CENTRAL BANK OF MONTENEGRO

Financial Stability Report

2014

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ABBREVIATIONS USED IN THE REPORT

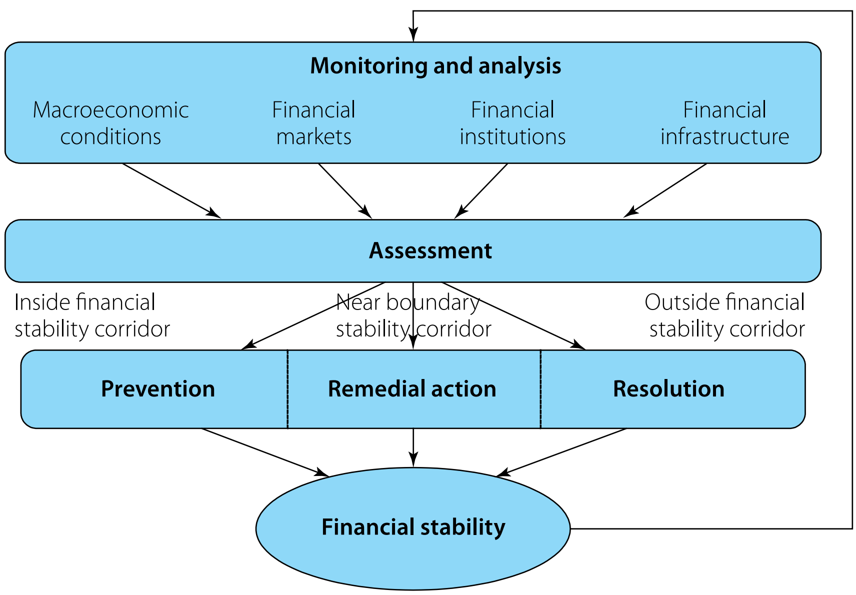
ARIMA model	Autoregressive integrated moving average model
AED	Dirham, currency of the United Arab Emirates
GDP	Gross Domestic Product
CBCG	Central Bank of Montenegro
CDS	Credit default swap
CHF	Swiss Frank
DNS	Deferred net settlement
EBRD	European Bank for Reconstruction and Development
ECB	European Central Bank
EIB	European Investment Bank
EMU	Economic and Monetary Union
EONIA	Euro overnight index average
EPCG	Elektroprivreda Crne Gore (Electric Power Company of Montenegro)
EU	European Union
EUR	Euro
EURIBOR	Euro interbank offered rate
FED	Federal Reserves
GBP	Pound Sterling
(H)CPI	(Harmonised) Consumer Prices Index
JPY	Japanese Yen
KAP	Kombinat aluminijuma Podgorica (Aluminium Plant)
KfW	Kreditanstalt für Wiederaufbau
LFS	Labour force survey
LIBOR	London interbank offered rate
MF	Ministry of Finance
MFI	Micro-credit financial institutions
IMF	International Monetary Fund
MSCI	Morgan Stanley Capital International
NOK	Norwegian kroner
VAT	Value added tax
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	United States of America
FDI	Foreign Direct Investments
OF MN	Official Gazette of Montenegro
UK	United Kingdom
USD	United States Dollar
VIF	Variance inflation factor
WIIW	Wiener Institut für Internationale Wirtschaftsvergleiche
ZZZ	Employment Office

CONTENTS

INTRODUCTORY REMARKS

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

Schematic 1 – Framework for maintaining financial stability



Source: Schinasi, G., 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-dimensioned policies. Of course, the objective cannot be the preventing of all potential problems in the financial market because it is impossible to manage all risks and uncertainties, and there is also no market that has not undergone fluctuations or turbulences. Therefore, efforts should be put on minimizing the biggest risks and ensuring system vitality in case of a crisis. Thus, the very objectives of the Financial System 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

In 2014, the global economy continued to record growth similar to 2013, recording a 3.3%[1] growth rate. The growth was relatively uneven throughout 2014 and the IMF estimated that the advanced economies grew at a rate of 1.8% at annual level, while emerging and developing economies grew at a rate of 4.4%. It was estimated that the global trade volume rose by 3.1% in 2014 (compared to 3.4% in 2013).

Table 1.1

Overview of main global indicators, y-o-y, %

Indicator	2013	2014	Forecast		Difference from October 2014 projections (percentage points)	
			2015	2016	2015	2016
GDP growth						
World Output	**3.3**	**3.3**	**3.5**	**3.7**	**-0.3**	**-0.3**
Advanced economies	**1.3**	**1.8**	**2.4**	**2.4**	**0.1**	**0.0**
Emerging and Developing Economies	**4.7**	**4.4**	**4.3**	**4.7**	**-0.6**	**-0.5**
USA	2.2	2.4	3.6	3.3	0.5	0.3
euro area	-0.5	0.8	1.2	1.4	-0.2	-0.3
Germany	0.2	1.5	1.3	1.5	-0.2	-0.3
France	0.3	0.4	0.9	1.3	-0.1	-0.2
Italy	-1.9	-0.4	0.4	0.8	-0.5	-0.5
Spain	-1.2	1.4	2.0	1.8	0.3	0.0
Japan	1.6	0.1	0.6	0.8	-0.2	-0.1
UK	1.7	2.6	2.7	2.4	0.0	-0.1
Canada	2.0	2.4	2.3	2.1	-0.1	-0.3
Advanced economies outside G7 and euro area	2.2	2.8	3.0	3.2	-0.2	-0.1
European emerging and developing economies	2.8	2.7	2.9	3.1	0.1	-0.2
Russia	1.3	0.6	-3.0	-1.0	-3.5	-2.5
China	7.8	7.4	6.8	6.3	-0.3	-0.5
India	5.0	5.8	6.3	6.5	-0.1	0.0
Latin America and the Caribbean	2.8	1.2	1.3	2.3	-0.9	-0.5
Middle East, North Africa, Afghanistan and Pakistan	2.2	2.8	3.3	3.9	-0.6	-0.5
Sub-Saharan Africa	5.2	4.8	4.9	5.2	-0.9	-0.8
World trade volume (goods and services)	**3.4**	**3.1**	**3.8**	**5.3**	**-1.1**	**-0.2**
Consumer Prices						
Advanced economies	1.4	1.4	1.0	1.5	-0.8	-0.4
Emerging and developing economies	5.9	5.4	5.7	5.4	0.1	0.2

Source: World Economic Outlook (WEO) Update, IMF, January 2015

[1] According to the IMF's World Economic Outlook report, updated in January 2015

However, having in mind different results by selected countries/regions and taking into account the problems with public finances and slow economic recovery in the EU, as well as problems with public finances in the USA, and still relatively high unemployment rates (in the EU in particular), it may be noted that the global economy is still not on the path of a steady growth. It particularly refers to the advanced economies (except USA to some degree), while emerging and developing economies currently find themselves in a much better position as opposed to the one in pre-crisis period. For instance, it is estimated that in 2014 China became the world's largest economy in terms of purchase power parity, i.e. when price differences are eliminated in comparing GDP. In 2014, according to the IMF's data, China accounted for 16.5% while the USA made up 16.3 of global GDP in terms of purchase power parity.

The general impression is that globally competitive and export oriented countries continue to develop 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 of the system.

Table 1.2

GDP per capita and unemployment rate per selected countries (ranked by column "GDP per capita (PPP), $", part "2014/2008, %")

Country	BDP per capita (PPP), $		Unemployment rate, %	
	2014/2008, %	2014	2014/2008, %	2014
China	74.2	12,893	-2.4	4.1
India	49.5	5,777	...	...
Poland	27.6	24,429	33.5	9.5
Turkey	24.4	19,556	-5.4	9.5
Macedonia	19.9	13,204	-14.3	29.0
Brazil	18.1	15,153	-30.3	5.5
Germany	16.1	44,741	-29.9	5.3
Australia	15.5	46,631	45.2	6.2
Russia	14.6	24,764	-10.4	5.6
USA	13.2	54,678	8.5	6.3
Japan	12.7	37,683	-6.9	3.7
Montenegro	**11.2**	**15,219**	**7.1**	**18.0**
Bosnia and Herzegovina	11.1	9,808	8.9	25.5
Serbia	11.0	12,605	46.7	21.6
Switzerland	10.5	55,237	30.2	3.4
Austria	10.0	45,411	31.6	5.0
France	8.4	40,445	33.3	10.0
UK	6.8	37,744	10.8	6.3
Island	5.6	42,630	143.8	4.0
Netherlands	4.2	47,365	136.5	7.3
Luxemburg	1.5	92,507	68.1	7.1
Italy	-1.2	34,455	85.3	12.6
Slovenia	-2.1	29,359	125.5	9.9
Croatia	-4.0	20,392	102.7	16.8
Cyprus	-12.8	27,986	355.4	16.6
Greece	-14.8	25,753	236.6	25.8

Source: World Economic Outlook (WEO) Update, IMF, October 2014, Monstat, CBCG calculations

The year 2014 was marked by disinflationary and deflator trends in the euro area/EU. The annual inflation rate declined from 0.8% in January to -0.2% in December, primarily as a result of lower energy prices. In other words, throughout the year, the inflation rate moved away from the medium-term objective of the Eurosystem's monetary policy, i.e. inflation rate below, but close to 2%. This led the makers of monetary policy measures in the euro area to additionally lower the reference interest rates and expand the spectrum of instruments referring to the purchase of securities/quantitative easing.

Unemployment and Current Account Deficit

In 2014, almost all countries of the euro area recorded decline of unemployment rates[2]. Unemployment rate declined in Greece, Spain, Portugal and Ireland. Despite this fact, they are still high in Ireland and Portugal where they amount to 10.5% and 13.4% and extremely high in Spain and Greece where they amount to 23.7% and 25.8%. On the other hand, unemployment rates additionally increased in Italy (0.3 percentage points), and amounted to 12.9% at end-2014. These rates also improved in Slovenia (by -0.2 percentage points) being 9.7% at end-2014. Croatia and Cyprus are ranked as the worst in the EU, after Greece and Italy. The unemployment rate in Croatia and Cyprus amounted to 16.4% at end-2014 after improvement of 0.7 and 0.1 percentage points that occurred over the year.

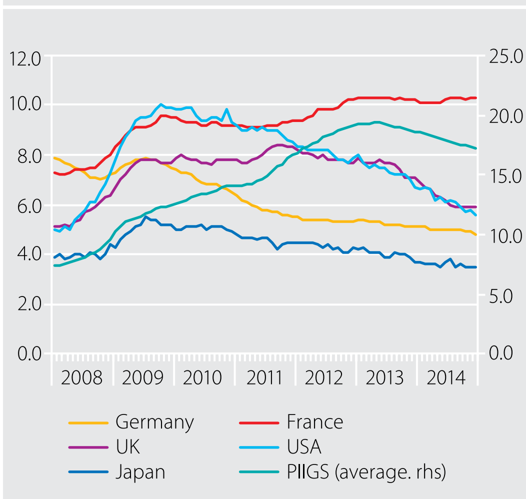
On the other hand, Germany was the only euro area/EU country that recorded unemployment decline in period after the crisis outbreak. This decline continued also in 2014 (by 0.3 percentage points), and the unemployment rate amounted to 4.8% at end 2014, being the highest unemployment rate in the EU, lower than the rate recorded in Austria (4.9%). Contrary to Germany, the unemployment rate in France grew about 3 percentage points in relation to the period before the crisis, and after a slight growth during 2014, the unemployment rate amounted to 10.3% at the end of the year (which was below the euro area average).

The unemployment rate in the USA also recorded a decline in 2014 (reaching the level of 5.6%), thus continuing a gradual decline as of Q4 2009 when it reached the level of 10%. The unemployment rate in Japan also declined by 0.2 percentage points amounting to 3.5%. 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.

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 mostly continued to decline, i.e. to turn into surpluses. It is estimated that virtu-

Figure 1.1

Change in unemployment rate in selected countries, 2008-2014, by LFS, % (PIIGS includes: Portugal, Ireland, Italy, Greece and Spain)

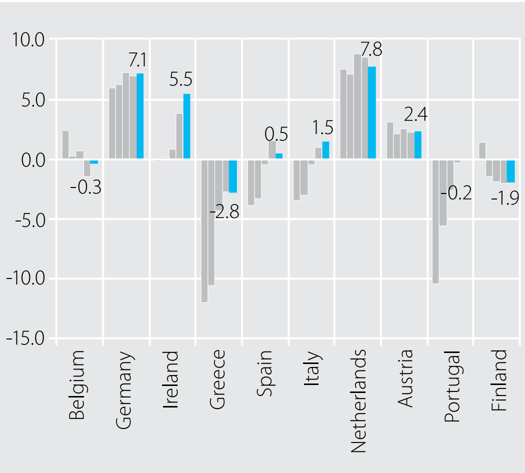


Source: Eurostat, CBCG calculations

[2] Last available monthly data at the time of writing of this part of the report were taken for unemployment rates from December 2014

Figure 1.2

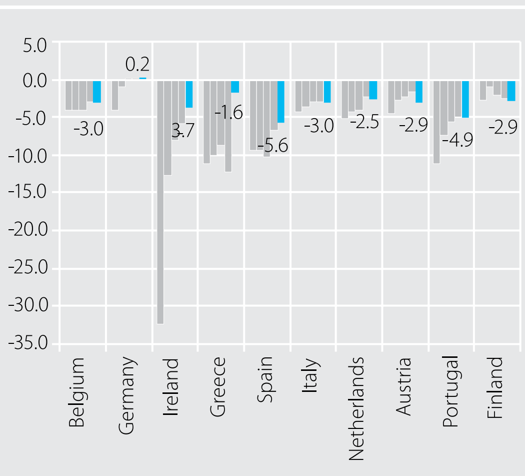
Current account deficit in selected countries of the euro area, GDP % (2010-2014; 2014 presented in blue colour)



Source: European Commission – autumn forecast 2014 (November 2014)

Figure 1.3

Budget deficit in selected countries of the euro area, GDP % (2010-2014; 2014 is shown in blue colour)



Source: European Commission – autumn forecast 2014 (November 2014)

ally all countries of the periphery, except Greece (-2.8% of GDP), recorded the current account surpluses in 2014 – Spain, Italy and Portugal slight surpluses, and Ireland in the amount of 5.5% of GDP. 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.

Public Finance and Financial Markets

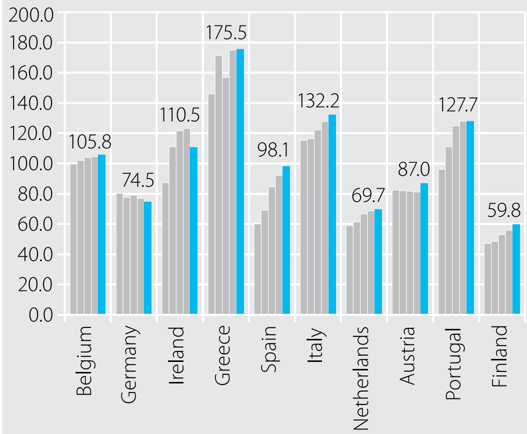
In general, 2014 was characterised by a certain continuation of optimism in terms of public finances of the euro area periphery. To wit, the painstaking austerity measures, structural reforms and certain ECB measures started to show results. However, the problems of weak growth (or decline) of economic activity remain and the makers of economic policy measures still have a lot to do. In addition to this, depreciation of euro and increase of stock indices marked financial markets in 2014.

Graphs 1.3 and 1.4 show summarised movements of public finances in the euro area countries. It is clear that there is an ongoing process of strong fiscal consolidation 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 or stagnating the public debt growth. However, public debt decline is missing, except in the case of Germany.

In 2014, a significant geopolitical event was the Ukrainian crisis, which is still in progress. The crisis caused strained relations between the USA and EU on one side and Russia on the other. It included introduction of certain sanctions and reduction of economic cooperation. To some degree, this had negative effects on the growth of the EU countries, but it seems it had a much larger negative effect on the position of the Russian economy, given the decline of the Russian ruble against the US dollar, and all the problems it has caused. It is estimated that the Russian economy increased only by 0.6% in 2014, while it is expected to decline by as much as 3% in 2015.

Figure 1.4

Public debt in selected countries of euro area, GDP % (2010-2014; 2014 is shown in blue colour)



Source: European Commission – autumn forecast 2014 (November 2014)

In early November 2014, as it was planned, the ECB started banking supervision in the euro area, which signals the completion of the first phase of the so-called banking union project. This was preceded by a comprehensive assessment of banks that will be controlled by the ECB, which lasted for a year, and was made up of a detailed overview of asset quality and stress testing. One of the objectives of comprehensive assessment was to have a better insight of the banks' position and relative risks before the ECB formally took the role of a supervisor. About 130 of the most significant banking groups, whose assets make up over 80% of total assets of banks in the euro area will fall under direct supervision of the ECB. In cooperation with the national supervisory bodies, the ECB will also be entitled to supervise other banks, if such action is deemed necessary.

During 2014, most of the euro area periphery countries gained access to financial markets, and yields on their bonds fell dramatically compared to end 2013, especially bonds with shorter maturity date. In parallel, CDS on public debt of those countries declined in 2014.

Yields on the U.S., German and Swiss government ten-year bonds declined during 2014 to 2.2%, 0.5% and 0.3%, respectively, as a result of positive perception and expectations of financial markets in relation to the abovementioned securities and their alternative financial instruments. The price of gold remained stable in 2014 and declined only by 1.4% to 1.184 U.S. dollars for a fine ounce of gold at the end of 2014. It bears mentioning that in 2014, yields on government securities in the EU declined mostly as a result of ECB's policy – both the trends of the ECB's interest rates and the securities purchase programmes.

Stock market indices of developed economies were also at a higher level compared to the end of 2013. The MSCI developed market index was 2.9% higher compared to end-2013, while the MSCI index covering all markets for the same period recorded somewhat lower growth of 2.1%, and due to the decline of the MSCI emerging market index of 4.6%. In 2014, the MSCI indices (as global indices) reached the record high levels, despite the fact that emerging market index declined at the end of the year. When it comes to indices of individual markets, DAX-Frankfurt or DJIA-New York reached their record highs during 2014, increasing by 2.7% and 7.5%, respectively. NIKKEI-Tokyo increased by 7.1%, while FTSE 100-London and CAC 40-Paris recorded mild decline of 2.7% and 0.5%, respectively. On one hand, this represents a positive signal, while on the other hand it partially represents a matter of concern.

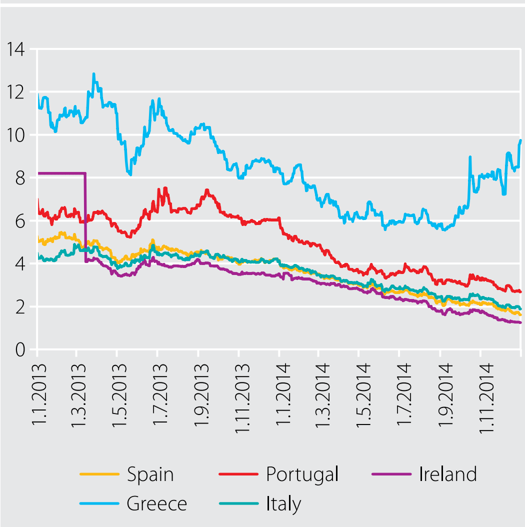
This is because it is not quite clear where the optimism of financial markets comes from, taking into account still unconvincing economic recovery perspectives at the global level.

Even though there were some oscillations, 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 rather low levels in 2014, similar to 2013[3].

During 2014, euro nominally depreciated against major currencies, except Japanese yen. The exchange rate of the euro depreciated against U.S. dollar, British pound and Swiss franc by 12% (from 1. 3742 to 1. 2098 USD against 1 EUR), 6.4% and 2%, respectively. Appreciation against the Japanese yen amounted only to 0.1%, following strong appreciation in 2013. Daily variations of the exchange rate of the euro against the abovementioned currencies were relatively small, with variation coefficient of 4%, 2.3%, 2.1% and 0.7%, when it comes to the exchange rate of euro against U.S. dollar, Japanese yen, British pound and Swiss franc, respectively. It bears mentioning further depreciation of euro against the Swiss franc in the beginning of 2015, following the announcement of the Swiss National Bank that it will not prevent appreciation of Swiss franc against the euro, starting from middle of January 2015.

Figure 1.5

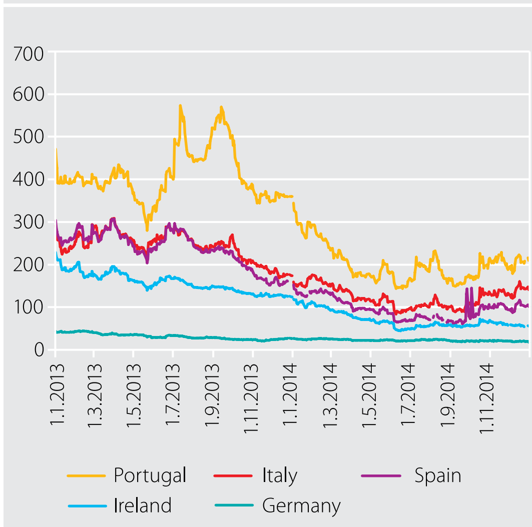
Yields on ten-year government bonds,%, 2013-2014.



Source: Bloomberg

Figure 1.6

CDS on government bonds in basis points, 5-year contracts, 2013-2014

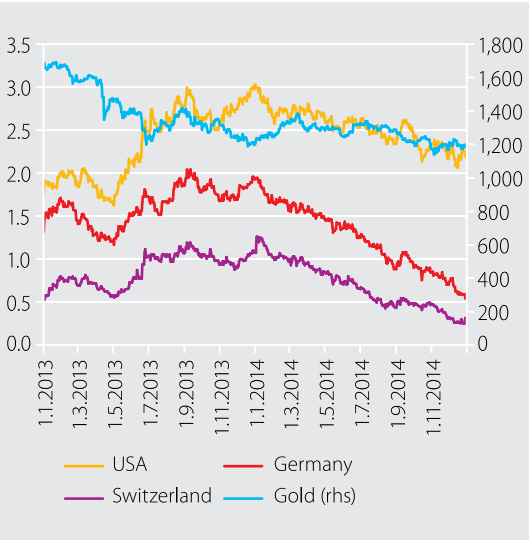


Source: Bloomberg

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.

