CENTRAL BANK OF MONTENEGRO

FINANCIAL STABILITY REPORT 2017

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Bulevar Svetog Petra Cetinjskog 6
81000 Podgorica
telephone: +382 20/664-997, 664-269
fax: +382 20/664-576

WEB SITE: http://www.cbcg.me

DESIGNED BY: Andrijana Vujović
Nikola Nikolić

TRANSLATED BY: Translation Services Division

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ABBREVIATIONS USED IN THE REPORT

GDP	Gross Domestic Product
CBCG	Central Bank of Montenegro
CDA	Central Depository Agency
CHF	Swiss Franc
DJIA	Dow Jones Industrial Average
DNS	Deferred Net settlement
ECB	European Central Bank
EONIA	Euro Overnight Index Average
EU	European Union
EUR	Euro
EURIBOR	Euro Interbank Offered Rate
FED	Federal Reserves
FTSE	Financial Times Stock Exchange
GBP	Pound Sterling
HP	Hodrick-Prescott
JPY	Japanese Yen
LIBOR	London Interbank Offered Rate
IMF	International Monetary Fund
MSCI	Morgan Stanley Capital International
PPP	Purchasing Power Parity
ROAA	Return on Average Assets
ROAE	Return On Average Equity
RTGS	Real Time Gross Settlement
USA	United States of America
FDI	Foreign Direct Investments
USD	US Dollar

CONTENTS

INTRODUCTION

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

The CBCG uses microprudential regulation and supervision for fostering and maintaining financial stability. However, since the microprudential regulation and supervision are primarily focused on stability of individual banks, the CBCG uses, if needed, macroprudential instruments which effects influence the entire system, paying maximum attention to a complex relationship between banks and other economic entities. Irrespective of the aforesaid statutory obligation, the Financial Stability Report represents one of the ways the CBCG contributes to financial stability through raising awareness of other economic and financial policy makers, the financial sector, and the general public on sources of financial stability risk in the financial sector.

The Financial Stability Report analyses trends of those risks that are considered to have or may have systemic character, that is, systemic risk. Basically, systemic risk may occur as the consequence of certain internal imbalances and vulnerabilities in the financial system/banking sector, and also as the consequence of external shocks that may hit the economy in general or directly the financial system.

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

1. SYSTEMIC RISKS ANALYSIS AND ASSESSMENT

Generally, systemic risks were relatively moderate at end-2017 and the situation did not materially change relative to end-2016.

The main structural economic and financial cause of systemic risks i.e. system vulnerabilities in Montenegro lies in inadequate international competitiveness of Montenegro`s economy in parallel with a high level of non-productive spending against accumulation. The consumer-driven business model has been established, in which spending (which is primarily reflected in high foreign trade deficit) is funded from foreign capital flows - equity and debt. By nature, debt investments bear particular risk as they imply the existence of repayment deadlines (unlike equity investments), whereby the external debt - both government and private sector debts- has become alarmingly high. This has formed a significant dependence and sensitivity of growth of Montenegrin economy on quantities and prices of foreign borrowing flows.

Against such background, financial positions of both the economy and households are rather strained. In 2017, the corporate sector debt towards the Montenegrin banks rose by 42.2 million euros or 4.5%, while the share of this debt in GDP somewhat declined, from 23.7% to 23.1%. However minor, this was still a continuance of the corporate sector deleveraging in relation to the second half of 2008 when this sector's debt peaked (exceeding 56% of GDP). This deleveraging was largely a result of the sale of non-performing loans of banks to third parties - factoring companies founded mostly by parent banks of local subsidiaries, whereby loans sold remained mostly in the balance sheets of the enterprises[1]. In H2 2017, the amount frozen based on enforced debtors' debt in the process of enforced collection dropped from 601.3 million euros to 539.4 million euros[2], settling at a still high 12.7% of GDP[3].

Households debt to Montenegrin banks significantly increased over the past few years in nominal terms although in relation to GDP it was considerably lower compared to the leverage peak (35% at end-September 2008, 25.7% at end-2016, and 26.5% at end-2017). Real wages saw a minor decline of

[1] As at end-2017, banks sold close to 866.3 million euros of assets, mostly bad debts of the corporate sector, to third parties.

[2] This downturn mainly came in response to the Constitutional Court`s decision prescribing that bills of exchange cannot be subject to enforced collection directly by creditors, which was why all such requests have been ithdrawn from the Enforced Collection System. If the withdrawn requests, i.e. the bills of exchange in question, are to be executed via public enforcement officers, the increase in the frozen amount can be expected in the upcoming period.

[3] Since mid-2017, the CBCG has been committed to producing and monitoring the indicators of enforced debtors' debt (in addition to indicators relating to legal persons that are not economic entities) after previously initiating and coordinating the deletion of inactive economic entities'' accounts.

0.1% y-o-y in 2017[4], remaining below the 2010 maximum. According to the Labour Force Survey, the unemployment rate declined notably to 16.1% in 2017 compared to 17.7% in 2016, but it remains high with a strong structural component.

A high and growing level of public debt and public guarantees in Montenegro, as an integral part of the above trends, is a relatively strong source of systemic risk in Montenegro. Following a decline in public debt in relation to GDP experienced in 2016, the public debt rose from 64.4% to 65.1% of GDP in 2017. This allowed for the public debt standstill between 2015 and 2017 as a result of vigorous growth of the nominal GDP in relation to the public debt growth and in relation to fiscal deficits, which averaged at 4.4% of GDP in this two-year period. Montenegro's 2017 credit rating was B+, with the outlook from negative to stable that was upgraded in October. In general, the main challenge for the public finance is imminent over the period 2019–2021 when 717.6 million euros debt arising from Eurobonds will mature[5], while the beginning of the 14-year repayment of loan for financing Bar-Boljare highway section is planned for 2021.

Although significantly lower, non-performing loans remain the leading systemic challenge in the banking sector. The situation improved in the reporting year as the share of non-performing loans declined from 10.3% to 7.3%. However, this share remains high which exerts a negative pressure on banks' risk appetite, that is, the level of lending activity and lending conditions. On the back of the increased volume of new loans in relation to the repayment of old loans, credit growth reached a solid 11.8% though mainly fuelled by the increase in retail loans, loans to central government as well as higher international banking accounts' balances (also classified as „loan"), whereas the growth of loans extended to the corporate sector stood at 4.5%. In 2017, the share of (net) loans in assets rose slightly to 53%, whereby just above half of the banks' assets was directed to loans relative to 81.1% in 2008.[6]

As another part of the above processes, direct exposure of banks to the government (central government) increased from 455.8 million euros to 523.6 million euros in 2017, making up 12.5% of banks' assets. This growth was mainly driven by increased debt arising from loans, while the government's debt towards the banks arising from securities saw no major changes. Banks' exposure to the government was 0.04% at the beginning of 2009 when its ongoing growth started.

An important systemic challenge for banks was also the relationship between interest rates, spreads, competition, and profitability. Current concentration is lower than it was before [7]. Further growth in interest rates decline spurred the spread to drop from 6.5 percentage points to 6.1 percentage points over the year. Moreover, the average interest rate on new loans (weighted amount in loans) declined from 7.3% in 2016 to 6.9% in 2017. On the other hand, interest rate spread on total earning assets i.e. interest-bearing liabilities saw a slight drop from 4.7 percentage points to 4.3 percentage points, remaining substantially lower than the aforesaid standard spread. However, in addition to the profit of 35.1 million euros made at the system level, and primarily due to high allowances for impairment and

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4 CBCG assessment

5 The amount of debt was initially 1.08 billion euros, however, bond package valued at 362.4 million euros was redeemed in mid-April 2018.

6 The calculations made here do not account for other loan receivables.

7 At end-2017, 15 banks operated in Montenegro, with this year's Herfindahl-Hirschman Index (HHI) falling below 1,000 points compared to the value of over 2,400 points in the pre-crisis period.

provisioning, profitability indicators were less favourable than the spreads indicated, with the annual ROE averaging at mere 2.7% in the period 2013–2017.

Generally speaking, banks are currently the most stable segment of economic system, which substantially reflects in the stability and growth in deposits in the banking sector. These deposits grew to 3.27 billion euros (which was the all-time high) and they made up the largest portion of banks' liabilities and capital (78.1%). This additionally strengthened liquidity position of banks against the backdrop of not so pronounced lending growth. Total liquid assets of banks grew by 13.9%, reaching 1.06 billion euros in the reporting year. Their share in relation to assets and deposits also rose, to 25.3% and 32.7% respectively, thus remaining at high levels. In the context of structural limitations of Montenegro`s economic growth, these liquid assets, are currently banks' best safety reserve against the risk of asset quality deterioration and/or deposit outflow.

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

With regard to real estate prices as the key form of property (and collateral) against the backdrop of underdeveloped financial markets and instruments, at the end of this year it cannot be said that the prices exceeded the fundamentals substantially, i.e. that the market was significantly overheated. Moreover, this market had been experiencing a certain prices standstill over the past few years.

Montenegro Stock Exchange turnover amounted to just 47.5 million euros (1.1% of GDP) compared to 115.2 million euros recorded in 2016. Such a prominent decline is attributed primarily to the 2016 government bonds issue. The Monex index declined by 11.6% relative to end-2016 and it was still multiple times lower relative to its maximum values from April 2007. The capital market in Montenegro has lost systemic relevance it had during the period the bubble was formed and after its burst which, in turn, reflected on expectations, spending, credit growth and, ultimately, on economic growth. In addition, primary equity and bond markets were underdeveloped at the time and they have never developed as a source of funding for the corporate sector, as the banks have always prevailed.

The CBCG`s payment system and the CDA`s securities settlement system, as the key financial infrastructure pillars in Montenegro, continued to work undisrupted in 2017.

Scheme 1.1

Key risks to financial stability	
High level of public debt and budget deficit considering limited growth prospects of the Montenegrin economy and the possibility of increase in Euro interest rates in international markets i.e. costs of debt (re)financing in the future.	→
Negative feedback loop between a high share of non-performing loans and poor credit growth in the context of uncertain economic growth.	↓
Growing exposure of banks to the government considering the challenges in government finances.	↑
Pressure of concentration decline/competition growth in the banking sector on a decline in spreads and profitability.	→

Explanation

High systemic risk

Moderate systemic risk

Low systemic risk

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

2. INTERNATIONAL ECONOMIC AND FINANCIAL ENVIRONMENT

2.1. Global economic trends

The latest IMF assessments showed that global economy growth for 2017 was 3.8% or a notable 0.6 percentage points above that seen in 2016. As in the previous years, growth in emerging and developing economies made the largest contribution of 4.8% to the global growth, while advanced economies reported a growth of 2.3%. The USA and the euro area were the drivers of growth among advanced economies, both recording a growth rate of 2.3%, whereby the Japanese economy grew by 1.7%. On the other hand, with respective growth rates of 6.9% and 6.7%, China and India gave the main boost to growth in emerging and developing economies as well as on the global level. After a 0.2% decline in 2016, Russia experienced economic activity growth of 1.5%. Growth recorded in the group of Europe's emerging and developing economies, which includes Montenegro, was estimated to 5.8%, significantly above 3.2% from 2016[8].

Table 2.1

Overview of selected global indicators, %

Indicator	2016	Estimate for 2017	Forecasts		Differences relative to October 2017 projections, percentage points	
			2018	2019	2018	2019
Real growth of GDP						
World	3.2	3.8	3.9	3.9	0.2	0.2
Advanced economies	1.7	2.3	2.5	2.2	0.5	0.4
USA	1.5	2.3	2.9	2.7	0.6	0.8
Euro area	1.8	2.3	2.4	2.0	0.5	0.3
Japan	0.9	1.7	1.2	0.9	0.5	0.1
Emerging and developing economies	4.4	4.8	4.9	5.1	0.0	0.1
China	6.7	6.9	6.6	6.4	0.1	0.1
India	7.1	6.7	7.4	7.8	0.0	0.0
Russia	-0.2	1.5	1.7	1.5	0.1	0.0
European emerging and developing economies	3.2	5.8	4.3	3.7	0.8	0.4
Commodity prices, average rate						
Oil	-15.7	23.3	18.0	-6.5	18.2	-7.2
Non-energy products	-1.5	6.8	5.6	0.5	5.1	1.0
Consumer prices, average rate						
Advanced economies	0.8	1.7	2.0	1.9	0.3	-0.1
Emerging and developing economies	4.3	4.0	4.6	4.3	0.2	0.2

Source: IMF, April 2018

[8] Albania, Bosnia and Herzegovina, Bulgaria, Montenegro, Croatia, Hungary, Macedonia, Kosovo, Poland, Romania, Serbia and Turkey.

Expectations for future periods focus on maintaining similar levels of global growth, with the estimated growth rate of 3.9% in both 2018 and 2019. The growth will accelerate on the back of faster growth of emerging and developing economies where the expected China's slowdown will be compensated by more rapid growth of other economies and advanced economies, primarily the U.S. economy. European emerging and developing economies (including Montenegro), are expected to slow down to 4.3% in 2018 and 3.7% in 2019.[9]

The IMF's April forecasts also pointed to some uncertainties regarding the achievement of the aforesaid growth rates in the period 2018–2019, while expecting balanced risks in the first quarters of that period. The subsequent period is expected to signal stronger presence of negative risk factors than positive ones. Stronger and sooner-than-expected growth of the US dollar interest rates, protectionist policies carrying potentially adverse impact on global trade, populist/nationalist-oriented economic policies and geopolitical tensions, as well as weaker general support to global integration stand out among the negative risk factors.

Decline in commodity prices slowed down in 2017, primarily fuelled by a 23.3% increase in the prices of oil (average rate). The IMF forecasts suggest that oil prices will extend their uptrend into 2018, while the non-energy products, as a heterogeneous group of commodities, will experience a less prominent price growth. In 2017, aluminium price rose from 1,701 to 2,241 $/t, continuing the trend started at end-2015 when the price of this metal was just above 1,400 $/t.

2.2 Global financial trends

Leading central banks, with some exception of the Fed, extended their extremely expansive monetary policies into 2017, maintaining their reference interest rates at record lows and continuing with the programme of purchasing government and corporate securities on the secondary market (quantitative easing). In 2017, the Fed made three hikes to their federal funds rate, pushing its year-end range to 1.25% -1.5% compared to 0.5% - 0.75% from the beginning of the year[10]. In October 2017, the Fed initiated a gradual reduction of its securities portfolio established within the quantitative easing programme[11]. The ECB made no changes to its reference interest rates in 2017, thus the interest rate on the main refinancing operations (MRO) stood at 0% during the entire year. In addition, the securities portfolio, established through the quantitative easing programme, had increased at monthly pace of 80 billion euros until April, which was followed by monthly increases of 60 billion euros until the year-end[12].

