.7	1.2	2.3
Slovakia	1.8	0.9	2.0	0.9	2.0
Slovenia	-2.5	-1.7	-2.0	-2.4	-2.5
Average	**1.2**	**1.1**	**2.2**	**0.9**	**1.9**
Southeast Europe					
Albania	1.6	1.5	1.7	1.2	2.0
Bosnia and Herzegovina	-0.5	0.8	1.8	0.1	1.8
Bulgaria	0.8	0.7	1.8	0.4	2.0
Macedonia	-0.3	3.0	3.0	2.4	2.7
Kosovo	2.5	2.5	3.5	2.5	3.5
Montenegro	**-0.5**	**1.5**	**2.0**	**1.5**	**2.0**
Romania	0.7	2.5	2.4	2.2	2.4
Serbia	-1.7	2.2	1.3	1.4	1.7
Average	**0.4**	**2.0**	**2.1**	**1.6**	**2.2**

The CBCG model estimate indicates that real GDP in 2014 will range from 3.2% to 3.8%, with the central projection of 3.5%. For the purpose of testing the central projection of GDP, a GDP estimate using consumption method was made. The main assumptions for the calculation using the consumption method include:

- Stagnation and insignificant growth of 0.3% of the households' spending. The stagnation of income based on wages and pensions will affect the households' spending. This spending may slightly increase as a result of certain new employment due to the strengthening of investment activity, particularly in the second half of the year;

- The share of public spending in this period may grow as a result of expenditures for financing the first section of the highway, which will be implemented through capital budget. Still, multiplication investment effects will influence the fiscal revenues growth and no major fiscal burdens are expected;
- Growth in investments in fixed assets due to intensified purchase of investment equipment and plants needed for the construction of the announced major projects;
- Changes in inventories will be at the same level as the ones in 2013;
- Exports of goods and services will gradually grow as a high basis of visible exports from 2013 occurs. Imports will show weak growth and it will be under the influence of intensified import of investment equipment and substitution of import of food by domestic production.

According to the consumption method, GDP will grow at a rate of 3.5% in 2014, which confirms the validity of the central projection of GDP growth.

On the other hand, the weighting of estimated real GDP growth rate of international institutions and agencies shows that Montenegro's GDP growth in 2014 will amount to 2.3%.

2.2. Inflation

After a continuous and expressed deflation over the year, the annual inflation rate in December 2013 fell to 0.3% relative to 5.1% from December 2012. The inflation rate of this year resulted from a rather diversified trend in the prices of products and services included in Montenegro`s CPI, whereby significant deviations existed within these categories. The price growth primarily arose from an increase in the prices from the category "alcoholic beverages and tobacco" of 7.4% (due to higher tobacco prices and due to increase in excises on tobacco and tobacco products), "housing" of 1.7% (due to the higher prices of electricity), "other products and services" of 3% (due to increase in prices of electrical appliances for personal care and other products and appliances for personal care), and "health" of 1.4% (due to increase in prices pharmaceutical products).

A decline in inflation primarily resulted from a decline in the prices of products from the category "food and non-alcoholic beverages" of 0.6% although the prices of products from this category trended differently. Among them, the most important was decline in the prices of milk, cheese and eggs, oils and fats, bread and grains. A decline in these prices was "higher" than the growth in vegetable prices, a sub-group which has had the most important influence on the general growth in the prices with weight of 3.84% and the price growth of 11.3%. In addition to food and beverages, the largest influence on a decline in inflation had the decline in the prices from the category "transport" of 1.1% (due to a decline in the prices of fuels and lubricants, and maintenance and repair of vehicles), and "recreation and culture" of 2.7% (due to decline in prices of books).

Graph 2.3

Consumer prices, annual growth rate, %

Source: Monstat

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

Table 2.10

Share of individual categories in total inflation				
	Weight	Growth rate DEC 13 / DEC 12	Share in percentage points	Share in %
TOTAL	1,000	0.3	0.3	100.0
Food and non-alcoholic beverages	386.4	-0.6	-0.23	-81.0
Alcoholic beverages and tobacco	37.9	7.4	0.28	96.8
Clothes and footwear	70.7	0.3	0.02	7.4
Housing, water, electricity, gas and other fuels	153.1	1.7	0.26	91.1
Furnishing and household equipment	46.9	-0.1	-0.01	-2.4
Health	38.2	1.4	0.05	18.1
Transport	101.0	-1.1	-0.11	-38.2
Communication	57.1	-0.7	-0.04	-12.8
Recreation and culture	27.2	-2.7	-0.07	-25.3
Education	15.7	0.2	0.00	1.0
Restaurants and hotels	23.0	0.1	0.00	0.5
Miscellaneous goods and services	42.8	3.0	0.13	44.8

Source: Monstat, CBCG calculations

According to the harmonised CPI (methodological standard in the EU/euro area, which differs somewhat from the CPI), the annual inflation rate in Montenegro amounted to 0.4%, after 4.4% from December 2012. For the purpose of comparison, the annual inflation rate in Montenegro in December 2013 was lower than the inflation rate in the EU and the euro area (1% and 0.8% respectively). It was also lower than in Slovenia (0.9%) and Croatia (0.5%), and also compared to the one recorded in other regional candidate and potential EU candidate countries, other than Bosnia and Herzegovina where deflation was recorded.

Table 2.11

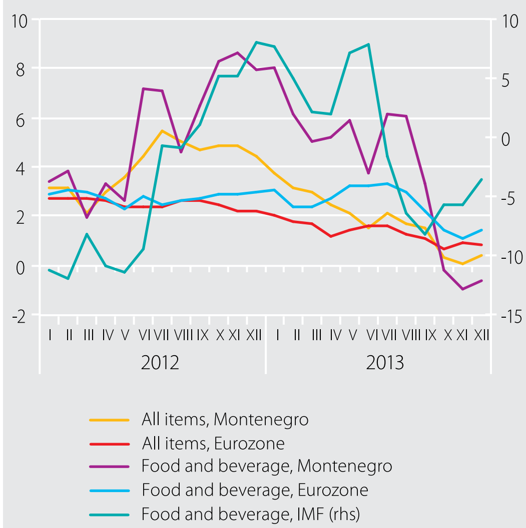
CPI (HCPI) of selected countries, %									
	XII `08 / XII `07	XII `09 / XII `08	XII `10 / XII `09	XII `11 / XII `10	XII `12 / XII `11	III `13 / III `12	VI `13 / VI `12	IX `13 / IX `12	XII `13 / XII `12
EU	2.2	1.4	2.6	3.0	2.3	1.9	1.7	1.3	1.0
Euro area	**1.6**	**0.9**	**2.2**	**2.7**	**2.2**	**1.7**	**1.6**	**1.1**	**0.8**
Croatia	2.9	1.9	1.8	2.1	4.7	3.4	2.2	1.7	0.5
Slovenia	1.8	2.1	2.2	2.1	3.1	2.0	2.2	1.5	0.9
Montenegro	**6.9**	**1.5**	**0.7**	**2.8**	**5.1**	**3.3**	**2.2**	**1.8**	**0.3**
Macedonia	4.1	-1.6	3.0	2.8	4.7	3.1	4.2	1.6	1.4
Serbia	8.6	6.6	10.3	7.0	12.2	11.2	9.8	4.9	2.2
Albania	2.2	3.5	3.4	1.7	2.4	2.4	2.3	1.7	1.9
Bosnia and Herzegovina	3.8	0.0	3.1	3.1	1.8	0.6	1.0	-0.5	-1.2
Kosovo	0.5	0.1	6.6	3.6	3.7	2.6	2.6	0.2	0.5

Source: Statistical Offices

The category "food" remained the most important category – factor of total inflation rate having weight of 38.6% for CPI, i.e. 33.1% for the HCPI (which was even higher in the previous period). In the euro area, in accordance with the average household spending and its spending for food and non-alcoholic beverages, the same weight amounted only to 15.4%. Consequently, global changes in food prices are less reflected on the general inflation in the euro area compared to Montenegro. Moreover, deviation in the food prices` trending in Montenegro relative to the euro area resulted from many factors: stocks and their relative size, possibility of substitution and preferences towards the substitution, geographic position and transport costs, development of competition with importers and retailers, changes in tax, customs, administrative and other economic policy measures, current overall situation in the economy, and sometimes difference in the structure of the same category "food and non-alcoholic beverages", and other economic and other factors. Speaking about the difference compared to global food prices, changes in the EUR/USD exchange rate remain another important deviation factor.

Graph 2.4

General inflation trend and food products inflation in Montenegro and euro area, together with IMF food and beverage index; HIPC, %, annual rate



Source: Monstat, Eurostat, IMF

The IMF forecasts decline in food prices (stock exchange standardised products) of 10.4% during 2014, after which the stagnation is expected. Somewhat low level of prices of oil and other energy products is expected. Therefore, from this aspect, deflationary effects should be expected globally in 2014.

The Fan Chart showing inflation in Montenegro based on the ARIMA model assessment for 2014 shows 90% probability that CPI inflation, depending on the month, will range between -0.5% and 2.2%. Also, the inflation ranging between -0.2% and 2.2% is forecasted for end-2014. Namely, as the time span for forecasting increases, uncertainty increases as does the forecast span for projections.

Assumptions referring to inflation forecast (nominal annual growth) for 2014 include:

1. In addition to the international institutions' assumptions that no significant growth in food prices will occur, the model inflation projections assumes seasonal oscillations of agricultural products;
2. Although it is assumed that the prices of oil and oil derivatives will not be increased in 2014, due to geopolitical tensions, we assumed that the prices of oil and oil derivatives will increase up to 5%;
3. Bearing in mind uncertainty of weather conditions, growth in electricity prices is assumed of 5%;
4. Real wages increase in 2014 will be at the 2013 level;
5. The real estate prices will remain stagnant and slightly decline,
6. 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, it is expected that the inflation rate in 2014 will range between 0% and 3%. However, as the Fan Chart is curved to lower inflation levels, our expert assessment is not symmetric, but a more central (realistic) projection is close to lower threshold of the expected inflation rate.

2.3. Fiscal deficit/surplus

The impact of the global economic crisis resulted in the non-implementation of fiscal projections as per the planned volume and dynamics also in 2013. Thus in 2013, the budget of Montenegro was characterized by a larger deficit than planned, partially as a result of calling upon guarantees granted to KAP[10]. On the other hand, better VAT collection and contributions relative to the plan, and certain savings enabled easing of the effects of calling upon the guarantees and prevented higher fiscal deficit.

Table 2.12

Fiscal surplus/deficit						
Description/Period	2009	2010	2011	2012	Projection 2013	Projection 2014
Current revenues (in million €)	1,169.3	1,140.4	1,129.1	1,121.0	1,235.1	1,268.1
Expenditures (in million €)	1,301.4	1,252.6	1,318.8	1,333.9	1,363.5	1,337.6
Deficit/surplus (in million €)	-132.1	-112.2	-189.7	-212.9	-128.3	-69.5
Deficit/surplus (as % share in GDP)	-4.4	-3.6	-5.9	-6.8	-3.8	-2.0

Source: Ministry of Finance

Source (current) budget revenues in 2013 amounted to 1.235.1 million euros or 37.0% or the estimated GDP[11]. These revenues were 6.3% higher than planned due to the higher collection of VAT (56.1 million euros or 15.1%) and contributions for pension and disability insurance (15.1 million euros or 6.7%). These revenues recorded the y-o-y increase of 10.2%.

The estimates of the Ministry of Finance show that the total budget revenues amounted to 1.605.2 million euros or 48.1% of the estimated GDP in 2013.

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

[11] Estimated GDP for 2013 amounts to 3.336 million euros.

Table 2.13

Revenues of the Budget in 2013							
Type of revenue	Realisation in 2013	Share in GDP	Share in revenues*	Plan for 2013	Realization in relation to plan	Realization in 2012	Realization in 2013/2012
	in million €	%	%	in million €		in million €	
Taxes	755.7	22.7	61.2	700.4	107.9	687.4	109.9
Personal income tax	95.6	2.9	7.7	90.9	105.2	82.3	116.2
Corporate profit tax	40.6	1.2	3.3	41.9	96.9	64.0	63.5
Real estate turnover tax	1.4	0.0	0.1	1.5	94.7	1.4	99.9
VAT	429.2	12.9	34.7	373.0	115.1	354.7	121.0
Excise tax	161.4	4.8	13.1	157.4	102.5	151.8	106.4
International trade and transactions tax	22.3	0.7	1.8	31.2	71.4	29.0	76.9
Other Republic taxes	5.1	0.2	0.4	4.4	115.4	4.3	118.9
Contributions	398.5	11.9	32.3	384.2	103.7	362.3	110.0
Contributions for pension and disability insurance	241.9	7.3	19.6	226.8	106.7	216.5	111.8
Contributions for health insurance	134.7	4.0	10.9	133.9	100.6	125.7	107.1
Contributions for unemployment	10.8	0.3	0.9	11.2	96.0	10.0	107.8
Other contributions	11.1	0.3	0.9	12.2	90.6	10.0	110.5
Duties	27.1	0.8	2.2	29.1	93.1	18.0	150.4
Fees	13.2	0.4	1.1	13.9	95.5	12.7	104.2
Other revenues	33.1	1.0	2.7	29.4	112.5	35.1	94.2
Receipts from loan repayment and funds transferred from the previous year	7.6	0.2	0.6	4.8	157.3	5.5	137.6
CURRENT REVENUES	1,235.1	37.0	100.0	1,161.8	106.3	1,121.0	110.2
Borrowings and loans from domestic sources	102.8	3.1	6.4	0.0	---	63.5	162.1
Borrowings and loans from abroad	230.5	6.9	14.4	250.0	92.2	258.1	89.3
Donations	6.6	0.2	0.4	0.0	---	5.0	131.4
Revenues from privatization	11.9	0.4	0.7	8.0	149.4	3.5	343.9
Growth (-) /use (+) of Government deposits	18.2	0.5	1.1	-44.0	-41.3	0.9	2,015.4
TOTAL BUDGET REVENUES	1,605.2	48.1	100.0	1,375.8	116.7	1.452.0	110.6

* As a share in current revenues and for other types of revenues (revenues from privatisation, donations and borrowings and loans, use of Government deposits) as a share in total revenues.

Source: Ministry of Finance

In 2013, budget expenditures[12] amounted to 1.363.5 million euros or 40.9% of the estimated GDP. When it comes to expenditures, there is an increase of 2.2% as compared to 2012. Compared to the plan, the expenditures were 8.5% higher (106.4 million euros), and the deviation is mainly a result of the aforesaid calling of the Government guarantees for loans (107.2 million euros, while in 2012, some 24.7 million euros was spent for these purposes).

[12] Total expenditures less debt repayment.

