



CENTRAL BANK OF  
MONTENEGRO

# **REPORT ON THE RESULTS OF THE MACROECONOMIC RISK ANALYSIS**

**Podgorica, November 2021**

Pursuant to Article 14 item 9 and Article 45 paragraph 2 item 5 of the Central Bank of Montenegro Law (OGM 40/10, 46/10, 6/13, and 70/17), at its meeting held on 10 November 2021, the Council of the Central Bank of Montenegro adopted the following

## **REPORT ON THE RESULTS OF THE MACROECONOMIC RISK ANALYSIS**

### **1. Introductory remarks**

This analysis covers the macroeconomic risks that Montenegro faces. The identification of individual risks does not mean that they will materialize, but that it is necessary to carefully monitor them in the coming period and take preventive measures to combat them or minimize their impact if it is not possible to completely eliminate them. Economic policy makers should pay attention to all indicated macroeconomic risks, bearing in mind that this is not a final list as new risks keep emerging. The risks analysed in this study are divided into: short-term and long-term macroeconomic risks, risks from the banking system, fiscal risks, inflation risk, external risks, and the like.

### **2. Short-term macroeconomic risks**

**Continued growth of energy prices and limited availability on world markets** - Rising energy prices may adversely affect economic developments in Montenegro. This primarily refers to the growth of the value of imports, the deterioration of the balance of payments, and growing inflation expectations. Limited availability of energy, should it occur, could cause a stagnation of economic trends.

Oil prices rose to over USD 80/bbl in October. According to the forecast of the International Energy Agency (IEA), by the end of this year and in 2022, the global demand for oil will increase further, as will production. Global inventories are declining. The notable uptrend in electricity prices has begun in June 2021, and the highest price was recorded in early October this year, EUR 270/MWh. According to futures contracts for the rest of this year, the price will remain above EUR 200/MWh, and it will remain at this level in the first quarter of 2022 due to expected higher consumption during the winter months. In the second and third quarters, the price is expected to fall to close to EUR 100/MWh which is, however, twice as high as in recent years. Gas prices have also grown remarkably. In January this year, it averaged at EUR 17.5/MWh only to reach EUR 116.4/MWh in early October. According to futures contracts, the price of gas will range from EUR 85 to 90/MWh by the end of the first quarter of 2022, after which a decline is expected, although not to the level it was in the same period this year.

**Growing illiquidity in the real economy** – A risk of liquidity shortfall in the real economy has been present as of the COVID-19 pandemic outbreak. This risk is moderate but with growing tendency and impact intensity.

In the period from 31 March 2019 until 30 September 2021, the number of blocked economic entities registered in the Central Register of Business Entities increased by 4.6% or by 1,233 (from 14,151 to 15,384). The amount of frozen funds increased in the same period by 35% or by 185.8 million euros (from 638.2 million euros to 824.0 million euros), while the average amount of frozen funds per debtor increased by 8.5 million euros or 18.8%. At the same time, the share of the 10 largest debtors in the total amount of the blockade increased from 14.7% to 23.01%, and that of the 50 largest debtors from 36.9% to 44.3%. This indicates that the largest portion of the frozen amounts refers to the largest debtors, as well as that long-term debts account for the largest part of the debts given that out of 824.0 million euros, only some 8% referred to continuous blockades with maturities of up to 365 days.

The growing illiquidity of the economy poses a multiple risk to the Montenegrin economy. The limited ability to collect receivables from creditors (commercial, banks and the government) jeopardizes the stability of the banking sector and government budget revenues. This also has a negative effects on employment as well as on sustainability of "healthy" companies that do not have inherent liquidity problems. Combined, these effects increase credit risk and country risk, which may result in reduced and more expensive lending activity of domestic banks, i.e. an increase in the cost of borrowing funds on international financial markets, both for the private sector and the state.