In November, the Bank of England raised its interest rate from 0.25% to 0.5%, while the Bank of Japan and the Swiss National Bank maintained their interest rates at the level of 0.1% and -0.75% throughout the year, respectively. In respect of quantitative easing - total assets of the FED saw virtually no change over the year, while total assets of the Eurosystem and the Bank of Japan constantly grew over the year, increasing by 22.1% and 9.4% compared to end-2016, respectively.

[9] For the period 2018–2020, the IMF projected that Montenegro's economy will experience the respective annual growths of 3.1%, 2.4%, and 3.0%

[10] At the meeting held in March 2018, the rate was additionally raised to 1.5% - 1.75%.

[11] The FED decided to reinvest only the matured principal for treasury bonds exceeding 6 billion dollars, and 4 billion dollars for agency securities secured by mortgage loans. These limits were subsequently raised, and starting from April 2018, they stood at 18 and 12 billion dollars, respectively.

[12] It was later decided that this increase will move at a pace of 30 billion per month.

Short-term reference interest rates „mirrored" the reference interest rates of the central banks. Thus, the six-month USD LIBOR grew by 0.52 percentage points over the year to 1.84%, while the EONIA and the three-month EURIBOR fell by just 0.02 percentage points and 0.01 percentage points to a negative -0.35% and -0.33%, respectively

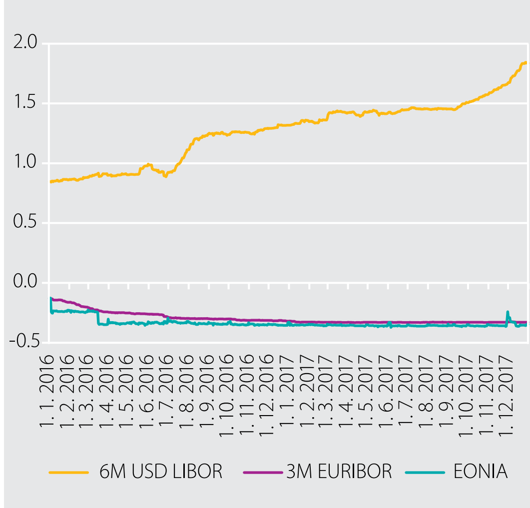
US Dollar interest rates are expected to gradually increase over the upcoming period. The U.S. economy is in a far better situation compared to the 2007–2009 economic and financial crisis, as solid growth rates were established (they were notably higher than in the euro area in the post-crisis period) and the unemployment rate was below 5%. However, the share of those who were unemployed half a year or longer in the total number of unemployed persons was 22.9% in December 2017 compared to 17% before the subprime mortgage crisis, while the share of working age labour force amounted to some 63% relative to 66% in the pre-crisis period. At the same time, inflation in the USA was still within the Fed's 2% target, thus it is unreasonable to expect any upsurges thereof but some gradual changes can be expected instead. The participants at the meeting of the Federal Open Market Committee held in March 2018 where the decision was taken to increase the FED`s reference interest rate within the range of 1.5% - 1.75% estimated that the adequate levels of the Fed`s reference interest rate at end-2018, 2019, and 2020 will be 2.1%, 2.9%, and 3.4% respectively (median value of participants' expectations).

The euro area economy is in more fragile situation than the U.S. economy. The problem is largely structural and it is expected that the ECB will continue to maintain a record low level of interest rates. This was announced at the meeting of the ECB`s Governing Council held in December where it was stated that the rates would be kept at the same or similar levels considerably beyond September 2018, a date marked as the moment until which the ECB would certainly continue to carry out quantitative easing.

The euro appreciated nominally against the leading global currencies in 2017, specifically 14.1% against the US dollar, 10% against the Japanese yen, 9.2% against the Swiss franc, and 4.1%

Graph 2.1

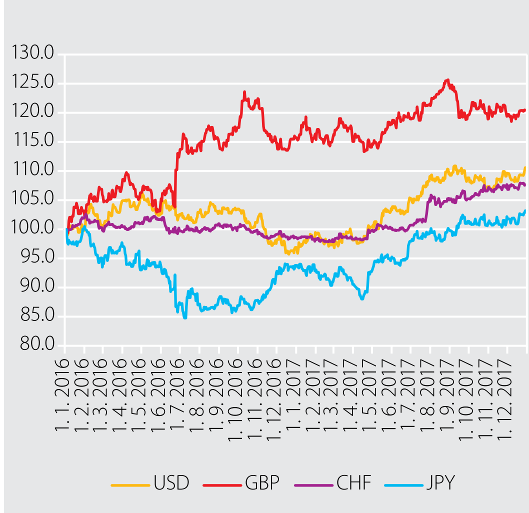
Short-term market interest rates, 2016–2017, %



Source: Bloomberg

Graph 2.2

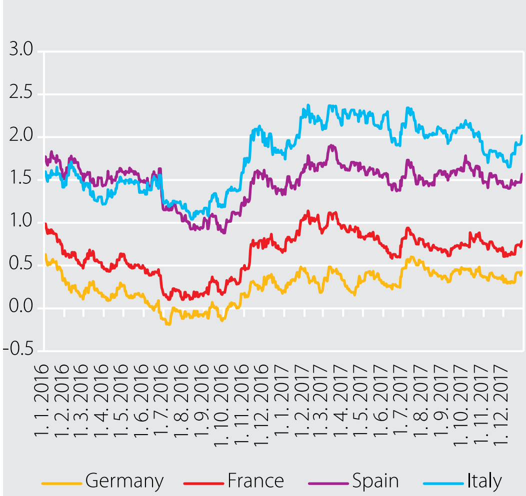
Nominal euro exchange rate, 2016–2017, 1 January 2016 = 100



Source: Bloomberg, CBCG calculations

Graph 2.3

10-Year Government debt Bond Yields in the euro area, 2016–2017, %



Source: Bloomberg

against the British pound. The highest exchange rate fluctuation of the euro was in relation to the US dollar and yen, while the fluctuation in relation to the pound was the mildest. The euro appreciated from 1.0517 to 1.2005 US dollars for euro, averaging at 1.1303 US dollars for euro. Currently, the ECB's monetary policy is not expected to push for the euro appreciation, while the expected gradual growth in U.S. dollar interest rates should go towards the dollar appreciation or the euro depreciation.

Generally, the situation of extremely low yields on government bonds deepened in 2017. The fact that the Swiss 10-Year Government Bond Yields averaged at -0.09% serves as the most radical example of this. In reference to the euro area countries, 10-year government bond yields of Germany, France, Italy, and Spain saw mild increases, whereas the yields on Portugal and even more on Greece debt declined. The 10-Year Government Bond Yields of Japan and Great Britain experienced no major changes, while the US treasury bond yields significantly exceeded those recorded in 2016.

The spreads, which are the differences between a country's bond yields and German government bond yields, were similar to those recorded in 2016, i.e. still very compressed. With regard to 10-year government bonds, yield on German debt amounted to 0.37% on average, while spreads on French, Italian, and Spanish debt averaged at mere 0.44 percentage points, 1.71 percentage points, and 1.2 percentage points, respectively. This is extremely low bearing in mind the problems Italian and Spanish banking sectors have been experiencing as well as vulnerabilities regarding the external debt of these countries. Secondly, it leads to delays of necessary fiscal and structural reforms in these countries and their absence will deteriorate the economic position of these countries once the normalisation period occurs, that is, when yields on government debt of these countries start to rise.

The analysis of stress and risk indicators suggests that the financial markets volatility saw further decline in relation to 2016. The downturn in the *TED* spread[13] and the *LIBOR-OIS* spread[14] was particularly prominent in H1 2017, whereas the *VIX* index, as a measure of the expected volatility in the US stock prices, declined gradually over the year. Gold prices, as a specific indicator of stress and risk in global economy and in financial markets, were somewhat higher than in 2016, a mere 0.8% observed through an average price, and by 13.5% in relation to end-2016. During 2017, the prices of gold experi-

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

[14] LIBOR-OIS spread is the difference between the three-month LIBOR and the three-month overnight indexed swap (OIS) in percentage points.

enced major oscillations, increasing from 1.147 \$/oz to nearly 1.350 \$/oz early in September, and dropping to 1,302.8 \$/oz towards the year-end.

The advanced countries' stock markets were extremely optimistic with all leading indices trending upwards compared to end-2016 and to mean 2016 values, whereby some of them, e.g. the New York *DJIA*, the London *FTSE* 100, or Frankfurt *DAX* experienced their all-time highs. Moreover, the *MSCI*, SE index for developing and emerging markets rose by 34.3% in relation to end-2016, and by 23.1% in relation to its mean 2016 value, nearing its all-time highs seen during the pre-crisis period.

The record SE indices were accompanied by the value of real estate peaking in many countries, e.g. in the USA where the nominal real estate prices exceeded those recorded prior to the subprime mortgage loans crisis. The policy of keeping the leading central banks' interest rates at historical nadirs was undoubtedly the factor that influenced the growth in prices of financial assets and real estate in the post-crisis period. Certain indicators showed that bubbles were not formed which was, inter alia, the position of the former Fed's Governor. However, it seems that there was unrealistic optimism to a certain extent and the expected gradual increase in the Fed interest rates will rein in the prices of financial assets and real estates, at least in the USA.

3. DOMESTIC ECONOMIC ENVIRONMENT

3.1. General macroeconomic developments

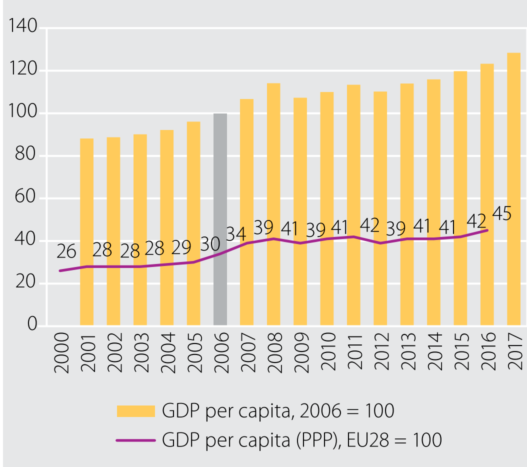
Preliminary Monstat data show real growth of 3.1%, 5.2%, 4.7%, and 4% for four consecutive quarters of 2017, which represents the real annual GDP growth of 4.4% after weighting of the amounts against quarterly GDP. On the other hand, the latest European Commission`s estimates indicated a growth rate of 3.9%. According to Monstat`s annual data by industries, overall growth was spurred by growths reported in the tourism, construction, and retail trade sectors, while industrial output registered a decline.[15]

However, the estimated growth rate of 4.4% significantly exceeded that of 3.2% estimated by the Ministry of Finance at the beginning of 2017, at the same time signalling the pick-up of economic activity after the growth rate of 2.9% recorded in 2016. This was mainly due to the above-the-projected household spending, amidst a more prominent rise in lending activity to the retail sector and better-than-expected labour market conditions. The Ministry of Finance estimated growth rates of 3% and 2.7% for 2018 and 2019, while the European Commission estimated growth rates of 3% and 3.3% over the same periods. According to the worst-case scenario, based mainly on a decline in investment activity and tourism revenues, the Ministry of Finance estimated growth of 1.8% and 1.9% for the observed periods. As per the model-based CBCG projections for 2018, the GDP growth will range from 2.7% to 3.2%, with the central projection of about 3%.

Historically, real GDP *per capita* in 2017 was 28.4% higher than the one achieved in 2006, while its growth was a modest 12.5% relative to real GDP *per capita* in 2008 due to relatively weak growth rates in between 2009 and 2017 and partly due to an increase in the population in Montenegro over the same period[16]. Observed in terms of purchasing power parity, Montenegro's GDP *per capita* in 2016 amounted to 45% of EU average compared to 42% in 2015 and 41% in 2008. Thus, convergence to the EU was practically stopped in the post-crisis period after the growth from 26% to 41% recorded between 2000 and 2008. However, Montenegro's growth recorded in 2016 induced a substantial advance in regards to convergence, which will be further enhanced after Eurostat has processed data for 2017.

Graph 3.1

Montenegro's GDP per capita, 2000–2017

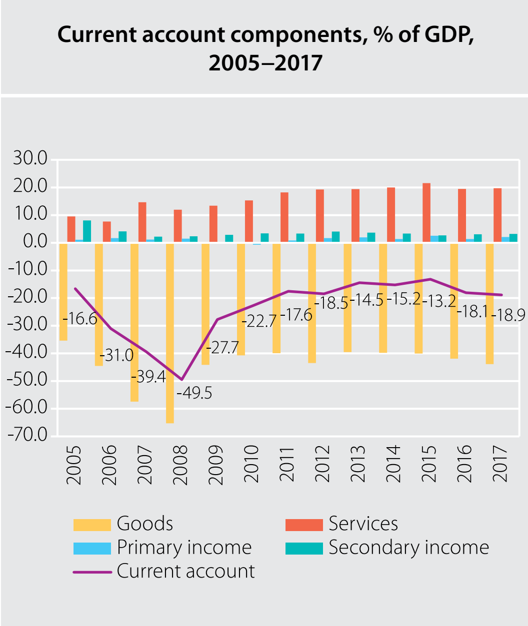


Source: MONSTAT, Eurostat, CBCG calculations

[15] *Autumn 2017 Economic Forecast*, November 2017

[16] CBCG assessment

Graph 3.2



Source: CBCG, Monstat

Measured by the consumer price index, prices increased by 1.9% y-o-y in December 2017, accounting for the inflation pick up of 1% y-o-y. In general, the December average of inflation rates for the period 2009–2017 amounted to 1.7%, currently showing no substantial inflation or deflation risks. Historically, price stability in Montenegro has been constant since the introduction of the euro as the legal tender, with minor oscillations over the years.

The current account balance amounted to a negative -799.3 million euros in 2017 or 18.9% of GDP, which was a significant increase compared to a negative -715 million euros or 18.1% of GDP in 2016. With regard to the structure, this deficit was generated by a negative balance in the goods account that amounted to 1.86 billion euros (compared to 1.66 billion euros in 2016), which deepening could not be compensated by positive balances on other sub-accounts of the current account. The goods account deficit widening was driven by an increase in the visible imports from 2 billion euros to 2.24 billion euros. To an extent, such a rise in the goods deficit was to be expected in view of the implementation of significant infrastructure projects.

As in the previous years, the 2017 deficit was primarily funded by foreign direct investments and their net inflow of 474.3 million euros or 11.2% of GDP. Also, historically, constant current account deficit was also funded by foreign portfolio investments and other foreign investments with pronounced debt features. Moreover, debt instruments (intercompany debt) also accounted for a portion of foreign direct investments so the „other side" of current account deficit was in fact the accumulation of external debt of Montenegro of all resident sectors, the government included, although the external government debt was the most prominent.