Table 2.14

Budget expenditures in 2013							
Type of expenditures	Realisation in 2013	Share in GDP	Share in revenues*	Plan for 2013	Realisation in relation to plan	Realisation in 2012	Realization in 2013/2012
	in million €	%	%	in million €		in million €	
Current expenditures	600.3	18.0	44.0	592.6	101.3	667.0	90.0
Gross salaries and contributions charged to employer	366.1	11.0	26.9	372.1	98.4	374.7	97.7
Other personal earnings	12.0	0.4	0.9	10.5	114.7	10.1	119.5
Expenses for material and services	90.4	2.7	6.6	82.0	110.3	150.5	60.1
Current maintenance	20.4	0.6	1.5	20.5	99.8	22.5	90.6
Interest	67.4	2.0	4.9	70.4	95.8	56.9	118.6
Lease	7.9	0.2	0.6	7.9	100.7	7.1	111.5
Subsidies	17.4	0.5	1.3	14.2	122.5	25.9	67.4
Other expenditures	6.3	0.2	0.5	5.8	109.0	13.4	46.9
Capital expenditures of current budget and state funds	12.2	0.4	0.9	9.3	131.1	-	-
Transfers for social protection	483.0	14.5	35.4	497.9	97.0	481.6	100.3
Transfers to institutions, individuals, NGOs and public sector	94.3	2.8	6.9	91.9	102.6	31.5	299.3
Total capital expenditures	61.8	1.9	4.5	65.6	94.1	76.0	81.3
Borrowings and loans	2.8	0.1	0.2	1.7	160.0	1.8	155.0
Reserves	14.1	0.4	1.0	7.4	192.0	18.1	78.1
Net increase of liabilities	0.0	0.0	0.0	-95.3	0.0	33.1	0.0
Repayment of guarantees	107.2	3.2	7.9	0.0	---	24.7	433.8
EXPENDITURES	1,363.5	40.9	100.0	1,257.1	108.5	1,333.9	102.2
Repayment of debts to residents	112.7	3.4	7.0	23.8	473.5	60.6	185.9
Repayment of debts to non-residents	68.8	2.1	4.3	62.7	109.7	54.9	125.4
Repayment of liabilities from previous period	60.3	1.8	3.8	32.2	187.3	2.6	2,293.6
TOTAL EXPENDITURES	1,605.2	48.1	100.0	1,375.8	116.7	1,452.0	110.6

* As share in expenditures and with other type of outflows (debt repayment) as share in total outflows.
Source: Ministry of Finance

According to the Ministry of Finance's estimates, the Budget of Montenegro ran a deficit of 128.3 million euros or 3.8% of GDP in 2013, being one percentage point higher than planned. This was the five subsequent year of fiscal deficit, while the average level of deficit during these five years amounted to 4.9% of GDP. Also, this is the fifth consecutive year of the primary budget deficit (balance between deficit and interest expenditures). However, the fact that the budget deficit was lower than last year even besides the calling of guarantees and a high level of extraordinary expenditures remains encouraging. If it had not been for vulnerabilities from the previous period (guarantees and payments based on court decisions), the budget deficit would have been below 1% of GDP, which would be among the best results in Europe.

Moreover, the repayment of debt amounted to 241.8 million euros (this amount is not included in the 2013 deficit), thus the total lacking funds in 2013 amounted to 370.1 million euros or 11.1% of GDP. This amount was financed from foreign borrowings (230.5 million euros), borrowings from domestic sources (102.8 million euros), use of Government deposits (18.2 million euros), the sale of state property (11.9 million euros) and donations (6.6 million euros).

Pursuant to the Budget of Montenegro Law for 2014, a deficit is planned in the amount of 69.5 million euros (2.0% of GDP), and since 73.3 million euros is planned for interest payments (an expenditure that refers to the budget execution and planning in the previous year), a slight primary budget surplus is planned for 2014 (3.8 million euros). Still, it will be a real challenge to remain within these deficit limits (and make primary surplus) since, inter alia, the budget execution on both revenues and expenditure sides were not made according to the plan.

Table 2.15

Plan of main Budget categories for 2014, in million euros	
Current revenues	**1,268.1**
Taxes and contributions	1,195.7
Other revenues	72.4
Expenditures	**1,337.6**
Current budget spending	1,235.8
Capital budget of Montenegro	101.8
Deficit	**69.5**
Primary surplus	**3.8**
Debt repayment	**171.4**
Principal repayment to residents	30.0
Principal repayment to non-residents	108.1
Repayment of liabilities from the previous period	33.3
Lacking funds	**241.0**
Financing	**241.0**
Borrowings and loans from foreign sources	228.0
Donations	8.0
Revenues from privatisation and sale of property	5.0

Source: Budget of Montenegro Law for 2014 (OGM 61/2013)

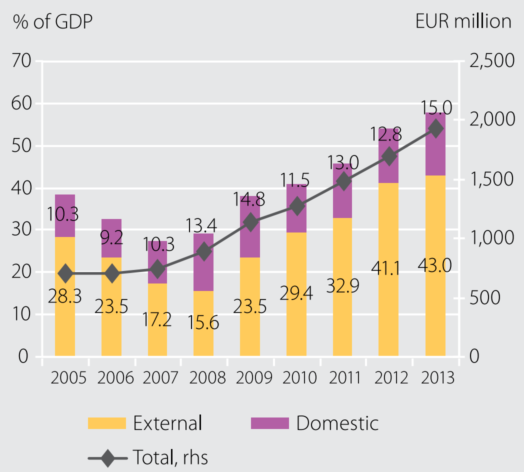
2.4. Public Debt

Since fiscal deficits automatically spill over to debt and thus increase it, the public debt of Montenegro also increased in 2013 and, according to the Ministry of Finance data, reached over 1.9 billion euros or 58% of the estimated GDP for 2013. In relation to end-2012, the public debt grew by 13.8%, and the public debt is expected to grow in 2014. In the period 2008-2013, debt grew by 30.5 percentage points (from 27.5% to 58% of GDP), and currently it is close to Maastricht criteria (60% of GDP), although it is still lower compared to the majority of the EU countries.

Domestic debt increased by 96.2 million euros during 2013 or 23.8%, primarily due to an increase in debt of local self-governments and debt based on loans with commercial banks, each over 50 million euros.

Graph 2.5

Public debt trend, end-period



Source: Ministry of Finance

The external public debt amounted to 1.433 million euros or 43% of GDP. In relation to end-2012, it increased by 138 million euros or 10.7%, mostly due to the new issue of Eurobonds (December 2013) in the amount of 80 million euros, and credit arrangement with Deutsche bank in the amount of 60 million euros signed in July 2013 when urgent funds were needed for the payment of the guarantees based on loans for KAP.

Table 2.16

Domestic debt structure, 31 December 2013 (as per debt balance)				
Creditor	Domestic debt, in million €	GDP %	Public debt %	Total public debt %
Local self-government debt	135.9	4.1	27.1	7.0
Loans with commercial banks	102.9	3.1	20.6	5.3
Liabilities for indemnification	90.2	2.7	18.0	4.7
Treasury bills	78.4	2.4	15.7	4.1
Frozen foreign currency deposits	68.9	2.1	13.8	3.6
Loans with non-financial institutions	18.0	0.5	3.6	0.9
Labour Fund bonds	4.6	0.1	0.9	0.2
Accrued pensions	1.8	0.1	0.4	0.1
TOTAL	**500.7**	**15.0**	**100.0**	**25.9**

Source: Ministry of Finance

Table 2.17

External debt structure, 31 December 2013 (as per debt balance)					
Creditor	External debt, million €	Undrawn funds, million €	% GDP	% of external public debt	% of external public debt
EUROBOND	460.0	0.0	13.8	32.1	23.8
Credit Suisse	242.0	0.0	7.3	16.9	12.5
International Bank for Reconstruction and Development (IBRD)	235.6	23.3	7.1	16.4	12.2
Member countries of the Paris Club of Creditors*	98.8	0.0	3.0	6.9	5.1
European Investment Bank (EIB)	96.3	39.5	2.9	6.7	5.0
International Development Association (IDA)**	61.4	0.2	1.8	4.3	3.2
Deutsche bank	60.0	0.0	1.8	4.2	3.1
Erste	27.8	0.0	0.8	1.9	1.4
EUROFIMA	20.8	0.0	0.6	1.5	1.1
Czech Republic's EXIM	19.7	0.0	0.6	1.4	1.0
EBRD	18.6	18.5	0.6	1.3	1.0
German development bank (KFW)	18.3	78.6	0.5	1.3	0.9
Steiermarkische Sparkassen	16.5	0.0	0.5	1.2	0.9
Hungarian loan	10.4	0.0	0.3	0.7	0.5
Council of Europe Development Bank	9.1	0.0	0.3	0.6	0.5
Polish loan	9.0	0.0	0.3	0.6	0.5
Erste Health Fund	8.6	0.0	0.3	0.6	0.4
French loan – Natixis	8.1	0.0	0.2	0.6	0.4
The European Community	5.5	0.0	0.2	0.4	0.3
ICO Deponija	5.0	0.0	0.1	0.3	0.3
Exim Ante Đedović	1.0	0.0	0.0	0.1	0.1
International Finance Corporation (IFC)	0.6	0.0	0.0	0.0	0.0
TOTAL	**1,433.0**	**160.0**	**43.0**	**100.0**	**74.0**

* As at 31 December 2013, 26.3% of debt was denominated in USD, CHF and NOK.
** Debt was denominated in SPV, thus directly into USD, EUR, GBP and JPY.

Source: Ministry of Finance

Clearly, the dynamics of deficit and further increase of debt must be balanced in the forthcoming period. Also, it should be borne in mind that an increase in public revenues and a decrease in expenditures would pressure the financial system, i.e. the banking sector as its key part primarily through deterioration of the financial position of the non-financial private sector and the impact on irregular loan repayment.

Box 2.1 – Credit rating of Montenegro

Montenegro was assigned a BB- credit rating in foreign currency by Standard and Poor's (S&P) at end-2013. Montenegro's credit rating did not change during 2013, and it has been the same since June 2012 after its decline from BB to BB–. However, at end-November 2013, outlook was downgraded from stable to negative. BB+/stable assigned in March 2007 was the highest rating since S&P has been assigning rating to Montenegro, i.e. since December 2004.

BB– is a "non-investment speculative grade" where "an obligor is less vulnerable in the near term than other lower-rated obligors. However, it faces major ongoing uncertainties and exposure to adverse business, financial, or economic conditions, which could lead to the obligor's inadequate capacity to meet its financial commitments". Negative outlooks mean that there is possibility (but not uncertainty) that the rating will be downgraded in the next 6 to 24 months.

Compared to other regional countries, Montenegro belongs to a group of countries with worse rating together with Macedonia and Serbia at end-2013, whereas Macedonia has a stable outlook. Greece ranks the last with B minus rating. However, other regional countries are in no better position compared to Montenegro. Only Slovenia and Bulgaria had investment grade (A minus and BBB, respectively), while the rating for Croatia as the latest EU member was state downgraded to BB inJanuary 2014.

Table 1

S&P long-term foreign currency credit rating for regional countries (as at end-2013; as per rating)

Country	Rating	Issue date	Outlook	Issue date
Slovenia	A–	12.02.2013	Stable	12.02.2013
Bulgaria	BBB	30.10.2008	Negative	13.12.2013
Romania	BB+	27.10.2008	Positive	22.11.2013
Croatia	BB+	14.12.2012	Negative	02.08.2013
	(BB)	(24.01.2014)	(Stable)	(24.01.2014)
Macedonia	BB–	24.05.2013	Stable	24.05.2013
Montenegro	**BB–**	**13.06.2012**	**Negative**	**29.11.2013**
Serbia	BB–	07.08.2012	Negative	07.08.2012
Bosnia and Herzegovina	B	28.03.2012	Stable	28.03.2012
Albania	B	06.12.2013	Negative	06.12.2013
Greece	B–	18.12.2012	Stable	18.12.2012

Source: Bloomberg

Guarantees

At end-2013, foreign guarantees of Montenegro amounted to 279.6 million euros or 8.4% of GDP, i.e. 14.5% of total public debt. The amount of funds that have not been withdrawn yet should also be taken into account and which will be guaranteed by the Government in the case of withdrawal. This refers to the amount of 121.4 million euros (3.6% GDP), i.e. 6.3% of total public debt.

Table 2.18

Foreign guarantees as at 31 December 2013, in EUR (as per debt balance; risk guarantees are in blue)

Creditor	Loan	Borrower	Year of signing	Contracted amount	Withdrawn	Debt balance per loan
EIB	SMEs through commercial banks	Commercial banks	2009	90,000,000	90,000,000	75,771,740
EXIM Kina	Purchase and repair of ships	Crnogorska plovidba	2010	34,385,798	34,385,798	*34,385,798
WTE Wassertechnik	Waste water management project	Budva Municipality	2010	29,250,000	29,250,000	29,250,000
EIB	Project of European Roads	Monteput	2004	24,000,000	24,000,000	21,480,014
KfW	EPCG – Replacement of filters in Thermal Power Plant Pljevlja I expansion of substations Podgorica-Ribarevine	EPCG	2008	15,000,000	14,181,782	13,431,782
EBRD	Montenegro Rail Infrastructure urgent rehabilitation 2	Rail Infrastructure Jsc Podgorica	2009	15,000,000	12,477,787	12,477,787
EBRD	Project of purchasing electromotor units and diagnostic equipment	Railway transport	2010	13,550,000	12,304,396	12,304,396
EXIM Kina	Purchase and repair of ships	Barska plovidba	2013	33,663,200	9,280,000	*9,280,000
KfW	NLB	NLB	2009	16,000,000	16,000,000	9,090,909
EIB	Airports Modernisation	Airports of Montenegro	2004	12,000,000	11,000,000	8,866,667
KfW	Erste banka	Erste banka	2009	15,000,000	15,000,000	6,818,182
EBRD	Regional Water Supply Project – Phase I of the Construction of the Southern Branch	Regional Water supply – first tranche	2007	8,000,000	8,000,000	6,000,000
EIB	Power System Reconstruction	EPCG	2002	11,000,000	8,023,090	5,974,324
EBRD	Regional Water Supply Project – Phase II of the Construction of the Southern Branch	Regional Water supply – second tranche	2008	7,000,000	7,000,000	5,541,667
KfW	EPCG-Piva	EPCG	2007	16,000,000	5,453,382	5,453,382
Abu Dhabi fund	Water supply project	Regional Water Supply	2010	8,611,979	4,661,506	**4,661,506
Czech Export Bank	Completion of the railroad Podgorica-Nikšić	ZICG	2011	5,000,000	4,978,102	4,480,292
EBRD	Airports Modernisation	Airports of Montenegro	2003	11,000,000	10,235,127	4,258,821
KfW	EPCG - Substation Podgorica -Ribarevine	EPCG	2007	5,400,000	4,586,898	3,405,648
EBRD	Montenegro Rail Infrastructure Rehabilitation Project - Phase III	Rail company of Montenegro - third tranche	2010	4,000,000	3,509,248	3,383,917
	Montenegro Rail Infrastructure Rehabilitation Project - Phase III Annex	Rail company of Montenegro - third tranche	2012	10,000,000		
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	2,375,000
KfW	EPCG-Perućica	EPCG	2003	3,580,000	3,580,000	796,000
EIB	Montenegro Rail Infrastructure Rehabilitation	Rail company of Montenegro	2010	7,000,000	134,000	134,000
EBRD	Credit line for deposit protection	Deposit protection fund	2010	30,000,000	0	0
KfW	Interconnection cable	Montenegrin Electrical Transmission System	2013	25,000,000	0	0
OTP	KAP	KAP	2009	49,680,000	49,680,000	0
VTB	KAP	KAP	2010	60,000,000	60,000,000	0
	TOTAL			562,120,977	440,721,115	279,621,831

* Debt is denominated in USD.
** Debt is denominated in AED, but with fixed exchange rate against USD.