### **3. Long-term macroeconomic risks**

**Climate change** - According to the UN Framework Convention on Climate Change, Montenegro is a vulnerable country. Climate change in Montenegro is manifested through: a) more frequent and longer heat waves and more frequent extremely high and low temperatures, which affects the growth of the average annual temperature and more frequent dry periods during the year, reduction of water potential in Montenegrin rivers, reduction of total annual amounts of snow (years with very intense snowfall are possible), increase in sea temperature, and increase in the number of fires; b) increase in the intensity of rainfall with flood potential, with the impact on soil erosion, penetration of salty sea water into rivers, more pronounced tides and ebbs, increasing wave height, and decreasing beach areas; c) more frequent occurrence of strong stormy winds; and d) occurrence of diseases atypical for the Mediterranean region.

Climate change is having a negative impact on economic growth and prosperity, with fossil fuel-based industries being hit hardest. When it comes to Montenegro's economy, climate change affects the agricultural sector (through reduced yields and loss of agricultural land), fishery (through lower fish catches), health (through increased treatment costs, i.e. health system costs), the energy sector and industries (through the closure of plants that emit large amounts of CO<sub>2</sub>, reduced operation of hydropower plants during dry periods), tourism (through changes in tourist flows), the public sector (through rising investment costs in damaged infrastructure, rising economic subsidies and social assistance), construction (through the introduction of new standards in order to increase resilience to the negative effects of climate change and difficult working conditions at high temperatures), the financial sector (through the growth of bad loans and write-offs, growth of premiums paid in the insurance sector, loss of value of certain financial

instruments), and water management (through reduced water potential, mixing seawater with river flows). All these branches have a significant share in the formation of Montenegro's GDP. This affects economic growth, employment, inflation, public debt, and the costs of its financing, and jeopardizes both macroeconomic and fiscal stability.

**Health risks** –All risks related to the health of the population, both globally and nationally, have increased significantly over the past two years so that the lives and work of the population are in the state of constant uncertainties. A large number of health institutions warn of the emergence of new viruses and other microorganisms that can have a detrimental effect on the health of the population. The fact is that the consequences and effects of the current pandemic are long-term, as well as that they have a significant material impact. Risks of future pandemics are possible and they are related to high fiscal but also wider macroeconomic risks because they can reduce the health potential of the population, and thus the health balance, i.e. they can result in instability in all areas of human life.

**Low level of diversification of Montenegro's economy** - Despite significant changes over the past 30 years, the Montenegrin economy is still underdiversified, with the prevailing the service sector and, consequently, a low level of technological equipment, i.e. weak (commodity) export base and high import dependence, with uneven regional development and underutilization of (all) available comparative advantages. As a result, there is a risk of low resilience of the Montenegrin economy to external shocks and boom-bust cycles, as well as to internal shocks caused by a risky model of economic growth based on large FDI in a small number of projects. High dependence on the service sector was most noticeable during the current pandemic.

In the last five years, ¼ GDP on average has been generated from the export of tourist services, and 75% of GVA in service activities has been generated by tourism, trade, and construction. At the same time, activities with a higher technological base accounted for a mere 11% of GDP. Such a high concentration of GDP in a limited number of sectors indicates inflexibility of the economy and its significant exposure to sector-specific shocks, whether internal or external (such as foreign trade or transport disruptions during the COVID-19 pandemic in 2020). In addition, Montenegro's economy is highly exposed to boom-bust cycles, which particularly affect labour-intensive activities such as the service industry, which dominates the Montenegrin economic structure. In addition, boom-bust cycles are inherent to the current model of economic growth based on large FDI in a limited number of sectors. This is evidenced by the movement of growth rates of Montenegrin GDP in some years in the last two decades, with a sharp jump in growth in the years of large FDI in tourism or transport projects and low growth in the years of their absence.