3.2. Position of non-financial institutions[17]

In 2017, the debt of non-financial institutions to banks saw a minor rise[18] from 937.2 million euros to 979.4 million euros, continuing a general standstill of this debt initiated after 2011 and following the extensive deleveraging recorded between 2008 and end-2011. In relation to GDP, deleveraging of non-financial institutions continued after 2011, albeit at slower pace, resulting in the debt balance of 23.1% of GDP at end-2017(compared to 23.7% at end-2016 and 30% of GDP at end 2011). New debt of

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

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

non-financial institutions based on new loans taken from banks amounted to 510.3 million euros, which was a decline of 3% y-o-y. In reference to purpose, new debts mostly referred to loans granted for liquidity for working assets of 56.7% (59% in 2016). This has been the most common type of loan granted to non-financial institutions for years[19].

Since deposits by nonfinancial institutions made a full recovery in the post-crisis period by reaching a record 1.13 billion euros at end-2017, they also deepened their position as a net creditor in the banking system in the amount of 154.1 million euros or 3.7% of banks' total assets, which is a rather unusual occurrence. This situation stands opposed to that observed in April 2009, when nonfinancial institutions represented the banking sector's net debtor with as much as 36.8% of banks' total assets.

However, it is worth mentioning that the actual balance of indebtedness of non-financial institutions cannot be viewed only through their debt to banks since the latter sold the major part of their assets to third parties - mostly parent banks, either directly or through factoring companies founded by them. Banks sold assets in the amount of 866.3 million euros between 2006–2017. A significant portion of the sold assets referred to non-performing loans (debt) of nonfinancial institutions.

At end-2017, the number of blocked business entities in the CBCG's enforced collection system was 12,719 or 29.7% out of 42,898, which is the total number of active business entities. Total debt based on which business entities were blocked amounted to 539.4 million euros, whereby due to high debt concentration, the debt of the top ten borrowers stood at 87.3 million euros (16.2% of debt), and that of the top 50 borrowers was 204.5 million euros (38.4% of debt). A total of 2,031 economic entities were under uninterrupted account blockage up to 365 days with the frozen amount of 35.3 million euros, whereas a total of 10,688 business entities were blocked over 365 days, with the frozen amount of 504.1 million euros, accounting for 93.5% of the total frozen amount, thus this debt will remain uncollectable for the most part. However, sound non-financial institutions seem to have increased their deposits, which is indicative of the improved liquidity.

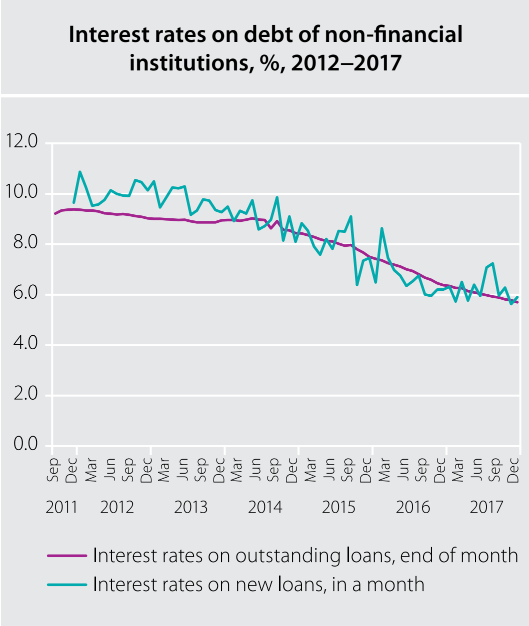
When it comes to the maturity of non-financial institutions` debt to banks, debts maturing after three years accounted for the main share of 55.5% at end-2017 (54.5% at end-2016)[20]. Debt with agreed maturity of over one year made up 78.7% of the debt. In reference to the debt's currency structure at end-2017, debts in euros accounted for 99.4%, while a mere 0.6% referred to debt in other currencies, which was a situation that has not changed essentially over the last years.

Although still relatively poor, the quality of debt of non-financial institutions to banks additionally improved during 2017. According to the banks' classification, non-performing debt amounted to 142.2 million euros at end-2017 compared to 185.3 million euros at end-2016. Thus, the share of non-performing debt in total non-financial institutions' debt declined from 19.8% to 14.5% (35.6% at end-Q1 2013). However, at least two important factors influenced a decline in this share over the last several years: 1) transfer of significant amounts of non-performing debt outside the balance sheet of banks, and 2) write-offs of non-performing debt from the balance sheet of banks.

[19] These data refer to all legal entities but they are sufficiently representative, since 82.5% of total debt arising from loans to legal persons referred to non-financial institutions .

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

Graph 3.3



Source: CBCG

In 2017, the average interest rate on total non-financial institutions` debt based on loans further declined, from 6.4% to 5.7%, signalling a continuance of the rate`s downtrend. Similarly, this year, the average interest rate on new loans declined from 6.7% to 6.1% (compared to 10% in 2012)[21]. Regardless of its significant decline recorded over the past six years, the nonfinancial institutions' price of borrowing remains notably high. Moreover, this decline in the price of borrowing was not enough to substantially change the non-financial institutions' position, which serves as a confirmation that lower borrowing price is just one of the prerequisites for achieving profitability and international competitiveness of these institutions. When it comes to nonfinancial institutions, structural factors, i.e. the overall business environment play a more significant role.

3.3. Households' position

In 2017, the households' leverage towards banks significantly increased[22] from 1,018 million euros to 1,123.1 million euros, fuelling this debt's growth initiated in 2013 after a period of deleverage between September 2008 and end-2012. The households' leverage thus exceeded the pre-crisis level for the first time, reaching its new all-time high. In relation to GDP, households' debt amounted to 26.5% of GDP at end-2017 (relative to 25.7% at end-2016, and 35% of GDP at end-September 2008). Households' leverage exceeded that of nonfinancial institutions for the first time in 2016, with this trend deepening in 2017.

In 2017, households' debt based on new loans amounted to 476.5 million euros, which was an increase of 1.4% y-o-y. In reference to purpose, as much as 63.7% (57.6% in 2016) of the new debt referred to cash loans (non-earmarked), which has been the prevailing type of loans to the households' sector for years. In addition, new leverage based on loans for the apartment purchase and refurbishing declined in both absolute terms from 77.6 million euros to 63.7 million euros and as a share in total new households' leverage from 16.5% to 13.4%.

Apart from the retail loans reaching their all-time high, the position of the retail sector as a net creditor also deepened on the back of a more vigorous growth of retail deposits, which also reached their historical high of as much as 1.7 billion euros at end-2017. Thus at end-2017, households' net creditor position accounted for 13.9% of total assets of banks compared to 13.6% at end-2016, while at end-May 2009, households were a net debtor in the banking sector in the amount of 7.6% of total assets of banks.

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

[22] Households also include non-resident natural persons.

With regard to the maturity of the households' debt to banks, the debt with maturity of over three years accounted for the main share of 90.2% of debt at end-2017 (89.2% at end-2016),mainly due to the housing loans-based leverage[23]. Debt with the agreed maturity of over one-year made up 97% of debt. In reference to the debt's currency structure, the debt in euros accounted for 99.5% at end-2017, while just 0.5% referred to debt in other currencies, thus showing a continued downtrend in the share of debt in other currencies, primarily in the Swiss Francs.

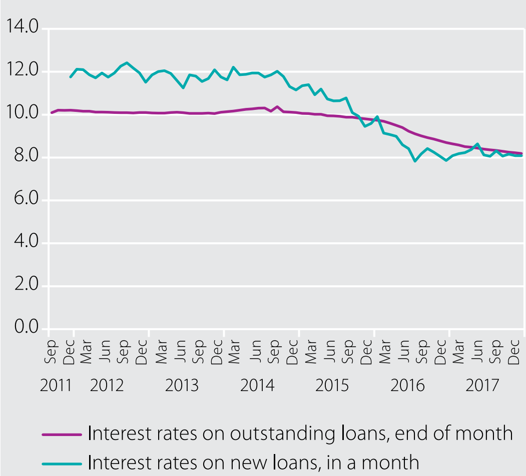
The quality of households' debt to banks additionally improved during 2017. According to the banking classification, non-performing debt of households amounted to 61.3 million euros at end-2017 compared to 70 million euros at end-2016. Thus, the share of non-performing debt to total debt of households declined from 6.9% to 5.5% (compared to 12.7% at end-Q2 2013).

An average interest rate on total households' debt based on loans additionally declined during 2017 from 8.7% to 8.2%, continuing the rate's downtrend initiated after 2014. Similarly, the average interest rate on new leverage based on loans declined from 8.5% to 8.2% in 2016 (compared to 12% in 2012)[24]. Regardless of its significant decline recorded over the past six years, the households' price of borrowing is obviously still high.

According to the Labour Force Survey, the 2017 unemployment rate was 16.1% or 1.6 percentage points below the 2016 rate. After a substantial decline in unemployment during the last boom (2006-2008), when it dropped from 35.5% in 2005 to 17.9% in 2008, the rate saw a mild downtrend followed by oscillations in some of the subsequent years, clearly indicating a prominently structural character of unemployment in Montenegro.

Graph 3.4

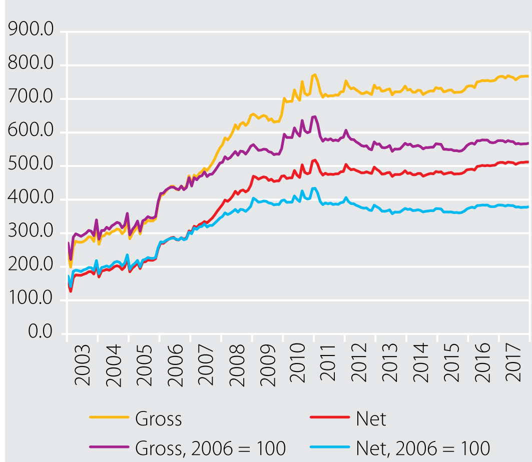
Interest rates on households' debt, %, 2012–2017



Source: CBCG

Graph 3.5

Nominal and real wages in Montenegro, in euros, 2003–2017



Source: Monstat; CBCG calculations

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

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

Observed through the average 12-month data, nominal net wages rose by 2.3% in 2017, from 499 euros to 510.3 euros, which was their highest annual level since the introduction of euro as the legal tender in Montenegro. On the other hand, real net wages saw a minor annual decline of 0.1% in 2017[25]. However, they remain below the historical maximum recorded in 2010. Compared to 2006, both nominal and real wages increased, by 80.3% and 34.4%, respectively.

3.4. Government finances

The 2017 government budget recorded a deficit of 237.6 million euros (5.6% of GDP) or by 65.6 million euros above 172 million euros planned under the budget review. The above-planned deficit was mainly due to the expenditure arising from the repayment of debt from the previous period in the amount of 40 million euros, which are not included in the deficit calculation, as a rule. When it comes to other major deviations from the plan, the expenditure for services exceeded the plan by 16.8 million euros, while the expenditure for social welfare transfers were 24.4 million euros below planned. On the other hand, source revenues were 14.1 million euros bellow plan. The budget deficit has been recorded for the eighth consecutive year, whereas the average deficit in the period 2009–2017 amounted to 5.1% of GDP.

Table 3.1

Main categories of Montenegro's budget, 2016–2018

	2016 (statement of accounts)		2017 (estimate)		2018 (plan, per the budget review)	
	million euros	% of GDP	million euros	% of GDP	million euros	% of GDP
Budget revenues	**1,487.1**	**37.6**	**1,565.9**	**37.0**	**1,765.2**	**40.1**
direct taxes	631.3	16.0	656.2	15.5	695.6	15.8
indirect taxes	718.1	18.2	809.9	19.1	912.3	20.7
non-taxable income	137.6	3.5	99.8	2.4	157.4	3.6
Budget expenditure	**1,622.0**	**41.0**	**1,803.6**	**42.6**	**1,904.4**	**43.3**
Current expenditures	1.557.2	39.4	1.548.0	36.5	1.612.6	36.7
Wages, gross	422.5	10.7	445.4	10.5	439.0	10.0
Transfers for social welfare	555.0	14.0	538.1	12.7	551.4	12.5
Capital expenditures	64.8	1.6	255.5	6.0	98.7	2.2
Surplus/deficit, cash	**-135.0**	**-3.4**	**-237.6**	**-5.6**	**-139.1**	**-3.2**
Net increase/decrease in liabilities	-12.7	-0.3	-	-	-	-
Surplus/deficit, adjusted	**-122.3**	**-3.1**	**-**	**-**	**-**	**-**

Source: Ministry of Finance

According to the latest Ministry of Finance report on debt, as at 31 December 2017, public debt amounted to 2.76 billion euros or 65.1% of GDP, of which the external debt made up 2.21 billion euros, internal debt was 413.9 million euros, and debt of local self-governments accounted for 131 million euros.

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

Debt arising from Eurobonds takes a significant place within the external public debt. Montenegro entered the international bond market for the first time in September 2010 and there have been seven Eurobond issues since that time. Three of them were repaid, and currently outstanding issues are those from 2014, 2015, 2016, and 2018.[26] Government budget realised a portion of its funding needs through two issues of bonds in the Montenegro Stock Exchange, bearing in mind surpluses of liquid assets of banks and their conservatism in lending to non-financial institutions and households. The March 2014 issue was repaid in full at the beginning of March 2018, leaving the 2016 issue as the only outstanding one.

Apart from the 2018 issue, the remaining three groups of current Eurobonds are of five-year maturity and they will be due in the period 2019–2021. Total amount that matures based on these three issues is 717.6 million euros of the remaining principal. The year 2020 will be particularly demanding when 321.1 million euros of principal on the March 2015 issue will become due. The amount of 80 million euros for the repayment of four-year bonds issued on the Montenegro Stock Exchange in November 2016 should be added to this amount. Also, the repayment of the loan for funding highway will begin in 2021, which will additionally pressure the government finances. Namely, the subject of the loan arrangement for highway signed in October 2014 with the Chinese Exim Bank is a loan of 944 million U.S. dollars with a 6-year grace period and a 14-year repayment period after the expiry of the grace period. As at end-2017, the debt towards Exim Bank stood at 337.9 million euros (translated into euros), and every new withdrawal will increase the public debt arising from that loan.

In the medium term, it is expected that the withdrawal of funds based on loan with Exim Bank will contribute to further increase in Montenegro's debt in other foreign currencies to about 23% from the current 13.8%. This will significantly expose the country to a risk of the euro depreciating against the US dollar. However, no drastic impact of this portion of debt is expected, since it is highly unlikely that the euro will substantially depreciate against the US dollar during many of the upcoming years of loan repayment and also due to the level of share of this portion of debt that will not be over excessive even when it reaches the expected maximum.