Source: Ministry of Finance

If domestic guarantees were added to the amount, total guarantees would amount to 303.6 million euros at end-2013 or 9.1% of GDP. Thus, the sum of total public debt and total guarantees amounted to 67.1% of the estimated GDP for 2013.

Table 2.19

Domestic guarantees as at 31 December 2013, in EUR (as per debt balance; risk guarantees are in blue)

Creditor	Borrower	Year of signing	Contracted amount	Withdrawn	Debt balance per loan
NLB Montenegrobanka	Bauxite Mines a.d. Nikšič	2009	5,000,000	5,000,000	5,000,000
NLB Montenegrobanka	Melgonia-Primorka	2010	4,000,000	4,000,000	4,000,000
Erste banka a.d. Podgorica	Pobjeda a.d. Podgorica	2010	3,500,000	3,500,000	3,500,000
Hipotekarna banka a.d.	Montenegro Airlines	2009	2,700,000	2,700,000	2,700,000
Hipotekarna banka a.d.	Montenegro Airlines	2011	2,000,000	2,000,000	1,802,534
NLB Montenegrobanka	Montenegro Airlines	2010	1,800,000	1,800,000	1,487,282
Podgorička banka	Pobjeda a.d. Podgorica	2009	2,970,000	2,970,000	1,446,503
NLB Montenegrobanka	Montenegro Airlines	2011	2,400,000	1,410,000	1,410,000
Prva banka a.d. Podgorica	Montenegro Airlines	2013	1,200,000	1,200,000	1,200,000
CKB a.d. Podgorica	Adriatic Shipyard a.d. Bijela	2012	1,050,000	1,050,000	875,000
Investment and Development Fund	Crnogorska plovidba a.d. Kotor	2011	1,500,000	1,000,000	518,298
Hipotekarna banka a.d.	MI-RAI GROUP DOO NIKŠIĆ	2010	800,000	800,000	0
Hipotekarna banka a.d.	MI-RAI GROUP DOO NIKŠIĆ	2011	700,000	700,000	0
Erste banka a.d. Podgorica	Electrode Factory "Piva" Plužine	2011	1,500,000	1,500,000	0
Hypo Alpe Adria banka	Lenka a.d. Bijelo Polje	2011	525,000	525,000	0
TOTAL			31,645,000	30,155,000	23,939,616

Source: Ministry of Finance

As the CBCG pointed earlier, the risk of calling of certain guarantees realised also in 2013. The largest amount referred to two remaining guarantees for loans granted to KAP in the amount of slightly above 102 million euros. However, some domestic guarantees were called just before the end of the year: two for loans to company MI-RAI Group, and one for each loan granted to the Electrode Factory Piva and company Lenka. Also, the loan guarantee for Railway Transport of Montenegro was taken over. Overall, 107.2 million euros was used in 2013 for the payment of (principal) the remaining debt on the called guarantees.

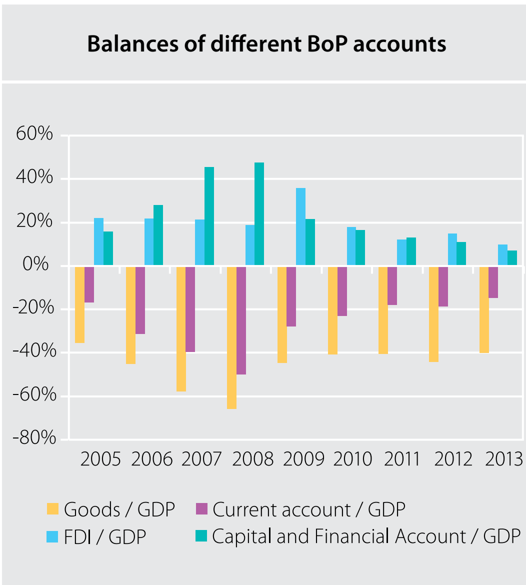
Further risk of calling of the issued guarantees represents a particular concern. When it comes to the issuing of new guarantees, the implementation of a rather restrictive approach which has started after 2011 is something that should be dealt with in the following period.

2.5. Balance of payments

The current account deficit recorded a significant decrease in 2013. Observed through the structure of the current account, a decrease in the deficit was mostly a result of a decline in trade deficit and an increase in the services account surplus, while changes in the balances of other sub-accounts of the current account were insignificant.

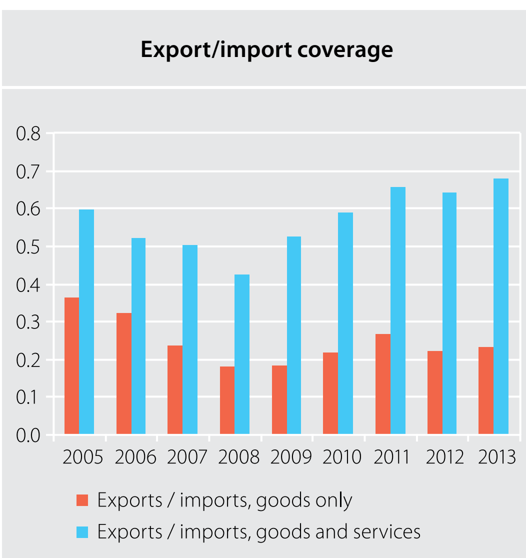
Preliminary data show that the current account deficit amounted to 486.9 million euros, which is 17.1% less than in 2012. The current account deficit's share in GDP amounted to 14.6%, which represents an ongoing downtrend in this share (18.7% in 2012).

Graph 2.6



Source: CBCG

Graph 2.7



Source: CBCG

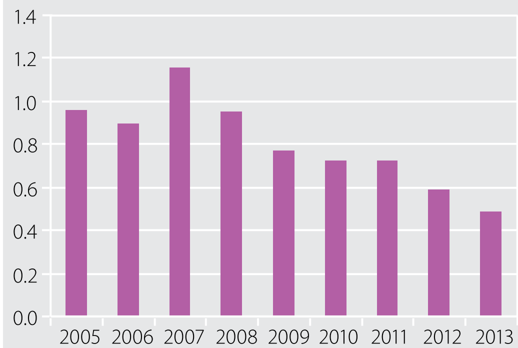
Foreign trade recorded an increase in exports (2.8%) and a decline in imports (2.7%), whereas the decline in imports was more significant in absolute terms. In terms of structure, the biggest change refers to a decline in revenues from the export of aluminium and almost the same level of growth in revenues from the export of electricity, to the extent that Montenegro was a net exporter of electricity in 2013. Other changes in the structure of imports were insignificant compared to 2012. Simultaneously, the largest change in the structure of imports referred to a lower import of electricity and a decline in expenditures from the import of oil and oil derivatives. The import/export coverage amounted to 23.2%, representing an increase of 1.2 percentage points relative to 2012. However, a still moderate export/import ratio points to the necessity of a further promotion and stimulation of investments in export-oriented and/or import substitution production, i.e. above all, the necessity of an increase in competitiveness of domestic producers and productivity of the domestic labour force. The compensation of trade deficit with the surplus in the services account cannot be an optimal option since the economy would be more balanced, diversified, and more resilient with a wider and more competitive spectrum of products.

An increase in external demand positively affected trends in the services account which recorded a surplus increase of 5.6% (646.8 million euros), primarily due to higher net revenues from the construction services (by 34.5 million euros, after a decline of 1.5 million euros in 2012) and travel-tourism revenues (by 2.8%, i.e. 17 million euros). The coverage of the foreign trade deficit with surpluses recorded in other sub-accounts amounted to 63.4% in 2013, which is 5.7 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 2013, mostly due to the decline in inflows based on equity investments in companies and banks, FDI net inflow recorded a decline by 29.8% compared to the previous year. FDI net inflow thus amounted to 323.9 million euros or 9.7% of GDP. The portfolio investments account recorded a net inflow of 42 million euros, which is 66.7 million euros more in comparison to 24.7 million euros of net outflow in 2012. This was mostly due to the issue of Eurobonds in the amount of 80 million euros in Q4 2013. At the same time, the account of other investments recorded a net outflow of 54.6 million euros, which is similar to net outflow of 55.1 million euros in 2012.

Graph 2.8

Coverage of current account deficit by the surplus in the capital and financial account (deviation of 1 is owed to net errors and omissions)



Source: CBCG

Trends in the balance of payments in the following period will depend on trends in the international capital markets and financial soundness and expectations for the domestic economy and government sector. Considering that considerable FDI inflows in the past years came from the EU countries, negative trends in these countries may influence a further decrease in capital inflows. Taking into account a high correlation between capital inflows and economic growth, a decrease in capital inflows represents a threat to sustainability of Montenegro's growth model which is based on large spending and imports.

Thus, the current account deficit is not necessarily negative in a situation in which it is connected with the balanced current (and/or future) economic growth. The structure of imports is important –in general, worse situation is the one in which the import of investment goods (or consumer goods for investment purposes) is neglected to the benefit of consumer goods. The manner and sustainability of financing are also important: equity investments are, as a rule, more desirable than debt investments, particularly if indebtedness is more significant. The balance of payments trends alone do not represent a threat to financial stability in the case of Montenegro, but they still point to the need for economic reforms and implementation of the growth model of the economy.

2.6. Real estate market

The real estate prices declined in 2013 after a three-year period of stagnation. Analysis of the chain index of real estate price trends shows that the stagnation of prices stopped in Q2 2013, with upward or downward fluctuations up to 5%, which lasted from September 2010 until March 2013. In June 2013, an average real estate price[13] in Podgorica amounted to 1.069.8 euros/m^2, which indicates a q-o-q de-

[13] 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.

cline of 8.5%. The decline in real estate prices in Podgorica resulted primarily from the decline in the prices of apartments at attractive locations in Zone 1 and Zone 2.

Table 2.20

Summary statistics of the average value of apartments in Podgorica, € /m²

Period	Prices in €	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
Mart 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
Jun 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
March 2013	1,169.4	99.9	68.9
June 2013	1,069.8	91.5	63.1

Source: CBCG

According to estimates of real estate agencies, the market turnover declined in 2013 in relation to 2012 and 54.6% of the surveyed agencies recorded decline in turnover in 2013, while the remaining portion of the surveyed agencies recorded a stagnation in the turnover over the same period.

A considerable supply of residential premises still existed in the real estate market in 2013, while a demand was limited due to the lack of funds for the purchase of real estate. The demand was highly differentiated, since there is a demand for specific buildings. Consequently, a high demand started to adjust to a very exigent and extensive supply through a decline in the prices of residential premises.

Table 2.21 shows that, depending on the level of significance, the zone to which a residential unit belongs influences the price of that unit. Moreover, the number of rooms, internet access, ownership of garage, balcony and the floor of the location of the residential unit also affect the price. Robustness tests show that the model (as shown in the table below) is well-specified and that there is no problem with multicolinearity (low VIF value) or with functional form (Ramsey RESET test).

Table 2.21

Summary statistics and results of econometric model of the average value of residential premise, June 2013				
lnprice	Coefficient	Standard error	t	P>|t|
lnmetar	-.1971602	.0539673	-3.65	0.000***
room2	.0800534	.046852	1.71	0.088*
room2plus	.1178877	.0614765	1.92	0.056**
internet	.0754963	.0301911	2.50	0.013**
Garage	.1134318	.0362818	3.13	0.002***
balconyplus	.1603246	.0675788	2.37	0.018**
Balcony2	.0927726	.0549155	1.69	0.092*
Pg1	.1179445	.035153	3.36	0.001***
house	-.1104659	.0439134	-2.52	0.012**
over6floors	-.1093833	.0394946	-2.77	0.006***
constant	7.305478	.2339991	31.22	0.000***

Diagnostics:
Number of observations = 498
Multicolinearity, VIF = 3.21
Ramsey RESET test
F (3. 474) = 1.07
Prob > F = 0,3618

Explanation:
* significance to 10%,
** significance to 5%,
*** significance to 1%.

The table below shows the trends of real estate prices in the selected countries according to the web site *Global Property Guide*. As it can be seen, divergent trends in real estate prices characterised 2013, whereby the highest extremes were recorded in UAE - Dubai (21.4% increase), i.e. in Spain (9.5% decline). All Balkan countries included in the report recorded a decline in real estate prices. For instance, Croatia felt further decline of 6.6% in 2013 after a decline in prices that occurred during 2012 (8.8%).

Table 2.22

Real estate prices trend in selected countries (ranked per the annual growth rate in Q3 2013)				
Country	Annual change, Q3 2012, %	↑→←↓	Annual change, Q3 2013, %	Quarterly growth, Q3 2013, %
UAE-Dubai	14.4	↑	21.4	6.5
Taiwan	5.5	↑	15.0	0.1
Estonia-Tallinn	-0.9	↑	12.5	3.8
Philippines, Makati CBD	4.6	↑	11.1	1.6
Germany	1.2	↑	9.6	4.4
USA (Case Shiller)	2.0	↑	9.4	2.0
Hong Kong	13.0	↓	7.8	2.2
Japan	-2.6	↑	7.6	1.6
Kina-Shanghai	-2.2	↑	7.1	1.5
Brazil-Sao Paulo	12.0	↓	7.0	3.0
SAD (FHFA)	2.3	↑	6.7	1.6
Denmark	3.3	↑	6.5	0.6
New Zealand	5.2	↑	6.4	0.7
Israel	3.2	↑	5.6	1.3
Australia	-2.0	↑	5.3	0.7
Poland	-7.6	↑	5.1	4.2
Turkey	6.7	↓	4.7	3.6
Indonesia	-0.3	↑	4.5	-2.2
Thailand	0.1	↑	3.8	3.7
Switzerland	3.3	→	3.5	0.8
Ireland	-11.0	↑	3.5	4.1
Sweden	-2.0	↑	3.1	1.7
Latvia-Riga	-0.1	↑	2.4	1.7
Singapore	-2.9	↑	2.1	-0.6
Island	2.2	←	2.0	1.4
Canada	2.4	←	1.6	1.1
United Kingdom	-4.0	↑	1.5	1.8
Lithuania	-4.8	↑	0.8	0.4
Norway	6.5	↓	-0.1	-2.0
Bulgaria	-6.8	↑	-0.2	0.9
Finland	-1.0	→	-0.2	-0.1
Portugal	-9.4	↑	-1.6	0.5
South Africa	-1.8	←	-2.0	-1.3
Slovakia	-4.1	↑	-2.9	-0.8
India-Delhi	5.3	↓	-3.6	-7.9
The Netherlands	-11.4	↑	-4.9	-1.5
Croatia -Zagreb	-8.8	↑	-6.6	-0.5
Romania	-12.8	↑	-7.2	-1.4
Russia	-3.9	↓	-8.2	-2.0
Greece	-13.6	↑	-8.9	0.8
Spain	-14.5	↑	-9.5	-1.7

↑ = increase in changes of prices of houses more than one percentage point
→ =increase in changes of prices of houses less swwwwwwthan one percentage point
← = decrease in changes of prices of houses less than one percentage point
↓ = y-o-y decrease in changes of prices of houses more than one percentage point

Source: Global Property Guide, 2013

Residential loans are a significant determinant of demand in the real estate market. Housing loans accounted for 9.2% of the estimated GDP at end-2013, being lower than in 2012 and 2011. There is a considerable deleveraging and decline in lending activity, both in absolute and relative terms, which influenced the limitation of demand.