**Demographic risks** - The socioeconomic development of Montenegro is accompanied by the demographic transition of the society. Significant aging of the population will cause a significant change in terms of the number and age structure of the population, so it is to be expected that the values of the median age index, the aging index, and the dependence index will increase.<sup>1</sup> Montenegro already has a negative rate of natural increase because the mortality rate (11.7 ‰) is higher than the birth rate (11.4 ‰). Apart from the above, a simple replacement of the population

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<sup>1</sup> Due to the increase in the number of elderly people, government expenditure will increase due to the need to service pension and health care obligations that will be exposed to high burdens.

has not been achieved since the late 1980s, as the number of children is less than 2.1 per female, which is necessary to maintain the population at the same level.

All this can lead to a shortage of labour<sup>2</sup> (in the long run) and the risk of inefficient handling of that issue.

**Uneven regional development** - According to the Law on Regional Development, Montenegro is divided into three regions, but there is a pronounced discrepancy in regional development of the country. The Northern region lags significantly behind although, paradoxically, most natural resources are concentrated in it. This region, compared to the other two regions (Central and Coastal region) is characterized by high unemployment, outflow of population, underdeveloped infrastructure, low income, low population density, low utilization of natural resources, low living standard, underdeveloped industry, insufficient quality of the labour force, and the like.

**Supply chain risk** - Existing supply chain structures have been optimized for operating costs that had not included new health requirements, restrictions on the movement of people and goods, as well as health risk insurance. With the emergence of new business factors, due to the pandemic, a number of companies have not been able to deal with the growing number of unplanned barriers efficiently. For this reason, the new business conditions have led to the interruption and shortening of supply chains for a number of national companies, especially those that are import-dependent which, in addition to the created restrictions on the demand side, induced an additional shock on the aggregate supply side. To build resilient supply chains, companies have focused on responding adequately to this challenge, which has impacted business cost growth through rising prices of durable and consumer goods, especially for import-dependent countries. Cost increase in prices has led to an increase in business risks created by this phenomenon.

**Statistics challenges and data quality** - Problems in the field of production, publication and dissemination of statistics have been present for a long time. Accurate and reliable information requires improving the quality of statistics, primarily the sources of statistics, in order to influence information symmetry, the effectiveness and efficiency of decision-making. Quality statistics are crucial for making quality decisions at the micro and macro levels.

The risks that Montenegro faces in this area are:

- Incomparable and non-uniform methodology of data collection, sectorisation and disclosure, and, in that sense, the existence of insufficiently reliable and untimely data.
- Non-compliance with the European System of National Accounts - ESA2010, with special emphasis on government finance statistics. The importance of implementation of the ESA2010 methodology stems from the fact that it is one of the criteria for the temporary closure of negotiations with the EU for the negotiating chapters 17 - Economic and Monetary Union and 18 – Statistics.

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<sup>2</sup> Labour force deficit is also prominent now in some labour market segments such as tourism.

Other present challenges are:

- Non-disclosure of all data necessary for decision making;
- Decentralization of existing registers, which leads to inadequate availability, use and differences in data;
- Public unavailability of the key registry of institutional units;
- Insufficient coverage and timeliness of the Central Register of Business Entities, and
- Unsatisfactory administrative capacity of official producers of statistics.

#### **4. Risks in the banking sector**

**NPL increase** - In the economy where a number of legal entities are still facing the consequences of the COVID-19 pandemic, accumulated high levels of unemployment, and a potential growth of variable interest rates, there is also a risk of NPL growth in the coming period. Also, it should be taken into consideration that certain temporary measures introduced by the Central Bank of Montenegro (CBCG) to alleviate the impact of the pandemic on the economy and citizens will expire at the end of the current year. Currently, loan amounts under moratorium or restructuring programs are not negligible, but they are not at the level that could bring banks into a credit risk crisis (about 7% of the banks' portfolios). Also, the announced fiscal measures by the Ministry of Finance and Social Welfare (MFSW) will represent a significant financial incentive to those categories of the population in lower pay grades.