Figure 1.7

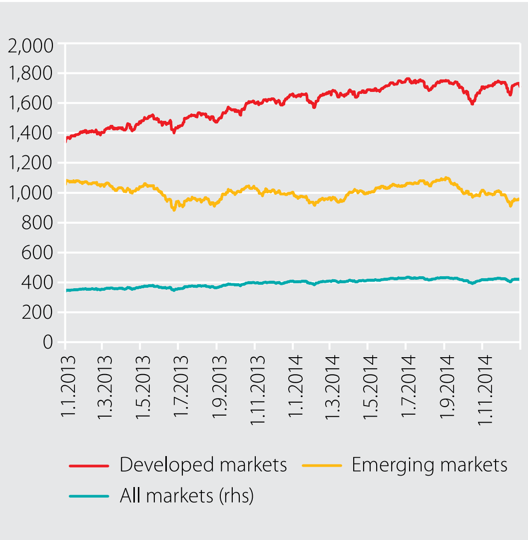
Yields on 10-year government bonds of the USA, Germany and Switzerland (%) and the price of a fine ounce of gold in US dollars, 2013-2014



Source: Bloomberg

Figure 1.8

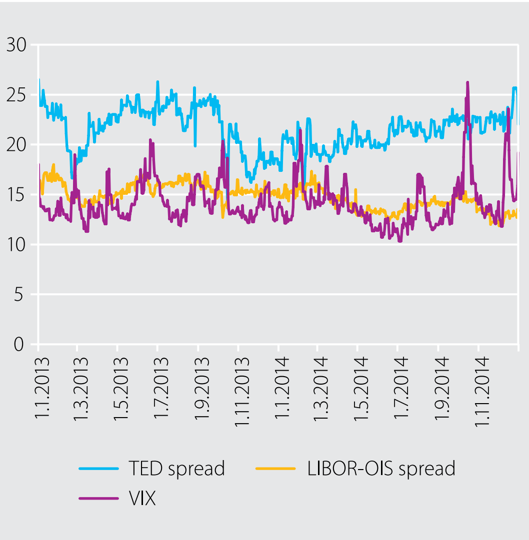
MSCI global indices, 2013-2014



Source: Bloomberg

Figure 1.9

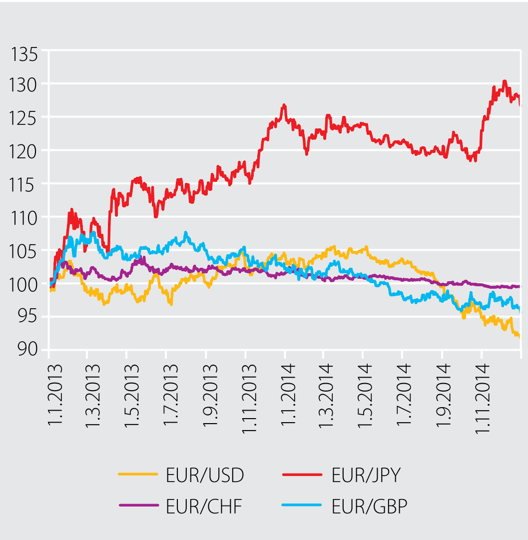
Volatility/stress indicators in financial markets, 2013-2014



Source: Bloomberg

Figure 1.10

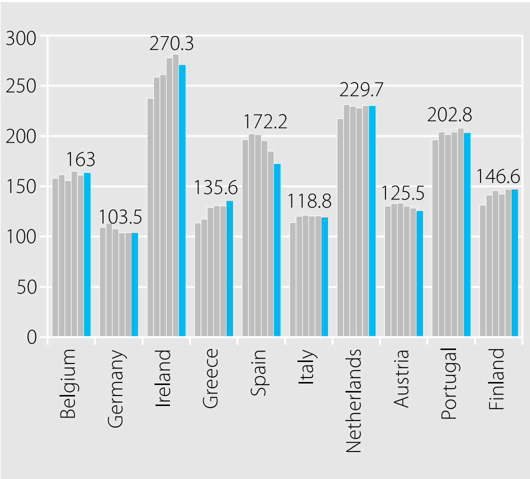
Euro against other currencies, 2013-2014, 1 January 2013=100 (rise/fall indicates euro appreciation/depreciation)



Source: Bloomberg, CBCG calculations

Figure 1.11

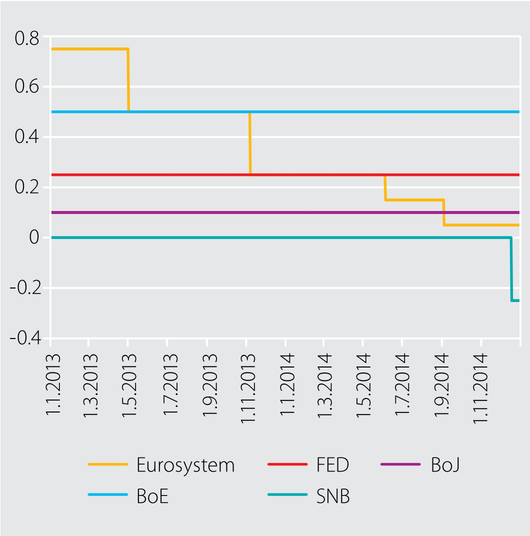
Debt of the private sector of the euro area countries (2008-2013; 2013 shown in blue colour)



Source: Eurostat

Figure 1.12

Reference interest rates of central banks, %, 2013-2014



Source: Bloomberg

Figure 1.11 shows 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 significant reduction of interest rates in that period (particularly in the euro area peripheral countries) and it was used by the entities of that sector. 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. Figure 1.11 shows deceleration, i.e. stopping of the private debt growth during the post-crisis period.

Monetary Policy of Leading Central Banks

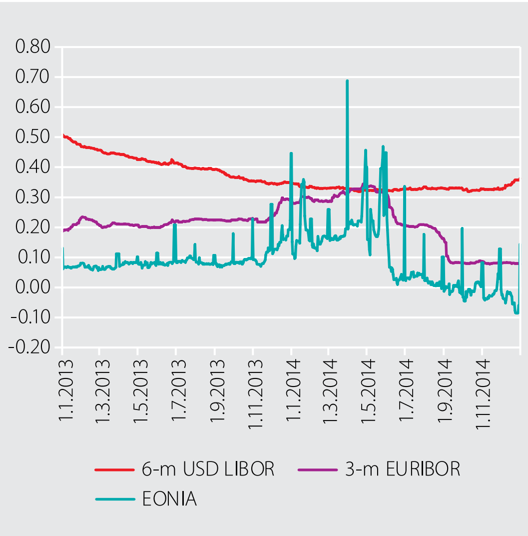
Against the backdrop of continued and feeble economic growth, and particularly taking into account expectations, central banks of leading economies continued with the record low interest rate policies in 2014. For example, the Fed has kept its target federal funds rate unchanged since December 2008 (0-0.25%), and after the last meetings of the FOMC in 2014 it was announced that the rates could 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 0.25% to 0.15% at the meeting held in early June, and from 0.15% to 0.05% at the meeting held in early September, which represents the record low level. At the same time, the interest rate on overnight deposits declined to -0.2%. 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 0-0.1% (since December 2008), respectively. Reference interbank rates were at record low levels: the EONIA was around 0.1% (since September 2014 it was mostly negative), while the 3M EURIBOR was around 0.21%, and 6M LIBOR on the US dollar amounted to 0.33%.

[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.

In 2013, the mentioned central banks, with a partial exception of the Eurosystem, mainly maintained the so-called "quantitative easing" programmes, i.e. (electronic) money issue, where they directly injected liquidity into the banking system and tried to additionally decrease the interest rates in the economy by buying government securities from banks. As a consequence, during 2014, the Fed's assets rose by 11.5% and those of the Bank of Japan by 33.9%. However, after the FOMC meeting held in October 2014, the Fed decided to stop the programme of monthly purchase of new agency bills, i.e. long-term Treasury bills, after it previously reduced the purchase of the mentioned bills throughout the year. The Fed did this as additional signals arrived that the labour market and economic activity in general are significantly better in relation to the time when the assets purchase programme started. However, the ECB prepared for expansive actions by introducing targeted long-term refinancing operations, asset-backed securities purchase programme as well as covered bond purchase programme. In addition to this, at the meeting held in January 2015, it was decided that from March 2015 the ECB will start buying euro government bonds in the secondary market, which will represent quantitative easing in the right sense of the word. This possibility was announced a long time ago, in August 2012. 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 the work and the private sector finds a way to transform and increase productivity.

Figure 1.13

Reference market interest rates, %, 2013-2014



Source: Bloomberg

Commodity prices

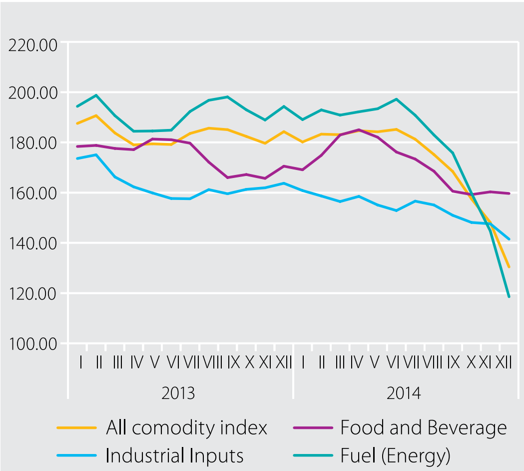
According to the IMF's commodity price index (excluding precious metals), commodity prices recorded the y-o-y decline of as much as 29.2% in December 2014. However, observed through an average of 12-month indices, the prices dropped by 6.3%, since the prices recorded the highest decline during the last quarter 2014. Although the prices of food and beverages and industrial products fell by 6.4% and 13.6% respectively, the index value in December 2013 was largely affected by lower prices of energy products (39%), since the IMF's commodity price index assigns them the highest weight[5]. Observed through the average, the energy product prices fell during 2014 by 7.5%.

Due to the importance of aluminium for the Montenegrin economy, we are presenting the price trending of this industrial input. The aluminium price increased y-o-y by 9.8% in December 2014, amounting to 1.909.46 USD/t, while the average annual growth amounted only to 1.1%. However, the values remain significantly lower in relation to prices of over 3,000 USD/t which were recorded in spring 2008.

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

Figure 1.14

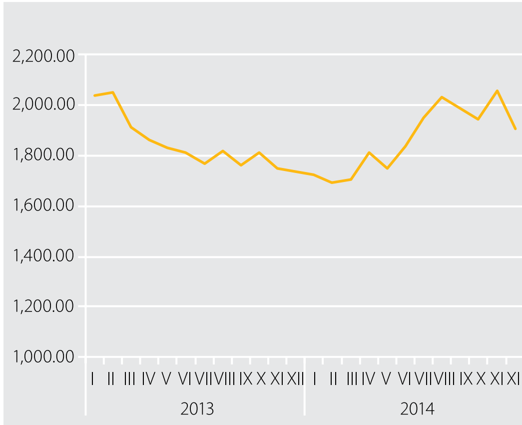
Commodity prices (2005 = 100), 2013-2014



Source: IMF

Figure 1.15

Price of aluminium tonne, 2013-2014 (in USD, London Metal Exchange, monthly average)



Source: IMF

Expectations in 2015

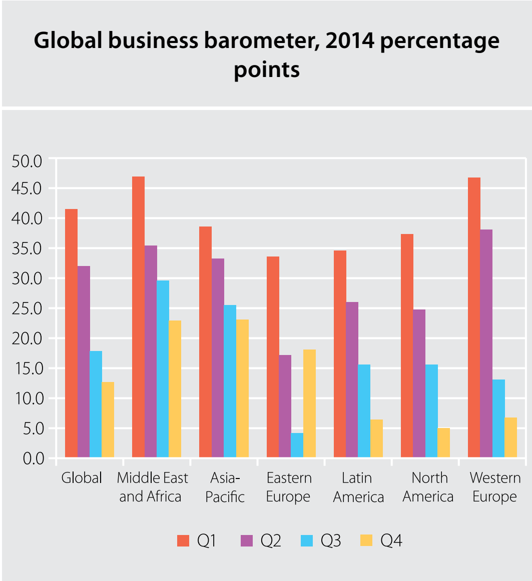
According to the IMF January 2015 forecast, the global economic growth is expected to amount to 3.5%. Moreover, it should be noted that this forecast was revised downwards by 0.3 percentage points in relation to October 2014, due to the forecast revisions downwards for several countries: Germany, Italy, Japan, Russia, China, Brazil and Mexico. It is encouraging that the growth rate of 3.6% is forecasted for the USA, which 1.2 percentage points more in relation to the growth rate from 2014. The US labour market additionally recovered during 2014, but the persisting high level of long-term unemployment and a low labour force participation in total population is still a matter of concern. Maintaining of very low growth rate is forecasted for the Japanese economy (0.6% compared to 0.1% recorded in 2014).

Observed by groups of countries, it is forecasted that advanced economies would grow at the rate of 2.4%, emerging and developing economies at the rate of 4.3%, and the latter are estimated to give the major contribution to total growth in 2015. As expected, China and India will be the main drivers of growth (with Mexico, while the Russian economy is expected to decline by as much as 3%). As regards advanced economies, the global growth contribution will mostly come from the USA, the UK, Germany, Spain, Canada and Japan. However, possible escalation of tensions in Ukraine could have negative effects on economic growth.

According to the IMF forecasts, the growth of the European emerging and developing economies will amount to 2.9% in 2015, which is a modest yet improved growth rate compared to 2014 (2.7%).

Briefly, what is the most encouraging is the somewhat higher global growth rate in 2015 in comparison to 2014 and a significant improvement in financial markets. However, much remains to be done, and the announced structural/institutional reforms need to be implemented properly, thoroughly 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 of 1.2% (from 0.8% in 2014), since this is the region with which Montenegro has the strongest economic relations.

Figure 1.16



Source: "The Economist" / "The Financial Times"

The Financial Times and the Economist's Global Business Barometer shows a decline of expectations during 2014 and the worst expectations in the last quarter of 2014.[6] To wit, the balance between the top managers expecting improvement in business environment/economic situation in the next six months as compared to those expecting the opposite amounted to 12.7 percentage points. The expectations by regions: from 23.1 percentage points among managers from Asia-Pacific and 23 percentage points among managers from the Middle East and Africa to only 5 percentage points among managers from North America.

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 2015 show that the prices of oil and non-energy products would decrease on average by 41.1% and 9.3%, respectively. Similar to 2014, the forecast for oil prices is partially conditioned by a forecast on weaker demand in relation to large oil production of 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 1.848 U.S. dollars per tonne in 2015 or they will decline by 1% compared to the price in 2014.

[6] 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).

As regards revenues from tourism, faster growth 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 2015 compared to 2014, even though it remains uncertain to what extent will the Ukrainian crisis influence the arrival of tourists from Russia and Ukraine.

Finally, the most 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, as well as a large number of announced investment projects (as well as those whose implementation has already started). However, 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.[7] As regards banks' borrowings, they will dominantly be affected by financial positions of their parent banks and the latters` willingness to potentially finance their subsidiaries. More significant support of parent banks for improving lending activity should not be expected in 2015, and the subsidiaries will have to look for funds for lending in the domestic market or via credit lines granted during the previous period.

[7] 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 domestic financial system.

2. MACROECONOMIC DEVELOPMENTS IN THE COUNTRY

2.1. Economic Activity Developments

The indicators determining overall economic growth in Montenegro showed mild upward trend in 2014. Thus, the manufacturing industry and the sector of electricity, gas and steam supply will be having negative effects, while the retail trade, tourism, mining and quarrying, and forestry will have positive effects on total growth rate in 2014. The construction sector generated dual result, depending on which indictor in the Table 2.1 is deemed relevant.

Table 2.1

Trends of selected activities, 2014/2013, %	
Retail trade, turnover (constant prices)	3.8
Tourism	
Number of arrivals	1.7
Number of overnights	1.5
Manufacturing, physical volume	-6.7
Construction	
Value of completed works	2.0
Effective work hours	-4.6
Electricity, gas and steam supply	-19.6
Mining and quarrying, physical volume	14.4
Forestry, physical volume (index weighted)	17.9

Source: MONSTAT

Estimated real GDP growth in 2014 was around 1.5%. According to IMF estimates, the Montenegrin economy in 2014 grew at the rate of 2%, according to the European Commission estimates 1.4%[8], and according to EBRD estimates at the rate of 1.3%.

The previous year was characterised by an increased number of employees (1.2%) and registered unemployed persons (3.4%), as well as slight decline in gross and net wages of 0.4% and 0.5% respectively. These were obvious slight movements in the labour market, and general position of the household sector is still relatively “fragile”. Namely, observing the trends of average wages and inflation, it can be said that the earnings of the population have not had a real growth during the past four years; instead,

[8] According to the winter forecast 2015 (February 2015).

they recorded a decline due to the fact that the prices increase exceeded significantly the growth in wages, especially in 2012.

Data from the labour market according to the MONSTAT's Labour Force Survey should be also added to this, where the unemployment rate remains at high level of 19%, with continued low employment rates (ratio of employment and working age population) of about 40% and activity rate (ratio of labour force (i.e. active) and 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

Basic labour market indicators (annual average)

	2013	2014	Change (2014/2013), %
Employed	171,474	173,595	1.2
Unemployed	32,190	33,284	3.4
Wages, gross, €	726	723	-0.4
Wages, net, €	479	477	-0.5

Source: MONSTAT, Employment Agency of Montenegro

Table 2.3

Unemployment in countries in the region, labour force survey, %

Country	Unemployment rate, 2014
Slovenia	10.0
Croatia	17.5
Montenegro	**19.0**
Serbia	21.0
Bosnia and Herzegovina	27.0
Macedonia	28.0

Source: WIIW, November 2014

Key problem of the economy present in 2014 as well was a sizeable illiquidity. Observed through enforced collection indicators, the position of the real economy somewhat worsened compared to 2013. The share of persons[9] with frozen accounts in total number of persons performing an activity declined in 2014, thus it was 21.8% at the end of 2014. However, blocked amounts were significantly higher. Thus at the end of 2014, the blocked amount of entities with frozen accounts uninterruptedly for a period longer than one year was 437.7 million euro (9% more), while the total amount blocked was 496.1 million euro, recording an increase of 13.5%.

Moreover, the fact that Montenegrin economy cumulatively showed only a slight growth in period 2009-2014 remains as a concern, i.e. the 2014 GDP was insignificantly higher than the 2008 GDP; this is even more the case since the pre-crisis growth did not generate sufficient number of new jobs (alt-

[9] Includes legal persons and entrepreneurs.

hough a significant progress was made), i.e. in that context growth benefits were distributed rather unevenly.

Table 2.4

Basic statistic of enforced collection, end of the period			
	2013	2014	Change, %
Number of persons with frozen accounts	12,981	14,160	9.1
As % of total number of persons	23.5	21.8	(percentage points) -1.8
entities with uninterruptedly frozen accounts up to one year, EUR	35.384.040,03	58.394.100,19	65,0
entities with uninterruptedly frozen accounts for more than one year, EUR	401.636.556,82	437.717.022,82	9,0
Total, EUR	437.020.596,85	496.111.123,01	13,5

Source: CBCG

Forecast of GDP trends in 2015 and impact on financial stability

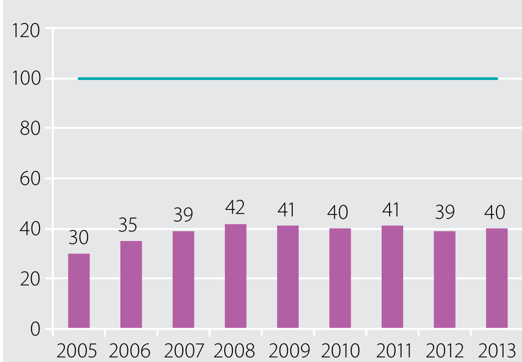
Growth in 2015 will primarily depend on the following factors: inflow of foreign capital, credit supply (and the overall situation in the banking sector), the situation in industry, economic situation in the EU and the region, as well as on the dynamic for realisation of the announced investment projects in 2015. The inflow of capital, the main driver of the real economy during the several past years, will certainly 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). However, it should be noted that there are some important announcements when it comes to the FDI inflows.

When it comes to the willingness of banks to grant loans, it is unrealistic to expect that prudential policy of banks will significantly change during 2015, which is largely attributed to continued high share of non-performing loans. The situation in the metal processing industry will of course remain dependent on developments in KAP, which is very difficult to predict. Direct and indirect effects of the investment projects (together with the first section of the Bar-Boljare highway, and other projects) will be present in 2015 to the extent in which their implementation will start/continue.

An accelerated growth is expected in 2015 as per forecasts of international financial institutions presented Table 2.9. However, the growth rate of 3.3% (a rate obtained by weighing GDP growth estimates by international institutions, from the

Figure 2.1

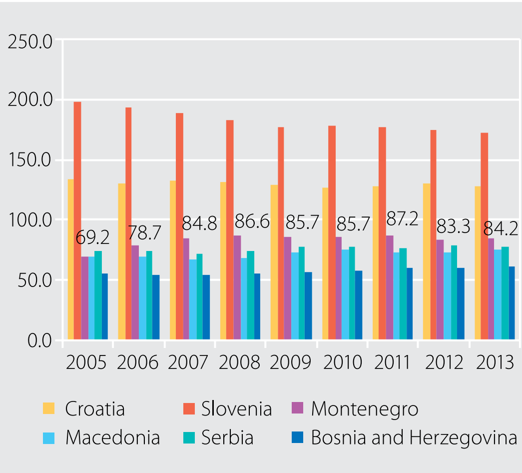
Montenegrin GDP per capita at purchasing power parity, EU28=100, 2005-2013



Source: Eurostat

Figure 2.2

Montenegrin GDP per capita at purchasing power parity, EX YU (excluding Kosovo) = 100, 2005-2013



Source: Eurostat, CBCG re-scalding

same table) is not quite satisfactory for the Montenegrin economy, having in mind the current difference in the level of the living standard compared to the EU countries, to which the Montenegrin society strives, although in comparison to the region Montenegro records good results.

The document titled "Montenegro Economic Reform Programme 2015-2017", published by the Government in January 2015, contains two macroeconomic scenarios, whereby the baseline scenario envisages real GDP growth of 3.5% in 2015, while the lower-growth scenario, which includes some of the abovementioned problems in addition to other, envisages a 2.1% growth.