Table 2.23

Housing loans trend, 2005-2013.

Year	GDP, EUR million	Housing loans in EUR thousand, end-year	Population*	Housing loans, end-year	
				in % of GDP	in % of GDP
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	3,148.9	309,729	620,029	9.8	500
2013	3,335.9	305,509	620,029	9.2	493

* 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, Monstat

In 2013, the exposure of the banking sector to the construction sector declined although it remained high (the highest after trade sector and manufacturing industry). High concentration of debt was not evident in the construction sector, which reduces the risk of financial instability of this market. Also, the restructuring of loans to the construction sector has been announced for 2014.

Considering a large supply in real estate, diversification of demand, limited domicile demand for real estate due to the reduction in personal spending, high interest rates on housing loans and their decline, fall of FDI inflows into real estates, and the announcement of restructuring of loans to the construction sector, further adjustment of supply and demand should be expected through a slight decline in real estate prices. Such expectations result from the survey conducted by the CBCG in the beginning of 2014. Hedonic index of the survey recorded decline in average price of an apartment in Podgorica by 9% relative to the survey results conducted in June 2013. In addition, majority of real estate agencies estimated stagnation in real estate market turnover and prices during 2014, whereas a substantial number of the surveyed agencies (36.4%) expected also decline in real estate prices.

Such trend in the real estate market prices implies low to moderate risk of increase in construction companies' illiquidity, collateral treatment, i.e. mortgage foreclosures and further reduction in lending activity of the banking sector. However, it should be pointed out that the implementation of significant tourist and infrastructure projects in Montenegro in H2 2014 will reduce the aforesaid risk, generate FDI inflows and generate in general rehabilitation of real estate turnover.

3. FINANCIAL SYSTEM

3.1. Banking System

The following aggregates of the banking sector stand out among the most important trends of the main banking sector aggregates in 2013: 1) further increase in deposit financing and decline in borrowing financing, as well as an increase in liquid funds at the expense of loans (decline in loan to deposit ratio), 2) movement of deposit structure in favour of demand deposits, but with further increase in share of long-term deposits (due to the decline in long-term deposits up to one year), 3) further balancing of net foreign assets, and 4) significant increase in banks' exposure to the public sector, i.e. central Government.

With regard to the liabilities and capital structure, banks continued with deleveraging on borrowings taken and were largely financed through deposits (70.9%) and borrowings (10.9%) at end-2013[14]. Total assets grew by 2.4% at end-2013 compared to end-March 2013 due to a stronger growth in deposits over a decline in borrowings. On the other hand, the loan portfolio additionally (slightly) declined, and cash and deposits with central banks to total assets ratio rose by 3.8 percentage points to 13.3%. Consequently, gross loans to deposits ratio amounted to 96% at end-2013 and it fell by 4.9 percentage points compared to end-March 2013.

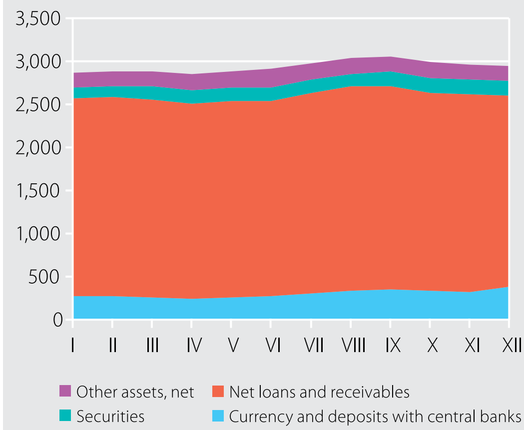
During 2013, total deposits grew by 5.9% to 2.097.7 million euros at end-2013[15]. Some 59% of this amount referred to retail deposits (including also non-resident natural persons) or 1.237.5 million euros. This growth (90.7 million euros)

[14] See box 3.1 (below) for notes concerning data comparability in the banking sector.

[15] Including balances at *escrow* accounts and excluding interest payables and accruals and prepayments for fees.

Graph 3.1

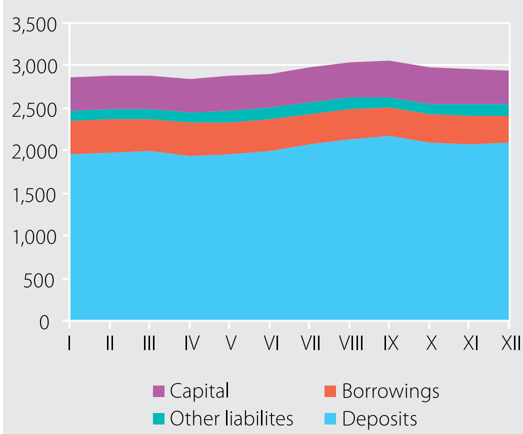
Assets structure during 2013, end of month period, in EUR million



Source: CBCG

Graph 3.2

Liabilities and capital structure during 2013, end of month period, in EU million

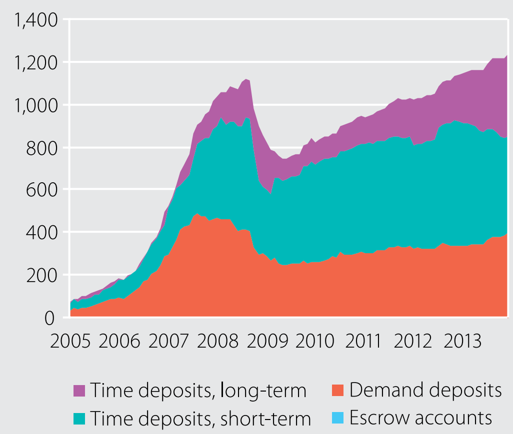


Source: CBCG

largely contributed to an increase of total deposits. With regard to the retail deposits` structure by maturity, demand deposits grew by 2.3 percentage points (to 32,2%) at the expense of time deposits, but still with a further increase of long-term deposits of 11.5 percentage points (to 30.9%) and a decline of short-term deposits of 13.8 percentage points (to 36.9%). This was largely due to an increase in time deposits from one to three years and a decline in time deposits from three months to one year.

Graph 3.3

Retail deposits by maturity, end of month period, in EU million



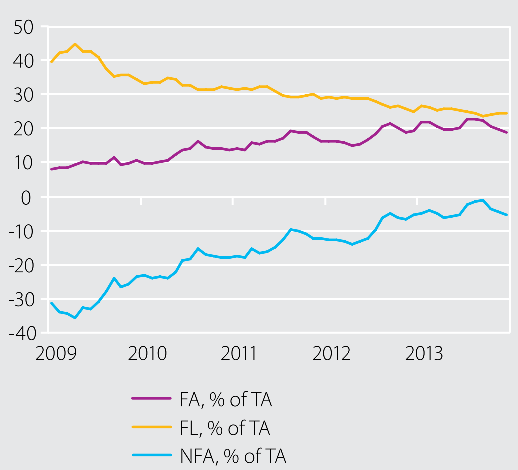
Source: CBCG

Foreign assets and liabilities were additionally balanced during 2013 by further growth in foreign assets and a fall in foreign liabilities. For instance, at end-September, the net foreign assets to total assets ratio amounted to only -1.2%, whereas this gap somewhat deepened at end-2013, amounting to -5.5%, where foreign assets accounted for 18.9%, and foreign liabilities accounted for 24.4% in total assets. These were the lowest levels of net foreign assets since 2007. The largest gap was recorded at end-April 2009 when foreign liabilities reached no less than 44.6% of total liabilities and net foreign assets was -35.5% relative to total assets.

During 2013, banks became even more exposed to the government. Exposure based on loans and receivables to the Central Government increased from 57.2 million euros to 105.5 million euros over the last three quarters of 2013, with the continuance of exposure based on securities. On the other hand, since liabilities of banks to the Cen-

Graph 3.4

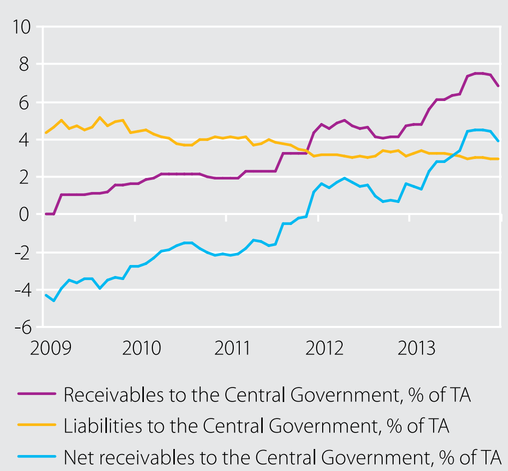
Foreign assets, foreign liabilities and net foreign assets to total assets, end of month period



Source: CBCG

Graph 3.5

Banks' exposure to the government to total assets, end of month period



Source: CBCG

tral Government did not change, net receivables of banks to this sector grew by more than 1.7 times over the same period.

Box 3.1 – IAS 39

The implementation of the International Accounting Standard 39 has started as of 1 January 2013 when a new Decision on Minimum Standards for Credit Risk Management and a new Decision on the Chart of Accounts for Banks were passed. This resulted in incomparability of data from the period before and after 2013[16].

One of the significant changes refers to the introduction of the concept of value adjustments – compared to the previous concept of provisions – which is calculated by banks based on their internal methodologies, while provisions were prescribed by regulation. In practice, a lower level of value adjustments relative to provisions resulted in lower impairment of assets and an increase in capital. However, provisions are still calculated, and the difference between the calculated provisions and value adjustments represents a deductible item from own funds, which creates a certain prudential filter. Thus, this change will not reflect on the solvency ratio level, i.e. on capital adequacy.

Furthermore, allowances for impairment and provision expenses are shown in profit and loss in parallel to value adjustment. It is very important to point out that these expenses are incomparable with the "expenses for losses on asset items" (which corresponded to provisions), because these are profit and loss items which substantially determine the final result of the banks in period after credit boom.

The next big change referred to returning of the previously written off loans (and receivables) from the category "E" and supporting provisions (i.e. value adjustments) from the off-balance sheet records into balance sheet. This increased the gross position (and net position in practice) of loans[17]. Thus, loan portfolio indicators additionally deteriorated, i.e. they are not comparable in period before and after 2013.

Similarly, a new position on the asset side was created – loans and receivables which included, inter alia, deposits with banks and other financial institutions[18], while "cash and deposit accounts with central bank" stand as the most liquid position in that respect. Finally, IAS 39 requires disclosure of interest and accrued fees together with the respective loans and receivables and a disclosure of asset items net of value adjustments in the balance sheet.

The CBCG reconstructed some of the series from the period before 2013 by applying a new methodology/data revision. However, data on loans and receivables, as well as on capital – due to the returning of loans and receivables from the category "E" into the balance sheet and the introduction of value adjustments relative to provisions – remained incomparable before and after 2013 as well as all ratios calculated using these indicators. Value adjustment is incomparable with the provisions as well as concepts of allowances for impairment and provision expenses and provision expenses on asset items, which made financial results before and after 2013 incomparable as well as all derived ratios. On the other hand, data on deposits and borrowings (liabilities and capital side) are comparable, as well as data on liquid assets (due to the possibility of data revision), although the new decisions resulted in changes of the definition of liquid assets, causing artificially its decline.

---

16 Decision on Minimum Standards for Credit Risk Management in Banks (OGM 22/2012, 55/2012, 57/2013), Decision on Chart of Accounts for Banks (OGM 55/2012)

17 For details, see the Guidance on the manner of recording loan loss provisions, value adjustments and written off items of the on-balance sheet assets when determining opening balance in banks' business books for 2013 (OGM 61/2012).

18 Loans and receivables: loans granted to all sectors, deposits with banks and other deposit institutions and other receivables (factoring and forfaiting, receivables under acceptances, guarantees and bills of exchange outstanding).

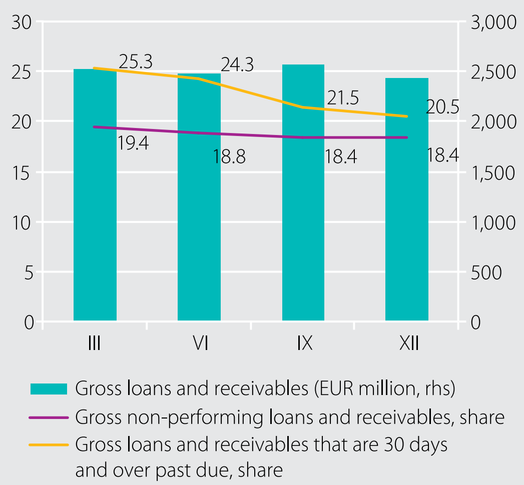
As a result of the aforesaid reasons, comparisons in this part of the report will frequently refer only to 2013, comparing the balance as at end of December with the financial information as at March 2013 when the banks sent reports to the Supervision Department using the new chart of account for the first time. Comparisons (and graphs) were also made compared to the period before 2013 where it was possible or where it has been evaluated that the comparison still makes sense to highlight incomparability of some of these indicators.

3.1.1. Credit risk

Although the main parameters of quality of the loan portfolio of banks slightly improved during 2013, credit risk remained the most prominent risk in the system even after this year. The banks continued to suffer the consequences of relaxed lending policies from the pre-crisis period although to a smaller extent in 2013, and continued to write off and sell parts of their loan portfolios. In 2014, the trend of loan quality will be uncertain, primarily due to high and increasing illiquidity in Montenegro's economy. Therefore, it is practically inevitable that the banks will continue pursuing prudent lending policies.

Graph 3.6

Share of certain gross loans and receivables to total gross loans and receivables, 2013, %, end of month



Source: CBCG

The amount of gross loans and receivables[19] declined by 3.3% to 2.441.8 million euros compared to Q3 2013. Even new loans[20] (807.6 million euros) granted during 2013 could not improve the overall situation (635.4 million euros in the last three quarters 2013).