According to its baseline scenario, the Ministry of Finance projected a public debt growth to drop notably to 59.7% of GDP in 2020, while the lower-growth scenario projection for the same year is 63.8% of GDP. The IMF made similar projections for 2020 under its baseline scenario, projecting the public debt of 59.4% of GDP or 61.1% of GDP, with outstanding debts of local self-government, that is, 68% of GDP including guarantees.

At end-2017, the balance of debt arising from government guarantees stood at 312.8 million euros or 7.4% of GDP. Moreover, the balance of debt arising from external guarantees amounted to 262.5 million euros (6.2% of GDP), while the balance of debt on domestic guarantees was 50.3 million euros (1.2% of GDP). At end-2016, the debt arising from government guarantees stood at 344.9 million euros or 8.7% of GDP. When it comes to issuing guarantees, the government has been pursuing a notably more moderate and prudent policy compared to several years ago. There were no guarantees issued in 2016, while two guarantees were issued in 2017, specifically for loans granted to the Railway Infrastructure of Montenegro (for the reconstruction of the railway infrastructure) and the PC „Regional

[26] In mid-April 2018, a Eurobond issue in the amount of 500 million euros was executed under a 7-year maturity and at the interest rate of 3.375%. The issue will, inter alia, be used to redeem portions of bonds to be issued in 2019, 2020 and 2021, in the respective amounts of 110.9 million euros, 178.9 million euros and 72.6 million euros.

Water Supply of the Montenegrin Coast“, Budva (for the purposes of refinancing the Abu Dhabi Fund for Development loan).

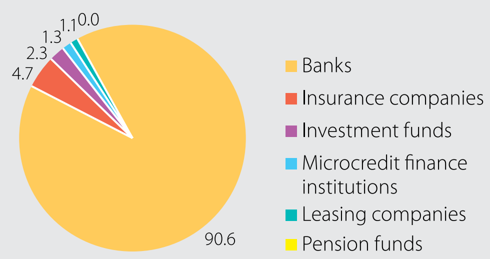
4. FINANCIAL SYSTEM

With its prevailing and growing share, the banking sector represents the backbone of financial intermediation in Montenegro. At end-2016, this share accounted for as much as 92.6% of total financial sector's assets. Beside banks, insurance companies are also on a steady upturn, taking up a share of 4.5% in the financial sector at end-2016.[27]

The structure of Montenegro's financial system is not unusual in relation to the EU or neighbouring countries. In comparison to the euro area, it resembles most that of the latest euro area members. Although banks make up the main portion of the financial system in most euro area countries, the share of the banking system in Montenegro's financial system is still higher than in any other euro area country. At end-2016, total assets of Montenegro's financial sector stood at 105.8% in relation to the GDP.

Graph 4.1

Montenegro's financial sector structure, %, end-2016



Source: Competent national supervisors

The remaining part of the financial system (pension funds, investment funds, microcredit financial institutions and lease companies) is small or relatively underdeveloped. Microcredit financial institutions, as a structure supplementing the banking sector, continued their uptrend into 2017, with their assets growing at an average rate of 12.2% over the past five years. The share of microcredit financial institutions in total assets of the financial sector was a mere 1.3% at end-2016. In the euro area, investment and pension funds and other parts of the financial intermediation sector usually account for a much more developed and bigger share of the financial system than is the case in Montenegro. Over the past years, the activities of lease companies have contracted, resulting in a drastic decline in their assets. Pursuant to the Law Amending the Central Bank of Montenegro Law[28], starting from 2017, the Central Bank of Montenegro has regulated/supervised leasing, factoring, purchase of receivables, micro-lending and credit-guarantee operations[29].

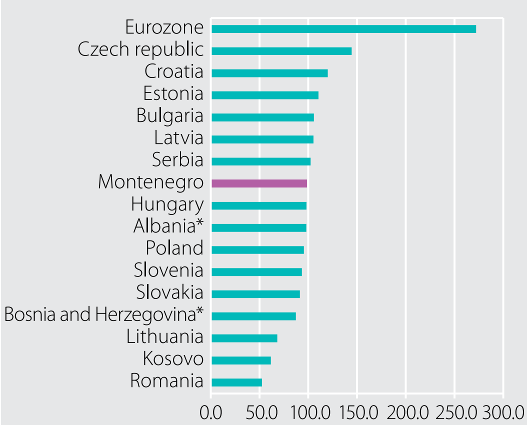
[27] Latest available data

[28] OGM 70/2017

[29] Law on Financial Leasing, Factoring, Purchase of Receivables, Micro-Lending and Credit-Guarantee operations (OGM 73/17) will enter into force as of 11 May 2018.

Graph 4.2

Banking sector assets in relation to the GDP, %, end-2017 [30]



Source: National central banks and statistical offices

The credit expansion occurring on the eve of the crisis, the banking sector assets exceeded the GDP level for a three-year period between 2006 and 2008. Total assets of banks to GDP ratio saw a sharp drop in the post-crisis period, down to 86.1% in 2011, recovering over the past five years. Thus it amounted to 98.7% of GDP at end-2017. Montenegro's financial intermediation development generally matches that of the neighbouring countries as well as the East European EU members.

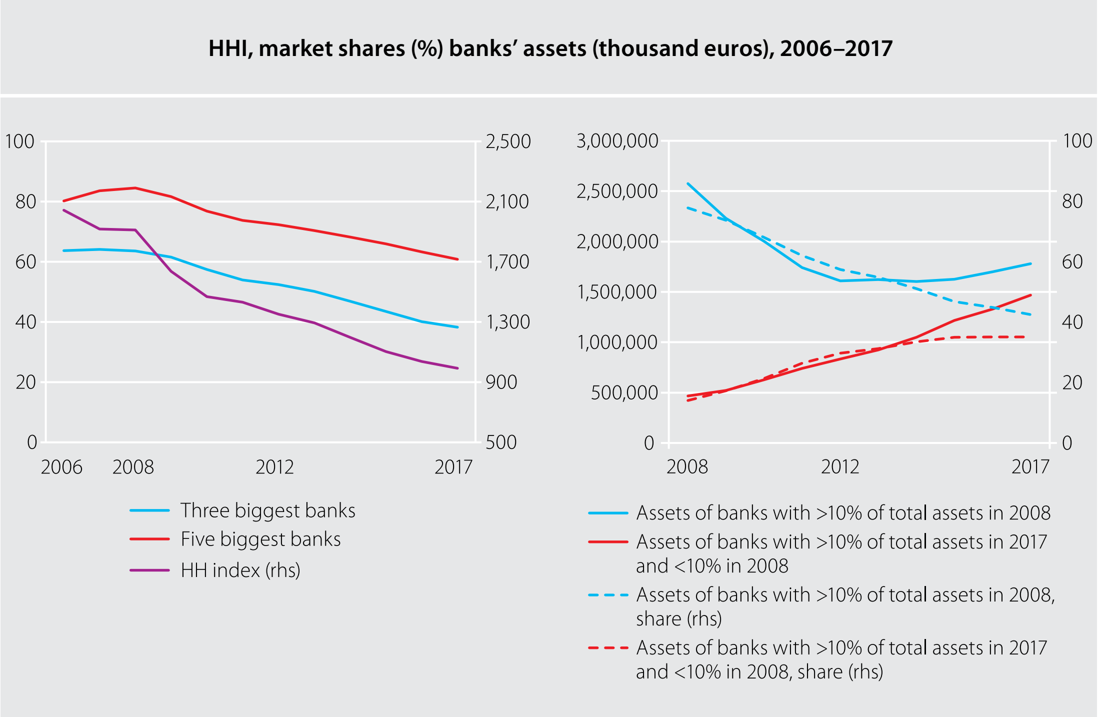
A total of 15 banks operate in Montenegro. The majority of the capital is foreign-owned, which is also characteristic of some of the EU countries and in the region. The share of foreign capital of banks in total capital averaged at 80% in 2017. In respect to the country of origin of the foreign capital, five main proprietary interests originate from Austria, France, Hungary, Slovenia and Serbia. Banks with the majority foreign capital control 73% of Montenegro's banking market.

Competition in the Montenegrin banking market has changed substantially over the past ten years, recording a continuous downtrend over a longer period. In reference to assets, the market share of three and five largest banks was declining, respectively amounting to 38.3% and 60.8% at end-2017. As per the HHI, from the highly concentrated market in the pre-crisis period Montenegro's market turned into a low-concentrated market, which has remained its distinctive feature over the past years. Such trend was mainly fuelled by a decline in assets of the previously largest banks, as well as a significant increase in the lending portfolio of the previously smaller banks, as well as new banks entering the Montenegrin market.

Increased competition in the Montenegrin market can be observed through market capacity indicators. To wit, Montenegro's number of credit institutions per capita substantially exceeds the euro area average. On the other hand, the number of ATMs, organisation units (branches, sub-branches, and teller's windows) and bank employees in relation to population is below the euro area average, however above the minimums recorded in the euro area. In addition, assets per banking sector employee are significantly lower compared to all euro area countries. Nevertheless, differences among banking sectors must be taken into account - the level of banking services development and diversity, the size of financial centres, the availability of qualified labour force, economy of scale, etc.

[30] Data for countries marked with an asterisk refer to end-2016.

Graph 4.3



Source: CBCG

4.1. Banks' balance sheet structure

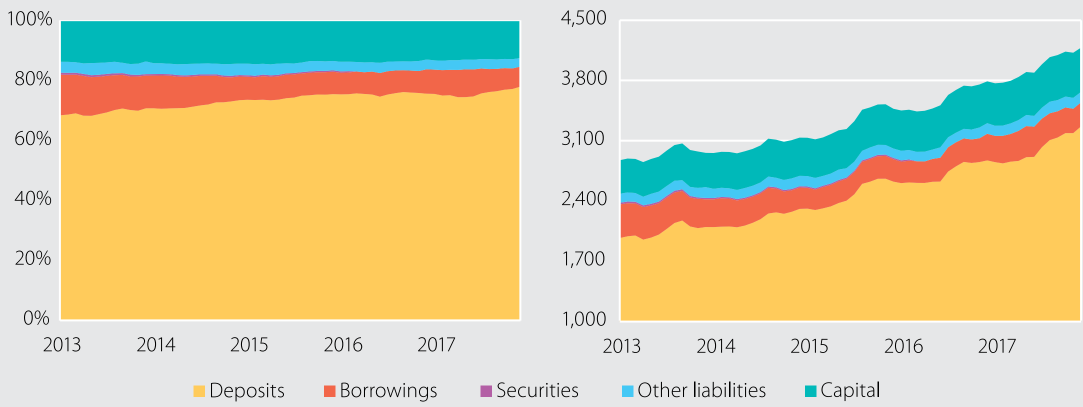
At end-2017 total assets and liabilities of banks stood at 4.18 billion euros, recording the annual growth of 10.3%. Over the past three year, total assets and liabilities of banks rose at an average rate of 10.1%, with a substantial increase in the amount of liquid assets acting as the key component of the growth. Such trend extended into 2017.

Funding of banking activities was stable. The level of financing from the nonfinancial sector's deposits prevailed in the majority of individual banks and on the aggregate level as well. Decreased financing from borrowings characteristic for the country's banking system immediately after the crisis continued in 2017 as well. In 2017, total borrowings dropped by 9.7%, with their share in liabilities and capital declining by 1.5 percentage points, down to 6.7%. Loans taken from foreign banks accounted for 4.9% of total assets and liabilities of banks.

Total deposits have been hitting all-time highs over the few past years. At end-2017, they rose to 3.27 billion euros, accounting for the year-on-year increase of 13.8%. Corporate sector deposits also reached record levels in 2017, recording the annual growth rate of 17.1%. On the other side we also had retail deposit that peaked for the fifth subsequent year, growing by 11.1% in 2017. Non-resident deposits accounted for a significant portion of total deposits, as much as 20% at end-2017, with a 12.4% rise in relation to end-2016. In relation to GDP, at end-2017, total deposits were at the same level of 77.8% as at end-2007, which is their highest level in relation to GDP. The share of deposits in liabilities and capital increased by 2.4 percentage points, up to 78.1%.

Graph 4.4

Liabilities and capital: structure (lhs) and amount in million euros (rhs), 2013–2017

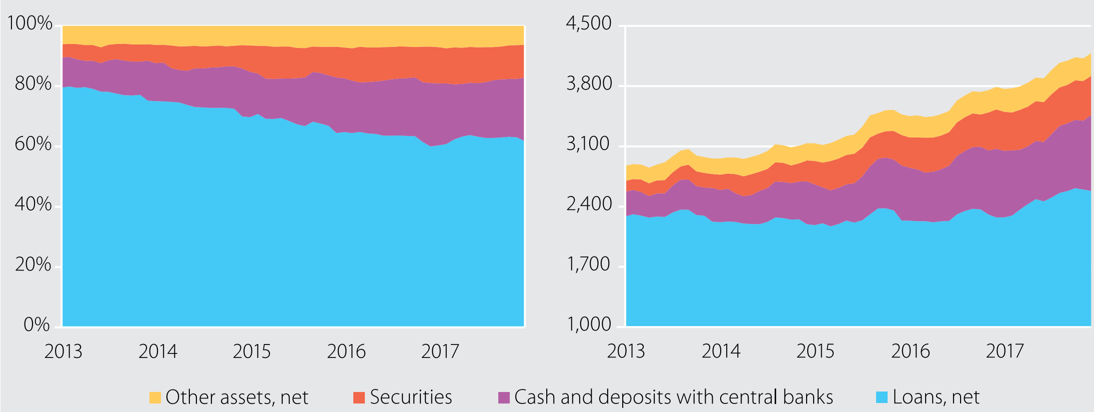


Source: CBCG

The most prominent assets' structure change occurring in 2017 reflected in an increase in total loans, which had been stagnant for few years. Given the nature of Montenegro's banking system, lending is expectedly the main function of banks. Total loans still account for the main share in assets; however, this share has been on a downturn for years now, primarily on the back of a more prudential lending, as well as the adverse effects of the crisis and partly due to growth recorded in other assets segments. Net loans made up 61.7% of assets at end-2017.