Table 2.5

Montenegro: Selected economic indicators, 2013-2016

Indicator	2013	2014	2015	2016
		Forecasts		
Real GDP growth, %	3.3	2.0	3.0	3.5
Unemployment rate (as % of total labour force)	19.5	19.3	18.6	17.0
Consumer prices index, %	2.2	-0.2	0.8	2.1
Current account deficit (% of GDP)	-14.6	-14.2	-13.8	-14.0
Budget deficit (% of GDP)	-4.6	-1.4	0.0	0.3
Public debt (% of GDP)	58.1	58.9	58.6	59.4

Source: European Commission, the autumn forecast 2014 (November 2014)

Table 2.6

Montenegro: Selected economic indicators, 2010-2015 (Forecasts with assumption of current economic policies also applying in the future period)						
Real economy	2010	2011	2012	2013	2014	2015
					Forecasts	
Nominal GDP (in million euro)	3,104	3,234	3,149	3,327	3,387	3,588
Gross national savings (as percentage of GDP)	-2.6	-2.0	0.9	1.3	3.0	3.8
Gross investments (as percentage of GDP)	22.8	19.5	19.5	15.9	18.1	24.0
	Change in percentages					
Real GDP	2.5	3.2	-2.5	3.3	2.0	4.6
Industrial output	17.5	-10.3	-7.1	10.6	…	…
Tourism						
Arrivals	4.6	8.7	4.8	3.7	…	…
Overnights	5.5	10.2	4.3	2.8	…	…
CPI (annual average)	0.7	3.1	3.6	2.2	-0.6	1.2
CPI (period end)	0.7	2.8	5.1	0.3	0.6	0.9
GDP deflator	1.6	0.9	-0.1	2.2	-0.1	1.3
Average net salary (12 month average)[1]	3.5	1.0	0.6	-1.6	…	…
Cash and loans (period end)						
Loans to private sector[2]	-8.9	-13.0	-3.1	2.1	-3.6	3.2
Corporates	-11.2	-20.3	-4.9	0.1	…	…
Households	-5.7	-3.2	-1.1	3.7	…	…
Private sector deposits	5.9	1.2	7.2	5.4	…	…
General Government finances, at accrual realisation[3]	as percentage of GDP					
Revenues and grants	41.3	38.5	40.0	41.5	42.9	42.1
Expenditure[5]	45.9	43.8	45.9	44.8	43.8	47.5
Deficit/surplus	-4.6	-5.2	-5.9	-3.3	-0.9	-5.3
Primary deficit/ surplus	-3.6	-3.8	-4.0	-1.1	1.4	-3.1
Domestic financing (net)	-1.4	0.7	-0.8	-2.4	-2.2	-2.7
Privatisation proceeds	0.8	0.5	0.4	0.8	0.6	0.0
Gross General Government debt (stock at end of period)	40.9	46.0	54.0	58.2	58.5	60.7
General Government debt and issued guarantees	52.4	57.8	65.0	67.6	67.9	70.1
Balance of payments						
Current account balance	-22.9	-17.7	-18.7	-14.6	-15.1	-20.2
Foreign direct investments	17.8	12.0	14.7	9.7	9.7	10.6
External debt (stock at end of period)	115.5	117.6	126.6	128.7	132.9	137.5
Of which: private sector[4]	86.1	84.7	85.5	85.6	88.0	87.1
Real effective exchange rate (based on CPI; average % change)						
(minus refers to depreciations)	2.8	-3.2	3.3	-1.1	…	…
Additionally:						
Aluminium price (in euro per tonne)	1,644	1,822	1,542	1,348	1,340	1,417

1) Including a change in the MONSTAT methodology, starting from 1 January 2010;
2) Changes in classification of off-balance sheet items created a break in structure in 2012; annual change in credit growth in 2013 cannot be compared due to the change in methodology;
3) Data includes state funds and municipalities, but not the state owned companies;
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, February 2015 (Original source: MF, CBCG, MONSTAT, Employment office, IMF's forecasts and assessments)

Table 2.7

Montenegro, WIIW forecasts from November 2014			
Indicator	2013	2014	2015
		Projections	
Real GDP growth (%)	3.3	2.1	2.9
Consumer prices (% change compared to the previous year)	2.2	0.0	1.0
Unemployment rate, % (according to the Labour Force Survey)	19.5	19.0	19.0
Current account (% of GDP)	-14.6	-15.4	-15.9

Table 2.8

Real GDP growth, EBRD projections, %					
Country/Region	2013	Projections, January 2015		Projections, September 2014	
		2014	2015	2015	Change Sep – Jan
Central Europe and Baltic Countries					
Croatia	-0.9	-0.5	0.5	0.5	0.0
Estonia	1.6	1.7	2.2	2.5	-0.3
Hungary	1.5	3.2	2.4	2.2	0.2
Latvia	4.2	2.5	3.0	3.7	-0.7
Lithuania	3.3	2.9	3.2	3.4	-0.2
Poland	1.7	3.2	3.0	3.3	-0.3
Slovakia	1.4	2.4	2.6	3.0	-0.4
Slovenia	-1.0	2.7	1.6	1.0	0.6
Average	**1.5**	**2.8**	**2.6**	**2.8**	**-0.2**
Southeast Europe					
Albania	1.4	1.5	2.5	2.5	0.0
Bosnia and Herzegovina	2.5	0.9	2.7	2.7	0.0
Bulgaria	1.1	1.5	0.8	2.0	-1.2
Macedonia	2.7	3.8	3.5	3.0	0.5
Kosovo	3.4	2.5	3.5	3.5	0.0
Montenegro	**3.3**	**1.3**	**3.0**	**2.5**	**0.5**
Romania	3.5	2.6	2.8	2.8	0.0
Serbia	2.6	-2.0	0.5	2.0	-1.5
Average	**2.8**	**1.7**	**2.2**	**2.6**	**-0.4**

According to the model-based projections in 2015, the GDP growth rate will be 3.25%. For testing the central projection of GDP, a GDP estimate using the expenditure method was also done. Starting assumptions for the calculation using the expenditure method include:

- growth of the households' spending from 1.9% to 2% due to certain new employment, caused by the strengthening of investment activity and potential increase in wages and increase in

lending activity of banks, expected from entry of new banks and possible reduction of lending interest rates due to larger market pressures;
- public spending growth ranging from 1.3% to 1.7% as a result of expenditures for financing the first section of the highway, which will be implemented through capital budget;
- Growth in investments in fixed assets of 12.8% due to foreign direct investments in construction of the Smokovac-Mateševo Highway, in the area of tourism and energy;
- Changes in inventories will be at the same level as the last year's;
- Exports of goods and services will gradually grow at rate of around 3%, as a consequence of stabilisation and growth in industrial production and tourism consumption;
- Imports will show growth ranging from 3.5% to 4%, because of investors' need to import equipment, construction material and labour force, especially for the highway construction and substitution of import of food by domestic production.

According to the expenditure method, GDP will grow at a rate of 3.3% to 3.6% in 2015, which indicates that the value of the model-based projections of GDP growth is closer to the lower limit of the GDP range at expenditure method.

Weighting of the real GDP growth estimates by international institutions and institutes shows that the Montenegrin GDP growth in 2015 should be at the level of 3.26%.

Table 2.9

Estimate of international financial institutions in Montenegro GDP trend in 2015 (as %)	
Institution	Estimated growth rate for 2015
IMF	4.6
EBRD	3.0
UN department for economic and social affairs	2.7
European Commission	3.0
Vienna Institute	2.9
World Bank	3.4

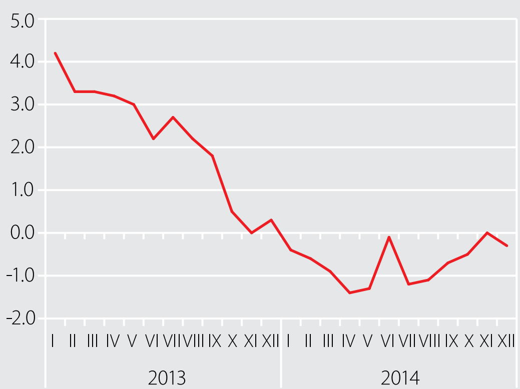
2.2. Inflation

Annual inflation rate in December 2014 was -0.3%, after being negative the entire year, as opposed to the rate of 0.3% from December of the last year. The price growth primarily arose from the increase in prices in the category *food and non-alcoholic beverages* by 0.8% (due to increase in prices of bread, grains and vegetables) and in category health by 3.6% (due to increase in prices pharmaceutical products).

Decline in prices of products from the category *transport* by 4.7%, due to the decline in price of fuel and lubricants by 11.1% and the category *communications* by 3.5%, due to decline in prices of telephone and facsimile equipment, telephone and facsimile services, were primary drivers for the declining inflation rate. If we observe detailed level of groups of products/services, the main contributors to the negative inflation rate were decline in prices of oils and fats by 11.7%, as well as decline in the electricity price of 2.7%.

Figure 2.3

Consumer prices, annual growth rate, %, 2013-2014



Source: MONSTAT

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

Table 2.10

Share of trends of individual categories of products in total inflation

	Weight	Growth rate, XII 14 / XII 13	Share, percentage points	Share, %
TOTAL	1,000	-0.3	-0.3	100.0
Food and non-alcoholic beverages	386.4	0.8	0.31	103.0
Alcoholic beverages and tobacco	37.9	0.9	0.03	11.4
Clothing and footwear	70.7	0.7	0.05	16.5
Housing, water, electricity, gas and other fuels	153.1	-0.3	-0.05	-15.3
Furnishing and routine household maintenance	46.9	-1.9	-0.09	-29.7
Health	38.2	3.6	0.14	45.8
Transport	101.0	-4.7	-0.47	-158.2
Communications	57.1	-3.5	-0.20	-66.6
Recreation and culture	27.2	0.6	0.02	5.4
Education	15.7	0.0	0.00	0.0
Restaurants and hotels	23.0	0.1	0.00	0.8
Miscellaneous goods and services	42.8	-1.0	-0.04	-14.3

Source: MONSTAT, CBCG calculations

According to the harmonised consumer prices index (HCPI) (methodological standard in the EU/euro area, which differs somewhat from the consumer prices index (CPI)), the annual inflation rate in Montenegro amounted to -0.6%, after 0.4% from December 2013. For the purpose of comparison, the annual inflation rate in Montenegro in December 2014 was lower than the inflation rate in the EU and euro area, which was -0.1% and 0.2% respectively. Compared to the one recorded in other regional official and potential EU candidate countries, Montenegrin inflation was higher than in Bosnia and Herzegovina and Macedonia, but lower than in Albania and Serbia.

Table 2.11

CPI (HCPI) of selected countries, %							
	XII 11/XII 10	XII 12/XII 11	XII 13/XII 12	III 14/III 13	VI 14/VI 13	IX 14/IX 13	XII 14/XII 13
Albania	1.7	2.4	1.9	2.2	1.5	1.5	0.7
Bosnia and Herzegovina	3.1	1.8	-1.2	-1.6	-1.4	-0.1	-0.4
Montenegro	**2.8**	**5.1**	**0.3**	**-0.9**	**-0.1**	**-0.7**	**-0.3**
EMU	2.7	2.2	0.8	0.5	0.5	0.3	-0.2
EU	3.0	2.3	1.0	0.6	0.7	0.4	-0.1
Croatia	2.1	4.7	0.5	-0.1	0.5	0.2	-0.1
Macedonia	2.8	4.7	1.4	0.2	-1.1	-0.7	-0.5
Slovenia	2.1	3.1	0.9	0.6	1.0	-0.1	-0.1
Serbia	7.0	12.2	2.2	2.3	1.3	2.1	1.7

Source: statistical offices

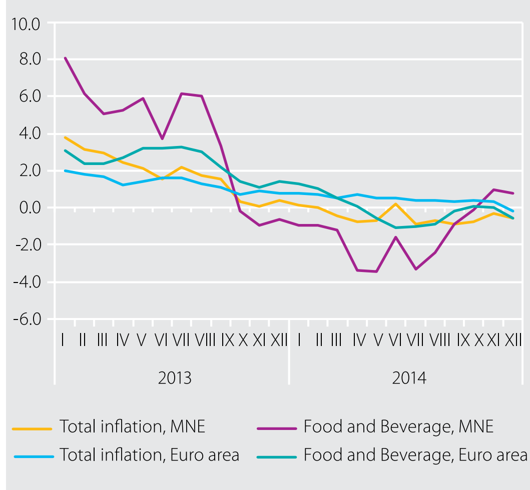
Weights of 38.6% for CPI and 31.7% for HCPI (which was higher in the past) make the food the most important category/factor in the total inflation in Montenegro. In the euro area, in accordance with the average household spending and its spending for food and non-alcoholic beverages, the same weight amounted only to 15.7%. Consequently, global changes in food prices are less reflected on the general inflation in the euro area compared to Montenegro. Moreover, deviation in food prices trend in Montenegro relative to the euro area is a result of many factors: presence of inventories and their relative size, possibility of 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 very category *food and non-alcoholic beverages*; and other economic and other factors. Speaking about the difference compared to global food prices, changes in the exchange rate EUR/USD remain another important deviation factor.

The IMF forecasts an average decline in food prices (standardised stock market commodities) of 10.8% during 2015, after which the stabilisation is expected, or a mild decline of the food prices after 2015. A drastically lower level of prices of oil and other energy products is also expected (observed at annual average), thus from this aspect, further deflationary effects should be expected from the global scene in 2015.

Inflation fan chart of Montenegro, based on ARIMA model assessment for 2015, shows 90% probability of inflation measured by the consumer prices index, depending on the month,

Figure 2.4

General inflation trend and trend of food commodities inflation in Montenegro and euro area; HIPC, %, annual rate, 2013-2014



Source: MONSTAT, Eurostat

which will range in interval from -0.5% to 2%. Whereby, the projected inflation for end-2015 is in range from 0% to 2%. Namely, as the time span for forecasting increases the uncertainty increases, as does the forecast span. The central projection of the model shows that an average inflation in 2015 will be 0.57%.

Starting assumptions for the inflation forecast for 2015 include:

1. Increase in geo-political tensions could spur the increase of energy sources prices;
2. Unfavourable weather could result in more pronounced growth in basic food commodities prices;
3. Adoption of the Law Amending and Supplementing the Law on Excise Taxes will gradually increase excise duties on cigarettes, alcohol and carbonated beverages;
4. Introduction of the fee on retail prices of fuels;
5. Increase of electricity price of 5% (planned increase of prices in August 2015 included);
6. Increase of investments and more intensive economic activity in 2015;
7. Real estate prices stagnation.

Any deviation in some of the said assumptions would require correction of the forecast.

On the other hand, experts' assessment is very similar to the model one, where the inflation in 2015 will range between -0.5% and 2%.

2.3. Fiscal Deficit/Surplus

The impact of the global economic situation resulted in the non-implementation of budget projections as per the planned volume and dynamics in the previous year, even though we may state that important positive results were achieved as a result of fiscal consolidation. Thus in 2014, feature of the Budget of Montenegro was larger deficit level than planned, primarily as a result of payment of liabilities from the previous period, capital expenditures in the current budget and repayment of called guarantees. On the other hand, better VAT collection and collection of contributions relative to the plan, along with certain savings, enabled easing of the effects of increased expenditures and prevented higher fiscal deficit.

Table 2.12

Fiscal deficit/surplus trend

Description/Period	2010	2011	2012	2013*	Estimate 2014	Projection 2015
Source revenues, in million euro	1,140.4	1,129.1	1,121.0	1,243.4	1,351.9	1,329.2
Expenditures, in million euro	1,252.6	1,318.8	1,333.9	1,444.8	1,454.4	1,565.0
Deficit/surplus, in million euro	-112.2	-189.7	-212.9	-215.8	-102.6	-235.8
Deficit/ surplus, as % share in GDP	-3.6	-5.9	-6.8	-6.5	-3.0	-6.6

* Deficit includes also net increase of liabilities of 14.4 million euro.
Source: Ministry of Finance

Source revenues of the Budget in 2014 were 1.35 billion euro or 39.8% of estimated GDP[10]. These revenues were higher by 5.9% relative to the plan, mainly as a result of higher level of generated revenues from VAT (by 41.6 million euro or 9.1%) and contributions for pension and disability insurance (by 35.2 million euro or 15%). Compared to 2013, source revenues recorded a growth of 8.7%.

According to the Ministry of Finance's estimate, total budget inflows (direct revenues and additional financing) in 2014 was 1.66 billion euro or 49% of estimated GDP.

Table 2.13

Revenues of the Budget in 2014

Type of revenue	Outturn	Plan	Difference relative to the Plan		2013	Difference relative to2013	
	mill €	mill €	mill €	%	mill €	mill €	%
BUDGET REVENUES	1,351.9	1,276.1	75.8	5.9	1,243.4	108.5	8.7
Taxes	833.2	797.8	35.4	4.4	755.7	77.5	10.3
Personal income tax	104.4	96.0	8.4	8.7	95.6	8.8	9.2
Corporate profit tax	45.0	44.4	0.6	1.4	40.6	4.4	10.8
Tax on immovable property transactions	1.5	1.5	-0.1	-4.2	1.4	0.0	2.7
Value added tax	497.6	455.9	41.6	9.1	429.2	68.4	15.9
Excise taxes	156.5	171.1	-14.6	-8.6	161.4	-5.0	-3.1
Tax on international trade and transactions	22.3	23.7	-1.5	-6.2	22.3	0.0	0.0
Other taxes of the Republic	6.0	5.1	0.9	17.5	5.1	0.9	17.3
Contributions	444.3	397.8	46.5	11.7	398.5	45.8	11.5
Contributions for pension and disability insurance	270.1	234.9	35.2	15.0	241.9	28.2	11.6
Contributions for health insurance	151.0	138.7	12.4	8.9	134.7	16.3	12.1
Contributions for unemployment insurance	12.2	11.6	0.5	4.7	10.8	1.4	12.9
Other contributions	11.0	12.7	-1.7	-13.2	11.1	-0.1	-0.7
Duties	15.0	20.9	-5.9	-28.3	27.2	-12.2	-44.8
Fees	17.0	13.0	3.9	30.2	13.2	3.7	28.1
Other revenues	29.5	31.4	-1.9	-6.0	33.7	-4.1	-12.3
Proceeds from loan repayments and funds carried forward from the previous year	7.4	7.0	0.3	4.8	8.5	-1.2	-13.6
Donations and transfers	5.5	8.0	-2.5	-31.6	6.6	-1.1	-17.3
ADDITIONAL FINANCING							
Borrowings and loans from domestic sources	104.4	0.0	104.4	…	145.4	-40.9	-28.2
Borrowings and loans from Foreign sources	205.7	228.0	-22.2	-9.8	188.5	17.2	9.1
Proceeds from sale of property	3.9	5.0	-1.1	-21.6	11.9	-8.0	-67.2
Increase / decrease of deposit	-1.8	-10.0	8.3	-82.5	44.0	-45.8	-104

Source: Ministry of Finance

[10] Estimated GDP for 2014 is 3.39 billion euro.

The Budget expenditures[11] in 2014 were 1.45 billion euro, which make 42.9% of estimated GDP. By comparison to 2013, the expenditures recorded an increase of 0.7%. If compared to the plan, expenditures were higher by 9.6% (by 126.9 million euro) where the difference is mainly a result of repayment of labialise from the previous period (of 65.3 million euro) and higher capital expenditures in the current budget (by 54 million euro).

Table 2.14

Expenditures of the Budget in 2014							
Type of expenditure	Outturn	Plan	Difference relative to the Plan		2013	Difference relative to2013	
	mill €	mill €	mill €	%	mill €	mill €	%
BUDGET EXPENDITURES	1,454.4	1,327.6	126.9	9.6	1,444.8	9.6	0.7
CURRENT EXPENDITURES	1,379.3	1,237.3	142.0	11.5	1,367.6	11.7	0.9
Current budget expenditures	691.5	632.1	59.4	9.4	605.6	85.9	14.2
Gross wages and contributions charged to employer	387.3	386.3	1.0	0.3	371.0	16.3	4.4
Other personal earnings	11.8	11.5	0.3	2.6	12.0	-0.2	-1.6
Expenditures for material	28.6	30.8	-2.2	-7.2	27.3	1.3	4.8
Expenditures for services	51.9	42.7	9.2	21.7	47.5	4.4	9.3
Expenditures for current maintenance	21.3	21.7	-0.4	-1.8	20.4	0.9	4.2
Interest	75.0	75.6	-0.6	-0.8	67.9	7.1	10.4
Lease	8.0	8.1	-0.1	-1.2	7.9	0.1	1.5
Subsidies	18.4	18.9	-0.4	-2.4	17.4	1.0	5.7
Other expenditures	24.8	26.2	-1.5	-5.6	21.9	2.8	12.9
Capital expenditures in the current budget	64.4	10.3	54.0	521.9	12.2	52.1	427.0
Transfers for social welfare	492.1	494.7	-2.6	-0.5	483.0	9.2	1.9
Social welfare related benefits	61.9	58.6	3.2	5.5	64.0	-2.2	-3.4
Funds for technological redundancies	22.6	17.3	5.3	30.9	13.1	9.5	72.6
Pension and disability insurance related benefits	384.4	397.3	-12.9	-3.3	383.2	1.2	0.3
Other healthcare related benefits	15.2	14.5	0.7	4.9	14.8	0.4	2.9
Other health insurance related benefits	8.1	7.0	1.1	15.6	7.9	0.2	2.9
Transfer to institutions, individuals, non-governmental and public sector	99.0	99.5	-0.4	-0.4	94.3	4.7	5.0
CAPITAL BUDGET	75.2	90.3	-15.1	-16.7	77.2	-2.1	-2.7
Borrowings and loans	2.5	2.1	0.3	16.1	2.8	-0.3	-9.7
Reserves	13.5	8.9	4.7	52.8	14.1	-0.6	-4.2
Repayment of guarantees	15.3	0.0	15.3	…	107.2	-92.0	-85.8
Repayment of liabilities from the previous period	65.3	0.0	65.3	…	60.5	4.7	7.8
Net increase in liabilities	0.0	0.0	0.0	…	14.4	-14.4	…
DEBT REPAYMENT							
Debt repayment	209.8	171.4	38.3	22.4	174.0	35.7	20.5
Repayment of securities and loans to residents	99.8	30.0	69.7	232.4	107.6	-7.9	-7.3
Repayment of securities and loans to non-residents	110.0	108.1	1.9	1.8	66.4	43.6	65.6
Repayment of liabilities from previous years		33.3	…	…			

Source: Ministry of Finance

[11] Total outflow less debt repayment

According to the Ministry of Finance estimate, in 2014 the Budget of Montenegro generated deficit of 102.6 million euro or 3% of GDP, which is 1.5 percentage points of GDP higher than planned. This was a sixth year in a row of budget deficit, while the average level of deficit during these six years amounted to high 4% of GDP. At the same time, this is the sixth consecutive year of the primary budget deficit (difference between deficit and interest expenditures). However, the fact that budget deficit was lower than the last year even besides high level of extraordinary expenditures is encouraging. If no vulnerabilities from the previous period had occurred (guarantees and payments based on court rulings), the budget deficit would have been much lower and in line with the planned.