The banks ended 2013 with a 18.4% share of gross non-performing loans and receivables in total loans and receivables (with the amount of 448.7 million euros), which is a decline of 1 percentage points in relation to the end of March[21]. Gross loans and receivables that are 30 days and over past due also declined from 25.3% to 20.5% (with the amount of 501.2 million euros). The share of gross non-performing loans and receivables almost constantly declined over the year, which primarily resulted from the sale of a part of loan portfolio by some banks. In 2013, banks continued to maintain a considerable level of restructured

[19] *Gross loans and receivables* whose trend is commented in this report include also the respective interest receivables and accrued fees (interest) if not otherwise mentioned.

[20] The information regarding new 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. It should be also borne in mind changes in debit balance and repayment of principal over year in 2013 and sale of certain amount of non-performing loans by some banks.

[21] Non-performing loans and receivables include categories C, D and E.

loan portfolios; therefore the share of restructured loans in total loans at end-2013 amounted to 21.1%, which is a decline of 0.2 percentage points relative to end-March. Total amount of gross restructured loans declined by 1.1%, from 429.9 million euros to 425.1 million euros.

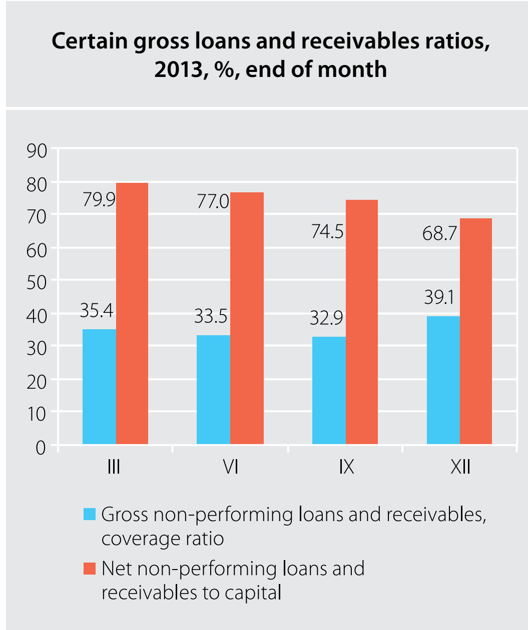
The ratio of gross non-performing loans and receivables coverage[22], although considerably higher in relation to end-March (39.1% against 35.4%), and still remained relatively low. Similarly, although the net non-performing loans and receivables to capital ratio declined from 79.9% to 68.7% at end-2013, it still remained high.

The real economy is the main source of credit risk. At end-2013, the share of 30 days and over past due gross loans in the corporate sector still remained very high in relation to the household sector, i.e. 30.1% against 15.5%[23]. 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 (orientation to imports and the domestic market), 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 five years. On the other hand, there is a considerable number of employees working in the public sector, which position has not been so destabilised mostly due to its possibility to borrow from abroad.

Credit risk stress testing

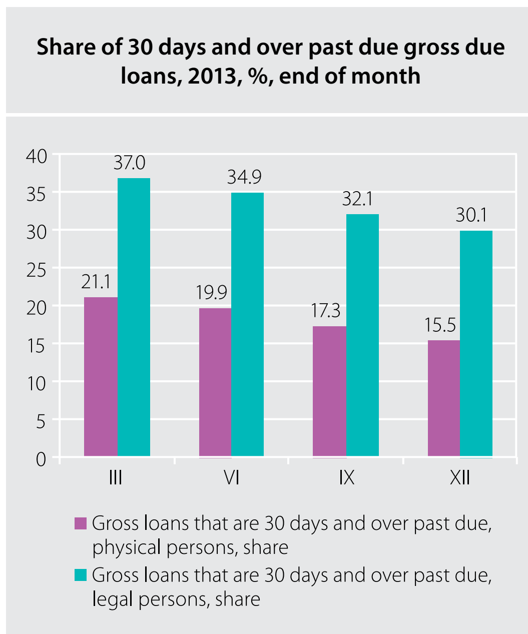
The following shocks were used to credit risk stress testing:

Graph 3.7



Source: CBCG

Graph 3.8

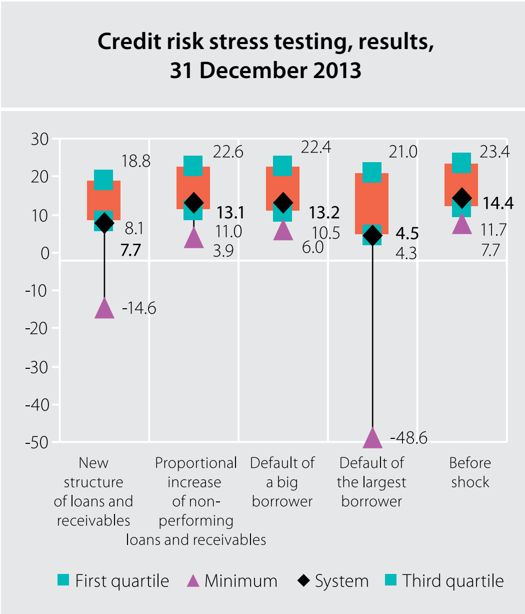


Source: CBCG

[22] Value adjustment for losses on gross non-performing loans and receivables to gross non-performing loans and receivables.

[23] Corporate sector includes also the government sector, otherwise ratio referring strictly to the economy would be even higher.

Graph 3.9



Source: CBCG

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 - 1%,
   - category B - 3%,
   - category C - 30%,
   - category D - 75%,
   - category E - 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).

In general, the testing confirmed the banks' sensitivity to credit risk, whereby the results differed greatly by the bank [24]. Stress testing showed that the banks are most sensitive to the first and fourth shock, whereby the system level solvency ratio declined by 6.7 percentage points and 9.9 percentage points, amounting to 7.7% and 4.5%, respectively. Five banks did not pass the first test, as they showed a shortfall of capital of 78.7 million euros, and seven banks failed the fourth test, with a shortfall of

[24] At 2013 year-end, one bank had the solvency ratio below the regulatory 10%. (The bank was recapitalised at the beginning of 2014, so the solvency ratio is again 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.

capital of 128.7 million euros. When it comes to the first and fourth test, capital of two and one bank would be completely „consumed“ in case of loans and receivables reclassification, i.e. in case of full bankruptcy of the largest debtor, and their solvency ratio would drop below zero. Two and three banks did not pass the second and third test, with a shortfall of capital of 16.1 million euros for the second and 10.8 million euros for the third test.

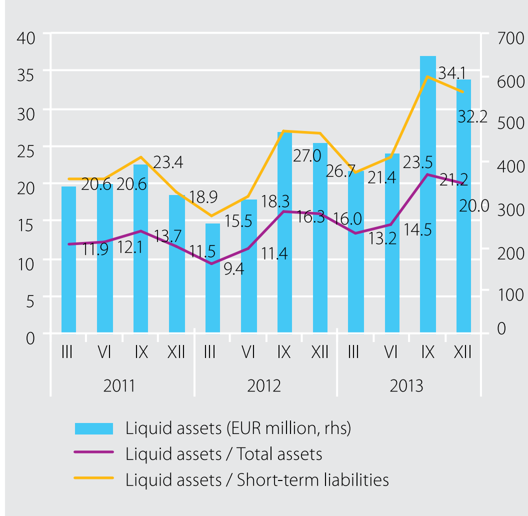
3.1.2. Liquidity risk management

In 2013, restrictive lending policies of banks also affected an increase in their monetary assets and the overall level of liquidity. At 2013 year-end, liquid assets[25] accounted for 20% of total assets and it amounted to 591.4 million euros which is the year-on-year increase of 31.8%. The coverage of short-term liabilities by liquid assets recorded a similar trend, amounting to 32.2% at 2013 year-end. Liquid assets slightly declined in Q1 and then it recorded an increase during Q2 and Q3 2013, but it declined in Q4 mostly due to a decline in banks' foreign accounts (demand deposits) of over 95 million euros.

As for the ten-day liquidity indicator, it remained substantially above the prescribed minimum during 2013, with, similar to liquid assets, very strong growth in Q2 and Q3 and decline in Q4.[26]

Graph 3.10

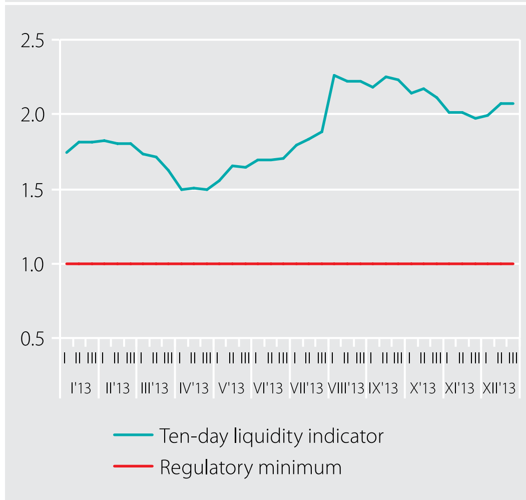
Selected liquidity indicators, %, end-month



Source: CBCG

Graph 3.11

Ten-day liquidity indicator



Source: CBCG

Liquidity risk stress testing

The aggregate ratio of cash and deposit accounts held with central banks (assets side) to deposits

---

25 Accounts number: 1001-4, 1007-10, 1012, 1122, 1126-27, 1130, 1134 i 1138 (see annex to the Decision on Chart of Accounts for Banks), plus 50% of allocated reserve requirement.

26 The indicator represents liquid assets to matured liabilities ratio, while minimum allowed level for ten-day period equals to 1 pursuant to the Decision on Minimum Standards for Liquidity Risk Management in Banks (OGM 60/2008). The definition of liquid assets and matured liabilities is given in the Decision. The definition of liquid assets has not changed and it is technically different category with regard to liquid assets and with regard to free liquid funds and available liquid funds (see below in the document).

(liabilities and capital side) was relatively low and amounted to 18.5%, which had a negative effect on deposit outflow testing for the majority of 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 central banks reduced by full amount of reserve requirement),
2. available liquid assets, i.e. free liquid funds increased by 50% of the reserve requirement amount.

Table 3.1

Liquidity risk stress testing, results as at 31 December 2013							
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	-440,052	11	-440,052	-341,603	11	-341,603
2.	Withdrawal of 30% of demand deposits	-68,955	8	-107,679	+29,494	6	-35,230
3.	Withdrawal of demand deposits (30% households, 50% legal persons)	-29,094	7	-77,857	+69,355	4	-11,788
4.	Withdrawal of time deposits (households and legal persons 40% each)	-168,984	10	-169,662	-70,535	8	-95,364
5.	Largest depositor's deposits withdrawal	+39,038	6	-52,886	+137,487	3	-36,670
6.	Withdrawal of 50% of 10 largest depositors' deposits	-30,653	7	-92,514	+67,797	6	-48,837
7.	Withdrawal of 100% of state deposits*	-32,544	6	-77,133	+65,905	4	-33,448

* Observed in the widest aspect, these are deposits oby the entire public sector.
Source: CBCG

Regardless of a positive trend of general 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, i.e. in case of possible deposit outflows. However, certain shocks were quite extreme, i.e. their realisation is not very likely. Besides, pursuant to the new definition of free/available liquid assets, they do not include deposits with banks and other financial institutions, which affects proportionate worse testing results. However, these funds are extremely liquid which could be used in case of the aforementioned shocks.

Without the use of reserve requirement, the system did not fail only in fifth test, while the system failed in the second and fourth test using the reserve requirement. Banks showed the worst results in the first test and the best in the fifth test. All 11 banks failed in the first test and the use of 50% of the reserve requirement would somehow solve the problem. Six banks failed in the fifth test where three banks solved the problem using 50% of the reserve requirement.

3.1.3. Market risk management[27]

Interest rate risk arising from the 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. Interest rate risk arising from non-trading activities is most certainly present, but the banks successfully transferred it on to their clients.

Interest rate spread[28] at the banking sector level insignificantly declined in 2013 as a result of a relatively high decline in the interest income to average earning assets ratio. At end-2013, the spread at the system level amounted to 4.05 percentage points (compared to 4.11 percentage point at end-March), while it differed significantly by banks, ranging from 2.5 to 8.8 percentage points.

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-2013 amounted to 1.4 million euros or 0.6% of core capital[30]. The most frequent foreign currency was US dollar (on both sides of the balance sheet), while the highest aggregate net open position referred to Swiss Francs in the amount of 0.5 million euros or 0.2% of core capital.

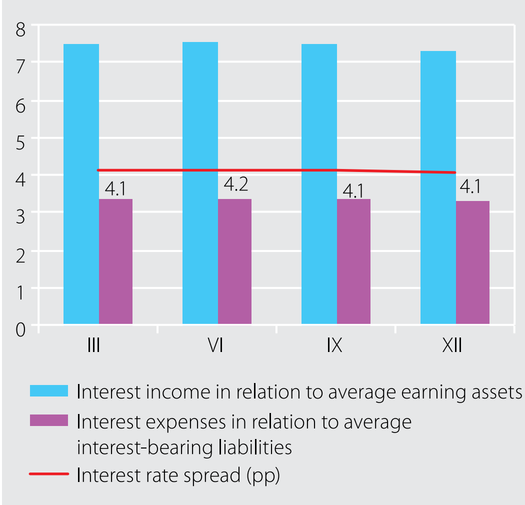
The majority of loans were denominated in euros. Only one bank showed a significant share of gross foreign currency loans (17.2%) in its loan portfolio, while at the system level this share was a mere 1.6%.

Market risk stress testing

The sensitivity of assets and liabilities positions to interest rate risk was tested through the appli-

Graph 3.12

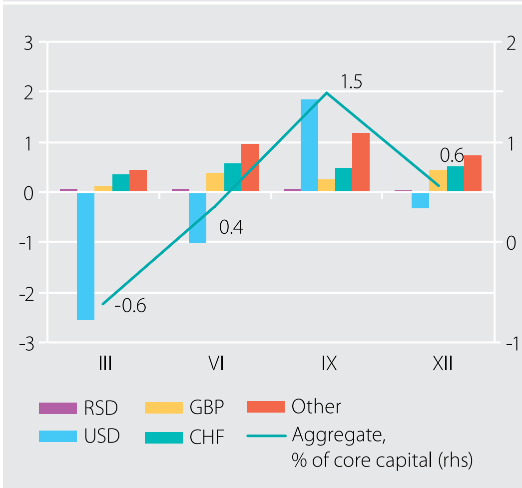
Interest rate spread in 2013, %[29]



Source: CBCG

Graph 3.13

Aggregate open net positions by currencies in 2013, EUR million, end-month



Source: CBCG

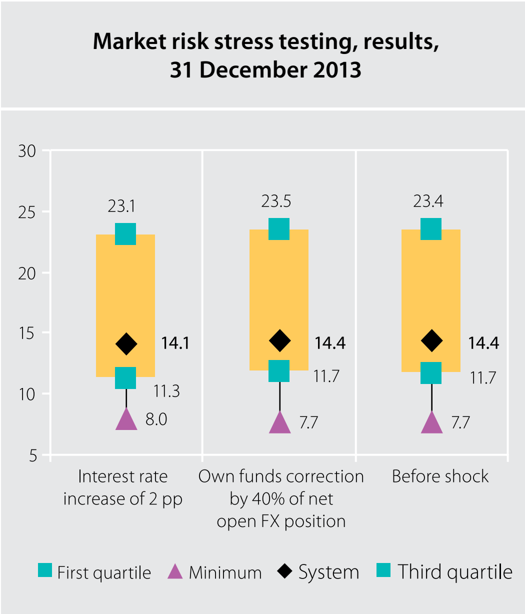
[27] This part relates to two types of market risks: interest rate risk and FX risk.