Graph 4.5

Assets: structure (lhs) and amount in million euros (rhs), 2013–2017



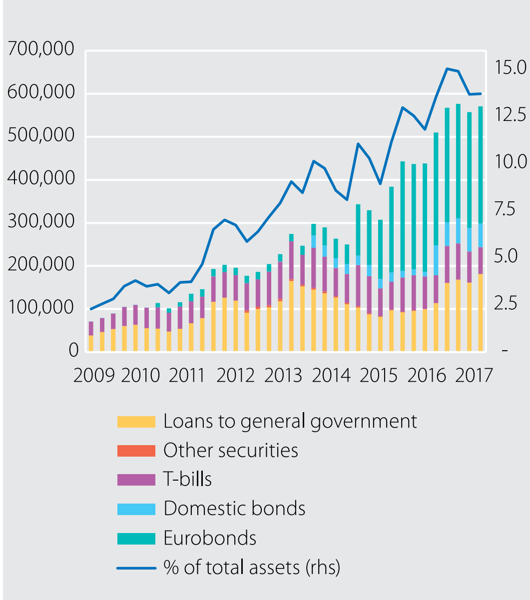
Source: CBCG

In 2017, banks operated mainly in the domestic money market but the total amount of securities in banks' ownership saw a mild year-on-year decline compared to end-2016. In addition, their share in assets dropped from 12.1% to 10.9% in 2017. The main portion of securities referred to securities issued by the Government of Montenegro (85.5%). These are investments with a favourable interest rate to risk ratio, which banks have found to be especially attractive over the past five years, given the substantial amount of liquid assets at their disposal as a result of prudential lending. In addition, regulatory risk weight for this type of investment is 0% (in accordance with international practice), whereby banks make profit for this type of portfolio and do not have any related regulatory capital requirements.

Over the past ten years, banks' credit exposure to the General Government also increased. In 2017, growth of loans to the Central Government was particularly prominent, reaching 136% over the one-year period. Loans granted to the General Government accounted for a minor portion of 7.7% of the banks' total portfolio[31]. Banks- total exposure toward the General Government based on loans and securities amounted to 13.7% at end-2017. Compared to the euro area countries, this was among the highest exposures of the banking sector to the national government[32].

Graph 4.6

Banks' exposure toward the General Government, in thousand euros and % of assets, 2009–2017



Source: CBCG

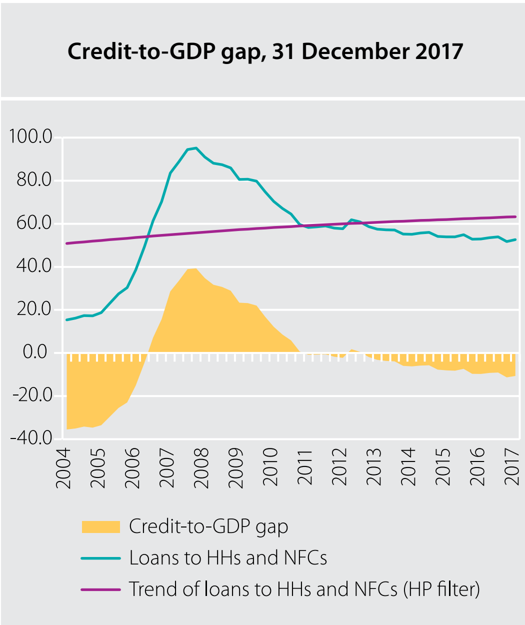
High liquidity of the system can also be observed through foreign assets. Banks' receivables from non-residents increased mostly based on cash and deposits in 2017. The amount of cash in the banking sector was double its long-term average. In the past two years, receivables from non-residents arising from deposits declined but remained substantial (8.1% of total assets and liabilities at end-2017). Banks' deposits held abroad referred mainly to demand deposits with prominently seasonal effect, through the summer tourist season influence. Total receivables from non-residents stood at 615.4 million euros or 14.7% of assets at end-2017. On the other hand, banks' payables to non-residents also increased, primarily those arising from deposits, while foreign loan payables declined. Payables to non-residents amounted to 861.3 million euros or 20.6% of total assets and liabilities. Thus, net foreign assets of banks stood at -5.9% of their total assets and liabilities at end-2017.

[31] In relation to total loans reduced by loans to other banks.

[32] However, four non-euro area countries recorded considerably higher exposures: Croatia (20%), Poland (20.4%), Romania (22.3%), and Hungary (24.3%).

4.2. Credit growth and non-performing loans

Graph 4.7



Source: CBCG

Regardless of the standstill in the level of total loans, the growing volume of new loans suggests that banks' lending activity intensified over the past years. In 2017, new loans saw the year-on-year drop of 4.4% but the amount of loans remained high (1.09 billion euros). Total loans (the unpaid principal balance) recorded the year-on year increase of 11.8% in 2017. However, the level of loans to nonfinancial institutions and households in relation to GDP reached its nadir in 2017 when it stood at 52.6% of GDP. Over the past six years an evident gap has been widening between the ratio of the private sector loans and GDP and the longstanding trend of that ratio.

In terms of FX risk, i.e. currency induced credit risk; the loans' currency structure is favourable. An insignificant portion of loans (0.7%) referred to loans in foreign currency.

In reference to the maturity structure of loans as per initially agreed maturity, long-term loans accounted for 87.3% (not including credit-type receivables) at end-2017. However, observed in terms of remaining loan maturity, the share of long-term loans appears to have been significantly lower, 66.2%.

Retail loans have experienced positive growth rates over the past five years, rising at two-digit growth rates over the last two years, as much as 10.3% in 2017. Moreover, retail loans grew at a pace faster than that of nominal growth of economic activity. At end-2017, retail loans reached their all-time high of 1.12 billion euros. Analysed in relation to GDP (26.7%), retail loans did not reach their 2008 record level (33.4%).

In 2017, new retail loans (476.5 million euros) increased by 1.4% y-o-y. In addition, new retail loans level nearly matched that of new corporate loans, which is indicative of the banks' lending activity focus shifting towards the retail sector. Total retail loans (outstanding principal balance) exceeded total corporate loans back in mid-2016.

The shares of cash/all-purpose loans and housing loans in retail loans were by far the largest, amounting to 52% and 29%, respectively. Cash loans surged in absolute terms as well as in terms of the number of credit accounts, and these were mainly loans with agreed maturity of over three years. Total housing loans also increased. An average housing loan value stood at 31 thousand euros at end-2017. On the other hand, this amount was insufficient to cover the purchase of an average apartment in

Montenegro[33], given the average price of residential real estate in the country[34]. This suggests that the purchase of residential units is financed from other sources such as financial assistance from parents (usually for the first apartment purchase), savings, additional loan (cash/all-purpose), inheritance, income from the sale of another real estate, etc. Therefore, banks are usually not exposed to credit risk for the full value of the residential unit.[35]

Total corporate loans stood at 979.4 million euros at end-2017, recording the annual growth of 4.5%. The level of total corporate loans had been drastically declining in the post-crisis years, and the downtrend finally halted in 2012. Since 2012, the total corporate loans level fluctuated around the average of 953.4 million euros, without significant deviations from the corporate loans balance recorded at end-2017. In relation to end-2008, corporate loans declined by 41%. In relation to GDP, total corporate loans amounted to 23.3%, more than twice below the record level of 53.4% reached at end-2008. Looking from this perspective, corporate loans do not seem to have made a prevailing contribution to GDP growth.

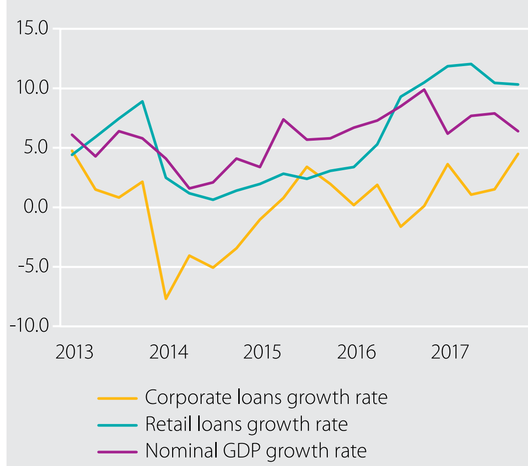
However, banks have placed relatively large funds in the corporate sector in 2017 as well. The amount of new corporate loans was 510.3 million euros, almost the amount of new corporate loans recorded in 2016. In terms of new corporate loans' maturity, an enormous portion referred to short-term loans, which were on an uptrend in 2017 after years of decline and which made up 42.4%.

As in the previous years, the main share of new corporate loans referred to loans for liquidity (working capital). Loans granted for the implementation of investment programmes made up less than 10% of new corporate loans. In respect to industries, the main portion of loans was granted for trade activities (29%), construction (15.2%), and service activities (11.5%).

Credit risk diminishing, observed through the share of non-performing loans, continued in 2017. Non-performing loans have been recording a longstanding downtrend, particularly prominent over the past three years. In fact, non-per-

Graph 4.8

Annual growth rate of retail loans, corporate loans and nominal GDP, %, 2013–2017



Source: CBCG

[33] As per the 2011 census, an average apartment surface area in Montenegro amounted to 71 square meters.

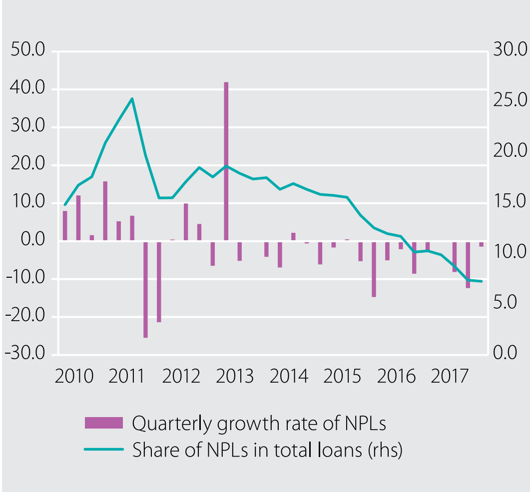
[34] As per the CBCG's regular survey on the real estate prices trending in Podgorica conducted in September 2017, an average price amounted to 1,017 euros per square meter of an apartment in Podgorica. The same survey showed that an average price of all types of real estate per square meter was 920 euros.
Preliminary Monstat data regarding new apartments show that an average price per square meter amounted to 1,111 euros in 2017.

[35] Data refers to the unpaid principal of housing loans (balance) and not new housing loans, but it is nevertheless relevant, as are the conclusions presented below.

forming loans continuously declined over the past ten quarters. In the one-year period, they recorded a decline of 51.6 million euros and they stood at 197 million euros at end-2017. This made for a share in total loans of 7.3% or by 3 percentage points lower y-o-y. The sum of non-performing loans in relation to GDP also continued to decline, amounting 4.7% at end-2017 compared to 6.3% at end-2016.

Graph 4.9

Quarterly growth rate of NPLs and share of NPLs in total loans, %, 2010–2017



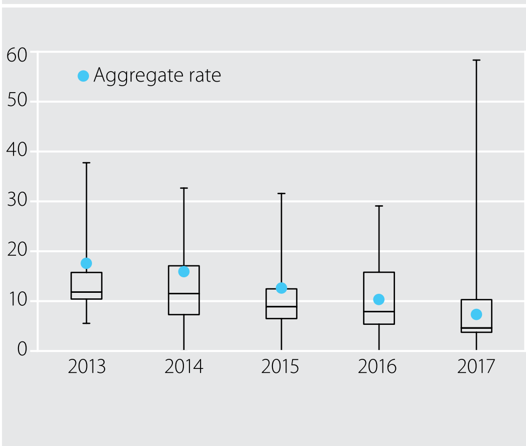
Source: CBCG

In the previous period, banks generally pursued a more prudent lending policy which reflected in rather low shares non-performing loans in banks that have had a significantly larger market share over the past few years. Furthermore, the significant non-performing loans reduction was observed in some banks with large market shares, which were classified as problem banks in the previous period. These banks have been recording favourable trends in the past five years. However, three banks have experienced a rise in the share of non-performing loans, with one small bank drastically deviating from the rest of the banking sector.

At end-2017, loans over 30 days past due were by 30.5% lower y-o-y. In addition, the loans classified as „A" recorded the year-on-year increase of 16.9%, while loans classified as „B" rose by 9.5%.

Graph 4.10

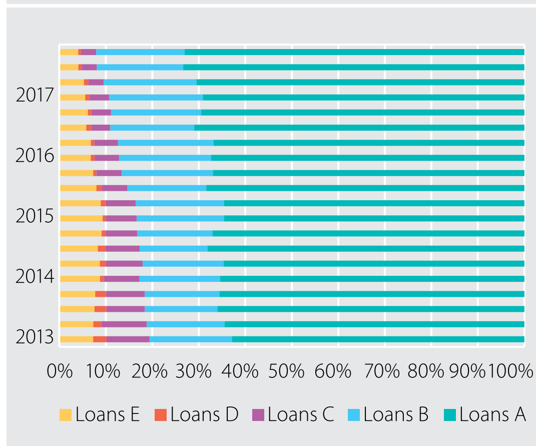
Non-performing loans and aggregate distribution, %, 2013–2017[36]



Source: CBCG

Graph 4.11

Trends of classified loans, 2013–2017



Source: CBCG

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

On the other hand, loans classified as „C“, „D“, and „E“ saw the year-on-year declines of 14%, 6.5%, and 26.7%, respectively.

The credit risk diminishing trend came in response to a rather active banks’ involvement in cleaning their balance sheets. In 2017, banks sold lower amounts of non-performing loans compared to previous years.

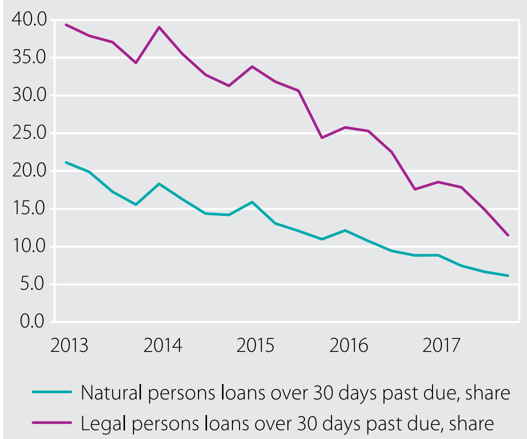
Likewise, the regulatory framework for non-performing loans workout was favourable. The application of the Law on Voluntary Financial Restructuring of Debts towards Financial Institutions was prolonged for another year and the scope of its application was widened to include loans classified as „D“.

In 2017, the amount of gross restructured loans recorded the year-on-year decrease of 16.6%. Gross restructured loans amounted to 220.3 million euros accounting for 8.1% of total loans. A decline in restructured loans referred mostly to corporate loans.

The amount of domestic corporate sector’s non-performing loans contracted by 26.4% y-o-y, with their share declining from 19.8% to 14.5%. This still makes for a high level of non-performing loans and a part of the portfolio posing the greatest risk. On the other hand, the share of retail sector’s non-performing loans stood at 5.5% at end-2017, compared to 6.9% at end-2016. The highest non-performing loans concentration remained in the trade sector, as well as construction and manufacturing industry, whereby banks’ receivables from the trade sector and manufacturing industry were significantly lower than in the previous year (40% and 43.8%, respectively). Corporate and retail loans over 30 days past due extended their downtrend into 2017, closing the year at 11.5% and 6.1%, respectively.