Moreover, the debt repayment amounted to 209.8 million euro (this amount is not included in the deficit), thus total lacking funds in 2014 amounted to 312.3 million euro or 9.2% of GDP. This amount was financed with foreign borrowings (205.7 million euro), borrowings from domestic sources (104.4 million euro), proceeds from the sale of state property (3.9 million euro) and generating-increasing the level the government deposits (1.8 million euro).

Table 2.15

Plan for main Budget categories for 2015, in million euro	
Direct revenues	**1,329.2**
Taxes and contributions	1,250.2
Other revenues	79.0
Expenditures	**1,565.0**
Current budgetary spending	1,280.3
Capital budget of Montenegro	284.7
Deficit	**-235.8**
Primary surplus	**-160.0**
Debt repayment	**398.3**
Repayment of principal to residents	46.7
Repayment of principal to non-residents	317.8
Repayment of liabilities from the previous period	33.8
Repayment of guarantees	0.0
Shortfall	**-634.1**
Financing	**634.1**
Borrowing and loans from domestic sources	0.0
Borrowing and loans from foreign sources	634.1

Source: Law on the Budget of Montenegro for 2015 (Official Gazette of Montenegro, No 59/2014)

According to the Law on the Budget of Montenegro for 2015, a deficit of 235.8 million euro (6.6% of GDP) was planned, and since 75.8 million euro is planned for interest payments (an expenditure that refers to the budget planning and budget execution in the previous period) that would mean that the planned primary budget deficit for 2015 is 160 million euro. A reason for budget deficit growth should be sought in the highway construction. However, it will be a challenge to remain within those deficit limits since, inter alia, budget executions on both revenues and expenditure sides were mainly not made according to the plan.

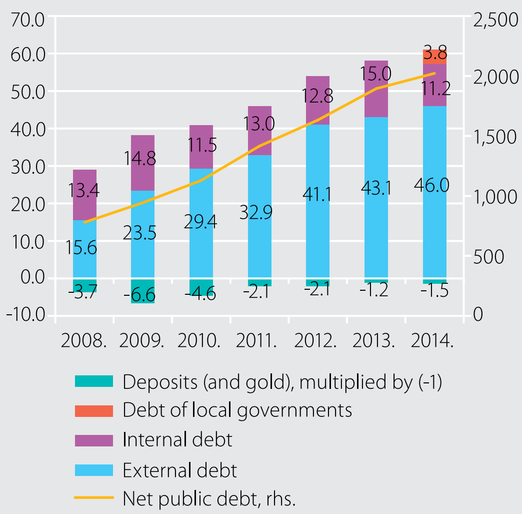
2.4. Public Debt

According to the Ministry of Finance data, the government debt at the end of 2014 was 1.94 billion euro or 57.3% of estimated GDP for 2014. If we add to debt the debt of local self-governments, of 128.8 million euro, the gross public debt at the end of 2014 was 2.07 billion euro[12]. The net public debt, as

[12] According to the Law on Budget and Fiscal Responsibility (Official Gazette of Montenegro, No 20/2014 and 56/2014), the public debt is defined as sum of the government debt and debt of local self-governments, whereby before 2014 their debt was included as part of the internal government debt.

Figure 2.5

Trend of net public debt (mil. euro) and its components (as % of GDP), 2008-2014, end of the period



Source: Ministry of Finance

a difference of gross public debt and deposits of the Ministry of Finance (which include gold), was 2.02 billion euro or 59.6% of GDP.

During 2014, the net public debt was increased by 127.8 million euro or 2.7 percentage points of GDP.

At the end of 2014, the internal debt was 381.2 million euro or 11.2% of GDP. Dominant share in its structure was of the debt for liabilities for indemnification (89.9 million euro), Treasury bills (77.7 million euro) and credits with commercial banks (71.4 million euro).

Table 2.16

Internal debt structure, 31-Dec-2014 (sorted by debt stock)

Creditor	Internal debt in million €	% of GDP	% of internal debt	% of total public debt
Liabilities for indemnification	89.9	2.7	23.6	4.3
Treasury bills	77.7	2.3	20.4	3.8
Credits with commercial banks	71.4	2.1	18.7	3.4
Old foreign currency savings	55.7	1.6	14.6	2.7
Domestic bonds	38.2	1.1	10.0	1.8
Legal persons and business organisations	36.1	1.1	9.5	1.9
Credits with non-financial institutions	6.7	0.2	1.8	0.3
Bonds of the Labour Fund	3.8	0.1	1.0	0.2
Pension benefits arrears	1.8	0.1	0.5	0.1
TOTAL	**381.2**	**11.2**	**100.0**	**18.4**

Source: Ministry of Finance

At the end of 2014, the external debt was 1.56 billion euro or 46% of GDP. If compared to the end 2013, it was higher by 128.7 million euro or nine percent, whereby the major contributor of the increase was the new issue of Eurobonds (in the Q2 2014) of 280 million euro gross (of which certain part was used to refinance the issue of Eurobonds issued in the period 2010-2011).

Table 2.17

External debt structure, 31-Dec-2014 (sorted by debt stock)				
Creditor	External debt in million €	% of GDP	% of external debt	% of total public debt
Eurobonds	647.4	19.1	41.5	31.3
International bank for reconstruction and development (IBRD)	229.4	6.8	14.7	11.1
Credit Suisse	204.0	6.0	13.1	9.9
European Investment bank (EIB)	103.8	3.1	6.7	5.0
Member countries of the Paris Club of Creditors *	98.9	2.9	6.3	4.8
International Development Association (IDA)**	62.2	1.8	4.0	3.0
Deutsche bank	60.0	1.8	3.8	2.9
German Development Bank (KFW)	25.2	0.7	1.6	1.2
Erste	18.0	0.5	1.2	0.9
EUROFIMA	17.0	0.5	1.1	0.8
EBRD	16.1	0.5	1.0	0.8
Czech EXIM	14.6	0.4	0.9	0.7
Steiermarkische Sparkassen	14.3	0.4	0.9	0.7
Hungarian loan	9.3	0.3	0.6	0.5
Council of Europe Development Bank	9.1	0.3	0.6	0.4
Polish loan	8.3	0.3	0.5	0.4
Austrian loan	7.4	0.2	0.5	0.4
French loan - Natixis	7.3	0.2	0.5	0.4
Spanish loan Internal debt structure, (sorted by debt stock)	4.8	0.1	0.3	0.2
European Commission	4.7	0.1	0.3	0.2
TOTAL	**1,561.7**	**46.0**	**100.0**	**75.4**

* As of 31-Dec-2014, 29.15% of the debt was denominated in USD, CHF, and NOK.
** Debt is denominated u SDR, thus indirectly in USD, EUR, GBP and JPY.

Source: Ministry of Finance

Box 2.1 – Credit rating of Montenegro

At the end 2014, Montenegro had B+ long-term credit rating in foreign currency, assigned by the credit rating agency *Standard and Poor's* or *S&P*. This credit rating is since mid-November 2014, when it was downgraded from BB- to B+, with outlook change from negative to stable. The highest rating awarded to Montenegro was BB+/stable, awarded in March 2007, since December 20014 when S&P started rating of Montenegro.

B+ is "Highly speculative rating" where an "obligor is more vulnerable than the obligor rated BB, but the obligor currently has the capacity to meet is financial commitments. Adverse business, financial, or economic conditions may likely impair the obligor's capacity or willingness to meet its financial commitments". Stable outlook means that the rating will not most likely change in the next six to 24 months.

Compared to other countries in the region, Montenegro belongs to a group of countries with worse rating, but ahead of Albania, Bosnia and Herzegovina and Greece having B rating. However, other countries in the region are in no better position compared to Montenegro. Only Slovenia and Romania had investment grade (A- and BBB-, respectively), while rating for Bulgaria and Croatia, the EU member states have rating BB+ and BB respectively.

Table 1

Long-term credit rating in foreign currency of S&P for countries in the region (end of 2014 situation, ranked according to the rating)

Country	Rating	Valid from	Outlook	Valid from
Slovenia	A-	12-Feb-2013	Stable	12-Feb-2013
Romania	BBB-	16-May-2014	Stable	16-May-2014
Bulgaria	BB+	12-Dec-2014	Stable	12-Dec-2014
Croatia	BB	24-Jan-2014	Stable	24-Jan-2014
Macedonia	BB-	24-May-2013	Stable	24-May-2013
Serbia	BB-	07-Aug-2012	Negative	07-Aug-2012
Montenegro	**B+**	**14-Nov-2014**	**Stable**	**14-Nov-2014**
Albania	B	06-Dec-2013	Positive	10-Oct-2014
B&H	B	28-Mar-2012	Stable	28-Mar-2012
Greece	B	12-Sep-2014	Stable	18-Dec-2012

Source: Bloomberg

Guarantees

At the end of 2014, the foreign guarantees of Montenegro were 305.4 million euro of nine percent of GDP. This is an increase of 25.8 million euro if compared to the end 2013 due to signing of one new guarantee in 2014, as well as due to withdrawal of un-withdrawn funds as to the repayment of loans during year. Furthermore, a part of undisbursed funds should be also mentioned for which the state will guarantee in case those are withdrawn. The amount in question is 90.8 million euro i.e. 2.7% of GDP.

Table 2.18

Stock of guarantees, in euro (sorted by the debt stock)						
Creditor	Loan	Borrower	Year of signing	Signed amount	Withdrawn until 31-Dec-2014	Debt stock as of 31-Dec-2014
EIB	Small and medium-sized enterprises via commercial banks	Commercial banks	2009	90,000,000	90,000,000	66,984,872
EXIM China *	Procurement and overhaul of shops	Montenegrin maritime shipping company	2010	39,037,971	39,037,971	39,037,971
EXIM China *	Procurement and overhaul of shops	Bar maritime shipping company	2013	38,217,610	38,217,610	38,217,610
WTE Wassertechnik	Wastewaters treatment project	Budva Municipality	2010	29,250,000	29,250,000	29,250,000
EIB	European roads project	Monteput	2004	24,000,000	24,000,000	20,146,681
EBRD	Construction of regional water supply system Project – South branch phase I	JP Regional water supply – first instalment	2007	8,000,000	8,000,000	12,416,667
EBRD	Construction of regional water supply system Project – South branch phase II	JP Regional water supply – second instalment	2008	7,000,000	7,000,000	
EBRD	Construction of regional water supply system Project – South branch phase I - Annex	JP Regional water supply – expansion of the second installment	2010	3,000,000	3,000,000	
KfW	EPCG – replacement of filters in the TPP Pljevlja and expansion of the transformer substation Podgorica-Ribarevine	EPCG	2008	15,000,000	14,319,613	12,069,613
EBRD	Project of urgent repair of the Railroad infrastructure 2	Railroad Infrastructure JSC, Podgorica (ŽICG)	2009	15,000,000	12,803,373	11,653,288
EBRD	Project of procurement of electrical engines and diagnostic equipment	Railroad transport JSC	2010	13,550,000	12,714,030	11,320,633
EBRD	Pljevlja – interconnecting cable	Montenegrin electricity transmission system JSC (CGES)	2014	20,000,000	10,450,853	10,450,853
EIB	Airports modernisation	JP Airports of Montenegro	2004	12,000,000	12,000,000	9,066,667
Abu Dhabi Fund **	Water supply project	JP Regional water supply	2010	8,720,509	8,720,509	7,267,395
KfW	Interconnecting cable	CGES	2013	25,000,000	6,773,100	6,773,100
EIB	Reconstruction of electricity system	EPCG	2002	11,000,000	8,023,090	5,439,460
KfW	EPCG-Piva	EPCG	2007	16,000,000	6,565,099	4,965,099
Czech export bank	Completion of the railroad Podgorica- Nikšić	ŽICG	2011	5,000,000	4,978,102	3,982,481
KfW	Erste bank	Erste bank	2009	15,000,000	15,000,000	3,545,455
EBRD	Airports modernisation	JP Airports of Montenegro	2003	11,000,000	10,236,006	3,415,032
EBRD	Project of railroad infrastructure reconstruction - Phase III	JP Railroads of Montenegro – third instalment	2010	4,000,000	3,550,570	3,172,990
EBRD	Project of railroad infrastructure reconstruction - Phase III Annex	Railroad infrastructure JSC, Podgorica	2012	10,000,000		
KfW	EPCG – transformer substation Podgorica-Ribarevine	EPCG	2007	5,400,000	4,793,987	2,937,737
EIB	Modernisation of railroad infrastructure	ŽICG	2010	7,000,000	2,134,000	2,134,000
KfW	NLB	NLB	2009	16,000,000	16,000,000	727,273
KfW	EPCG-Perućica	EPCG	2003	3,580,000	3,422,388	398,000
EBRD	Loan facility for deposit protection	Deposit Protection Fund	2010	30,000,000	0	0
TOTAL				481,756,089	390,990,299	305,372,876

* Debt is denominated in USD.
** Debt is denominated in AED, but with a fixed exchange rate for USD
Source: Ministry of Finance

If domestic guarantees were added to the amount, total amount of issued guarantees would be 314.3 million euro at end-2014 or 9.3% of GDP. Thus, the sum of the net public debt and total guarantees amounted to 68.9% of the estimated GDP for 2014.

Table 2.19

Domestic guarantees, in euro (sorted by the debt stock)					
Creditor	Borrower	Year of signing	Signed amount	Withdrawn until 31-Dec-2014	Debt stock as of 31-Dec-2014
Hipotekarna bank	Montenegro Airlines	2009	2,700,000	2,700,000	2,324,525
NLB Montenegrobank	Montenegro Airlines	2011	2,400,000	1,997,580	1,750,309
Hipotekarna bank	Montenegro Airlines	2011	2,000,000	2,000,000	1,518,136
Prva bank	Montenegro Airlines	2013	1,200,000	1,200,000	1,200,000
NLB Montenegrobank	Montenegro Airlines	2010	1,800,000	1,800,000	1,072,108
Crnogorska komercijalna bank	Adriatic Shipyard JSC Bijela	2012	1,050,000	1,050,000	893,309
Investment-Development Fund	Montenegrin maritime shipping company JSC Kotor	2011	1,500,000	1,000,000	185,495
TOTAL			12,650,000	11.747.580	8,943,881

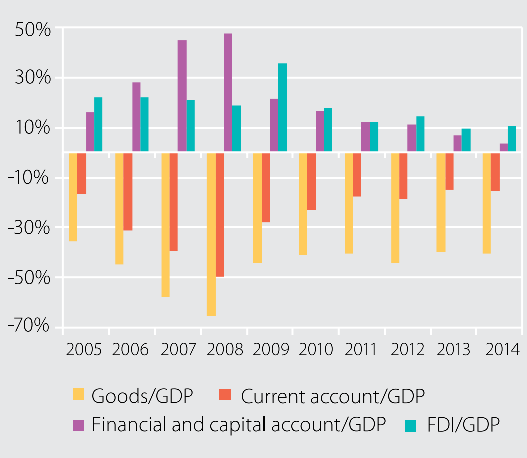
Source: Ministry of Finance

As the CBCG warned earlier, the risk of calling of guarantees was also materialised in 2014. Domestic guarantees were called in 2014, for the loans issued to the Bauxite Mines JSC Nikšić, Melgonija-Primorka LLC Bar and Pobjeda JSC Podgorica (two loans). A total of 15.3 million euro was spent in 2014 for liabilities arising from called upon guarantees.

Further risk of calling of the issued guarantees represents a particular concern. When it comes to issuing of new guarantees, the implementation of a rather restrictive approach, started after 2011, is something that should continue in the next period as well.

Figure 2.6

Balances of various Balance of Payments Accounts, 2005-2014



Source: CBCG

2.5. Balance of Payments

In 2014, the current account deficit recorded a mild increase. Observed through the structure of the current account, the increase in deficit was mostly a result of growth of the trade deficit and lower surplus in the primary income account, while the increase in the balance of services were not sufficient to offset negative trends in the balance of goods and primary income.

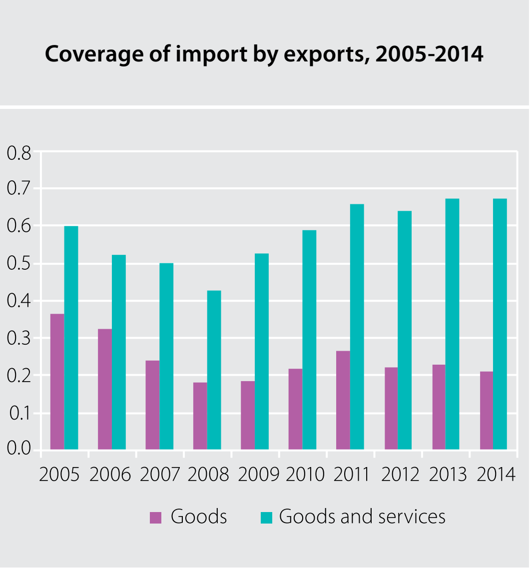
According to the preliminary data, the current account deficit amounted to 520.4 million euro, which is 6.9% more than in 2013. The share of the current account deficit in GDP was 15.3%, which stopped a multi-year downward trend for this share (14.6% in 2013).

Foreign trade recorded decrease in exports (8.4%) and slight increase in imports (0.5%). In terms of the structure, the strikingly biggest change refers to the decline in revenues from the export of electricity, non-ferrous metals, and steel and iron, while the biggest increase in revenues is recorded from export of meat and processed meat. The biggest change in the imports structure goes for the import of meat and processed meat, and the decline in expenditures for import of other means of transport and equipment, as well as import of electricity. Coverage ratio of imports by exports is 20.9%, which represents a decrease of 2 percentage points relative to 2013. Still modest export/import ratio points to the necessity of further promotion and stimulation of investments in export-oriented and/or import substitution production, i.e. above all, the creating conditions to increase the competitiveness of domestic producers and productivity of the domestic labour force.

An increase in external demand had a positive effect on trends in the services account, which recorded a surplus increase of 5.7% (690.4 million euro), primarily due to lower net outflows for other business services (outflow of 24.6 million euro after an outflow of 47.1 million euro in 2013) and higher net inflow from travel and tourism (17.1 million euro). The coverage of foreign trade deficit with surpluses recorded in other sub-accounts of the current account was 62% in 2014, which is 1.3 percentage points lower compared to the previous year.

Surplus on the capital and financial account was much lower if compared to 2013, due to profoundly higher deficit on the other investments account. In 2014, net FDI inflow was higher by 9.3% if compared to the previous year, mainly due to the increase in inflows from intercompany debt. Net FDI inflows thus amounted to 353.9 million euro or 10.4% of GDP. The portfolio investments account recorded a net inflow of 84.4 million euro, which is 42.4 million euro more in comparison to net inflow in 2013, mostly due to the issue of the Government Eurobonds in the amount of 280 million euro in Q2 2014, (where almost 85 million euro of that amount was used to refinance old Eurobonds, therefore making the new borrowing in excess of 195 million euro). Finally, the account of other investments recorded a net outflow of 195.7 million euro, if compared to outflow of 54.2 million euro in 2013.

Figure 2.7



Source: CBCG

In the following period, trends in the balance of payments will continue to depend on trends in the international capital markets and financial soundness and expectations for domestic economy and government sector. Considering that considerable FDI inflow 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 high correlation between capital inflow 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, 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 import is important –in general, worse situation is the one in which the import of investment goods (or consumer goods for investment purposes) is neglected on behalf 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 already significant. In general, the balance of payment trends alone do not represent a threat to the financial stability in the case of Montenegro, but they still point out to the need for economic reforms and implementation of development model of economy.

2.6. Real Estate Market

In 2014, the real estate market continued to adjust the large supply to limited demand, by reducing prices of residential units. Bearing in mind the differentiated demand, limited domicile demand for real estate due to reduced personal spending, high interest rates for housing loans and their reduction, decreased inflow of foreign direct investment in real estate, as well as presence of multi-month deflationary trend resulting in postponed purchase by buyers expecting further decline in prices, the real estate prices could be realistically expected.

Table 2.20

Summary statistics of the average value of residential units per square meter in Podgorica

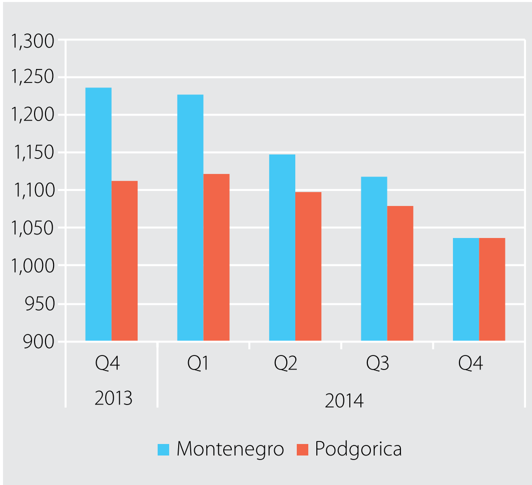
Period	Price, €	Chain index	Base index
September 2007	1,697.6	100.0	100.0
March 2008	1,738.3	102.4	102.4
September 2008	1,525.5	87.8	89.9
March 2009	1,402.1	91.9	82.6
September 2009	1,223.1	87.2	72.1
March 2010	1,128.3	92.2	66.5
June 2010	1,191.5	105.6	70.2
September 2010	1,177.1	98.8	69.3
December 2010	1,185.2	100.7	69.8
March 2011	1,171.2	98.8	69.0
June 2011	1,163.0	99.3	68.5
September 2011	1,174.0	100.9	69.2
December 2011	1,151.2	98.1	67.8
January 2012	1,168.3	101.5	69.0
June 2012	1,179.6	102.5	69.5
September 2012	1,172.3	99.4	69.1
December 2012	1,171.6	99.9	69.0
March 2013	1,169.4	99.9	68.88
June 2013	1,069.8	91.48	63.10
March 2014	971.4	90.80	57.22
September 2014	950	97.8	55.96

Source: CBCG

According to results of the September survey, the average real estate price per square meter[13] in Podgorica was 950 euro, which represents a decline of 2.2% if compared to March 2014. Analysis of the chain index of real estate price trends shows that the prices continued the decline in September 2014, which started in June 2013, after a three-year stagnation of prices on the real estate market.