[28] Interest spread is calculated as the difference between the interest income in relation to average earning assets and interest expenses in relation to average interest-bearing liabilities.

[29] Income/expenses are given cumulatively as at the beginning of the year, therefore, data for e.g. June 2013 relate to the trend as of the beginning of the year until end-June, not just Q2 2013 or June 2013.

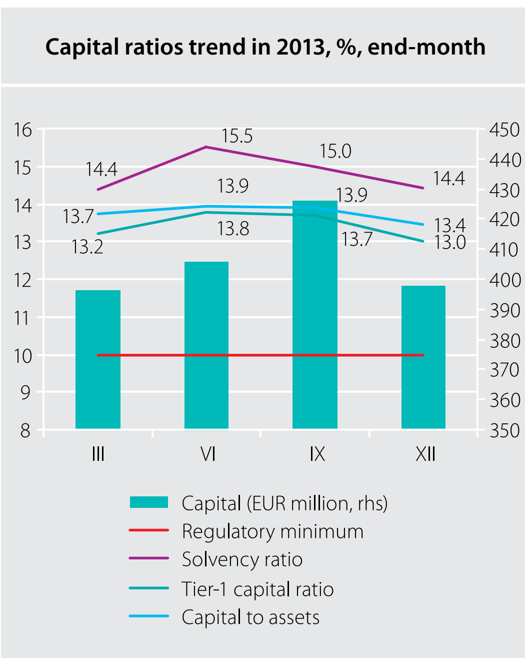
[30] For details on the composition of core capital see the Capital Adequacy Decision (OGM 38/2011, 55/2012).

Graph 3.14



Source: CBCG

Graph 3.15



Source: CBCG

cation 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 interest rate change.

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 40% 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 0.3 percentage points (i.e. 2.1% with somewhat more intense decline in certain banks and growth in solvency ratio with two banks). During the FX risk stress testing, there was an increase in the adequacy ratio of 0.03 percentage points (0.2% with somewhat larger oscillations in certain banks and increase in the solvency ratio with four banks). With regard to both tests, solvency ratio was below the regulatory minimum only in one bank.

3.1.4. Capital of the banking sector

At end-2013, the banks' capital accounted for 13.4% of total assets and liabilities, amounting to 397.8 million euros, which was 0.3 percentage points lower in relation to end-March, mostly as a result of a more intense increase in assets in relation to an increase in capital (2.4% against 0.4%). Two banks were recapitalised in the last three quarters of 2013 in the total amount of 12.4 million euros[31], but regardless of the recapitalisation, total capital increased by only 1.5 million euros, primarily as a result of financial results of -7.9 million euros and negative changes in the undistributed profit position (3.3 million euros).

The banking sector`s solvency ratio at end-2013 was insignificantly higher in relation to end-March, amounting to 14.4%. This ratio was above

[31] Total recapitalisation during entire 2013 amounted to 22.9 million euros and it referred to three banks, of which 10.5 million euros referred to recapitalisation of one banks which was actually implemented a few days before 2012 year-end, but for technical/accounting reasons it was included in the reports in January 2013.

the prescribed minimum of 10% in all banks except for one banks due to the asset quality review and consequently write off of a portion of loans in the last quarter. A bank whose adequacy ratio dropped below 10% was requested to recapitalise, which was done at very end of 2013, which could not be covered by reports for that year for technical reasons, consequently raising its adequacy ratio above the regulatory minimum.

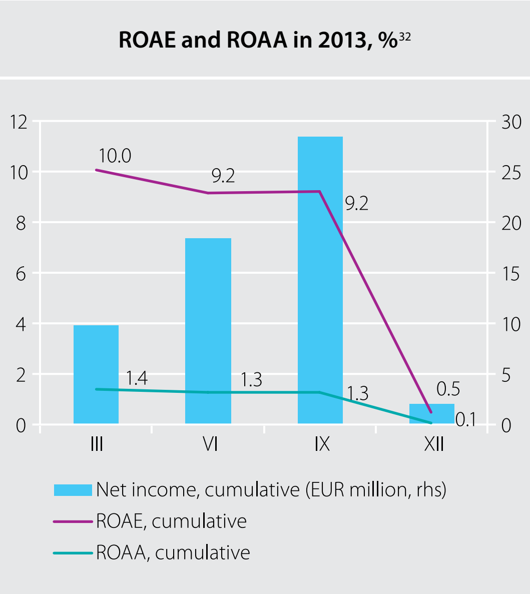
3.1.5. Profitability of the banking sector

The banking sector reported a positive financial result in 2013 in the amount of somewhat higher than two million euros. In addition, nine banks reported profit at end-2013, while loss was concentrated with two banks in the system - one large bank and another medium-sized bank (observed by assets size). Loss reported by these banks resulted from the loan portfolio review and significant write off of a portion of loans, which was done in Q4. However, both banks were profitable in the first three quarters of 2013. The ROAE and ROAA amounted to 0.5% and 0.1% in 2013, respectively.

If we exclude the impact of extraordinary income for 2012 (33.6 million euros), income was on similar level and of similar structure both in 2012 and 2013. (Surely, by definition, extraordinary income is not a type of income that can be seriously taken into consideration). Of other changes on the income side, fee and commission income increased, while interest and similar income declined. As for the expenses, the largest change referred to allowances for impairment and provision expenses which drastically declined in relation to the old category "provision expenses on asset items". Both the level and structure of expenses would be similar to 2012 without this change.

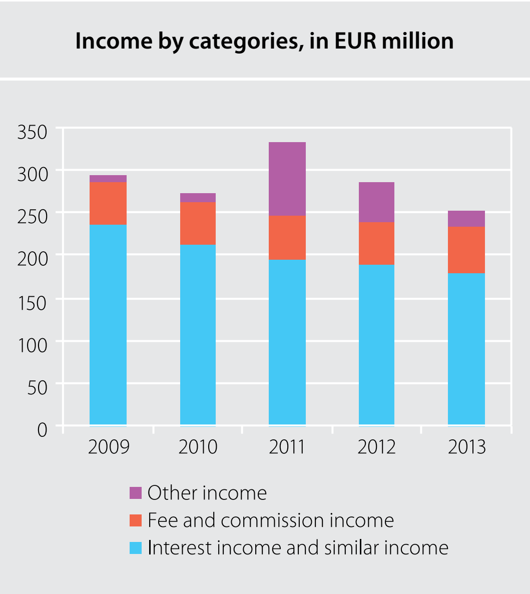
As for other trends that characterised the years following the crisis boom, the most prominent were a decline in interest income and similar in-

Graph 3.16



Source: CBCG

Graph 3.17

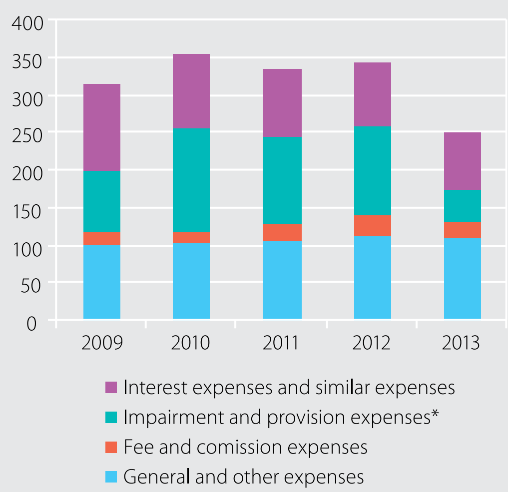


Source: CBCG

[32] Quarterly ROAE and ROAA were annualised multiplying the same ratios for Q1, H1 and the first three quarters (according to cumulative net profits) by 4, 2 and 4/3, respectively.

Graph 3.18

Expenses by categories, in EUR million



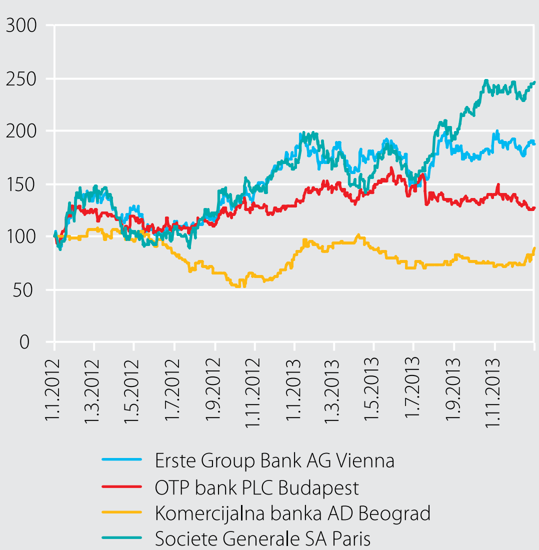
* Before 2013 „Expenses for losses on asset items"
Source: CBCG

come (with an increase in fee and commission income), as well as a strong presence of allowances for impairment and provision expenses – both of these categories primarily as a result of deterioration of the loan portfolio and write-offs of a considerable portion of loans. A decline in interest expenses and similar expenses (as a result of a combination of lower deposit interest rates and a decline in interest-bearing liabilities) and to a certain extent, an increase in fee and commission expense (although not in 2013 compared to 2012).

Box 3.2 – Parent banks in the financial markets in 2013

Graph 1

Prices of shares of banks which subsidiaries operate in Montenegro, 2012-2013, 01.01.2012=100

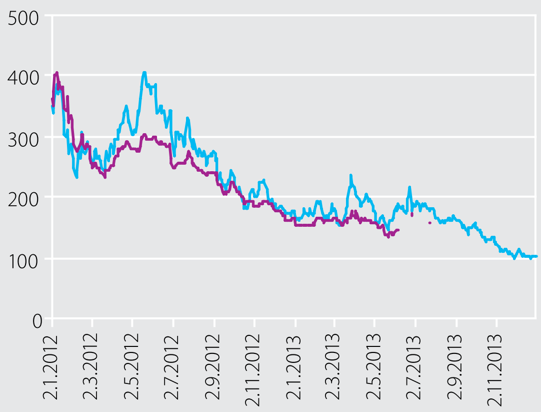


Source: Bloomberg, CBCG calculations

Eleven banks operate in Montenegro, whereby non-residents` capital accounts for the majority share in the capital of nine banks. Six banks are fully (or almost fully owned) by non-residents – major banking groups from Austria (two banks), France, Hungary, Slovenia and Serbia. Graphs and tables below show the prices of shares, CDS and bank ratings, and country ratings where registered offices of these banks are located. (Certain data were not available.)

Graph 2

CDS of banks which subsidiaries operate in Montenegro, 2012-2013, basis points



Source: Bloomberg

Table 1

S&P ratings for banks which subsidiaries operate in Montenegro (in alphabetic order) and for their parent countries, end- 2013

Bank	Rating	Beginning of validity	Country	Rating	Beginning of validity
Erste Group Bank AG Vienna	A	25.01.2012	Austria	AA+	13.01.2012
Hypo Alpe-Adria-Bank International AG Klagenfurt	No rating	03.01.2006.S&P 29.11.2011 Moody's			
Komercijalna banka a.d. Beograd	No rating	/	Serbia	BB-	07.08.2012
Nova Ljubljanska banka d.d. Ljubljana	CCC	12.03.2013	Slovenia	A-	12.02.2013
OTP Bank Nyrt. Budapest	BB	27.11.2012	Hungary	BB	23.11.2012
Société Générale S.A. Paris	A	23.01.2012	France	AA	08.11.2013

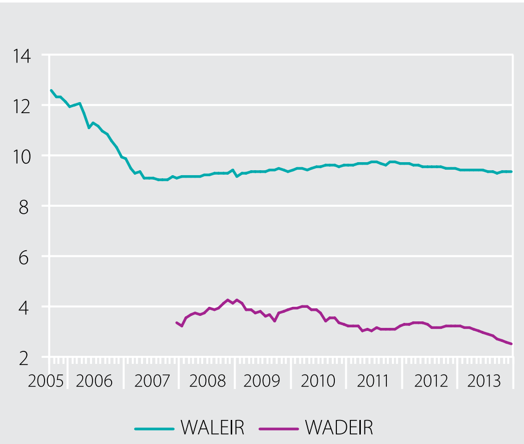
Source: Bloomberg

3.1.6. Interest rates

At end-2013, the weighted average lending effective interest rate (WALEIR) amounted to 9.36% at the system level and it was 0.11 percentage points lower in comparison to end-2012. Observed by the average of 12-month data (as at end-month), it declined by 0.17 percentage points in comparison to 2012 the WALEIR, from 9.56% to 9.39%. for the same period, the weighted average deposit effective interest rate (WADEIR) declined from 3.23% to 2.55%, i.e. observed by the average of 12-month data, the WADEIR decreased by 0.35 percentage points (2.92% in comparison to 3.26%).

Graph 3.19

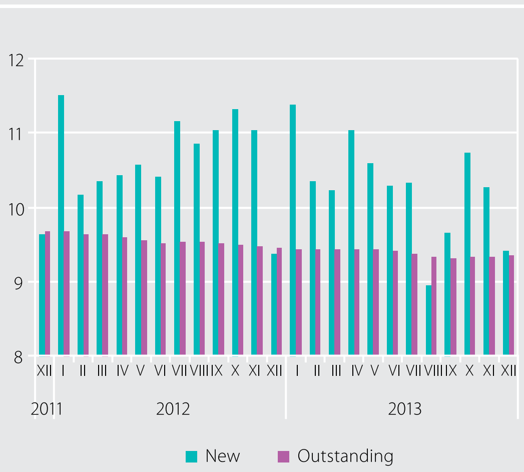
Weighted average lending/deposit effective interest rate, month-end, %



Source: CBCG

Graph 3.20

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



Source: CBCG

Looking at the past periods, the lending interest rates continued to decline in 2013, 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 trend of deposit interest rates in 2013 signalled the continuance of the declining trend that started after Q1 2010, which was shortly disrupted in 2012. When it comes to changes in lending and deposit interest rates in 2013, compared to 2012, it can be easily noticed that this is a very slight change in lending interest rates, while deposit interest rates suffered significant downward adjustments.