Graph 4.12

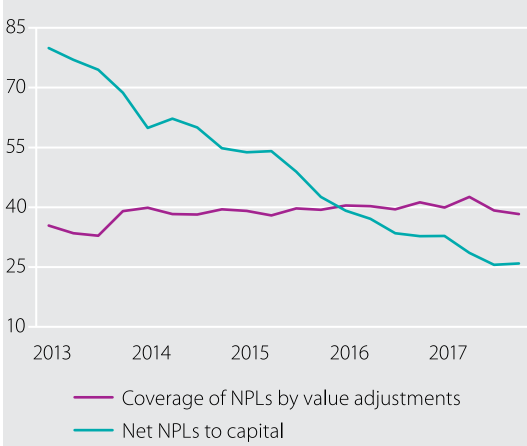
Natural and legal persons loans over 30 days past due, 2013–2017



Source: CBCG

Graph 4.13

Capital resilience to credit risk indicators, %, 2013–2017



Source: CBCG

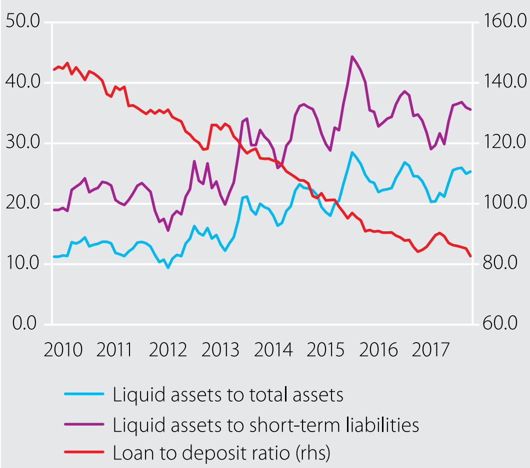
The coverage of non-performing loans by value adjustments for loan losses amounted to 38.3% at end-2017.[37] The net non-performing loans to capital ratio amounted to 25.9% at end-2017. This ratio has been trending downwards for several years, signalling a decline in the amount of capital exposed to credit risk.

4.3. Liquidity

Banks have access to a substantial amount of funds that can be reached at short notice. Banks' deposits held with financial institutions abroad were mainly in the form of demand deposits. At end-2017, these deposits made up 27.5% of liquid assets. In addition, funds in the amount of 474.4 million euros were placed in the settlement accounts with the CBCG. Additionally, banks held a sufficient amount of cash in their vaults.

Graph 4.14

Liquid assets and loans to deposits ratio (rhs), %, 2010–2017



Source: CBCG

In absolute terms, liquid assets increased by 13.9% or 1.06 billion euros, while their share in total assets rose to 25.3%. Both corporate and retail sectors continued to be net creditors in the system. The loans to deposits ratio has been on years-long decline, being below 100% since 2005. In 2017, this ratio's decline was significantly less prominent due to intensified lending activity. The liquid assets to short term financial liabilities ratio amounted to 35.6%, exceeding the value recorded at end-2016, regardless of the short-term liabilities increase of 302.6 million euros.

Deposit growth referred mainly to an increase in demand deposits, which have exceeded term deposits for three years in a row. Such trends were also present in the deposits of the retail sector and nonfinancial institutions' deposits. At end-2017, total demand deposits accounted for 61.7% of total deposits. For the sake of comparison, demand deposits accounted for 42% of total demand deposits at end-2013.

Maturity match of financial assets and financial liabilities per the remaining contractual maturity points to a negative cumulative gap in the period from one to 365 days.

[37] It refers to loans covering interest receivables and interest/fees prepayments and accruals. Value adjustments for losses on non-performing loans to non-performing loans ratio.

4.4. Solvency

In 2017, resilience of Montenegrin banks was slightly higher than in the previous year, with a moderate resilience growth being evident for some time now. Regulatory capital to risk weighted assets ratio (solvency ratio) and tier 1 capital ratio were higher than in 2016, on average. At end-2017, the solvency ratio amounted to 16.4%, being above the statutory minimum of 10% in all banks, while tier 1 ratio amounted to 15%. For comparison purposes, these two indicators stood at 14.4% and 13% at end-2013, respectively.

Total capital of banks amounted to 514.2 million euros at end-2017 and it made up 12.3% of total assets and liabilities. Capital recorded the annual increase of 5.6%. At end-2017, banks' share capital was 8% lower y-o-y.

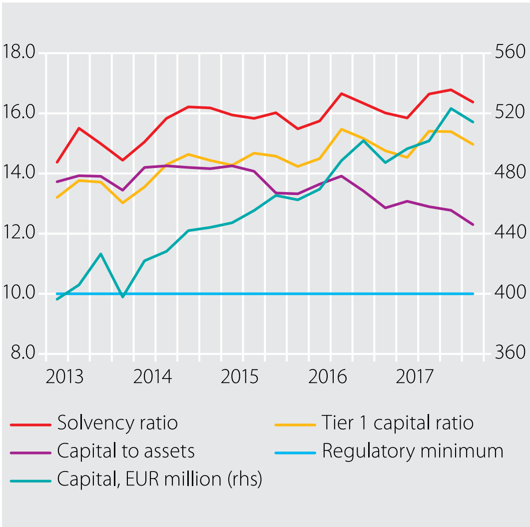
4.5. Profitability, interest rates, and competition

In 2017, banks' profitability improved significantly in comparison to 2016. Banks' net profit amounted to 35.1 million euros in 2017. Most banks reported positive financial results, but three small-sized banks operated with negative results. The main contribution to the surge in net profit reflected primarily in substantial reduction of allowances for impairment and provisions, which serves as yet another indicator of lower credit risk in the system. Higher fee and commission income and other income were the other two factors that have made a significant impact on the increase in earnings.

Return on average assets (ROAA) (0.9%) and return on average equity (ROAE) (7%) recorded significant year-on-year increases. ROAA and ROAE for the five largest banks ranged between 1% and 1.7% and 7.5% and 12.3%, respectively.

Graph 4.15

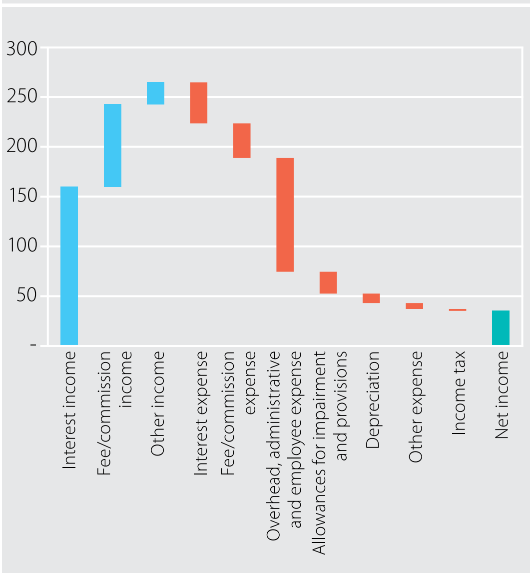
Selected capital ratios, %, 2013–2017



Source: CBCG

Graph 4.16

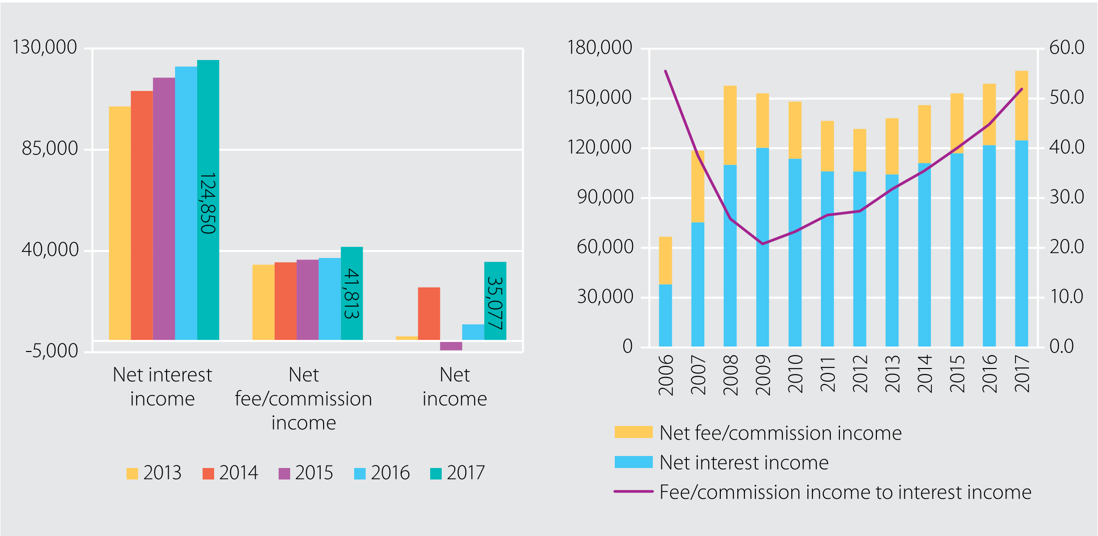
Components of the banks' statements of financial result in 2017, million euros



Source: CBCG

Graph 4.17

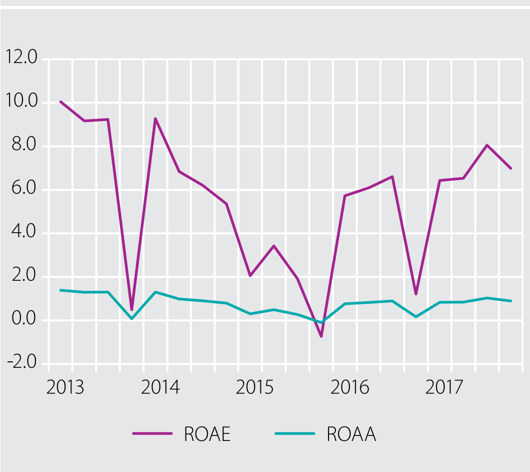
Interest income/expenses, fee and commission income/expenses: interrelation and comparison to total result, thousand euros



Source: CBCG

Graph 4.18

Selected profitability ratios, %, 2013–2017 [38]



Source: CBCG

Interest income has been declining since 2008 partly due to the contracted lending activity. This decline was slowed down substantially by the latest credit expansion observed in 2017. Interest expenses declined along with the interest income and at an even stronger pace. Banks currently finance themselves mostly from domestic deposits, with the deposit interest rates that fell considerably, the trend that continued in 2017. The effect of decline in interest income/expenses resulted in a consistent rise in net interest income.

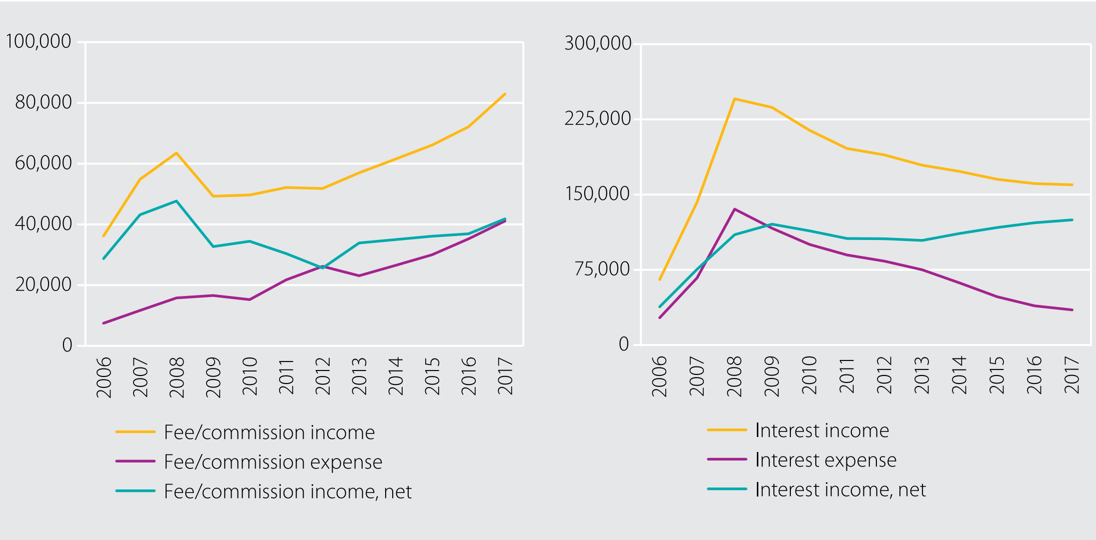
In the previous period, banks compensated the decline in the income arising from lending activity with income arising from investments in securities, as well as fee and commission income that has been recording prominent growth since 2012. The influence of fee and commission income on the total result is growing, as can be concluded from the fact that this income exceeded interest income by 50% in 2017.

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

However, the income from providing payment system services and credit card and ATM operations accounted for the main share of this income. An interesting fact is that net fee and commission income has been increasing, followed by increase in gross fee and commission income/expenses which has not been the case with net interest income growth, which has been followed by a decline in gross income/expenses.

Graph 4.19

Interest income/expenses, and fees and commissions income/expenses, thousand euros, 2006–2017

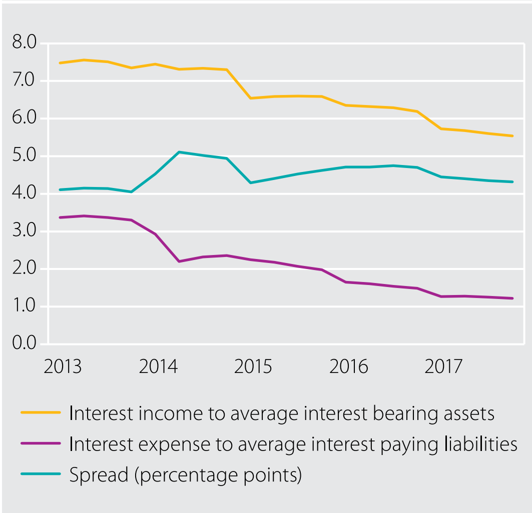


Source: CBCG

The aforesaid trend can be observed through income/expenses spread[39], which was somewhat lower in 2017, though still exceeding 4 percentage points. Interest income/expenses downtrend continued into 2017. In respect to individual banks, interest rate spread varied, ranging from 1.6 percentage points to 5.4 percentage points. Lower interest rate spread could strain banks' profitability in the medium term, bearing in mind the size and current status of Montenegro's economy.