**Excessive credit growth** - The risk of excessive credit growth is present, but it remains low with a decreasing intensity of impact. Namely, due to the growth of deposits and rather prudent credit policy of banks in Montenegro, the risk of excessive credit growth is relatively small at the moment, but it should not be completely ruled out. If we look at the deviation of the credit and GDP ratios in relation to the long-term trend of that ratio (credit-to-gdp gap), it can be seen that the ratio is currently slightly above its long-term trend. However, the growth of this ratio was not predominantly influenced by credit growth, but rather by a fall in GDP due to the COVID-19 pandemic. Even in the pre-pandemic years, there was no excessive general credit growth in Montenegro, but only certain episodes in certain segments such as cash retail loans which, due to their poor security, led to the accumulation of endogenously generated risks. The Central Bank has mitigated this risk with previously adopted macroprudential measures.

**Exposure of banks to the state** - The risk of banks' exposure to the state is present, but it is low with a downward direction and intensity of influence. Namely, over the years prior to the pandemic, this exposure continuously grew, reaching the level of 15%-16% of banks' assets on the eve of the COVID-19 pandemic. This was due to the favourable return-risk ratio in relation to other investment opportunities of banks, as well as the application of zero risk weight in accordance with the Basel principles. The aforementioned level of exposure was above the average recorded in the region. However, that vulnerability decreased during the pandemic as the exposure dropped by a few percentage points, in the context of the issuance of government Eurobonds in December 2020 (which were mostly bought by foreign financial institutions) in parallel with the Government's exit from the domestic treasury bills market.

**Increase of variable interest rates** - Interest rate risk is present and it is at a moderate level with a growing direction and of moderate intensity. The European Central Bank (ECB) had been pursuing a non-standard monetary policy for many years, first in response to the Global financial crisis and, recently, the COVID-19 pandemic. However, the normalisation of the ECB policy in the medium-term is expected with the obvious rise in prices in the euro area and a gradual recovery. The growth of rates on the euro market will have an impact on the growth of variable interest rates on the Montenegrin market.<sup>3</sup> This can affect the credit risk of debtors who had agreed on a variable interest rate<sup>4</sup>, and can also negatively affect investments and growth of government borrowing costs.

Also, the impact of the growth of euro rates is potentially present in the eventual issuance of government bonds on the international market. It is clear that if the euro rates move into the positive zone, the rates for Montenegrin borrowing will also increase. However, it should be noted that Montenegro is currently more present in the capital market than it was ten years ago, so the yields are in a more stable relationship with the usual market parameters. The latest bond issues had a spread compared to the benchmark German Government 10Y bond of around 300bp, while ten years ago these spreads had gone up to 650bp.

## 5. Fiscal risks

**Budget deficit** - After the pandemic outbreak in the spring of 2020, all countries in the world faced a significant drop in budget revenues, primarily due to the drastic decline in economic activity and the complete closure of certain activities. That was also the case with Montenegro. On the other hand, the implementation of sets of socioeconomic measures to address the impact of the COVID-19 pandemic has led to a significant increase in budget expenditures, so the deficit amounted to a record 10.2% of GDP at the end of 2020. Thus, this was the twelfth consecutive year of a budget deficit, with the average from 2009 to 2020 amounting to 5.3% of GDP.

The 2021 Law on the Budget of Montenegro envisages a budget deficit for this year in the amount of 175.3 million euros or 3.8% of the estimated GDP. Given that the deficit during the first eight months of 2021 amounted to 57.4 million euros or 1.2% of GDP, there is a good chance that the deficit will be lower than planned. Also, considering the projections for 2022, it can be concluded that the risk of budget deficit will still be present in the short-term, but that it will be of a moderate level and declining. It should be taken into account that risks that could arise from the operation of public companies (financial and operating) may increase the deficit level.

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<sup>3</sup> We believe that the question at this point is not whether there will be an increase in reference interest rates, but when there will rise.