Figure 2.8

Average prices of a square meter of apartments in newly constructed buildings in Montenegro, in euro, Q4 2013 – Q4 2014



Source: MONSTAT

The average price of a square meter of apartments in newly constructed buildings in Montenegro has also recorded a decline. Thus the average price of an apartment in newly constructed building in the last quarter of 2014 was 1,037 euro, which is a y-o-y decline of 16.1%. Major contributor of this decline was a decline in prices of newly constructed apartments in Budva. In Q4, the sale of apartments in newly constructed buildings in Montenegro recorded a decline of 7.8% if compared to the same quarter of the previous year. The highest average price of apartments in newly constructed buildings was contracted in Budva, amounting to 1,365 euro per square meter, followed by Podgorica with 1,036 euro, Bar with 1,180 euro and Nikšić with 539 euro per square meter.

The latest survey of real estate agencies carried out by the CBCG also points to the drop in real estate prices. Namely, 50% of surveyed agencies believe that prices of real estate in Montenegro recorded an average decline of 10% to 20%. Furthermore, 45% of surveyed agencies have recorded a decline in transactions on average between 30 and 50%, while 45% of agencies had no changes in turnover. Only 10% of surveyed agencies recorded an increase in turnover, on average between 10 and 30%.

Table 2.21 shows that, measured by the level of significance, the zone where the residential unit is located influences the price of the residential premise in Podgorica. Moreover, the residential unit in the first zone are more expensive than those in the third zone, while the residential units in the second zone are cheaper than the third zone[14]. If we consider types of residential units, apartments are more expensive than houses. Apartments that are up to 10 years old are more expensive than are others. Whether a residential unit has a garage or not also affects the price of the residential unit. Other qualitative features of the residential unit such as the number of rooms, number of balconies, type of heating and internet access have not had an impact on the price of residential units in Podgorica.

[13] According to the hedonic index obtained from the CBCG survey, where the prices do not reflect actual, 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.

[14] The third zone in treated as the baseline.

Table 2.21

Empirical results of the models for an average price of the residential dwelling, September 2014				
In price	Coefficient	Standard error	t	P>|t|
PG1	0.143***	0.032	4.45	0.000
PG2	-0.115***	0.041	-4.00	0.000
Stan	0.115**	0.041	2.79	0.006
Up to 5 years old	0.140**	0.053	2.64	0.009
Between 5-10 years old	0.211***	0.054	3.90	0.000
Owns a garage	0.072*	0.039	1.84	0.067

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

Diagnostic:
Number of observations 370;
R-squared = 0.4024;
VIF= 2.95;
Ramsey test F(3, 348) = 2.0
Prob > F = 0.1132

Robustness tests show that the model is well-specified, and there is no problem with multicollinearity (extremely low VIF value) or with functional form (Ramsey RESET test).

The table below shows the trends of real estate prices in the selected countries according to the *Global Property Guide*. As it can be seen, divergent trends in real estate prices characterised 2014: the highest growth were recorded in the United Arab Emirates - Dubai (23.73%), and the biggest decline in Ukraine (36.6%). It could be also noted that the European real estate market is recovering. As for the Balkan countries included in the Report, after a decline in real estate prices in 2013, the increase in prices was recorded in Croatia (2.64%) and Bulgaria (1.29%), while Romania and Greece have evidenced drop in prices.

Table 2.22

Real estate prices trend in selected countries (ranked according to the annual change in third quarter of 2014)				
Country	Annual change, Q3 2013, %	Trend	Annual change, Q3 2014, %	Quarterly change, Q3 2014, %
UAE – Dubai	21.37	↑	23.73	-1.13
Estonia (Tallinn)	12.46	↑	15.30	2.51
Ireland	3.45	↑	14.52	6.43
United Kingdom	1.47	↑	8.95	1.16
Turkey	4.65	↑	7.51	3.87
Australia	5.99	→	6.76	1.17
Island	2.03	↑	6.69	2.00
Israel	6.22	→	6.43	2.37
Latvia	2.44	↑	4.71	1.17
Lithuania	-0.47	↑	4.62	0.49
Czech Republic	0.22	↑	4.04	1.20
New Zealand	6.40	↓	3.93	-1.91
The Netherlands	-3.14	↑	3.89	1.58
Philippines	10.83	↓	3.58	2.43
Taiwan	14.97	↓	3.42	-1.60
Canada	1.61	↑	3.31	2.33
Brazil –Sao Paolo	6.98	↓	3.29	1.00
US (Case-Shiller)	9.31	↓	3.08	0.77
US (FHFA)	6.55	↓	2.76	0.84
Croatia	-17.69	↑	2.64	4.43
Indonesia	4.54	↓	2.19	-0.81
Thailand	3.61	↓	2.15	3.42
South Africa	-2.05	↑	1.91	0.47
Portugal	1.55	↑	1.86	2.67
Hong Kong	7.76	↓	1.57	4.53
Switzerland	3.46	↓	1.48	-0.02
Vietnam	-0.88	↑	1.45	-0.21
Norway	0.13	↑	1.32	-0.45
Bulgaria	-0.21	↑	1.29	-0.08
South Korea	-2.00	↑	0.59	-3.34
Japan – Tokyo	7.63	↓	0.49	-0.53
Slovakia	-2.87	↑	-0.23	0.42
Romania	-8.01	↑	-1.41	1.12
Finland	-0.24	↓	-2.15	-0.80
China	14.26	↓	-4.11	-3.83
Spain	-9.46	↑	-4.15	-2.71
Singapore	2.10	↓	-4.79	-0.38
Russia	-3.64	↓	-5.68	-0.74
Greece	-9.69	↑	-7.08	-0.17
Ukraine - Kiev	4.61	↓	-36.60	-10.45

Note:

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

Source: Global Property Guide, 2014

Residential loans are significant determinant of demand in real estate market. Housing loans accounted for 9.3% of the estimated GDP at end-2014, having a downward trend if compared to 2013 and 2012. There is a considerable deleveraging and decline in lending activity, both in absolute and relative terms, which probably affected the restraint on the demand.

Table 2.23

Housing loans trend, 2005-2014

Year	GDP, in million €	Housing loans, End-year stock, in thousand €	Population*	Housing loans, end-year	
				% GDP	Per capita (in €)
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	3,327.1	317,987	620.029	9.6	512
2014	3,393.0	315,089	620.029	9.3	508

* The estimated 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

During 2014, the exposure of the banking sector to the construction sector is the highest, following the exposure to the trade sector. However, the share of non-performing loans of the construction sector is considerably below the average. The downward trend of the real estate market prices bears a low to moderate risk of increasing the illiquidity of construction companies, treatment of collateral, precisely calling of mortgages and consequently further decline of the lending activity of the banking sector. Nevertheless, the announced restructuring of loans in the construction sector in 2015 should improve liquidity of construction companies, which would reduce the subject risk.

Most of the surveyed real estate agencies (55% of them) expect that the prices will decline, 35% of agencies is of the opinion that prices will not change, while only 10% of them believe that prices will go up. Nevertheless, 40% of agencies believe that the demand will remain the same, 30% of agencies expect an increase in demand for real estate, while 30% of agencies expect a decline in demand. As for the agencies' expectation concerning the number of foreign buyers, half of the surveyed agencies believe that the number will go down, while 30% of agencies is of the opinion that the number will be increased in the next year, and 20% of agencies believe that the number will be the same.

Considering high supply of real estate, diversification of demand, announced restructuring of loans in the construction sector, further adjustment of the supply against demand could be realistically expected, through a slight decline in real estate prices in the first half of the year. Likewise, strong ruble devaluation could have negative consequences on the real estate market. Namely, citizens of the Russian Federation who are owners of real estate in Montenegro could decide to cash out their immovable properties, by increasing an already high supply, which would result in a further decline of prices. However, it should be emphasized that the realization of important tourism and infrastructure projects in Montenegro in the second half of 2015 will generate inflow of foreign direct investments and have a general impact on a mild recovery of the real estate market turnover. Moreover, increase in lending activity of banks, expected to take place in the next year, lowering of interest rates on loans resulting from competition between banks, developments in the euro area and the euro crisis, could partially contribute to the revival of the real estate market and slight increase in real estate prices. Certain increase in real estate prices could be expected in municipalities where the construction of large tourism facilities is to begin, such as Porto Novi, Luštica, Porto Montenegro.

3. FINANCIAL SYSTEM

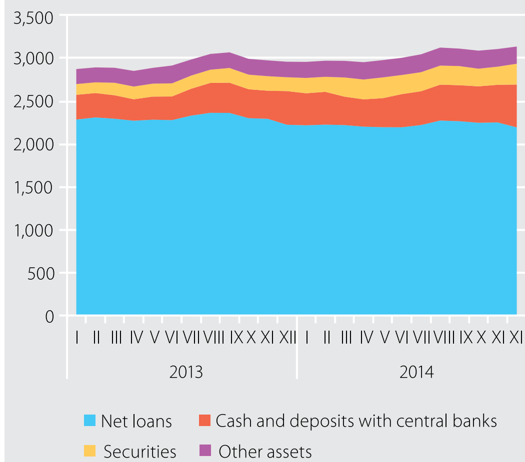
3.1. Banking System

During 2014, trends of the main aggregates were driven by the perception of unconvincing state of the real sector and the need to find new sources of revenues that are less risky. Despite a large number of new loans, total loans and receivables were reduced, and this-year's growth of the banks' assets was based on a significant growth of the monetary assets line items and accounts held with central banks, as well as on a sizeable increase in investments in securities.

A post-crisis trend of reduction of borrowing continued also in this year, which is a continuation of change in financing, whereby banks are increasingly being financed from deposits, which had the highest growth rate in this year since 2007. Foreign assets and liabilities and capital were further balanced. Liquid assets have had strong growth in this year as well, which is partly pointing to the problem of weaker lending. Exposure of banks to the government sector had a mild reduction.

Figure 3.1

Assets structure, 2013 - 2014, end of month period, in million euro



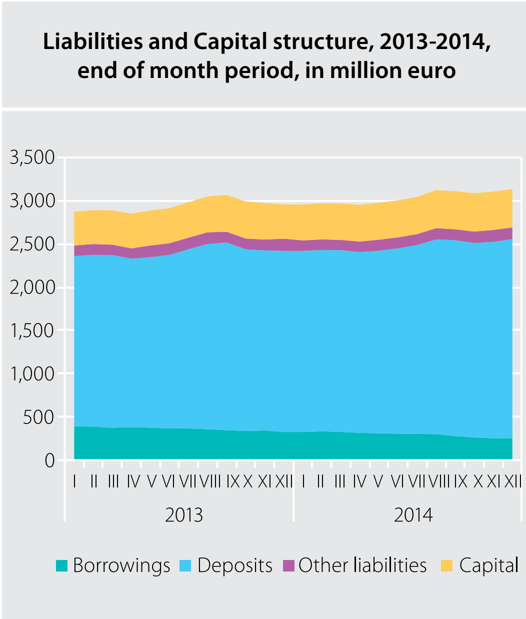
Source: CBCG

Concentration reduction in the banking sector continued also during 2014, but not only in terms of total assets and loans, but also in terms of deposits.

Total assets and liabilities grew by 6% at the end of 2014, compared to the end of 2013. As far as the structure of assets is concerned, the share of net loans and receivables declined by 5.2 percentage points to 70%, while the share of cash funds and deposits with central banks increased by 2.7 percentage points to 15.9%. Securities grew by 50.3%, thus their share in assets increased by 2.2 percentage points to 7.7% of assets. The structure of liabilities and capital has the deposits grew by 2.7 percentage points to 73.6% of the liabilities and capital at the end of 2014. Decline in borrowings was 23%, thus their share in liabilities and capital declined by 3 percentage points to 7.9%.

The gross loan to deposits ratio is in decline, and it was 84.6% at the end 2014, which is a y-o-y reduction of 11.4 percentage points.

Figure 3.2

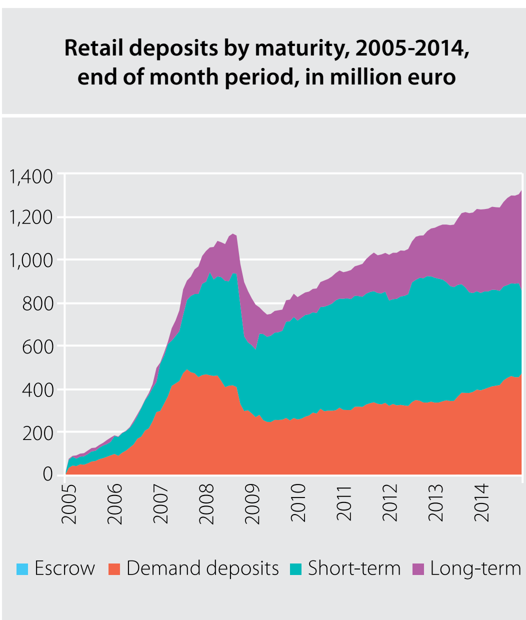


Source: CBCG

During 2014, total deposits grew by 10% to 2.31 billion euro at end-2014[15]. Some 57.7% of this amount referred to retail deposits (including also non-resident natural persons), or 1.33 billion euro. This growth (94.3 million euro) was a major contributor to the increase of total deposits. During 2014, a major re-shifting of maturity of retail deposits continued, thus the share of demand deposits (by 3.8 percentage points to 36%) and of the long-term deposits (by 5.4 percentage points to 36.3%) continued to grow at the expense of short-term deposits, where their share was reduced by 9.2 percentage points to 27.7%.

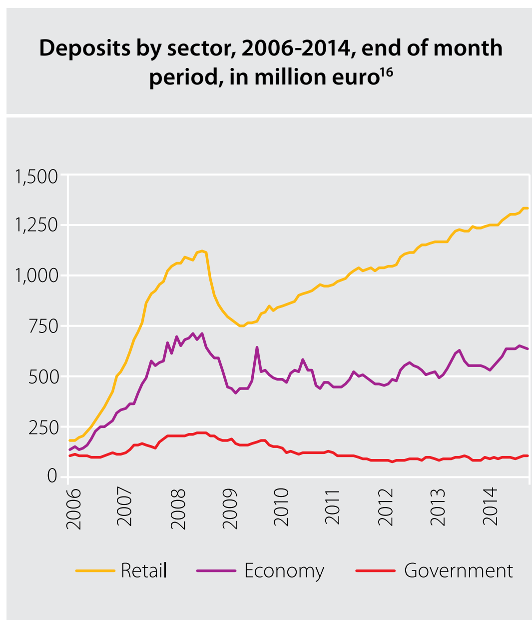
Total deposits have almost reached the record high value from the pre-crisis period in August/September 2008, while the retail deposits have long passed the pre-crisis level.

Figure 3.3



Source: CBCG

Figure 3.4



Source: CBCG

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

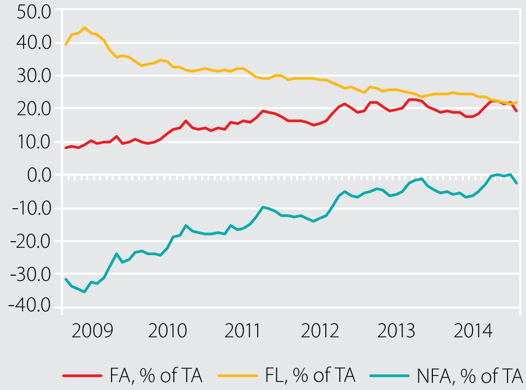
[16] For the economic sector deposits of privately owned business organisations, state-owned business organisations and entrepreneurs were taken into account. The government sector represents the general government (central government, regulatory agencies, local self-government units and state funds).

Foreign assets and liabilities and capital were additionally balanced during 2014 by further growth in foreign assets and fall in foreign liabilities and capital. For instance, in September and November, net foreign assets (NFA) was positive and the net foreign assets to total assets ratio was 0.2%. At the end of 2014, net foreign assets to total assets ratio was -2.3%, where foreign assets (FA) accounted for 19.5%, and foreign liabilities and capital (FLC) accounted for 21.9% in total assets and liabilities. These were the lowest levels of net foreign assets since 2007. For example, the largest disbalance was recorded at end-April 2009 when foreign liabilities and capital reached even 44.6% of total liabilities and capital and net foreign assets was -35.5% relative to total assets and liabilities.

Exposure of banks in absolute amounts to the Central Government grew in the first part of the year, and finished the year slightly above the level from the end of the previous year. In relation to total assets and liabilities, it declined from 6.9% to 6.8%. Loans and receivables from the General Government declined by 27%, while the exposure based on securities increased. On the other hand, liabilities of banks towards the Central Government at the year-end have had higher growth that the receivables, thus net receivables of banks against that sector declined and made 3% of total assets and liabilities.

Figure 3.5

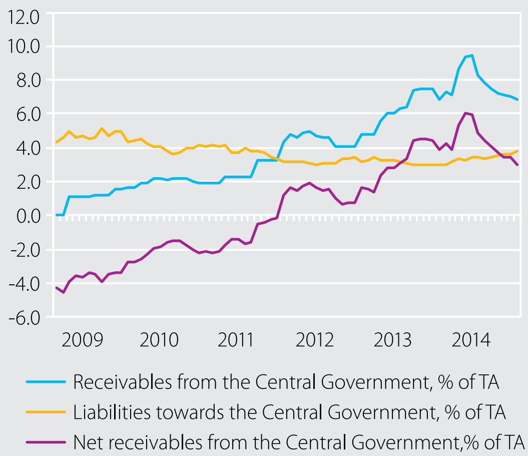
FA, FLC and NFA to total assets and liabilities, 2009-2014, end of month period



Source: CBCG

Figure 3.6

Exposure of banks towards the Central Government to total assets and liabilities, 2009-2014, end of month period



Source: CBCG

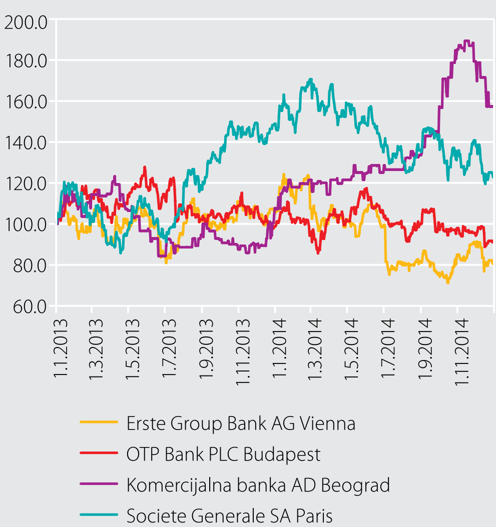
Financial System

Box 3.1 – Parent banks on financial markets in 2014

In 2014, there were 12 banks operating in Montenegro, seven of which with majority share of non-residents in capital. Out of those, six banks are entirely (or almost entirely) owned by non-residents – major banking groups from Austria (two banks), France, Hungary, Slovenia, and Serbia. Figures 1 and 2, and Table 1 show prices of shares, CDS spreads, and banks' ratings, as well as ratings of countries where the registered offices of those banks are located. Certain data were not available.

Figure 1

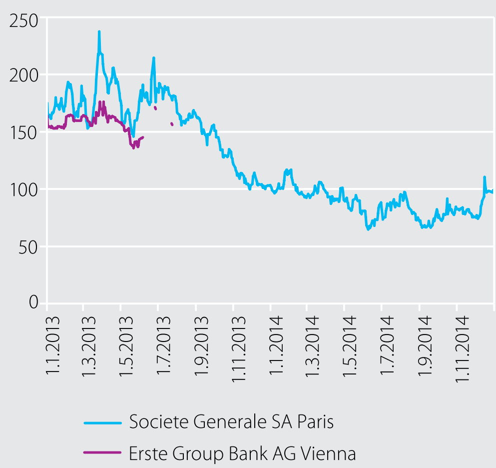
Prices of shares of banks having their subsidiaries operating in Montenegro, 2013-2014, 01 January 2013=100



Source: Bloomberg, CBCG calculations

Figure 2

CDS spreads of banks having their subsidiaries operating in Montenegro, 2013-2014, b.p.



Source: Bloomberg

Table 1

S&P ratings for banks having their subsidiaries operating in Montenegro (alphabetical order) and for their home countries, end-2014

Bank	Rating	Initial validity	Country	Rating	Initial validity
Erste Group Bank AG Vienna	A-	13.08.2014.	Austria	AA+	13.01.2012
Hypo Alpe-Adria-Bank International AG Klagenfurt	Without rating	/			
Komercijalna banka a.d. Beograd	Without rating	/	Serbia	BB-	07.08.2012
Nova Ljubljanska banka d.d. Ljubljana	Without rating	/	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

3.1.1. Credit Risk

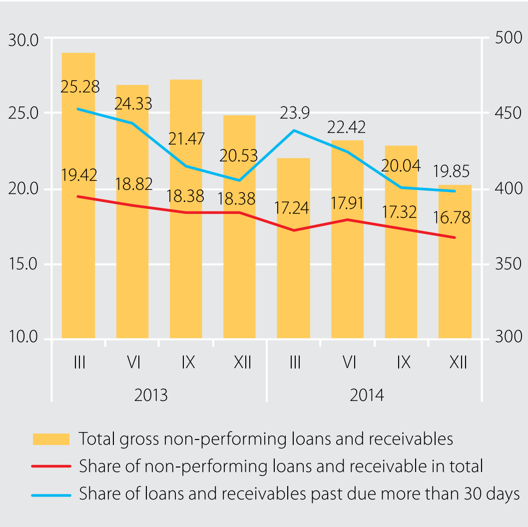
During 2014, the quality of the credit portfolio of banks recorded a slight improvement, but the credit risk remained especially high and represents a key risk in the banking system. During 2014, no major sale of assets took place, which was particularly pronounced in the previous five years, thus the decline in the non-performing loans level and receivables represents an "actual" improvement. However, illiquidity of the Montenegrin economy continues to be very high, which will be most likely manifested in the coming period and the banks will continue with prudential lending policy. In the coming year, the position of the part of the economy linked with construction of capital investments could be visibly improved, while the positive effects would be partially spilled over to other areas. Consequently, this could also improve the situation in the banking sector, at least for a certain period, through better collection of credits.