Graph 4.20

Income/expenses spread (percentage points) and its components (%), 2013–2017[40]



Source: CBCG

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

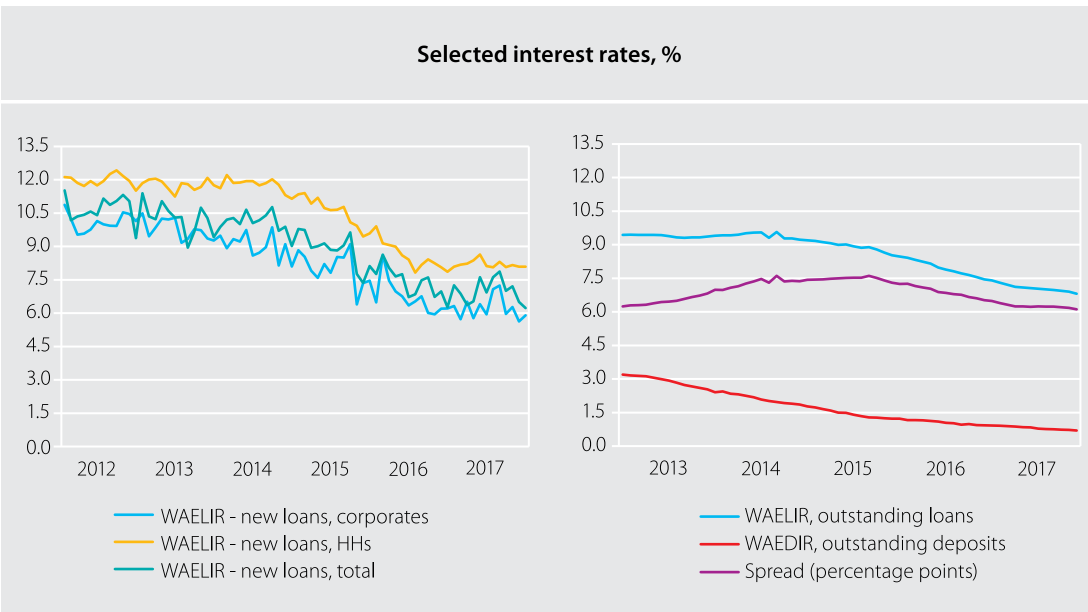
[40] Quarterly data for the first three quarters referred to a cumulative amount - first three months, first six months and first nine months of the year, respectively, and for annual period they were transferred by multiplying by 4, 2, and 4/3.

Lower interest rates and increased lending provide a favourable environment for both retail and corporate sector in Montenegro. However, the downtrend in the weighted average lending interest rate (for the entire loan portfolio of banks) slowed down in 2017. The weighted average deposit interest rate also continued to decline, while the interest rate spread[41] remained at a level above 6 percentage points.

In 2017, the weighted average interest rate on new loans amounted to 6.9%, declining in relation to 2016 when it stood at 7.3%. Comparison of the weighted average interest rate on new loans recorded in 2017 to that recorded in H2 2016 (6.9%) reveals that the rate's downtrend in fact slowed down.

The interest rate on total new loans stood at 6.2% at end-2017, recording the year-on year decline of 0.1 percentage points. The interest rate on new retail loans amounted to 8.1% at end-2017, increasing by 0.2 percentage points y-o-y. New businesses of the corporate sector were financed under rates lower than those for the retail sector and the rate recorded at end-2017 amounted to 5.9%, declining by 0.3 percentage points y-o-y.

Graph 4.21



Source: CBCG

4.6. Sensitivity analysis

The sensitivity analysis of credit risk revealed that some banks showed significant sensitivity levels, primarily after the application of the first and the fourth tests, while banks showed a large level of resilience to the second and third tests. Five banks failed the first test and their total lacking capital amounting to 29.7 million euros, whereas seven banks did not pass the fourth test and the amount of lacking capital was 23.7 million euros. However, the solvency ratio at the sector level did not fall below the statutory minimum after any of the tests applied.

[41] Difference between weighted average lending and deposit interest rates

Table 4.1

Sensitivity analysis of credit and market risks, 31 December 2017								
Box	Test	Solvency ratio after the test, %					Lacking capital at the sector level, thousand euros	Number of banks that failed the test
		Min.	Q1	Q3	Max.	System		
		Solvency ratio before the test, %						
		12.3	13.0	21.7	82.0	16.4		
Credit risk test								
1.	Negative reclassification of classified loans' structure*	-4.2	9.3	19.9	81.6	13.6	29,674	5
2.	Increase in non-performing loans by 30% and value adjustments by 40%	9.5	11.7	21.0	81.9	15.3	169	1
3.	Large debtor bankruptcy**	10.9	11.7	20.2	81.5	15.2	0	0
4.	Largest debtor bankrupt	-15.9	8.0	13.9	78.8	12.2	23,718	7
Market risks test								
1.	Interest rate increase by adding 2 percentage points to cumulative gap of interest rate sensitive positions with 181–365 days maturity	11.2	12.1	20.7	82.5	15.7	0	0
2.	Adjustment of net open FX position by 40%	12.2	12.9	21.7	81.9	16.3	0	0

* Reclassification of the structure of classified loans and receivables is implemented as follows: 1) category A – "pass" - calculated in the amount of 90%, and category B increased by 10% of loans from category A, 2) category B – "special mention assets" – calculated in the amount of 95% of the increased category B, 3) category C – "substandard assets" – calculated in the amount of 5% from category B, whereby 95% of category C was kept, 4) category D – "doubtful assets" - calculated in the amount of 5% from category C, while 95% from category D was kept, and 5) category E - "loss" – amount increased by 5% of the amount from category D.
** Median value of the debt of banks' 20 top debtors

Source: CBCG

As expected, the sensitivity to interest rate risk and the sensitivity to FX risk test showed minor negative impacts on the solvency ratio. In the first case, solvency ratio declined by 0.7 percentage points to 15.7% at the system level, while in the latter case, the system level decline was 0.1 percentage points, to 16.3%.

Table 4.2

Liquidity risk sensitivity analysis, 31 December 2017							
No.	Test	Coverage by immediately available liquid assets, thousand euros (648,433 as at 31 December 2017)			Coverage by available liquid assets, thousand euros (765,226 as at 31 December 2017)		
		Lacking amounts (-), sector	Number of banks that failed the test	Lacking amounts (-) for banks that failed the test	Lacking amounts (-), sector	Number of banks that failed the test	Lacking amounts (-) for banks that failed the test
1.	Outflow of 30% of deposits	-335,293	13	-369,112	-218,500	12	-271,525
2.	Outflow of 30% of demand deposits	48,847	6	-105,403	165,640	5	-51,074
3.	Outflow of time deposits: 30% for natural persons and 40% for legal persons	34,179	8	-103,638	150,972	5	-50,676
4.	Outflow of time deposits: 30% for natural persons and 40% for legal persons	229,042	8	-80,067	345,835	7	-37,454
5.	Outflow of deposits of the largest depositor	352,346	4	-21,331	469,139	1	-13,136
6.	Outflow of 50% of deposits of 10 largest depositors	191,504	6	-62,413	308,297	4	-32,094
7.	Outflow of 100% of deposits of public sector	147,061	8	-88,175	263,854	6	-35,056

Source: CBCG

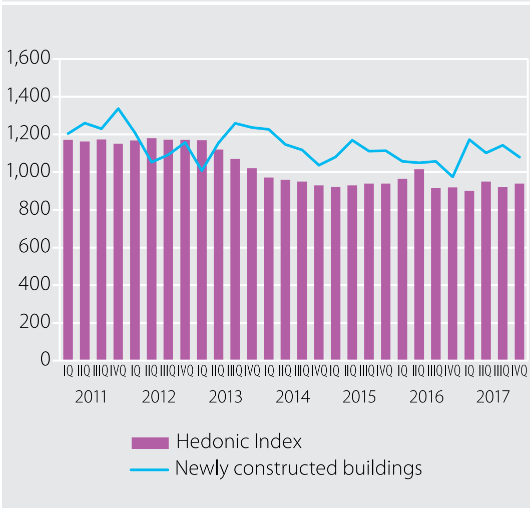
The sensitivity to liquidity risk test was actually tested as a risk of deposit run and, as expected, the test results revealed a strong liquidity of the sector that lacked liquid funds to respond to deposit outflow only in the case of the first test. In all other cases, inadequacy of liquid funds to cover deposit outflow appeared in individual banks. The most pronounced inadequacy, even after the use of reserve requirement funds, occurred after the application of the second test when five banks failed the test with the liquidity shortfall of 51.1 million euros. However, it should be noted that these tests were extremely severe and did not allow the possibility of resorting to banks' funds in the form of demand deposits held abroad, which amounted to 291.5 million euros at end-2017. These are very liquid funds that could be quickly deployed to prevent any shortfalls at the sector level even in the first and most severe liquidity test.

4.7. Real estate market

In 2017, the real estate market trends were similar to those seen in 2016. The year-on-year comparison of the quarterly real estate prices suggested that the trend of adapting large supply to a limited demand by reducing the prices continued in 2017. However, the results of a survey conducted in December suggested that the average price of real estate amounted to 939.7 euros per square meter, which represents a mild year-on-year increase of 2.2%[42].

Graph 4.22

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



Source: CBCG, Monstat

The average price per square meter of new apartments in Montenegro amounted to 1,079 euros in Q4 2017, recording the year-on-year increase of 10.7%. However, it should be noted that the differences in the prices of residential units in newly built buildings depend mostly on the share of the Montenegrin Fund for Solidarity Housing Development, thus, the higher the share of these housing units, the lower the prices of newly built housing units and vice versa.

The majority of real estate agencies (56% of them) estimated that the prices on the real estate market remained unchanged over the one-year period. Some 31% of agencies recorded a decline in real estate prices ranging between 5% and 10%. Moreover, the majority of agencies (56% of them) reported real estate trade at the last-year's levels. Increase in trading was recorded by 25% of agencies, while 19% of agencies recorded decline.

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

Housing loans are a significant determinant of demand on the real estate market. Housing loans accounted for 7.8% of the estimated GDP at end-2017, which is a decline in relation to 2016. The decline in this coefficient was induced by economic activity whose growth (4.4%) exceeded that of housing loans (0.7%).

Table 4.3

Housing loans trend, 2007-2017

Year	GDP, in million euros	Housing loans, stock at year-end, in thousand euros	Population	Housing loans, stock at year-end	
				% of GDP	Per capita (in euros)
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	3,457.9	315,089	620,029	9.3	508
2015	3,660.7	308,869	620,029	8.4	498
2016	3,729.5	328,558	620,029	8.3	529.9
2017	4,236.5	330,983	620,029	7.8	533.8

Source: CBCG and Monstat

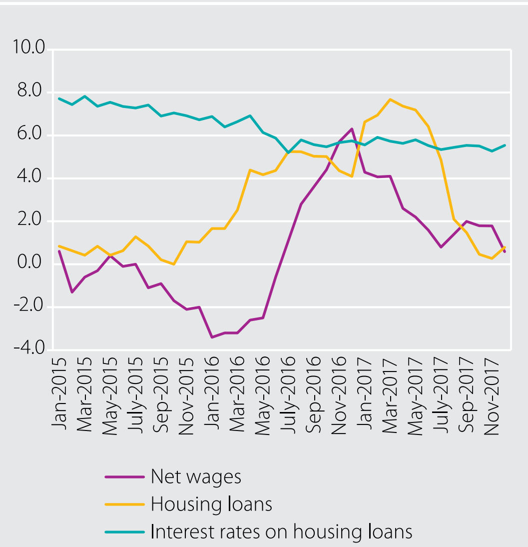
Regardless of the decelerated lending activity observed in the housing loans segment, this market has considerable potential, considering that its share remains significantly below the average recorded in the EU countries (around one third of GDP).

Any significant shifts in the prices of housing units would require an increase in demand, i.e. a higher share of housing loans in GDP, lower interest rates, higher growth of wages and salaries, i.e. more vigorous economic activity growth.

Long-term decline in real estate prices induced a rise in the liquidity shortfall of construction companies, which reflected on growth of the sector's leverage. Credit leverage of the construction sector amounted to 168.5 million euros at end-2017, recording the year-on-year increase of 20%. In 2017, in the total credit leverage of the corporate sector, construction accounted for 6.5% (the highest share being that of the trade sector).

Graph 4.23

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



Source: CBCG

Non-performing loans of the construction sector served as one of the channels through which the risks from real-estate market spilled over to the financial system during the crisis, producing a negative impact on its stability. The construction was actually the sector with the highest share of non-performing loans in total non-performing loans with 18.1%. At end-2017, non-performing loans of the construction sector amounted to 39.1 million euros, increasing by 2.3 million euros or 6.3%.

The announced Government project „1000+ apartments" will contribute to balancing apartments demand and supply. The project is expected to produce a positive economic effect as demand for housing construction will also have a positive impact on the construction sector.

Some 50% of real estate agencies estimated that the real estate market will experience price stagnation in 2018, while 31% find that the prices will grow between 5% and 10%. However, 69% of agencies believe that the price stagnation will induce an increase in demand for real estates, particularly from a growing number of foreign clients.

It is assumed that a slight recovery of the real estate market turnover will occur in the following period as a result of adjusting the supply to suit the demand, continuance of the Government „1000+ apartments" programme and a potential growth of FDIs in real estates. The pace of carrying out the important tourist and infrastructure projects in Montenegro in the upcoming period is also expected to fuel the recovery of the construction sector. Next year is expected to bring an increase in banks' lending activity as well as a decline in lending interest rates, which might contribute to the pick-up in the real estate market. However, it is estimated that this risk is not high at the moment.

4.8. Capital market

The turnover of a mere 47.4 million euros was recorded at the Montenegro Stock Exchange (1.1% of GDP) in 2017 compared to 115.2 million euros recorded in 2016[43]. The entire SE turnover was executed through secondary trade, given that there were no primary issues or equity or debt instruments. Share trading made up 75.9% of the secondary turnover, with the companies' share trade accounting for 23.8 million euros and the investment funds' share amounting to 12.2 million euros. The remaining portion of the secondary turnover of 11.4 million euros referred to bonds trading, mainly government bonds secondary trade in the amount of 9.3 million euros.

At end-2017, the SE indices Monex and Monex PIF, stood at 10,175.43 and 776.69 points, recording respective year-on-year declines of 11.6% and 16.3%.

4.9. Payment system

The CBCG`s Payment System - RTGS and DNS systems, as the main payment infrastructures in Montenegro, worked almost without interruptions during 2017. Of 2,150.5 working hours and one hour prolongation (totalling 129,090 working minutes) during 253 working days, the CBCG's payment sys-

[43] The November 2016 government bond issue accounted for 80.4 million euros or nearly 70% of the SE turnover recorded in that year.

tem was in delay of only 23 minutes, achieving the availability of 99.98% compared to 99.97% recorded in 2016.

In 2017, the CBCG's payment system processed payments valued 13.5 billion euros (3.2 the amount of GDP), i.e. 10.3% more than in 2016. Of this amount, 12.7 billion euros (94.2%) referred to the RTGS system and 783.1 million euros (5.8%) referred to the DNS system. In reference to the number of payments, the CBCG's payment system processed 10.2 million of payments or 5.4% more than in 2016. Of this amount, payments in the amount of 3.8 million euros (37.6%) referred to the RTGS system and 6.4 million euros (62.4%) referred to the DNS system. The average value of payments in 2017 amounted to 1,317 euros, with the RTGS accounting for 3,302 euros and the DNS averaging 122 euros.