<sup>4</sup> As at 30/09/2021, of the total approved bank loans, 71.5% were contracted at a flat rate and 28.5% at a variable interest rate. Of the total retail loans granted, 80% were contracted at a flat rate and about 20% at a variable interest rate. Of the total approved loans for the purchase of apartments and renovation, 59% were contracted at a flat rate and 41% at a variable interest rate. When it comes to wholesale banking loans, 64% were contracted at a flat rate and 36% at a variable interest rate.

**Public debt** - The high amount of deficit at the end of 2020 entailed the need for additional borrowing, which, together with a significant decline in GDP, led to an increase in gross public debt to the level of 4.4 billion euros or 105.3% of GDP, while the government debt amounted to 103.5% of GDP. High level of public debt is the key systemic risk in Montenegro. It is also one of the most important reasons for deterioration of the country's credit rating, which may increase the price of government borrowing in the medium term.

The estimated GDP growth will affect the reduction of the public debt's share in GDP in 2021. Also, the completion of the largest infrastructure project in the country, the highway construction, will lead to a gradual decline in the public debt. At the end of June 2021, the government debt amounted to 4,079.2 million euros or 88% of GDP, of which the external debt amounted to 3,652.6 million euros or 78.8% of GDP, while the domestic debt amounted to 426.6 million euros or 9.2% of GDP. Public debt risk remains the most significant high-level systemic risk, albeit being on a downtrend.

**“Marshall Plan – Europe Now“** - The "Marshall Plan - Europe Now" program announced by the MFSW envisages an increase in the minimum wage from 1 January 1 2022 from 250 euros to 450 euros, the abolition of health insurance contributions, the introduction of a non-taxable part of wages up to 700 euros of gross wage, as well as a progressive taxation of earnings and profits of legal entities, increase in the dividend tax rate, introduction of a special tax on cash withdrawals for legal entities, adoption of a new Law on Games of Chance, as well as the introduction of excise duties on products harmful to health (ice cream and sugar and cocoa products).

Positive aspects of this program are the improvement of the economic position of the poorer categories of the population, the reduction of the total tax burden on wages (which is too high), and the suppression of the informal economy.

However, the announced program brings with it a lot of doubts and ambiguities. The increase in the minimum wage, which would cover employees with the lowest education degree, i.e. the lowest coefficient for wage calculation, carries a certain fiscal risk because it raises the issue of adjusting the coefficients between employees with lower and higher education and, consequently, the budget burden given the large number of employees in the public sector (almost 40% of the total number of employees).

Furthermore, the idea of the program is to make some form of redistribution of labour costs paid by employer in such a way that employers would be released from a part of the obligations to the state (health insurance contributions and non-taxable part of wages) and in turn they would waive payment of wages “on hand” and report all employees properly, which would reduce the informal economy. However, a possible undesirable scenario of this tax reform could be a reduction in the number of employees or further tax evasion, despite the expected reduction of the informal economy. Also, the abolition of health insurance contributions, which make up 70% -75% of the total receipts of the Health Insurance Fund, will make the financing of the Fund highly dependent on the budget.

Before the implementation of this program, it is necessary to analyse in detail the revenue side of the budget of Montenegro, i.e. to determine whether the planned progressive taxation of wages, the

introduction of additional excise duties, and the suppression of the informal economy would offset the planned costs. It should be borne in mind that a progressive taxation of wages (if progressive rates are high) and an increase in corporate taxation may adversely affect the investment environment, and that increasing excise duties may lead to growth of the informal economy and even a reduction in public revenues, as this has happened in the past. Also, the growth of average salaries will condition the growth of pensions from 2023, which could further increase the budget deficit. It should be borne in mind that a significant increase in average wages can have a negative impact on the country's competitiveness and the attractiveness of the business environment for foreign direct investment if not accompanied by reciprocal growth in labour productivity.