In December 2013, the WALEIR on new loans[33] amounted to 9.42%, which is 0.04 percentage points higher in comparison to 9.38% from December 2012. However, WALEIR was lower during 2013, amounting to 10.28% in relation to 10.69% (simple average) or 10.12% in relation to 10.57% (weighted average). With regard to the structure, the decline of the lending interest rates in December 2013, compared to the rest of the year, was primarily affected by the amount of new loans granted to the corporate and government sectors. These loans were granted at lower interest rates and were considerably above the average from the rest of 2013.

Although data on interest rates on new loans/deposits cannot be compared as there is no statistics on interest rates on new deposits, it seems that there is room for further decline in interest rate on loans based on the existing indicators. It should be borne in mind that a lending interest rate is a result of the activity of several factors. Basically, banks have to pay interest rates on deposits and borrowings and cover operating expenses. In addition, banks currently transfer a

[33] 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. In addition, the fact that significant number of new loans is granted for refinancing, i.e. closing of old loans with another or the same banks calls for caution in interpreting data on interest rates on new loans and data on the amounts of new loans.

substantial portion of assets abroad where interest rates are much lower than in Montenegro. Finally, the profit margin reflects risk reward assumed by bank owners (mostly foreign banking groups) in respect of main investment, share capital. Since the Montenegrin economy is still riskier than the EU 28 average, it is realistic to expect that the requested/expected margin is higher.

However, although according to the theory, 11 banks should be sufficient for effective market activity and competitive establishment of interest rates, one gets the impression that competitive forces that would further lower interest rates on loans do not adequately act making these rates at least partially "unjustifiably" higher than the interest rates on deposits. This is not a desirable situation in the context of financial stability since higher lending interest rates block demand for loans which are necessary for growth. Moreover, they burden finances and functioning of entities that signed lending arrangements with possible negative consequences for the banks that granted loans in case of default. Therefore, the CBCG monitors the interest rates trending and, in accordance available instruments, it will react in the future if it estimates that the intervention leads to an optimum solution.

3.2. Micro-credit financial institutions

Total assets of micro-credit financial institutions (MFIs) amounted to 34.6 million euros at end-2013, recording a decline of 4% in relation to the end of March.

Net loans and receivables (90.1%) accounted for the main share in MFIs' total assets, while cash and deposit accounts with central banks made up 4.3%, and net other assets was 5.6% at end-2013.

MFIs' gross loans and receivables amounted to 37.2 million euros, recording a decline of 7.3% relative to end-March. Gross non-performing loans and receivables, i.e. gross non-performing loans and receivables 30 days and over past due accounted for 16.4%, or 17.7%, respectively and they declined by 0.8 percentage points or 1.5 percentage points, respectively in relation to end-March.

Observed by industries, almost all MFIs gross loans and receivables referred to natural persons, while observed by purpose, MFIs gross loans and receivables for fixed assets purchase accounted for the main share in the MFIs` loan portfolio structure (26.9%), followed by loans granted for liquidity – working capital (12.8%) and cash non-earmarked loans (11.4%)[34]. With regard to the maturity structure of MFIs` gross loans, long-term loans accounted for the main share (63.6%).

In the structure of MFIs' liabilities and capital, capital accounted for the main share (58.6%), amounting to 20.3 million euros at end-2013. Of total capital, 69.5% referred to donated capital, retained profit made up 13%, share capital was 9.1%, and current year profit amounted to 8.4% of total capital. On the other hand, liabilities made up 41.4% of liabilities and capital, i.e. 14.3 million euros.

MFIs reported a positive financial result of 1.7 million euros at end-2013 (positive results were recorded in each quarter of the year), whereby only one MFI, the smallest in size, reported loss in 2013.

Interest rates on MFI loans were on a downtrend in 2013, showing a lower level relative to 2012. The weighted average effective interest rate (WALEIR) was 26.38% at end-2013, and it declined by 2.1 per-

[34] These shares do not take into account interest receivables and fee (interest) prepayments and accruals.

centage points in relation to the previous year-end. When it comes to interest rates on new loans, the WALEIR amounted to 26.03% on loans granted in December 2013, which is 2.87 percentage points lower in comparison to the WALEIR on loans granted in December 2012.

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.

3.3. Capital market

Negative trends in the capital market also marked 2013. The turnover declined by 5.8% in comparison to 2012, and amounted to only 30.8 million euros, which is the lowest level of annual turnover since 2002. At end-2013, the main Montenegro Stock Exchange index, the MONEX 20, remained almost unchanged compared to 2012, and 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%.

Table 3.2

Key indicators at the Montenegro Stock Exchange in 2013	
MONEX 20, 31.12.2013	9,850.18
Annual index change	0.0%
Total turnover in 2013, in EUR	30,771,603
Turnover change, 2013 to 2012	-5.8%
Market capitalisation, in EUR, 31.12.2013.	2,838,968,101
Annual market capitalisation change	-2.2%

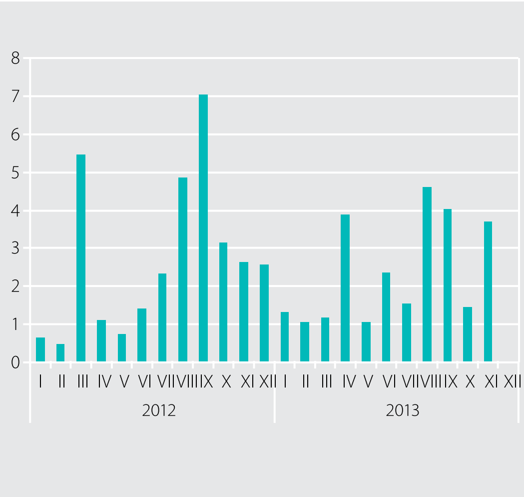
Source: Montenegro Stock Exchange

An average monthly turnover in 2013 amounted to a mere 2.6 million euros (compared to 2.7 million euros in 2012). On the other hand, the MONEX PIF index declined during the year by 0.9%, remaining at the 2005 levels.

The Montenegrin capital market still shows 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 confidence in the market. However, the assessment still remains that the share prices of some companies are currently unrealistically below their intrinsic values, which is also undesirable from the aspect of financial stability.

Graph 3.21

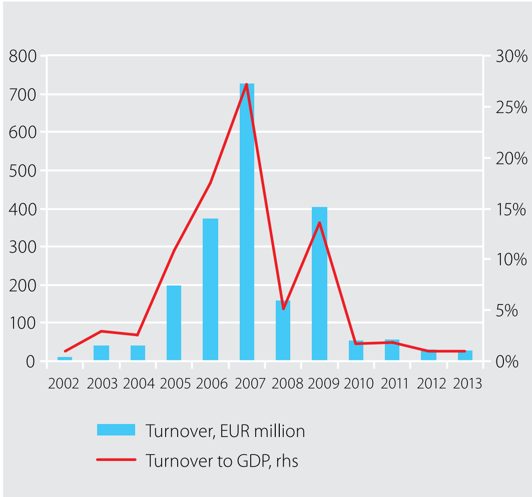
Monthly turnover, in EUR million



Source: Montenegro Stock Exchange

Graph 3.22

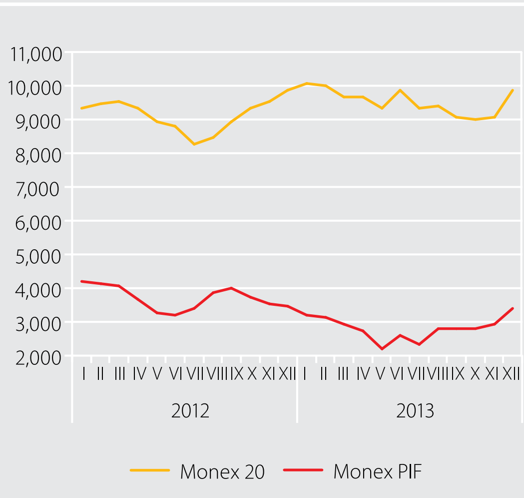
Annual turnover



Source: Montenegro Stock Exchange, Monstat

Graph 3.23

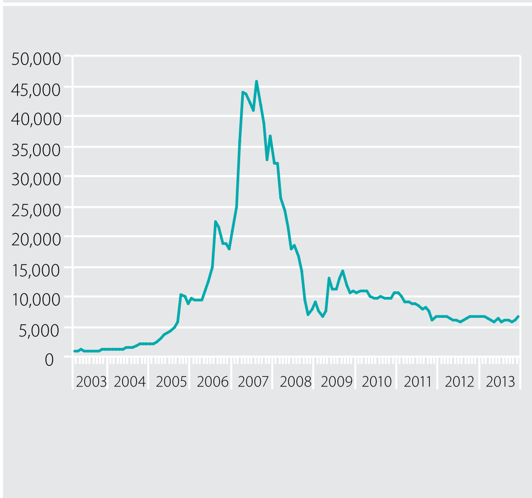
Indices trend, end-month



Source: Montenegro Stock Exchange

Graph 3.24

Simple average of MONEX 20 and MONEX PIF indices for the period March 2003-2013, end-month



Montenegro Stock Exchange, CBCG calculations

The capital market in Montenegro has traditionally relatively small role in corporate financing compared to banks, i.e. gathered amounts of capital through the issue of shares in Montenegro are small compared to capital that the corporate sector borrows in the form of loans from banks. However, this market should be developed, and the above mentioned discrepancies and weaknesses should be corrected so that it could contribute more in connecting those with surpluses of financial assets (depositors, investors) with entities which lack financial assets. Thus, the entire financial sector/system would be more liquid and developed, allowing for much more room for economic growth.

3.4. Insurance sector[35]

Growth in gross written insurance premium, an increase in total assets of the insurance sector, and a higher financial result recorded in 2013 were the main characteristics of the trends in the Montenegrin insurance sector.

Total gross written premium recorded in the insurance market amounted to 72.8 million euros in 2013, recording the year-on-year increase of 8.7%. Non-life insurance premiums accounted for the main share (85.1%) in the structure of premiums of insurance companies, in total amount of 61.9 million euros. Life insurance premiums amounted to 10.9 million euros and they grew by 14.8% relative to 2012 with a slight increase in the share of life insurance premium in total premium.

The analysis of the non-life insurance gross premium structure in 2012 shows that compulsory insurance accounted for the main share (55.7%), recording a 1.9 percentage points lower share in relation to the previous year[36]. In the life insurance premium structure, life insurance accounted for the main share of 87.3%, and together with supplementary insurance of persons comprised 99.4% of total life insurance premiums.

In 2013, eleven insurance companies operated in the Montenegrin insurance market, of which six engaged in life insurance, while five insurance companies engaged in non-life insurance, while foreign capital accounted for the main share in total capital. The insurance market concentration measured by the Herfindahl-Hirschman Index by gross written premiums declined from 2.333.80 points in 2012 to 2.209.34 in 2013.

The solvency margin of insurance companies amounted to 16.1 million euros while capital amounted to 35.3 million euros[37]. The capital to solvency margin ratio at the Montenegro insurance system level was 2.2 (1.8 at end-2012), which indicates that solvency of the insurance companies in Montenegro was satisfactory. In addition, total share capital of the insurance companies amounted to 49.8 million euros at end-2013. The liquidity ratio (liquid assets to short-term liabilities) amounted to 4.2, and it increased relative to end-2012 when it was 4.0.

The financial result at the insurance sector level was positive and it amounted to 3.7 million euros (compared to 2.1 million euros in 2012).

These figures lead to a conclusion that the insurance market was additionally consolidated during 2013, and that it currently does not impose a threat to financial stability.

---

[35] Information on the insurance sector that refers to 2013 are preliminary.

[36] Compulsory insurances are motor vehicle liability insurance, and liability insurance arising from the use of aircrafts and vessels.

[37] *Capital* is calculated based on regulation and not as a category from the balance sheet.

Generally, due to its size, the insurance sector does not have too much of an influence (156.7 million euros of total assets at end-2013). However, as with the capital market, development possibilities should be sought in this market as well. Higher gross premiums and balances of insurance companies mean more money (capital) in the system, since the insurance companies are entities which place further 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 arrangements/systems 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 i DNS[38]. 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	2,176		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
2013	**254**	**2,159**			**129,540**	**85**	**99.93**
I 2013	21	178	30		10,710		100.00
II 2013	20	170			10,200		100.00
III 2013	21	178	30		10,710		100.00
IV 2013	22	187			11,220	47	99.58
V 2013	19	161	30		9,690		100.00
VI 2013	20	170			10,200		100.00
VII 2013	22	187			11,220	38	99.66
VIII 2013	22	187			11,220		100.00
IX 2013	21	178	30		10,710		100.00
X 2013	23	195	30		11,730		100.00
XI 2013	21	178	30		10,710		100.00
XII 2013	22	187			11,220		100.00

Source: CBCG

[38] 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 2013, total production of interbank payment system, i.e. RTGS and DNS sub-systems, amounted to 129.540 minutes, with 85 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 2013, the value of total payment system transactions in the country amounted to 22.3 billion euros, i.e. 7.2% more in relation to 2012. On the other hand, the number of transactions increased by 8%, to 26 million transactions. The situation was the best in the last five years but worse compared to the period 2007-2008. Therefore, these indicators point to the persisting effects of the crisis and uncertain recovery of the economy, all of which reflected on cash flows in the payment system.

Table 4.2

Comparative indicators of total national payment system transactions, in EUR

	2013	2012	2011	2010	2009	2013/2012
Interbank	**10,123,092,075**	**9,103,468,406**	**9,069,817,107**	**8,673,777,093**	**8,900,719,570**	**111.2**
RTGS	9,552,596,535	8,553,655,836	8,519,229,139	8,140,415,076	8,392,787,439	111.7
DNS	570,495,540	549,812,570	550,587,969	533,362,017	507,932,131	103.8
Internal	**12,180,126,932**	**11,710,512,566**	**12,009,464,651**	**11,733,587,598**	**13,132,500,623**	**104.0**
Cashless	8,998,002,178	8,682,132,662	8,952,110,113	8,741,589,307	9,993,633,299	103.6
Cash	3,182,124,754	3,028,379,904	3,057,354,538	2,991,998,291	3,138,867,324	105.1
Total	**22,303,219,007**	**20,813,980,972**	**21,079,281,758**	**20,407,364,691**	**22,033,220,193**	**107.2**

Source: CBCG, commercial banks

Table 4.3

Comparative indicators of the volume of national payment system transactions, number of transactions

	2013	2012	2011	2010	2009	2013/2012
Interbank	**7,865,980**	**7,405,773**	**7,780,970**	**8,809,445**	**8,644,923**	**106.2**
RTGS	3,678,688	3,520,051	3,999,616	5,136,534	5,099,093	104.5
DNS	4,187,292	3,885,722	3,781,354	3,672,911	3,545,830	107.8
Internal	**18,113,762**	**16,648,750**	**15,862,001**	**16,483,085**	**17,215,483**	**108.8**
Cashless	12,549,144	11,602,066	10,805,920	11,275,833	11,895,934	108.2
Cash	5,564,618	5,046,684	5,056,081	5,207,252	5,319,549	110.3
Total	**25,979,742**	**24,054,523**	**23,642,971**	**25,292,530**	**25,860,406**	**108.0**

Source: CBCG, commercial banks

In addition to the existing space for further reduction of operational risk in the payment system, other potential risks arising from the payment system were minimized with the establishment of disaster recovery location (contingencies) and improvement of the technological/IT platform for the system operations, including 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 loan receivables that expose a bank to risk.