Lending dynamics during 2014 was weaker, which resulted in reduction of total loans. If compared to the end of 2013, the stock of gross loans and receivables[17] was reduced by 1.9% to 2.4 billion euro, and such situation could have not been "improved" even by 801.5 million euro of new loans[18] during 2014.

The banks ended 2014 with a 16.8% share of gross non-performing loans and receivables in total gross loans and receivables (with the amount of 402.1 million euro), which represents a decline of 1.6 percentage points if compared to the end of 2013. Gross loans and receivables past due for more than 30 days have also declining trend in the share from 20.5% to 19.9% (the amount being 475.6 million euro).

Figure 3.7

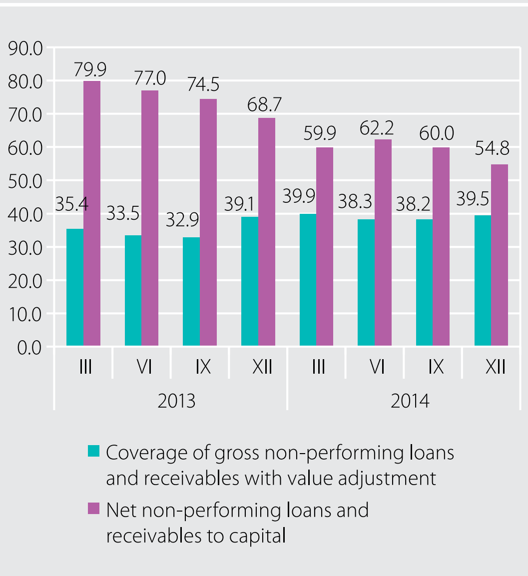
Total gross non-performing loans and receivables (right-hand scale)), in million euro, and share of some categories (left-hand scale), %, end of quarter period, 2013-2014



Source: CBCG

Figure 3.8

Certain ratios of gross loans and receivables quality, 2013-2014, %, end of month period



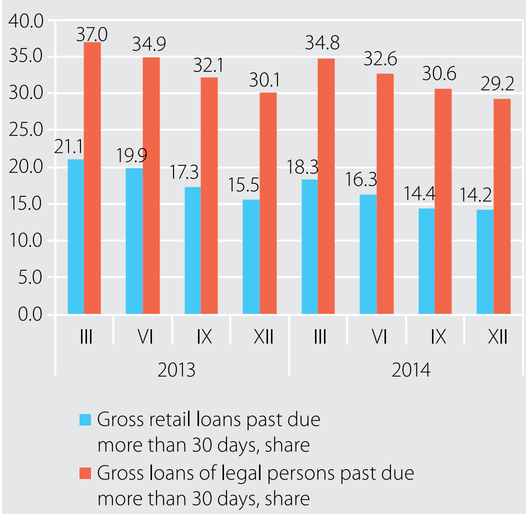
Source: CBCG

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

[18] The information regarding new loans refers to the contracted loans and not necessarily the amounts paid. Moreover, a number of loans were used to refinance/close old loans.

Figure 3.9

Share of gross loans past due more than 30 days, 2013-2014, %, end of month



Source: CBCG

In 2014, the banks continued to maintain significant level of restructuring loans portfolio, even though the amount of gross restructured loans declined by 10.9% to 378.6 million euro, while their share in total loans was reduced by 1.7 percentage points to 19.4%.

The ratio of gross non-performing loans and receivables coverage[19] is slightly higher if compared to the end of the previous year (39.5% against 39.1%), which is still relatively low coverage. Ratio of net non-performing loans and receivables to capital was more favourable at the end of 2014, as it declined from 68.7% at end-2013 to 54.8%, as a result of reduction of decrease of non-performing loans and increase of capital.

The real economy continues to be the main source of credit risk. At end-2014, the share of 30 days and over past due gross loans in the corporate sector[20] remained very high in relation to the household sector - 29.2% against 14.2%. A higher level of past due loans in the corporate sector in relation to households is not uncommon, since the household sector is forced to be more disciplined because they secure loans in a different way and have no "limited liability". Furthermore, when it comes to the current situation in Montenegro, the causes should be sought in the structure of the real economy (which is import-oriented and oriented towards the Montenegrin market), i.e. in the problems of certain sectors of the real economy which operate mainly based on the inflow from the balance of payments financial account, bearing in mind the fact that these flows had a downward trend in the past five years. On the other hand, considerable number of employees works in the government sector, which position has not been so destabilised during this period mostly due to the possibility of that sector to borrow from abroad.

Credit risk stress testing

The following shocks were used to credit risk stress testing:

1. The reclassification of classified loans and receivables and application of value adjustment stipulated in accordance with banks' methodologies, or average value adjustment 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 assets) calculated in the amount of 95% of the increased category B;

[19] Ratio of value adjustment for losses on gross non-performing loans and receivables to gross non-performing loans and receivables.

[20] Corporate sector include also government sector, otherwise ratio referring strictly to the real economy would be even higher.

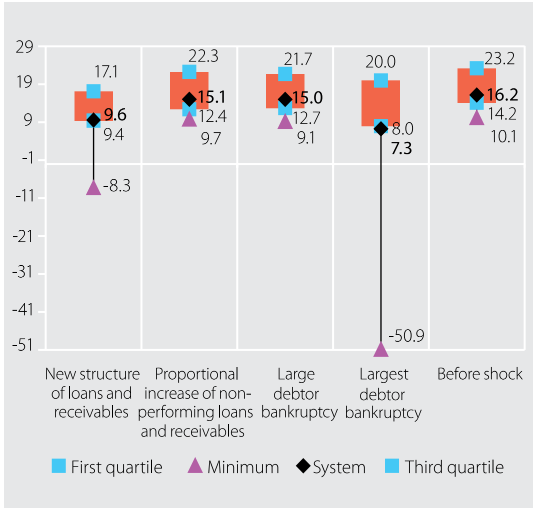
- category C (substandard assets) calculated in the amount of 5% from category B, whereby 95% of category C was kept;
- category D (doubtful assets) calculated in the amount of 5% from category C, while 95% from category D was kept;
- category E (loss) amount increased by 5% of the amount of category D.

  The following rates for categories A, B, D and E, precisely the following average provisioning rates for category C were applied to thus calculated categories of reclassified loans and receivables:
  - category A - 1%,
  - category B - 3%,
  - category C - 30%,
  - category D - 75%,
  - category E - 100%;

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

Figure 3.10

Credit risk testing, results, 31 December 2014



Source: CBCG

3. Default of one borrower whose exposure is calculated based on the arithmetic mean of a bank's 20 largest borrowers less the arithmetic mean of value adjustment for given exposures (so called real exposure);
4. Default of the largest borrower of a bank less the amount of value adjustment for given exposures (real exposure)

In general, the testing confirmed the banks' sensitivity to credit risk, whereby the results differed greatly from bank to bank. Stress testing showed that the banks are most sensitive to the first and fourth shock, whereby the system level solvency ratio declined by 6.6 percentage points and 8.9 percentage points, amounting to 9.6% and 7.3%, respectively. Whereby three banks did not pass the first test, as they showed a shortfall of capital of 57.7 million euro, while seven banks failed the fourth test, with the shortfall of capital of 85.7 million euro. When it comes to the first and fourth test, capital of two and one bank respectively, 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 respectively, with a shortfall of capital of 0.5 million euro for the second and 1.7 million euro for the third test.

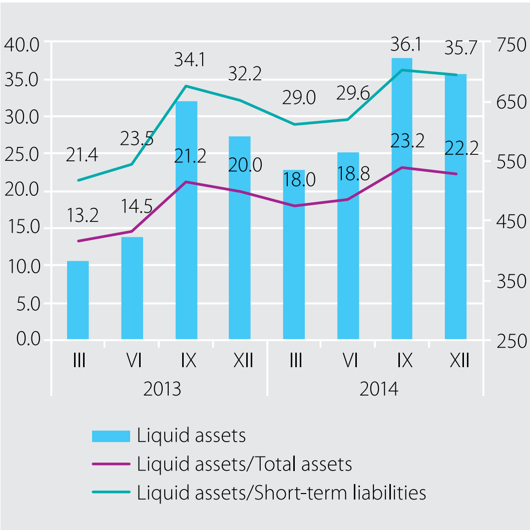
3.1.2. Liquidity Risk Management

General feature of 2014 was high liquidity of the banking sector. Monetary assets have recorded a large growth (of which large share pertains to funds on accounts abroad), while on the other hand lending activity was weaker, in other words free assets were less "engaged". At the end of 2014, liquid assets[21] accounted for 22.2% of total assets and amounted to 697.2 million euro, which is the year-on-year increase of 17.9%. The coverage of short-term liabilities by liquid assets recorded a similar trend, amounting to 35.7% at 2014 year-end. Liquid assets recorded a sizeable increase during Q3 even in this year, mostly due to an increase of balances on accounts with banks abroad (demand deposits). Similar to the last year's trend, the liquid assets declined in Q4 mainly due to changes in the same account.

During 2014, the ten-day liquidity indicator remained substantially above the prescribed minimum, with similar trend as for liquid assets.[22]

Figure 3.11

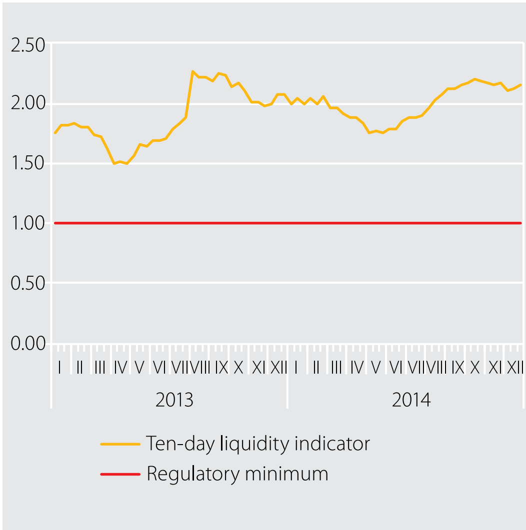
Selected liquidity indicators (left-hand scale), %, and total liquid assets (right-hand scale), in million euro, end of quarter period, 2013-2014



Source: CBCG

Figure 3.12

Ten-day liquidity indicator



Source: CBCG

Liquidity risk stress testing

Ratio of monetary assets and deposit accounts held with central banks (assets side) and of deposits (liabilities and capital side) is relatively low (at aggregate level amounts to 21.4%), which will have negative impact on results testing outflow of deposits for majority of banks.

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

---

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

[22] 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 (Official Gazette of Montenegro, No 60/2008). The definition of liquid assets and matured liabilities is given in the same Decision. It is worth mentioning that liquid assets are different category with regard to free liquid funds and available liquid funds (see below in the document).

1. available liquid assets (monetary assets and deposit accounts with central banks reduced by full amount of mandatory reserve requirement),
2. available liquid assets, i.e. free liquid funds increased by 50% of the mandatory reserve requirement amount.

The resilience to the following shocks was tested: 1) Withdrawal of 30% of total deposits; 2) Withdrawal of 30% of demand deposits; 3) Withdrawal of 20% of demand retail deposits and 30% of demand deposits of legal persons; 4) Withdrawal of 30% of term retail deposits and 30% of term deposits of legal persons; 5) Withdrawal of largest depositor's deposits; 6) Withdrawal of half of deposits of 10 largest depositors; and 7) Withdrawal of deposits of the public sector.

Aside from very positive trends 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 rather extreme, i.e. their realisation is not very likely. In addition to this, pursuant to the new definition of free/available liquid assets, they do not include deposits with banks and other financial institutions, which in proportion affect worse testing results. However, even those funds are highly liquid which could be also used in case of the aforementioned shocks.

Without the use of the mandatory reserve requirement, the system did not fail the third, fifth and sixth test, while the system would fail the first test even with the use of the mandatory reserve requirement. Banks showed the worst results in the first test and the best in the fifth test. A total of 11 banks failed the first test and the use of 50% of the mandatory reserve requirement would only solve the problem to a certain degree. Four banks failed in the fifth test, where one bank could solve the problem by using 50% of the mandatory reserve requirement.

3.1.3. Market Risk Management[23]

Interest rate risk arising from the trading activities hardly exists in the banking sector of Montenegro, since the trading positions that would be potentially affected by the interest rate change are negligible. Interest rate risk arising from non-trading activities is most certainly present, but the banks are mostly transferring it on to their clients.

Interest rate spread[24] at the banking sector level increased during 2014, primarily as a result of decline of the interest expenditures to interest-bearing liabilities and capital ratio. At end-2014, the spread at the system level amounted to 4.94 percentage points (compared to 4.05 percentage points at end-2013), while it differed significantly by banks, ranging from 3 to 8.7 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 of the banking sector at end-2014 amounted to 1.9 million euro or 0.7% of core capital[25]. The most frequent foreign currency was US dollar (on both sides of the balance

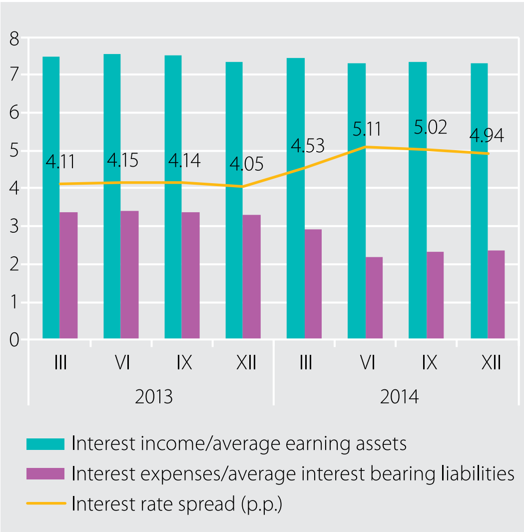
[23] This part relates to two types of market risks: interest rate risk and FX risk.

[24] 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.

[25] For details on the composition of core capital see the Decision on Capital Adequacy of Banks (Official Gazette of Montenegro, No 38/2011, 55/2012).

Figure 3.13

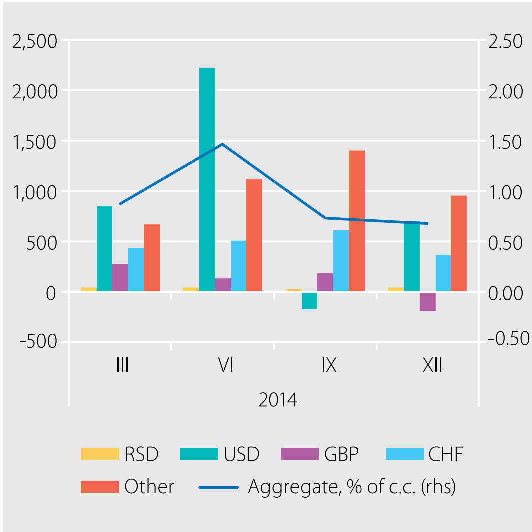
Interest rate spread, 2013-2014, %[26]



Source: CBCG

Figure 3.14

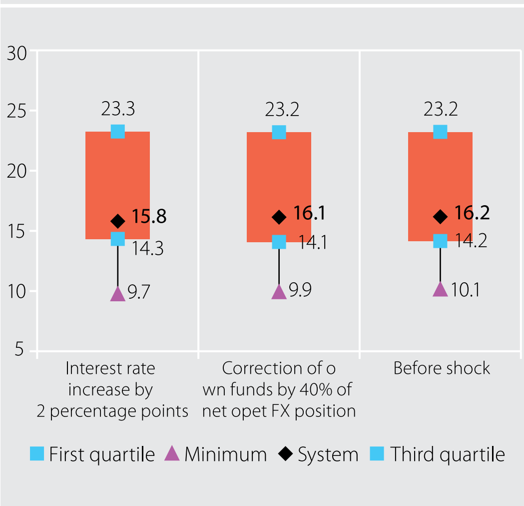
Aggregate net positions by currency, in thousand euro, end of month period



Source: CBCG

Figure 3.15

Market risk stress testing, results, 31 December 2014



Source: CBCG

sheet), while at the system level the highest net open position is in US dollars, 0.3% of core capital.

The majority of loans were denominated in euro currency. Only one bank showed a significant share of gross foreign currency loans (17.5%) in its loan portfolio, while at the system level this share was a mere 1.6%.

Stress testing of market risk

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

[26] Quarterly ratios are boiled down to annual by multiplying rations for first quarter, first semester and first three quarters (by corresponding cumulative incomes/expenditures from interest) with 4, 2, and 4/3 respectively.

Stress testing of direct FX risk was based on the net open FX spot position, precisely 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 of banks to interest rate and FX risks was not significant. After the application of interest rate change, the system responded with a decline in the capital adequacy ratio of 0.4 percentage points i.e. 2.3% with somewhat more intense decline in certain banks, while the solvency ratio grew in case of three banks. During the FX risk stress testing there was an insignificant decline in the solvency ratio of 0.04 percentage points i.e. 0.2%, with also somewhat larger oscillations in case of certain banks and increase in solvency ratio with four banks. In case of both tests, solvency ratio was below the regulatory minimum only in case of one bank.

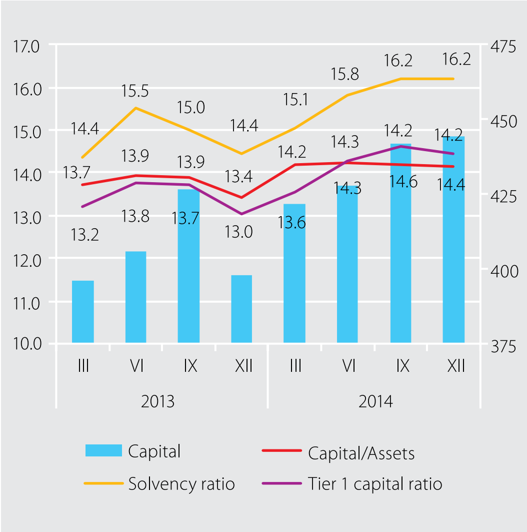
3.1.4. Banking Sector Capital

At end-2014, banks' capital accounted for 14.2% of total assets and liabilities, which was 0.7 percentage points higher in relation to end-2013 and amounted to 444 million euro. Two banks were recapitalised in the first two quarters of 2014 in total amount of 16.5 million euro. Aside from the recapitalisation and increased profit, the increase in total capital was also due to the fact that new bank came into the market having a share capital of 5.7 million euro at the end of the year. The negative changes in the retained earnings positions should be also mentioned in the breakdown of capital (13.6 million euro), as well as positive changes in the other reserves position, which was approximately the same.

Solvency ratio of the banking sector at the end of 2014 was markedly higher, if compared to the end of 2013 and it was 16.2%. The ratio was above the prescribed minimum of 10% in case of all banks.

Figure 3.16

Trend of core capital ratios (left-hand scale), %, and of the total capital (right-hand scale), in million euro, end of quarter period, 2013-2014.



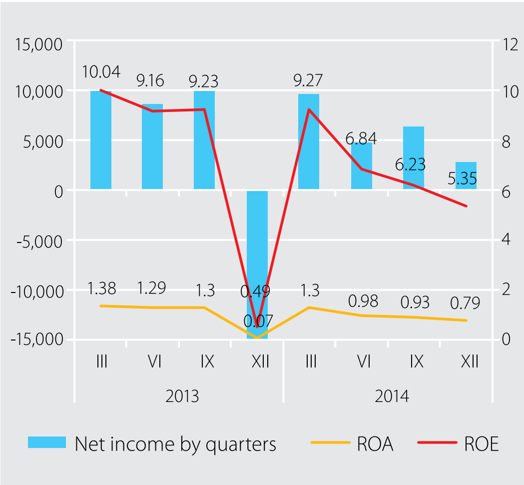
Source: CBCG

3.1.5. Profitability of the Banking Sector

The banking sector generated positive financial result in 2014, in the amount of 23.8 million euro. Ten banks operated at profit, while two banks operated at loss (one medium-sized and one small). Return on average equity (ROAE) and Return on average assets (ROAA) at the end of 2014 were 5.4% and 0.8% respectively, which was quite an improvement if compared to the previous year, where the negative result in Q4 almost annulled positive result from the first three quarters.

Figure 3.17

Financial Result (left-hand scale), in thousand euro, and ROAE and ROAA trend (right-hand scale), %[27] end of quarter period, 2013-2014.



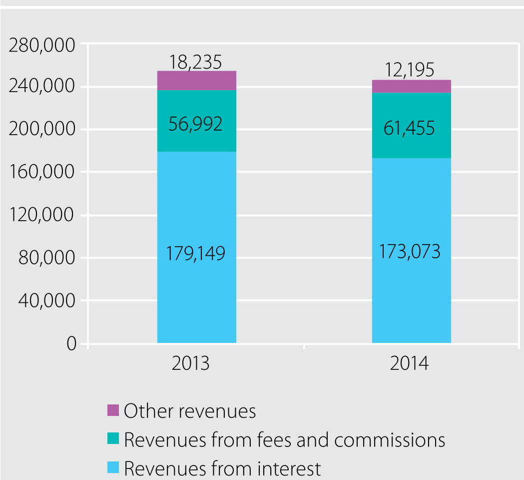
Source: CBCG

Income from interests is the most prominent income of banks, which have had almost the same share in total income despite decline of 3.4%. Interests expenses are also the most important expense of banks, which were reduced by as high as 17.2% during 2014, thus the net income from interests were higher than in 2013.

However, if we put aside the decline in interest expenses, allowances for impairment and provision expenses made the key difference in the financial result of 2014. They declined by 22.9 million euros and amounted to 21.1 million euro.