## **6. Growing inflationary pressures**

The annual inflation rate stood at 2.9% in September 2021, while the average annual inflation for the nine months of this year was 1.8%. The Central Bank's model projection indicates that inflation will range between 2.4% and 3.8% at the end of this year, with the central projection at 3.1%, while the expert assessment indicates that inflation will range from 2% to 4%. Having in mind the euroisation of the Montenegrin economy, the growth of inflation in the country is determined by external factors. Namely, the sharp jump in demand which followed the easing of the coronavirus containment measures, combined with the expansionary policy of central banks and financial assistance provided by countries around the world, has led to a sharp rise in prices globally. Also, the growth energy, metals, and food prices on the international markets significantly contributed to the global growth of prices.

Projections and reactions of key central banks and international financial institutions indicate that the growth of inflation is temporary, i.e. that the market itself will play the role of a regulatory mechanism, and that inflation will soon return to the target framework. The expectations of international institutions indicate that inflation should slow down as we approach the middle of the next year, meaning with the disappearance of the base effect of strong price growth.

The CBCG believes that the risks to the realisation of these projections are still very pronounced. Namely, the continued stagnation in supply chains, with the consequent further growth of energy prices and their further pressure on other prices of goods and services, would further contribute to the growth of inflation expectations. Also, multi-year expansive monetary policies that may affect long-term inflation growth should not be neglected.

Should these risks materialize and/or the inflation spiral widens, it is expected that the leading central banks will react by tightening their monetary policies, that is, by raising interest rates and with new open market operations with the aim of reducing excess liquidity. These measures will affect a decline in global inflation, and consequently the inflation trend in Montenegro.

## 7. External risks

**Current account deficit (level and structure)** - The risk that may arise from a high level of deficit (level and structure) is moderate, of stable direction and intensity. Namely, this risk is a consequence of low competitiveness and it is a long-term characteristic of the balance of payments of Montenegro. High current account imbalances over a long run could jeopardize macrofinancial stability. Taking into account that the current account deficit is mostly caused by the imbalance in the goods account, i.e. higher imports than exports of goods, a potential risk for Montenegro in the coming period is low competitiveness of the economy. Trade deficit was partially offset by the surplus on the services account, which was recorded owing to inflows from tourism revenues. However, high import dependence and high sensitivity of tourism to a wide range of impacts can potentially jeopardize liquidity of the national economy. The risk of low competitiveness of the economy and a continuously growing current account deficit affect two risks: insolvency risk (default on accumulated external debt due to falling domestic profitability and reduced investment opportunities) and liquidity risk.

Significant financing of the current account deficit with foreign direct investments, whose inflow has been stable over the past ten years (coverage of the current account deficit by net FDI inflow amounted to 42.9% in 2020), reduces risks. However, in the event of an adverse external shock in the form of a sudden cessation of foreign capital inflows, this risk may change direction and intensity in the short term.

**Private external debt** - The risk that may arise from a high level of private sector's external debt is moderate, but has an upward trend and a stable impact intensity. The analysis of the movement of the private external debt of Montenegro in the period 2010 - 2020 shows a very pronounced uptrend. Montenegro's private external debt is high and can be expected to increase further, thus making the country vulnerable, while the export base remains low and the structural current account deficit is on the rise. The stock of private external debt has increased in the past decade from 3.5 billion euros in 2010 to 5.5 billion euros in 2020. During this period, intercompany loans increased the most (from 841.4 million euros to 2.1 billion euros), which is a result of the growing number of foreign direct investments in the form of intercompany loans. If we look at the currency structure of the external debt of the private sector, we can see that it is overwhelmingly in euros (90%), so the currency risk is small. The structure of private external debt in terms of maturity is favourable, as over 90% of the debt is long-term (excluding deposits).

### CENTRAL BANK OF MONTENEGRO COUNCIL

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Podgorica, 10 November 2021

**CHAIRMAN  
GOVERNOR,**

Radoje Žugić