While the DNS participants were only banks, when it comes to RTGS, the situation was different regarding the structure of payments: banks ranked first with 6.9 billion euros (54.3%), followed by the Government Treasury accounts with 5.4 billion euros (42.3%), the CBCG with 397.6 million euros(3.1%) and other clients of the CBCG with 42.1 million euros (0.3%). Based on the number of payments in the RTGS, banks ranked first with 3.6 million payments (92.7%), the Government Treasury accounts with 274.1 thousand payments (7.1%), the CBCG with 5.2 thousand payments (0.13%), and other clients of the CBCG with 2.4 thousand payments (0.06%).

5. CONCLUSION

The government finances pose a relatively strong systemic risk in Montenegro. In that respect, the level of public debt (currently exceeding 65% of GDP) is neither the key problem nor cause of the problem but also to a large extent a consequence of the activity of other economic influences, primarily of structural factors. In general, the public debt growth in the case of Montenegro points to a persistently weak international competitiveness, high spending relative to low accumulation, and increased dependence on foreign capital inflows.

Montenegro experienced the largest economic growth between 2006 and 2008, mainly fuelled by high foreign investment inflows (substantially in real estates) and a sharp increase in banks' leverage arising from foreign borrowings mainly from their parent banks. However, since maintaining these inflows in the long-run was not possible, the economic growth could not continue at the same pace. In addition, the global financial crisis induced disrupted commodities and capital flows, increase in the corporate sector's illiquidity, and a growing need for bail-ins (growth in public expenditures).

As of 2009, the weakening of these foreign capital inflow channels has been partially compensated by growth in the government borrowing, primarily through bilateral credit arrangements and subsequently increasingly through Eurobond issues. At end-2017, the government's external debt amounted to 2.21 billion euros, whereby about half of the amount referred to loans and the remaining portion to Eurobonds[44]. Thus the economy avoided deeper recession, while its growth was feeble, averaging at 1.5% in the period 2009–2017, mainly due to the recession years 2009 and 2012. Moreover, even this type of funding can generate growth only by constantly increasing the debt, which is also unsustainable in the long run.

A substantial portion of public debt was created in the period of relatively available and cheap money on international financial markets, which largely resulted from the policy of historically lowest interest rates of the leading global central banks. Against this background, the state managed and still manages to borrow under low interest rates compared to the historical standards. However, even in such circumstances, the interest expenses were significant and estimated at 98.7 million euros (2.3% of GDP) in 2017, while their 2018 projections point to the amount of 85.5 million euros (1.9% of GDP). Therefore, a period of normalisation of interest rates at the international financial market, which will occur at a certain point in time (although not in the near future) will pose a special challenge to financing interest expenses and for debt refinancing. Therefore, it is of utmost importance that all adopted fiscal consolidation measures are implemented and that the public debt is reduced to a sustainable level, in line with the Ministry of Finance`s projections.

[44] A portion of Eurobonds is held by Montenegrin banks, but mainly by those that are foreign owned.

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

Increasing direct financial linkage between the government and banks ads to the complexity of Montenegro's position. The exposure of the banking sector to the government, which was only minor in the post-credit boom period, has been on an uptrend ever since, reaching 573.6 million euros or 13.7% of total assets of banks at end-2017 and is expected to grow further[45]. The reasons for strengthening this link were ambivalent. Banks realised favourable interest income compared to risks assumed through these investments, in the context of their risk aversion in the post-crisis period and a lack of better alternative solutions. Also, banks were additionally motivated as they did not have to allocate additional capital since these investments were treated as riskless (according to Basel standards that are applicable in Montenegro). On the other hand, liquid assets of banks were a valuable source of financing for the government, which was particularly prominent in the recent period during which the government has faced the challenge of financing debt in the international market. Regardless of its uptrend, at the current level, this leverage does not pose a threat to financial stability since it is still lower than in some EU countries.

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

The issue of non-performing loans (7.3% at end-2017) has persisted regardless of a notable decline achieved over the past years. Bad loans are no longer a systemic issue, but rather a problem of individual institutions. Still, it should be noted that a decline in the share of non-performing loans was largely achieved through write-offs and sale of bad assets, which leads to a conclusion that the issue was removed from the banking sector rather than actually resolved. All the aspects of this issue will not be possible to perceive before the CBCG`s mandate for supervising activities of non-banking financial service providers has been fully implemented and operational.

Banks still have the perception of high risk of real sector, which is best indicated by relatively limited lending activity (although considerably intensified in 2017), as well as still high lending interest rates (regardless of the substantial reduction of average lending interest rate) and other lending conditions. Negative feedback loop between a high share in non-performing loans and stagnant credit growth weakened significantly in 2017, however, in view of all the above said, it is early to say that all problems have been resolved.

[45] The data refers to the general government and not just to the central government.

Additionally, low profitability poses as a great challenge for banks. In the period 2013–2017, interest income declined from 179.1 million euros to 159.8 million euros, but a sharper decline in interest expenses induced an increase in net interest income from 104.3 million euros to 124.8 million euros. Banks compensated for the decline in interest income by the increase in fee/commission income to a large extent. However, a parallel growth in fee/commission expenses resulted in a small increase in net fee/commission income from 33.9 million euros to 41.8 million euros. Allowances for impairment and provisioning recorded in the same period were substantial, averaging at over 37 million euros annually. At the same time, total capital of banks rose significantly, by 116.4 million euros or 29.3%, resulting in the annual return on equity of only 2.7% in the period 2013–2017.

In parallel, the competition intensified, with 15 banks operating on the market and with the HHI per assets (which has generally been on a downtrend in the post-crisis period) currently below 1,000 points. The strengthening competition inducing the lowering of credit standards would be very unwelcomed since it would result in an inadequate risk management assessment, which could potentially reactualize the issue of non-performing loans in the future. However, there are no serious and firmly grounded findings that would point to credit standards lowering at this point.

ANNEX

Table 1 - Indicators of banking sector stability, 2013–2017

	2013				2014				2015				2016				2017			
	III	VI	IX	XII	III	VI	IX	XII	III	VI	IX	XII	III	VI	IX	XII	III	VI	IX	XII
Key indicators of the banking sector stability																				
Regulatory capital, % of risk weighted assets	14.4	15.5	15.0	14.4	15.1	15.8	16.2	16.2	15.9	15.8	16.0	15.5	15.7	16.7	16.3	16.0	15.8	16.6	16.8	16.4
Core capital (Tier 1), % of risk weighted assets	13.2	13.8	13.7	13.0	13.6	14.3	14.6	14.4	14.3	14.7	14.6	14.2	14.5	15.5	15.2	14.8	14.5	15.4	15.4	15.0
Capital, % of assets	13.7	13.9	13.9	13.4	14.2	14.2	14.2	14.2	14.2	14.1	13.3	13.3	13.6	13.9	13.4	12.8	13.1	12.9	12.8	12.3
Net non-performing loans, % of capital[1]	52.1	49.6	45.1	44.0	34.7	35.6	34.0	28.8	27.6	28.1	25.4	23.0	21.7	20.3	18.0	18.3	18.6	15.1	14.1	14.8
Net non-performing loans, % of capital[2]	79.9	77.0	74.5	68.7	59.9	62.2	60.0	54.8	53.8	54.1	48.9	42.6	39.2	37.1	33.5	32.8	32.8	28.6	25.6	25.9
Non-performing loans, % of total gross loans[3]	18.7	18.0	17.4	17.5	16.4	16.9	16.4	15.9	15.8	15.6	13.8	12.6	12.0	11.7	10.2	10.3	9.9	8.8	7.4	7.3
Non-performing loans, % of total gross loans[4]	19.4	18.8	18.4	18.4	17.2	17.9	17.3	16.8	16.7	16.4	14.7	13.4	12.9	12.6	11.0	11.1	10.7	9.5	8.1	8.0
Calculated regulatory reserves, % of non-performing loans	57.9	57.1	59.3	61.0	65.2	64.7	64.9	68.1	68.7	67.7	68.7	67.3	67.0	67.3	67.5	67.3	66.0	69.7	66.5	64.8
Value adjustments, % of non-performing loans	35.4	33.5	32.9	39.1	39.9	38.3	38.2	39.5	39.1	38.0	39.7	39.3	40.5	40.3	39.5	41.3	39.9	42.6	39.2	38.3
Distribution of loans per borrower, % of total loans																				
Residents	80.8	81.4	79.3	82.6	82.8	83.5	79.0	81.7	83.5	82.6	76.0	82.1	83.1	85.9	80.7	86.1	87.5	86.8	81.9	85.0
Depository institutions (banks)	0.3	0.4	0.4	0.3	0.4	0.2	0.2	0.2	0.2	0.1	0.1	0.2	0.2	0.1	0.1	0.1	0.1	0.3	0.3	0.1
Other financial institutions	0.1	0.0	0.1	0.1	0.2	0.1	0.2	0.2	0.2	0.1	0.1	0.1	0.2	0.2	0.1	0.3	0.2	0.3	0.2	0.2
General Government	3.9	4.8	6.5	6.3	6.0	5.7	5.2	4.7	4.4	3.7	3.2	4.1	3.9	4.0	4.0	4.7	6.4	6.5	6.0	6.7
Non-financial institutions	40.9	40.7	37.9	39.7	39.8	40.3	37.2	39.2	40.4	40.6	37.0	39.7	40.0	41.5	37.0	39.2	39.3	38.3	34.8	36.6
Retail sector	34.2	35.2	34.3	35.9	36.3	36.9	36.0	37.2	38.1	37.9	35.4	38.0	38.8	40.0	39.3	41.6	41.3	41.2	40.5	41.2
Other sectors	1.5	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.1	0.1
Non-residents	19.2	18.6	20.7	17.4	17.2	16.5	21.0	18.3	16.5	17.4	24.0	17.9	16.9	14.1	19.3	13.9	12.5	13.2	18.1	15.0
Financial	17.2	15.6	17.6	14.5	14.2	13.5	18.3	15.7	13.9	14.5	21.4	14.9	13.6	10.7	16.2	10.3	9.7	10.6	15.4	12.5
Non-financial	2.0	3.0	3.1	2.9	2.9	3.0	2.8	2.6	2.6	2.9	2.6	3.0	3.2	3.4	3.1	3.6	2.8	2.6	2.7	2.6
Net profit, % of average assets (ROA)	1.4	1.3	1.3	0.1	1.3	1.0	0.9	0.8	0.3	0.5	0.3	-0.1	0.8	0.8	0.9	0.2	0.8	0.8	1.0	0.9
Net profit, % of average equity (ROE)	10.0	9.2	9.2	0.5	9.3	6.8	6.2	5.4	2.5	3.4	1.9	-0.9	5.7	6.1	6.6	1.2	6.4	6.5	8.1	7.0
Net interest and similar income, % of gross income	61.1	61.3	60.1	58.3	62.0	61.7	60.8	60.2	62.3	60.3	58.4	58.1	62.4	59.7	58.8	58.1	57.4	57.7	55.6	54.4

Table 1 - continued

	2013				2014				2015				2016				2017			
	III	VI	IX	XII	III	VI	IX	XII	III	VI	IX	XII	III	VI	IX	XII	III	VI	IX	XII
Interest-free expenses, % of gross income	72.6	71.6	72.4	73.7	72.6	73.6	73.3	75.0	79.4	74.8	73.2	74.3	75.3	73.0	73.2	74.8	72.1	73.2	73.1	74.5
Liquid assets, % of total assets	13.2	14.5	21.2	20.0	18.0	18.8	23.2	22.2	18.6	20.5	28.5	24.8	21.9	22.6	26.8	24.5	20.3	21.2	25.8	25.3
Liquid assets, % of short-term liabilities,	21.3	23.5	34.1	32.2	29.0	29.6	36.1	35.7	29.9	32.1	44.3	40.1	32.8	34.4	38.6	34.8	29.0	29.9	36.5	35.6
Aggregate balance in foreign currencies, % of core capital	-0.6	0.4	1.5	0.6	0.9	1.5	0.7	0.7	1.9	2.5	2.6	2.3	4.1	2.9	2.6	1.7	1.9	1.8	1.5	0.9
Additional indicators of the banking sector stability																				
Large exposures, % of capital	87.4	60.2	66.6	110.6	103.8	91.3	100.7	98.9	106.7	106.9	126.4	109.8	107.7	110.9	133.4	112.2	105.1	104.2	121.5	108.0
Derivative financial assets, % of capital	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Derivative financial liabilities, % of capital	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.2	0.2	0.0	0.0	0.0	0.0
Trading income, % of gross income	1.1	1.4	1.7	1.6	1.4	2.4	2.4	2.5	3.4	2.4	1.4	2.5	2.0	2.4	2.6	3.1	3.5	3.0	2.9	3.0
Cost of salaries and fringe benefits, % of non-interest bearing expenses	45.8	44.6	43.5	42.9	44.5	43.3	42.1	41.7	42.6	42.3	41.3	40.5	41.7	41.3	40.4	39.6	40.8	39.4	38.1	37.3
Spread between average lending and deposit interest rates (percentage points)[5]	6.3	6.4	6.6	6.8	7.1	7.4	7.6	7.4	7.5	7.5	7.6	7.3	7.2	6.9	6.8	6.5	6.3	6.2	6.2	6.1
Deposits[6], % of total (without inter-bank) loans[7]	93.9	94.6	101.7	98.9	99.8	102.0	110.9	113.9	113.1	116.0	129.5	127.3	125.3	122.3	133.8	131.0	124.7	124.2	135.4	136.6
Loans in foreign currencies, % of total loans	3.7	3.6	3.2	3.6	3.2	3.4	3.0	3.7	6.7	7.2	7.5	7.9	7.8	6.1	5.5	6.2	6.4	5.8	5.4	6.5
Liabilities in foreign currencies, % of total liabilities	5.2	4.9	4.2	4.3	4.6	4.3	4.2	4.7	6.2	6.8	6.7	6.9	7.1	6.7	6.2	6.4	6.0	5.9	5.8	6.5
Loans to private sector, annual growth rate[8]					-1.7	-1.3	-1.8	-0.7	0.8	2.3	3.2	2.5	1.6	3.6	3.9	5.9	8.6	7.2	6.4	7.7

1/ non-performing loans reduced by calculated regulatory provisions
2/ impaired non-performing loans
3/ without interest and prepayments and accruals
4/ with interests and prepayments and accruals
5/ spread between weighted average lending effective interest rate and weighted average deposit interest rate
6/ total deposits excluding financial institutions' deposits with less than 1 year maturity
7/ total loans without interbank loans
8/ private sector refers to private companies, entrepreneurs and households

Source: CBCG

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