Figure 3.18

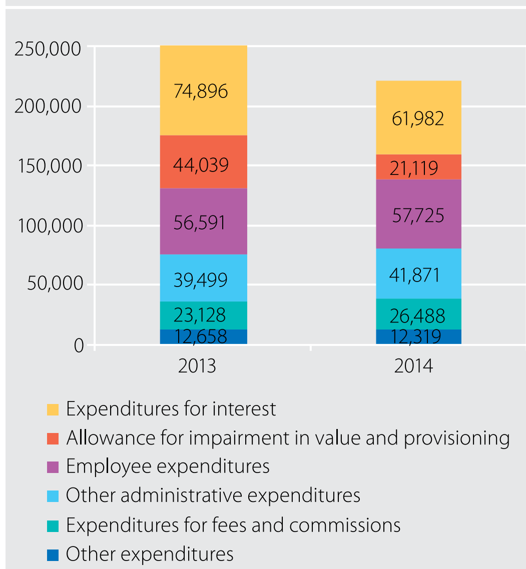
Income by category, 2013-2014, in thousand euro



Source: CBCG

Figure 3.19

Expenses by category, 2013-2014, in thousand euro



Source: CBCG

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

3.1.6. Interest Rates

At end-2014, the weighted average lending effective interest rate (WALEIR) at the system level was 9.22% and it was 0.14 percentage points lower in comparison to end-2013. In the same period, the weighted average deposit effective interest rate (WADEIR) declined from 2.54% to 1.83%, or if observing the average of 12-month data, in comparison to 2013 the WADEIR declined by 0.78 percentage points (2.14% compared to 2.91%) during 2014.

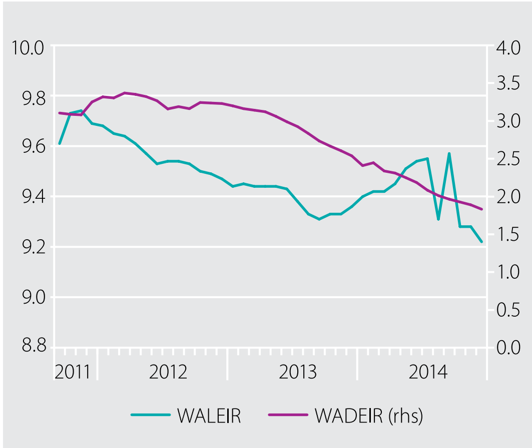
If we observe the historic series, the lending interest rates continued downward trend in 2014, which is a trend that started after November 2011, after they increased during the period mid-2007 – end-2011 by about 0.7 percentage points (increasing almost continuously during this period, from 9% to around 9.7%). However, it should be mentioned that the downward trend continued during 2014 only if we observe data for the year-end, while the lending interest rates have recorded an increase during the year as highs as up to 9.57% (end of September), therefore the lending interest rate were on average higher in 2014 compared to 2013.

On the other hand, trend of the deposit interest rates in 2014 was marked by the continued downward trend, which commenced after Q1 2010, and was shortly stopped in 2012. When it comes to changes in lending and deposit interest rates in 2014, compared to 2013, it is clear that this is a very slight change in lending interest rates, while deposit interest rates experienced significant downward adjustments.

In December 2014, WALEIR (PPAEKS) on new loans[28] amounted to 9.02%, which is 0.04 percentage points lower in comparison to 9.42% from December 2013. Generally, WALEIR was lower

Figure 3.20

Average weighted lending/deposit effective interest rate, end of month period, %, Sep 2011-2014



Source: CBCG

Figure 3.21

Weighted average lending effective interest rate for new loans (during a month) and total loans (end of month period), %, 2013-2014

Source: CBCG

[28] The amounts of new loans (which ultimately have the role of weight for determining the aggregate interest rates) represent the contracted and not paid amounts. Furthermore, 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 as well as the data on the very amounts of new loans.

during 2014, amounting to 10.09% in relation to 10.28% as simple average i.e. 9.55% in relation to 10.12% as weighted average. With regard to the structure, the WALEIR in December 2014, compared to the rest of the year, was lower primarily due to loans to the corporate sector, which were granted with lower interest rates and were in above the average from the rest of 2014.

Although data on interest rates on new loans/deposits cannot be compared, as there is no statistics for interest rates on new deposits yet, it seems that there is room for further decline in interest rate on loans based on the existing parameters. It should be taken into account that lending interest rate is a result of operation of several factors. Essentially, banks have to pay interest rates on deposits and borrowings and cover operating expenses. In addition, banks currently transfer a substantial portion of assets abroad where they can get much lower interest rates than in Montenegro. Finally, profit margin reflects risk reward assumed by bank owners (mostly foreign banking groups) in respect of main investment, the shareholders capital. Since Montenegrin economy is still riskier than the EU 28 average, it is realistic to expect that the requested/expected margin is relatively higher.

However, although according to the theory 12 banks should be sufficient for efficient 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 operate, 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 the growth. Moreover, they burden finances and functioning of entities that signed lending facilities with possible negative consequences for the very banks that granted loans if they face problem in collection. Therefore, the CBCG monitors the interest rates trend and, in accordance with available instruments, it will react in the future if it estimates that the intervention would lead to optimum solution.

3.2. Micro-Credit Financial Institutions

At the end of 2014, the total assets of micro-credit financial institutions (MFIs) amounted to 38.3 million euro, recording an increase of 10.7% in relation to the end of 2013.

Net loans and receivables (90.7%) accounted for the dominant share in MFIs' assets, while cash and deposit accounts with central banks made 3.3%, and net other assets was 6% of the total assets of MFIs at end-2014.

MFIs' gross loans and receivables amounted to 39.7 million euro, recording a growth of 6.7% relative to end-2013. The share of gross non-performing loans and receivables was 12% and they declined by 4.4 percentage points relative to the end of 2013. Share of gross loans and receivables past due for more than 30 days was 13.2% and they declined by 4.5 percentage points if compared to the end of 2013.

Observed by institutional sectors, almost all MFIs gross loans and receivables pertain to natural persons, while observed by purpose, MFIs gross loans for fixed assets purchase accounted for the dominant share in the MFIs loan portfolio structure (19.6%), followed by consumer loans (14.6%) and cash non earmarked loans (11%). With regard to the maturity structure of MFIs gross loans, long-term loans accounted for the main share (72.8%).

In the structure of MFIs' liabilities and capital, capital accounted for the majority share (51.7%), amounting to 19.8 million euro at end-2014. Of total capital amount, 71.3% referred to donated capital, retained earnings made 18.5%, while current year profit amounted to 10.2% of total capital. On the other hand, liabilities made up 48.3% of liabilities and capital, or 18.5 million euro.

MFIs generated positive financial result of two million euro at end-2014 (positive result was recorded in each quarter of the year).

Interest rates on MFI loans were on a downward trend in 2014, showing lower level relative to 2013. The weighted average effective interest rate (WALEIR) was 25.66% at end-2013, and it declined by 0.72 percentage points in relation to the previous year-end. When it comes to interest rates on new loans, the WALEIR amounted to 24.62% on loans granted in December 2014, which is 1.41 percentage points lower in comparison to the interest rates on loans granted in December 2013.

MFIs account for a very modest share of total approved loans and assets of the financial system in general, therefore, their risk to financial stability is small. This is even more the case since they are not legally allowed to accept deposits, so there is no threat that their financial position will be jeopardized through deposits outflow nor there is danger from the panic spread effect.

3.3. Capital Market

Trends on the capital market in 2014 were sizeably better if compared to the period of previous couple of years. The turnover was even three times higher if compared to 2013, and amounted to 108.2 million euro, which is the highest annual turnover since 2009. The main Montenegro Stock Exchange index, MONEX 20, grew by 15.3% at the end of 2014 if compared to the end of 2013, even though it was lower by more than 75% if compared to the end of April 2007 (the peak of the stock exchange activities). On the other hand, MONEX PIF index of investments funds recorded a decline of 11% in 2014.

Table 3.1

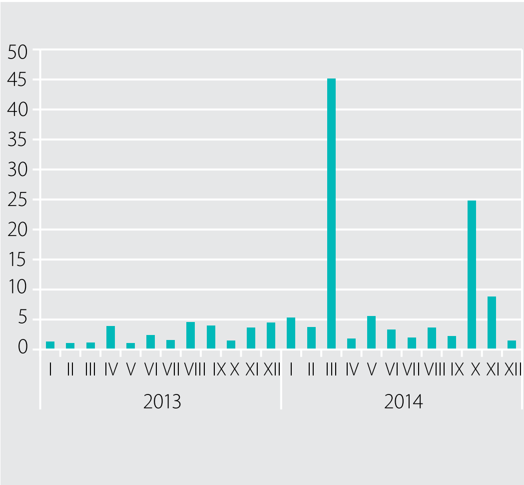
Core indicators of the Montenegro Stock Exchange developments in 2014	
MONEX 20, at 31-Dec-2014	**11,356.11**
Annual index change	15.3%
Total turnover in 2014, in euro	**108,157,203**
Turnover change 2014 to 2013	251.5%
Market capitalisation, in euro, 31-Dec-2013	**2,960,670,753**
Annual change in market capitalisation	4.3%

Source: Montenegro Stock Exchange

Average monthly turnover in 2014 amounted to nine million euro, if compared to 2.6 million euro in 2013. Primary emission of government bonds (43.2 million euro in March) and corporate bonds of one bank (10 million euro, in October and November) were major drivers for the increase in turnover.

Figure 3.22

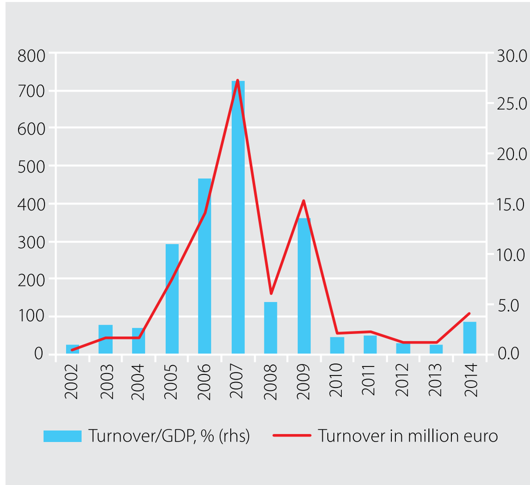
Monthly turnover, 2013-2014, in million euro



Source: Montenegro Stock Exchange

Figure 3.23

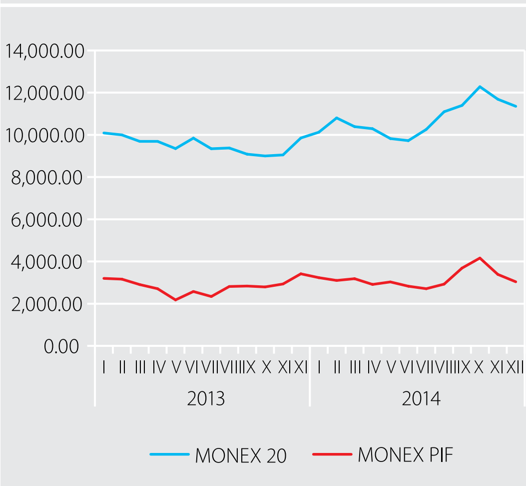
Annual turnover, 2002-2014



Source: Montenegro Stock Exchange, MONSTAT

Figure 3.24

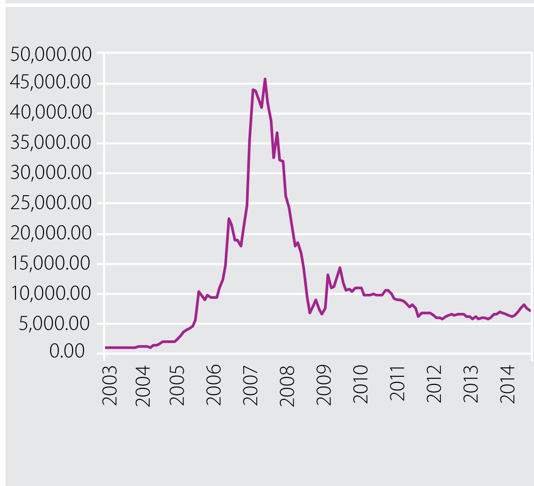
Indices trends, 2013-2014, end of month period



Source: Montenegro Stock Exchange

Figure 3.25

Trend of simple average of indices MONEX 20 and MONEX PIF, period March 2003-2014, end of month period



Source: Montenegro Stock Exchange, CBCG calculations

Montenegrin capital market is still showing numerous weaknesses, the most important being very low liquidity (depth) and poor protection of proprietary rights, especially the protection of minority shareholder's rights and the observance of basic principles of corporate governance. Issuers' information on their finances represents a special issue in terms of provision of accurate and regular information. Furthermore, considering the previous assessments and taking into account a precipitating decline of the indices` values in the after crisis impact, a considerable number of investors have lost the confidence in the capital market. However, the assessment 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.

Compared to banks, the capital market in Montenegro has traditionally relatively small role in real sector financing, i.e. gathered amounts of capital through the issue of shares in Montenegro are negligibly small compared to capital that the real economy borrows in the form of loans from banks. However, this market needs to be developed, and the above-mentioned shortcomings 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 more developed, creating much more space for economic growth. The primary issue of government and corporate bonds in 2014 was a good step forward in that direction.

Box 3.2 – First primary issue of government and corporate bonds on the domestic capital market

First primary issue of government and corporate bonds were carried out at the domestic capital market, which has considerably increased turnover on the domestic stock market in 2014 if compared to the previous period.

As opposed to bonds for foreign currency savings, where the government debt was simply converted into bonds, in 2014 the State has issued market bonds for the first time at the domestic capital, which implied gathering of capital i.e. primary issue in its true sense. The issue of the government bonds was carried out at the beginning of March, and the auction collected 43.15 million euro out of planned 100 million euro. Value of a single bonds was 10,000 euro, thus 4,315 bonds were sold, purchased primarily by domestic banks and insurance companies. Bonds have four years maturity with annual interest rate of 5%. It is also important to mention that bonds are amortising, i.e. repayment of both principle and interest is carried out in equal semi-annual annuities, which made bonds more attractive for investors vis-à-vis credit risk.

In October and November, one commercial bank issued subordinated bonds, in order to strengthen capitalisation i.e. the solvency ratio. Full planned amount of issue was sold, precisely ten million euro. Value of one bond was 100 euro, thus 100 thousand bonds were issued. Maturity is seven years with the annual interest rate of 6%. It is interesting to mention that bonds will yield semi-annual interest, while the principal will be repaid at maturity i.e. at the very end of the seven-year period.

Both bonds are tradable at the secondary market.

3.4. Insurance Sector[29]

The stagnation in gross written insurance premium, increase in total assets of the insurance sector and growing financial result marked the developments in the Montenegrin insurance sector in 2014 if compared to 2013.

Total gross written premium generated in the insurance sector amounted to 72.4 million euro in 2014, recording the year-on-year decrease of 0.5%. Non-life insurance premiums accounted for the dominant share (82.7%) in the structure of premiums of insurance companies, in total amount of 59.9 million euro. Life insurance premiums amounted to 12.6 million euro and they increased by 15.4% relative to 2013, with a slight increase in the share of life insurance premiums and decline of the share of non-life insurance premiums in total premium.

Observing the structure of non-life insurance premiums in 2014, compulsory insurance had major share (56.4%), recording an increase of 0.7 percentage points if compared to 2013[30]. In the life insurance premium structure, life insurance accounted for the highest share of 88.6%, and together with supplementary insurance of persons comprised 99.6% of total life insurance premiums.

In 2014, 11 insurance companies operated in the Montenegrin insurance market, of which six engaged in life insurance business, while five insurance companies engaged in non-life insurance, whereby the foreign capital accounted for the dominant share in total capital. The insurance market concentration measured by the Herfindahl-Hirschman Index by gross written premiums, the market concentration at the insurance market declined during 2014 from 2, 208.9 points to 2,041.3 points at the end of 2014.

The solvency margin of insurance companies was 15.7 million euro while capital amounted to 39.3 million euro[31]. Thus the capital to solvency margin ratio at the Montenegro's insurance sector level was 2.5 (2.2 at end-2013), which indicates that the solvency of insurance companies was satisfactory. In addition, total share capital of the insurance companies amounted to 52.1 million euro at end-2014. Liquidity ratio (liquid assets to short-term liabilities) was 8.3, and it was considerably higher relative to end-2013 when it was 4.7.

The financial result at the insurance sector level was positive and it amounted to 4.7 million euro (compared to three million euro in 2013).

These figures lead to a conclusion that the insurance market was further consolidated during 2014, and that this sector currently does not impose a major threats to financial stability.

Certainly, the insurance sector cannot have an overwhelming impact due to its size (170.1 million euro of total assets at end-2014). However, as with the capital market, possibilities for market growth 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

29 All information of the insurance sector referring to 2014 is preliminary.

30 Compulsory insurances are motor vehicle liability insurance, and liability insurance arising from the use of motor vehicles, aircrafts and vessels.

31 *Capital* is calculated according to regulations and not as a category from the balance sheet.

large portion of capital mostly towards other financial intermediaries (usually banks) or directly into the market, while providing unavoidable type of financial service. Low income of the population and the rather difficult state in the real economy are stated as the main reasons why the insurance market is not larger, as well as the lack of awareness of importance of service that this sector provides.

4. FINANCIAL INFRASTRUCTURE

A set of institutional arrangement/systems make the financial infrastructure which provides the 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 credit registry.

4.1. Payment System

The Central Bank of Montenegro is the operator of the interbank payment system consisting of two sub-systems, RTGS and DNS[32] systems. Core objectives of activities in this domain are payment system safety and efficiency in functioning, 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

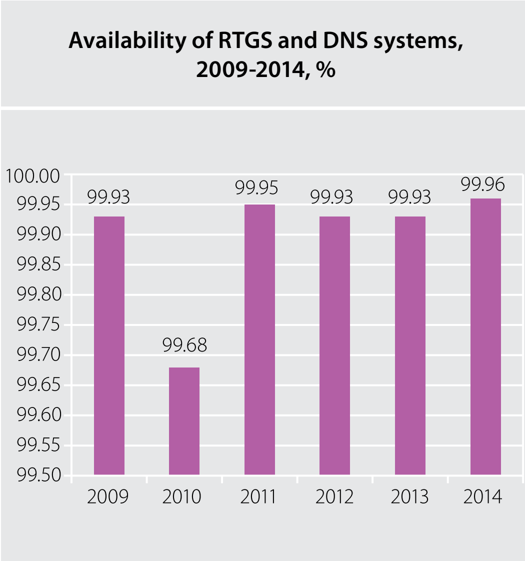
RTGS and DNS system availability

Period	Woking			Extension in min	Production in minutes	Suspension in min	System availability, in %
	Days	Hours	Minutes				
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
2014	**253**	**2,150**	**30**		**129,030**	**47**	**99.96**
I 2014	21	178	30		10,710		100.00
II 2014	20	170			10,200		100.00
III 2014	21	178	30		10,710		100.00
IV 2014	22	187			11,220		100.00
V 2014	18	153			9,180		100.00
VI 2014	21	178	30		10,710	31	99.71
VII 2014	21	178	30		10,710		100.00
VIII 2014	21	178	30		10,710		100.00
IX 2014	22	187			11,220	16	99.86
X 2014	23	195	30		11,730		100.00
XI 2014	20	170			10,200		100.00
XII 2014	23	195	30		11,730		100.00

Source: CBCG

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

Figure 4.1



Source: CBCG

In 2014, total output of the interbank payment system, i.e. RTGS and DNS systems, amounted to 129,030 minutes, with 47 minutes of suspension of the system; therefore the system availability was 99.96% continuing the trend of especially high availability recorded in the previous years.

In 2014, the value of total payment system transactions in the country amounted to 23.2 billion euro, or 3.9% more in relation to 2013. On the other hand, the number of transactions increased by 7.5%, to close to 28 million transactions. If we observe the structure, value of transactions increased due to increase in interbank transactions (8.7%), while the value of internal transactions slightly decreased by 0.1%. As far as the structure of volume is concerned, it was reversed, the volume of internal payment transactions was primarily driven by the increase in volume of total transactions, and grew by 8.8% as opposed to the growth of the interbank transactions volume of 4.4%.

Table 4.2

Comparative indicators of value of payment system transactions, in euro

	2014	2013	2012	2011	2010	2014/2013
Interbank	**11,006,358,207**	**10,123,092,075**	**9,103,468,406**	**9,069,817,107**	**8,673,777,093**	**108.7**
RTGS	10,407,060,461	9,552,596,535	8,553,655,836	8,519,229,139	8,140,415,076	108.9
DNS	599,297,745	570,495,540	549,812,570	550,587,969	533,362,017	105.0
Internal	**12,164,245,660**	**12,180,126,932**	**11,710,512,566**	**12,009,464,651**	**11,733,587,598**	**99.9**
Cashless	8,871,084,699	8,998,002,178	8,682,132,662	8,952,110,113	8,741,589,307	98.6
Cash	3,293,160,961	3,182,124,754	3,028,379,904	3,057,354,538	2,991,998,291	103.5
Total	**23,170,603,866**	**22,303,219,007**	**20,813,980,972**	**21,079,281,758**	**20,407,364,691**	**103.9**

Source: CBCG, commercial banks

Table 4.3

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

	2014	2013	2012	2011	2010	2014/2013
Interbank	**8,212,730**	**7,865,980**	**7,405,773**	**7,780,970**	**8,809,445**	**104.4**
RTGS	3,725,929	3,678,688	3,520,051	3,999,616	5,136,534	101.3
DNS	4,486,801	4,187,292	3,885,722	3,781,354	3,672,911	107.2
Internal	**19,704,536**	**18,113,762**	**16,648,750**	**15,862,001**	**16,483,085**	**108.8**
Cashless	13,556,253	12,549,144	11,602,066	10,805,920	11,275,833	108.0
Cash	6,148,283	5,564,618	5,046,684	5,056,081	5,207,252	110.5
Total	**27,917,266**	**25,979,742**	**24,054,523**	**23,642,971**	**25,292,530**	**107.5**

Source: CBCG, commercial banks

Potential risks arising from the payment system were reduced with the establishment of disaster recovery location and improvement of the technological/IT platform for operation of the system.

4.2. Credit Registry

The credit registry operating within the Central Bank of Montenegro since 2008, has as the primary objective gathering of relevant data on retail and corporate loans, all aimed at providing information which contribute to better assessment and credit risk management in banks. Information obtained from banks were initially used in the Central Bank for the purpose of conducting more efficient inspections, while the data 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 also obliged to submit information on all issued guarantees, credit cards, leasing facilities, overdrafts and other loan receivables that expose a bank to risk.