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.

Table 4.4

Number of clients by active loans, end-year						
	2008	2009	2010	2011	2012	2013
Natural persons	133,961	117,047	107,414	104,158	102,212	104,948
Legal persons	5,603	5,207	5,031	4,830	4,771	5,241
Total	**139,564**	**122,254**	**112,445**	**108,988**	**106,983**	**110,189**

Source: CBCG

Table 4.5

Number of clients by total receivables (loans, lease operations, credit cards and overdrafts), end-year						
	2008	2009	2010	2011	2012	2013
Natural persons	184,872	171,153	160,161	146,132	150,260	142,311
Legal persons	6,137	5,787	6,483	6,261	6,355	6,926
Total	**191,009**	**176,940**	**166,644**	**152,393**	**156,615**	**149,237**

Source: CBCG

Table 4.6

Number of searches for the observed period					
IX-XII 2008	2009	2010	2011	2012	2013
26,910	119,576	188,165	198,722	143,990	136,949

Source: CBCG

The Central Bank of Montenegro Law from 2010 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[39]. The implementation of this decision, where in addition to monthly, daily reporting on new 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 simultaneously 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 other financial sector participants can be included into the reporting system subject to the agreement concluded with the Central Bank,: 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.

[39] 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 materialize.

International environment

The pressures regarding the European debt crisis have undoubtedly weakened, and the situation in the global financial market dramatically improved. However, the global economic environment remains quite uncertain and full recovery has not completed (primarily in advanced economise). Unfortunately, this is also valid for the region surrounding Montenegro.

Since a small increase in economic activity is forecasted for Europe in 2014 (the latest official forecast of the IMF for the euro area is 1%), Montenegro, being a small and open economy which is directly or indirectly connected to Europe, is not expected to record high growth in 2014, and neither is the rest of the region. 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 and dependant, based on debt and equity investments.

National macroeconomic environment

In the period 2009-2013, the Montenegrin economy recorded a zero real growth, while a decline in economic activity was primarily avoided due to new public sector's borrowings (Eurobond issues and bilateral credit arrangements) and, of course, foreign direct investments. A positive growth rate was recorded in 2013. However, position of the economy has not significantly improved – moreover, liquidity deteriorated. The situation in the household sector showed no significant improvements in relation to the previous year.

In other words, growth in 2013 was more of a discontinuation of negative trends and consequences as at the end-2008 and 2009 crisis and the 2012 recession than an exit towards the path of a long-term sustainable and steady recovery. The domestic capital market is maybe the best reflection of the aforesaid. The total annual turnover in 2013 was only 30.8 million euros, while the MONEX 20 index, as an expectation indicator, although at the same level at end-2013 relative to end-2012 is still close to a 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).

The CPI prices increased by 0.3% in 2013, which is a significant decrease in relation to 5.1% recorded 2012, and below the increase of prices in the euro area (0.8%). In terms of the structure, growth of the prices was mainly the result of an increase in the prices of tobacco (as a result of increased excises) and electricity, while the category "food and non-alcoholic beverages", although with a diversified trend of its components, had the highest impact on a decline in the inflation rate at the aggregate level.

As for expectations in 2014, Montenegro will most certainly be exposed to the global price movements, with the largest influence by the food and oil prices. Nevertheless, according to the IMF forecasts, the global inflation pressure will be relaxed in 2014, 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 2013, the current account deficit remained without significant changes in comparison to 2012 (the deficit declined by 17.1% and its share in GDP declined by 4.1 percentage points), while the coverage of imports by exports slightly increased by 1.2 percentage points and amounted to a mere 23.2%. As for the structure, the decline in the deficit is mostly the result of a decline in the trade deficit and an increase in the services account surplus, while changes in the balances of other current account sub-accounts had minor effects. Nevertheless, the most important to mention is the continuation of capital inflow decline: net FDIs recorded a decline of almost 30%, where the decline relative to GDP was 5 percentage points, to 9.7%.

It is estimated that the fiscal deficit amounted to 3.8% of GDP in 2013, largely as a result of vulnerabilities from the past period (calling of guarantees and payments under court decisions). Moreover, debt repayment amounted to 241.8 million euros (the amount excluded from the deficit), thus, total lacking funds for 2013 amounted to 370.1 million euros or 11.1% of GDP. The 2013 deficit, in general, is a continuation of trends started in the 2009-2012 period; therefore the average deficit in the period 2009-2013 amounted to some 4.9% of GDP. Deficit planned for 2014 amounts to 2% of GDP.

The deficit consequently increased the public debt, which exceeded 1.9 billion euros at end-2013, of which over 1.4 billion euros referred to the external debt. On the other hand, issued guarantees (foreign and domestic) amounted to 303.6 million euros. The public debt is still not too high in relation to GDP; however, the debt growing tendency and aggravated provision of sources for its repayment are the matters of concern. In the period 2008-2013, the share of public debt in GDP increased by 30.5 percentage points (from 27.5% to 58%), while the share of guarantees increased to 9.1% of GDP[40]. In addition to the above, conditions in the private sector point to the vulnerability of this sector which taxation provides funds for debt repayment.

The Government borrowing certainly prevented contraction of the economic activity in the period 2009-2013. However, the budget has to be balanced as soon as possible and debt growth must be halted. Otherwise, the problem will be postponed and the subsequent absorption will be more painful. Budget balancing that has gradually started will have its feedback on the financial position of all domestic sectors, which will further exert pressure on the financial system (banks).

According to Monstat, an average price per square meter in a new building amounted to 1.152 euros, i.e. 3.2% more than in 2012 (1.6% in Podgorica), while a new-building apartment sale increased even by 53.2% (21.9% in Podgorica). According to the CBCG survey (covering both new and old properties, where older properties are dominant), an average real estate price in Podgorica declined by 8.5% in

[40] According to the Pre-accession Economic Program (Ministry of Finance), the debt will amount to 2.001.3 million euros or 56.9% of GDP at end-2014.

June relative to March 2013, and also by additional 9% in February 2014 relative to June 2013. This was accompanied by a decline in turnover of the real estate agencies over the one-year period. In view of the outlook for the Montenegrin economy and prudent and rather restrictive banking policies, it is not unreasonable to expect a downward movement in prices in 2014. This would put additional pressure on the construction sector (to which banks are significantly exposed) and potential foreclosure 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). However, in the context of the realisation of capital and infrastructure project, it is estimated that this risk is small, particularly in new building constructions.

Financial system

Consequences of very relaxed bank lending policies in the pre-crisis period were also felt in 2013 although to a lesser extent, so the banks continued to impair assets and sell loans, together with continued prudency in lending and a further accumulation of liquidity. Total assets thus increased by a mere 2.4%, while gross loans and receivables declined by 3.3% at end-2013 relative to end-March. However, six small/medium-sized banks increased their gross loans by 66.3 million euros relative to end-March (i.e. by 6.7%). However, they were outweighed by the amount of write-offs/sales with the largest banks in the system. Profit at the system level amounted to 2 million euros, with significant losses borne by two banks.

This primarily resulted from the sale of non-performing loans/receivables, the share of gross non-performing loans and receivables, i.e. the share of gross 30 days and over past due loans and receivables in total gross loans and receivables declined in relation to end-March 2013. Value adjustments for gross non-performing loans and receivables to gross non-performing loans and receivables ratio, although better compared to end-March, amounted to low 39.1% at end-2013. Moreover, net non-performing loans and receivables are still high compared to capital (68.7%). Finally, stress testing showed that some banks are still very sensitive to credit risk.

Liquidity of the banking sector is satisfactory. Stress testing showed in several banks inadequate liquidity in case of a potential bank run. However, it should be borne in mind that the tests used are rather strict and that relatively narrow definition of free/available liquid assets which would serve to cover outflows is used.

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

As for the capital market, 2013 was perhaps even worse than 2012. Although total turnover recorded a decline of as much as 5.8% in relation to 2012, it amounted to EUR 30.8 million and marked the lowest level of annual turnover since 2002. Furthermore, the MONEX 20 index remained the same, while the MONEX PIF slightly declined during 2013. 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. In addition, individual perceptions of personal wealth moves downward unrealistically causing the contraction of their consumption and, consequently, the general level of economic activity.

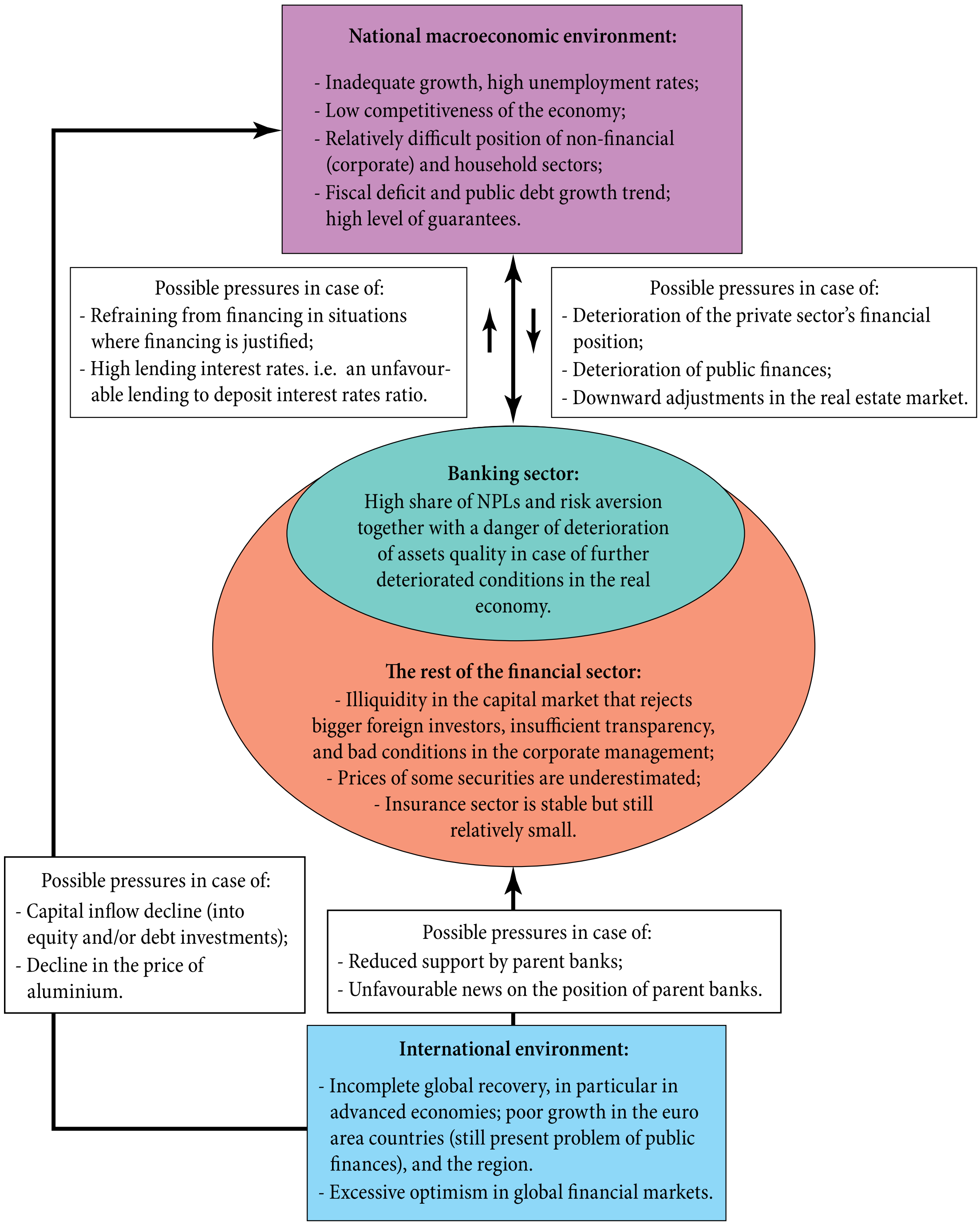
As for the insurance companies` position, the preliminary operating results show that this sector further stabilised in 2013. A potential influence of this sector on the rest of the financial system and/or the real economy is limited by its relative size. Nevertheless, a greater and stronger insurance sector would be desirable: it would mean more capital in the financial system.

Table 5.1 shows the key risks in the system.

Table 5.1

Key risks in the system		
Type of risk	Level of risk	Movement direction
International environment	Moderate	Stable to declining
Fiscal sustainability	Moderate to high	Stable
Credit risk	Moderate to high	Stable
Liquidity risk	Moderate	Declining
Market risk	Low	Stable
Financial infrastructure	Low	Stable
Insurance market	Low	Stable
Capital market	Moderate to high	Stable

Chart 5.1 – Key risks and influence directions



5.1. Policies for preservation of financial stability

Real sector/balance of payments

The real/private sectors remain very vulnerable. Only a strong and competitive private sector enables stable government finances, does not threaten the banking sector (which is exposed to it), and ensures 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 2014. In that sense, the measures of fiscal consolidation from 2013 and the beginning of 2014 are very encouraging (introduction of progressive personal income taxation, the lowering of expenses for materials and services as well as measures for better collection of taxes and contributions, i.e. reducing grey 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 an 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 2014 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 2014. Efforts should be made to keep the public debt permanently below the critical level of 60% of GDP. 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[41].

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: issue of new guarantees must be stopped, which was very well implemented in 2012 and 2013.

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 the banks need to continue to clean their balance sheets with all means available: sale, restructuring and finally write-offs. Adequate policy of asset impairment 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[42]. The CBCG 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 macro prudential inspection defers from micro prudential 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 the 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. Plans are regularly updated, and the CBCG contingency plan was successfully tested in October/November 2013 in cooperation with the World Bank.

41 A new organic Budget Law (so-called Law on Budget and Fiscal Responsibility, currently in the draft form) is a very good step forward.

42 Within the current programme for restructuring of NPLs in banks that is carried out in coomperation with the World Bank experts, the CBCG plays the role of mediator/catalist that is actively involved in the drafting of the Law on Voluntary Financial Restructuring.

CIP - Каталогизација у публикацији
Централна народна библиотека Црне Горе, Цетиње

336(497.16) (060.55) (047)

FINANCIAL Stability Report 2013. -2011- . - Podgorica (Bulevar Sv. Petra Cetinjskog 6) : Centralna banka Crne Gore, 2014 (Podgorica: DPC d.o.o.). - 28 cm

Godišnje
ISSN 1800-8941 = Financial Stability Report (Podgorica)
COBISS.CG-ID 18454544