The report obtained from the credit registry database includes all loan-related obligations that legal or natural persons have with all banks in Montenegro, as well as interest and regularity in repayment, or the quality of liabilities servicing. Contingent borrowing of a client, reflected through 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 of year						
	2009	2010	2011	2012	2013	2014
Natural persons	117,047	107,414	104,158	102,212	104,948	106,365
Legal persons	5,207	5,031	4,830	4,771	5,241	5,521
Total	**122,254**	**112,445**	**108,988**	**106,983**	**110,189**	**111,886**

Source: CBCG

Table 4.5

Number of clients by total receivables (loans, leasing, credit cards and overdrafts at current accounts), end of year						
	2009	2010	2011	2012	2013	2014
Natural persons	171,153	160,161	146,132	150,260	142,311	143,528
Legal persons	5,787	6,483	6,261	6,355	6,926	7,373
Total	**176,940**	**166,644**	**152,393**	**156,615**	**149,237**	**150,901**

Source: CBCG

Table 4.6

Number of searches for the observed period					
2009	2010	2011	2012	2013	2014
119,576	188,165	198,722	143,990	136,949	135,432

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[33]. 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 2011, 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 twelve banks, six MFIs and the Investment and Development Fund (IDF), and based on the contract concluded with the Central Bank, other financial sector participants can be also included into the reporting system (leasing 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, and other).

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 financial system of Montenegro.

[33] Until then, the participation in the registry was regulated exclusively by contracts. Law: Official Gazette of Montenegro, No 40/2010, 46/2010, and 6/2013. Decision: Official Gazette of Montenegro, No 27/2011 and 64/2012;

5. CONCLUDING REMARKS

Considerations about certain threats and vulnerabilities given in this chapter, as well as in the rest of the Report, are intended *to point* to threats to the financial system stability. That *does not mean* that threats will necessarily be realised.

International Environment

The pressures regarding the European debt crisis have undoubtedly weakened, while the situation in global financial markets was improved. However, the global economic environment remains uncertain and the growth is still not very satisfactory (primarily in advanced economies, with a partial exclusion of USA). Unfortunately, this is also valid for the region surrounding Montenegro.

Since a mild increase in economic activity is forecasted for Europe in 2015 (the latest official forecast of the IMF for the euro area is 1.2%), Montenegro, being a small and open economy which is directly or indirectly connected to Europe, is not expected to have high growth in 2015 originating from this source, as well as the rest of the region. Regarding the channels of influence and bearing in mind the current model of system functioning, the most important channel is the balance of payments` financial account (decline in the capital inflow/capital outflow). Therefore, both the government and the private sector remain quite vulnerable and dependant, both based on debt and equity investments.

National Macro-economic Environment

In the period 2009-2014, the Montenegrin economy cumulatively recorded a mere mild real growth, while the decline in economic activity was primarily avoided due to new public sector's borrowings (Eurobond issues and bilateral credit facilities), and, of course, foreign direct investments. Positive growth rate was recorded in 2014, but the state of the real economy has not significantly improved – worrying problems with weak liquidity continued. The household sector is not in much better situation in comparison to the previous year.

In other words, growth in 2013 and 2014 was more of a discontinuation of consequences from the end-2008 and 2009 crisis and 2012 recession, than an exit towards the road of a long-term sustainable and steady recovery. Domestic capital market is maybe the best confirmation of the previously mentioned. Even though the total annual turnover in 2014 was three times higher than in 2013, while MONEX20 index, as an expectation indicator, grew by more than 15% at the end of 2014, relative to end-2013, this index is still in decline by more than 75% in comparison to the boom from the spring 2007 (in a situation when some of the global indices completely recovered or even surpassed their pre-crisis values).

The CPI prices declined by 0.3% in 2014, if compared to the increase in prices of 0.3% in 2013. Decline in prices is mainly a consequence of decline in prices for the *transport* category (due to drop in prices of fuel and lubricants) and in the *communications* category due to decline in prices of telephone and facsimile equipment, of telephone and facsimile services. If sub-level of groups of products/services is observed, the main contributors for the negative inflation rate were prices of oils and fats, as well as prices of electricity.

As for the expectations in 2015, Montenegro will certainly be exposed to the global price movements, with the largest influence of food and oil prices. Nevertheless, for 2015 the IMF forecasts deflation trends at the global level (on average), thus there should not be pressures to the growth of prices in Montenegro from that end, even though this type of forecasts are uncertain.

As already pointed out, trends in the balance of payments are perhaps the indicator of the most significant imbalances in the Montenegrin economy. In 2014, the current account deficit was higher in comparison to 2013 (the deficit increased by 6.9%, and its share in GDP grew by 0.7 percentage points), while the coverage of import by export declined by two percentage points and amounted to a mere 20.9%. As for the structure, the increase of the deficit is mostly the result of the increase in trade deficit and lower surplus in the primary income account, while growth in the services account balance was not sufficient to offset negative trends of the goods balance and primary income. On the other hand, net FDI inflow was higher by 9.3% if compared to the previous year and it was 353.9 million euro or 10.4% of GDP.

It is estimated that budget deficit amounted to 3% of GDP in 2014, largely because of prior period vulnerabilities (calling of guarantees and payments upon court rulings). Moreover, debt repayment amounted to 209.8 million euro (the amount excluded from the deficit), thus, total lacking funds for 2014 amounted to 312.3 million euro or 9.2% of GDP. The 2014 deficit, even though lower than in 2013, is a continuation of negative trends started in the 2009-2014 period; thus the average deficit in the period 2009-2014 amounted at the level of around 4% of GDP. Deficit planned for 2015 is 6.6% of GDP.

The deficit consequently increased the public debt, which was 2.02 billion euro at end-2014, of which 1.56 billion euro referred to external debt. Furthermore, issued guarantees (foreign and domestic) amounted to 314.3 million euro. The public debt is still not too high in relation to GDP; however, the continued debt-growing tendency and aggravated provision of sources for its repayment are the matters of concern. During 2014, the share of net public debt in GDP increased to 59.6%, while the share of guarantees at the end of 2014 was 9.3% of GDP[34]. The high vulnerability of the private sector should be added to this, which taxation provides the funds for debt repayment.

Government borrowing certainly prevented contraction of the economic activity in the period 2009-2014, but the budget has to be balanced and debt growth must be halted; otherwise, the problem will be postponed and the subsequent absorption will be more painful. This balancing will have its feedback on the financial position of all domestic sectors, which will further make pressure on the financial system (banks).

According to MONSTAT, an average price per square meter in a new building was 1,089 euro, i.e. 5.5% less than in 2013 (4.3% lower in Podgorica), while a new-building apartment sale declined even by 28.0% (growth of 5.9% in Podgorica). According to the CBCG survey (covering both new and old immovable properties, whereby older immovable properties are dominant), an average real estate price in Podgorica declined by 2.2% in September relative to March 2014, accompanied by the decline in

[34] According to the Economic Reform Program for Montenegro (Government of Montenegro), the debt will amount to 2.24 billion euro or 63.2% of GDP at end-2015.

turnover of the real estate agencies surveyed in the latest survey. Bearing in mind the high supply of immovable property, differentiated demand, announcement of loan restructuring in the construction sector, it is realistic to expect further adjustment in demand with a mild decline in prices of real estate in the first half of the year. However, it should be emphasized that the realisation of major tourism and infrastructure projects in Montenegro in the second half of 2015 would generate inflow of foreign direct investments and in general had a slight impact on reviving the real estate market transactions. Moreover, the increase in the lending activity of banks which is expected in the next year, lowering of lending interest rates driven by banks' competition, developments in the Euro area and crisis of euro, could partially contribute to the reviving of the real estate market. Certain increase in real estate prices may be expected in municipality that will have construction of major tourism facilities, such as Porto Novi, Luštica, Porto Montenegro.

Financial System

In general, the banking sector experienced further consolidation during 2014. Banks have further increased financing from deposits (mainly domestic) if compared to borrowings (mostly foreign). Deposits recorded an annual growth of 10%. The liquidity grew as well, while banks have continued to redirect its sizeable share aboard, due to lack of better investment opportunities in Montenegro according to their perception. Total assets thus increased by 6%, while gross loans and receivables declined by 1.9% at end-2014 relative to end-2013, which further reduced the ratio of loans and deposits. The system-level profit was 23.8 million euro (with losses of two banks), against two million euro profit in 2013.

Despite improvements, the problem of the loan portfolio quality is very pronounced. The share of gross non-performing loans and receivables, i.e. the share of 30 days and over past due gross loans and receivables in total gross loans and receivables declined in relation to end-2013, but was still very high 16.8% and 19.9% respectively. Furthermore, value adjustments for gross non-performing loans and receivables to gross non-performing loans and receivables ratio, although somewhat better compared to end-2013, amounted to low 39.5% at end-2014. Similarly, net non-performing loans and receivables are still high compared to capital (54.8%). Finally, stress testing showed that some banks are still very sensitive to credit risk.

Liquidity level of the banking sector is satisfactory. Stress testing showed in several banks inadequate liquidity in case of potential high deposit outflows; however, it should be borne in mind that the tests used are rather rigorous, as well as that relatively narrow definition of free/available liquid assets which would serve to cover outflows is used.

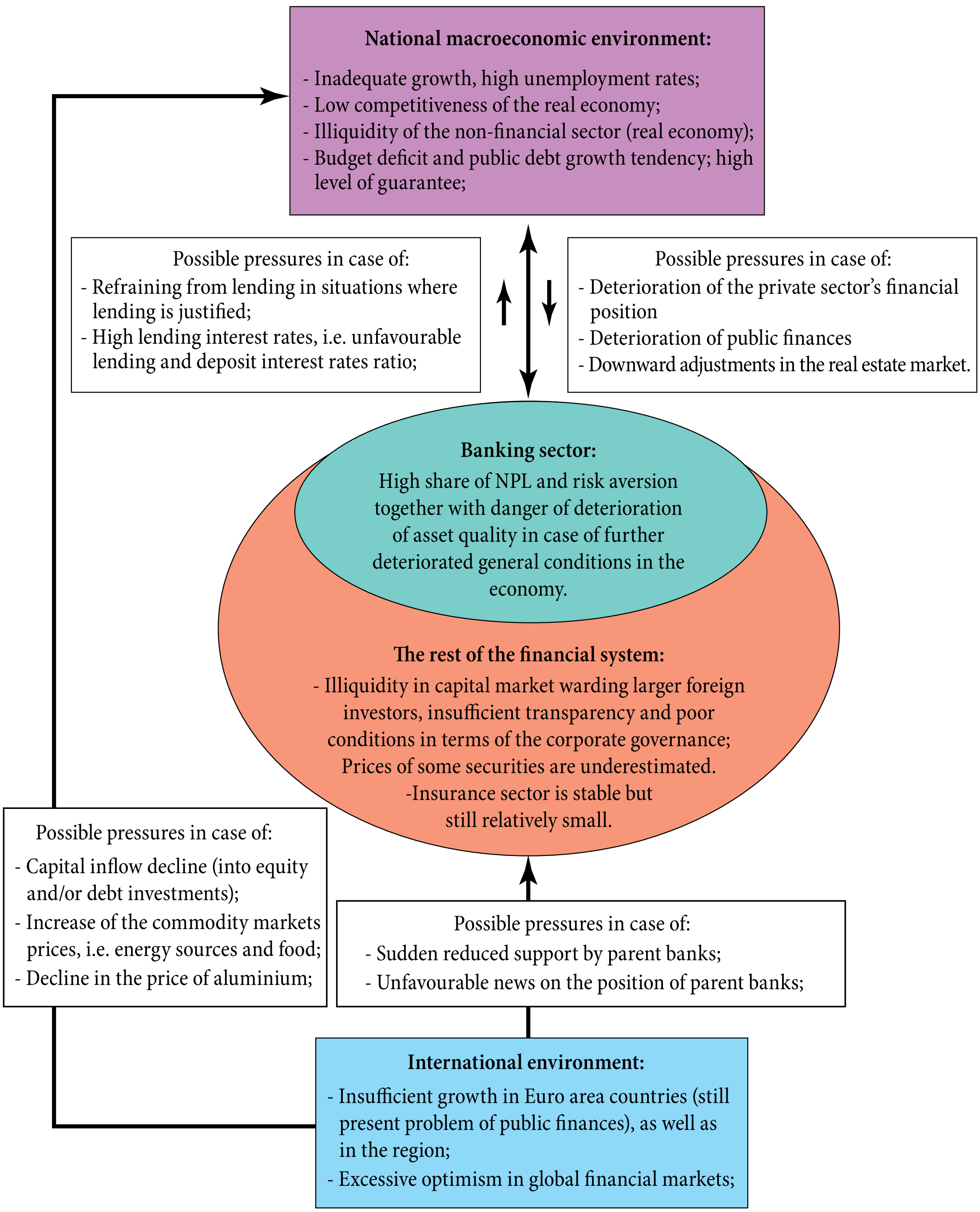
Stress testing also showed that interest and FX risks are negligible, at both the system level and individual bank levels.

As for the capital market, 2014 was better than 2013, primarily in terms of the turnover. Total turnover was three and half times higher in relation to 2013, and it amounted to 108.2 million euro (mainly due to primary issue of government bonds and bonds of one commercial bank), which is the highest level of annual turnover since 2009. MONEX 20 index grew 15.3%, while the MONEX PIF declined 11% during 2014. However, certain substantial defects of the market are still present. Furthermore, it seems that a certain number of shares was still 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 consolidated in 2014. Relative size of this sector continues to be a limiting factor for its potential impact on the rest of the financial system, i.e. on the real economy. Nevertheless, a larger and stronger insurance sector would be desirable: it would mean more capital in the financial system.

Schematic 5.1 and Box 5.1 show the key risks.

Schematic 5.1 – Key risks and directions of influence



Box 5.1 – System-level vulnerabilities of the banking sector

Poor diversification is a feature of the real sector, along with low productivity and competiveness with presence of significant level of uncertainty. Delay in broadest structural reforms is also present, which are necessary for this situation to change. On the other hand, banks cannot operate in isolation from the macro environment, thus are not acting as stimulus but maybe even to cautionary, de-stimulating. Generally banks are rather stable (liquid, profitable and solvent, even though having many problem assets), but their actions are partly unjustified and are de-stimulating macro environment which is already fragile. Key vulnerabilities that we can name are:

1. Unstable economic situation in the euro area/EU (low growth, deflation pressures) and still instable position of banks in the Euro area/EU, along with unstable economic development in Russia and "tensions" concerning the Ukrainian political crisis, making negative pressure on inflow of foreign direct investments, which was a main motor of the Montenegrin economy in recent years.

2. Rather sensitive situation in public finances of Montenegro, with continued budget financing with deficit and public debt growth, threatening to have negative implications on the financial system, whether indirectly (by impacting the balance sheets of the household and corporate sector), whether directly in terms direct exposure of banks to the State, which has had visible increase in previous couple of years.

3. High illiquidity in the real economy and poor position of the household sector, with high share of non-performing loans; this fact, along with the perception of banks on that prospects of the Montenegrin economy are not excessively favourable, are affecting that banks are reluctant in lending to residents (or doing so with high interest rates), choosing instead to invest funds abroad. Banks have sizeably reduced deposit interest rates, since they do not need new funds (liquidity). This is currently the most prominent system-level vulnerability and good example of vicious circle concerning the macro-economic environment-financial system.

4. Disparity in maturity of funds and sources of funds (or primary loans and deposits); even though this is not excessively pronounced problem or fact which is a not a general characteristic for banks as financial intermediaries.

5. Prominent share of non-resident entities in financing of Montenegrin banks, whereby this problem is much lower than in previous years; Level of borrowing from non-residents is drastically lower than it was in the past (even though continues to be significant), while the level of deposits of non-residents is rather important. However, the assumption is that the centre of economic activity of those depositors is more directed towards Montenegro than the data indicates.

5.1. Policies for preservation of financial stability

Real Sector / Balance of Payments

The real/private sector remains very vulnerable. Only a strong and competitive private sector enables stable state finances, does not threaten the banking sector (which is exposed to it) and provides jobs and personal earnings for the household sector. The public and banking sectors may themselves be a part of the problem, which is partly the case in Montenegro, i.e. 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 for 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, it seems from the current period of global instability, a desirable and normal condition for maintaining economic activity through borrowing or inflows for real estate. Firstly, because the capital flows are rather sensitive to instability occurrence and secondly because capital inflows (whether debt or equity) cannot last forever.

Debt does not have to be bad in all circumstances; however, artificial maintaining of standard through debt is undesirable. The situation is similar with capital inflows: the best are those through which the situation has essentially changed for the better, and where capital is used for production and not consumption purposes. This has not been the prevailing practice in Montenegro so far, when it comes to capital inflows, both in terms of real estate trading (households) and in terms the selling of state-owned companies (privatisations). Undoubted appetite for capital/higher standard in the household sector and certain real problems the State was facing only partially justify this situation. One form of equity investments needed in Montenegro is Greenfield investments (ideal for import-oriented activities), so far underrepresented. However, it should be noted that the (announced) construction of luxury tourism facilities at the coast would rather improve this situation.

Although the private sector should make a turn towards the above-mentioned activities, the support from the State is unavoidable. The State needs to provide a stable and predictable environment (legal, administrative and judicial) and in communication with the private sector, to create an umbrella strategy of economic development, which will be gradually implemented afterwards.

Fiscal deficit (surplus) / Public Debt

The government sector bears risks in 2015 as well. In that sense, the measures of fiscal consolidation from 2013 and 2014 are very encouraging: introduction of progressive taxation on personal income, lowering of expenses for materials and services, as well as measures for better collection of taxes and contributions, i.e. reducing grey economy. We can see how excessive debt can become a factor of limitation of growth and prosperity in case of the immediate neighbouring and the EU countries.

The fiscal deficit in 2015 will be rather higher than in the previous year. It would be desirable also to stop the public debt growth tendency, but that cannot be realistically implemented in the coming year, primarily due to borrowing for construction of the first highway section. Adoption of the Law on Budget and Fiscal Responsibility is also a solid step toward establishment of a tighter fiscal discipline.

The financial markets may see a sudden increase of 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 investors withdraw, risk premium increases (public debt financing becomes more expensive), credit rating is downgraded, the banking system operations are threatened, etc. The question of guarantees is inevitably brought together with question of the debt itself: issue of new guarantees must be applied very restrictively, which was significantly improved in the period 2012-2014.

Banking sector and the rest of the financial system

The banking sector acquired a painful, but precious experience from the pre- credit boom and later from the period of recovery from its consequences. However, this period is not over yet and the banks need to continue to clean their balance sheets with all means available: sale, restructuring and finally write-offs. Certainly, adequate policy of impairment remains inevitable in credit risk management. In addition, all possibilities for borrowing and recapitalisation need to be examined in advance. The Central Bank will monitor all these processes, which will continue, within its possibilities, to support the banking sector. Since the CBCG manoeuvring space is narrowed down 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 system stability because the prevention is the best policy.

Aside improvements reflected through higher activity in 2014 if compared to 2013, the capital market must strive to higher transparency (especially in regular disclosure of accurate financial statements of issuers, as well as information on business activities of all other market participants: the stock exchange, brokers, etc), a stronger protection of equity rights (primarily of minority shareholders), and the promotion, support and protection of core principles of corporate governance. The insurance sector also requires an increase in the level of transparency as well as reinforcement of supervision. Furthermore, it is necessary to intensify efforts to promote the significance of services provided to the society by the insurance companies.

Appendix 1: Selected Indicators of the Banking System Stability

Table 5.1

Selected indicators of the Banking System Stability								
	31-Mar-2013	30.06.2013	30.09.2013	31.12.2013	31-Mar-2014	30.06.2014	30.09.2014	31.12.2014
Capital, as %								
Solvency ratio	14.4	15.5	15.0	14.4	15.1	15.8	16.2	16.2
Total capital / Total assets (leverage ratio)	13.7	13.9	13.9	13.4	14.2	14.3	14.2	14.2
Net CDE class loans and receivables / capital	79.9	77.0	74.5	68.7	59.9	62.2	60.0	54.8
Assets quality, as %								
CDE class assets / Total assets	17.4	16.6	16.7	16.4	15.3	15.6	15.1	13.9
CDE class loans and receivables / Total loans and receivables	19.4	18.8	18.4	18.4	17.2	17.9	17.3	16.8
CDE class loans / Total loans	22.5	21.5	21.3	20.7	19.3	19.7	20.2	19.0
Impairment for CDE class loans and receivables / CDE class loans and receivables	35.4	33.5	32.9	39.1	39.9	38.3	38.2	39.5
Liquidity, as %								
Liquid assets / Total assets	13.3	14.5	21.2	20.0	18.0	18.8	23.2	22.2
Liquid assets / Total liabilities	15.4	16.8	24.6	23.1	21.0	21.9	27.1	25.9
Profitability, as %								
Return on average assets (ROAA) *	1.4	1.3	1.3	0.1	1.3	1.0	0.9	0.8
Return on average equity (ROAE) *	10.0	9.2	9.2	0.5	9.3	6.8	6.2	5.4
Income and expenses for interests and interest rates, as %								
Income from interests / Average earning assets (a) *	7.5	7.6	7.5	7.4	7.5	7.3	7.3	7.3
Expenses for interests / average interest-bearing liabilities and capital (b) *	3.4	3.4	3.4	3.3	2.9	2.2	2.3	2.4
Difference: a - b, in percentage points *	4.1	4.2	4.1	4.1	4.5	5.1	5.0	4.9
Interest rate on total loans (c)	9.4	9.4	9.3	9.4	9.4	9.5	9.6	9.2
Interest rate on total deposits (d)	3.1	3.0	2.7	2.5	2.3	2.2	2.0	1.8
Difference: c - d, in percentage points	6.3	6.4	6.6	6.8	7.1	7.4	7.6	7.4
Interest rate on newly-approved loans **	10.2	10.3	9.7	9.4	10.3	10.1	10.8	9.0

* Indicators containing flow variables are annualised by multiplying vales for the Q1, H1 and first nine months by 4, 2 and 4/3, respectively.

** Data refers to the last month in the quarter.

Source: CBCG

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