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1. INTRODUCTION

With a view to following contemporary trends in monetary policy, the Central Bank of Montenegro initiated the publication "Inflation Report" in mid-2005. The number of central banks that publish this report is constantly increasing. Many European central banks and those implementing the inflation targeting policy publish this kind of report.

Even though this type of reporting varies by country, it still contains certain standard components. Unfortunately, Montenegrin statistics is still in their infancy and cannot provide any significant information for this kind of reporting, especially about personal consumption, investment consumption, certain supply aspects, sector growth rates etc.

For the purpose of inflation monitoring, the CBM has developed an econometric model, the Arima model, which results are shown in a fan chart form. The model applied to historical data had a high reliability level. However, taking into account the unreliability of numerous statistical data, frequent one-off shocks, as well as a relatively short time series, we have extended the econometrical model with an expert assessment method.

The information in this report is based on the official data on inflation movements provided by Monstat. It is obvious that Monstat has made a mistake in calculating the movement of electricity prices. However, what is surprising is their complete lack of interest to correct this mistake. It could generate a number of consequences: a miscalculation of the inflation rate, an underestimation of the real GDP, a miscalculation of real salaries (with possible pressures for their increase), a poor base for the 2008 budget planning, and the like.

2. INFLATION INDICATORS[1]

According to Monstat data, the cost of living recorded a slower growth (0.4%) in the second quarter of 2007 when compared to the previous quarter (0.6%). However, monthly price growth of 1.7% was recorded in July, which resulted in the inflation rate of 2.8% in comparison with the previous year-end, i.e. 4.3% in the last twelve months.

During the period April-July 2007, prices rose by 2.1%. The main influence on this growth had the higher electricity prices, as well as the higher prices of liquid fuels and lubricants, while the movement of food prices reduced overall inflation.

According to Monstat, the electricity prices in July, and consequently in the entire period of April – July, grew by 30.9%. Thus, of the 2.1% inflation in July, 1.9 percentage points or 88.5% fell under electric power price growth.

Graph 1 – Cost of living, monthly growth rate

Source: Monstat

Table 1 – Inflation

	2006				2007		
	Q1	Q2	Q3	Q4	Q1	Q2	July
Change in relation to the previous year-end	0.8%	2.3%	1.7%	2.8%	0.6%	1.1%	2.8%
Annual change	2.8%	3.1%	2.7%	2.8%	2.4%	1.6%	4.3%
Quarterly change	0.8%	1.5%	-0.5%	1.0%	0.6%	0.4%	VII / VI: 1.7%

Source: Monstat

[1] *The inflation rates in July 2007 are overestimated due to Monstat`s methodological mistake in calculating electricity prices.*

Food prices fell by 0.5% in the period April – July, accounting for -11.8% of inflation. Observed per sub-groups, the main influence on inflation movement had the prices of fresh and processed vegetables -25.5% (growth rate being -8.6%), fresh and processed fruit 16.3% (growth rate being 7.2%) and fresh eggs -7% (growth rate being -10.3%). Within the fresh and processed vegetables group, the prices of tomatoes and peppers had the main effect on a decrease in the prices of the observed group. Their respective seasonal drop amounted to 44.1% and 33.7%, accounting for -10.9% and -9.6% of total inflation, respectively. When it comes to an increase in the prices of fresh and processed fruit, it is primarily due to an increase in the prices of apples of 23.5%, which contributed 10% to total inflation.

During the period April – July 2007, the striking oil price fluctuations in the world markets continued, and a continuous growth has been recorded as of January. During April, oil prices rose by 8.4%, resulting in the price of the OPEC reference basket of USD 63.4/barrel. The reason for oil price growth was primarily due to the concern regarding insufficient supply during the summer months and potential obstacles to oil delivery owing to current geopolitical turmoil. In April, Brent crude oil price was USD 67.5/barrel, on average. In May, the OPEC reference basket price was at somewhat higher level (1.5%) when compared to April, while in the same comparative period the Brent oil price slightly fell (0.2%). During May, the oil price pressure was exerted by oil refineries` breakdown and increased demand due to the holiday season, while large crude oil supplies had a reverse effect. During June, the pressure on prices was due to concern for petrol supply, geopolitical situation and refineries` breakdowns. However, the large crude oil supplies had the stabilizing effect. The price of the OPEC reference basket increased by 3.7% in June in comparison to May, amounting to USD 66.8/barrel. In June, Brent crude oil price amounted to USD 71.6/barrel, being 6.2% higher than in May. The prices recorded a new peak in July. The OPEC reference basket was USD 71.75/barrel and Brent crude oil was USD 77.01/barrel. The pressure on oil prices growth in July was made by the interrupted supply from the Western African region, relying on crude oil supplies in the USA, positive expectations regarding the US economy, as well as negative expectations regarding oil offer from the countries which are not the OPEC members.

Under the global market influence, liquid fuels and lubricant prices in Montenegro recorded a growth of 8.9% during the period April – July 2007, resulting in their share in total inflation of 16.9%.

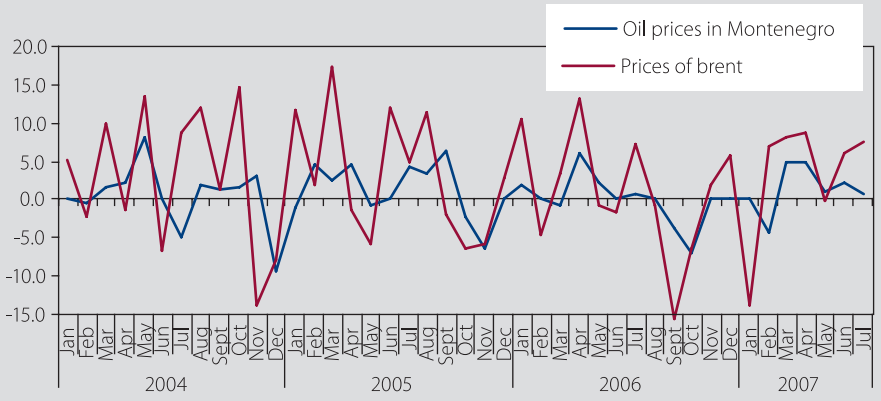
The prices of services recorded a growth of 1.4% during the period April – July and were determined by increases in the prices of public utility and housing services, transportation and postal services, services related to vehicle maintenance, as well as educational services. These price increases contributed 0.14 percentage points to inflation, while their share in inflation was 6.7%.

Table 2 – Share of price movements of certain products in total inflation

	weight	VII '07/III '07.	Growth rate	Contributions	Share in total inflation
TOTAL	10,000	102.11	2.11	2.11	100.00
Food	5,046	99.50	-0.50	-0.25	-11.84
Tobacco and beverages	694	100.28	0.28	0.02	0.92
Clothing and footwear	845	100.27	0.27	0.02	1.08
Housing	1,259	115.52	15.52	1.95	92.45
Electricity	605	130.92	30.92	1.87	88.51
Personal hygiene and health care	712	99.99	-0.01	0.00	-0.03
Education, culture	460	100.12	0.12	0.01	0.26
Transportation and postal services	984	103.99	3.99	0.39	18.58
Liquid fuels and lubricants	400	108.91	8.91	0.36	16.87
Goods	8,994	102.19	2.19	1.97	93.31
Services	1,006	101.41	1.41	0.14	6.69

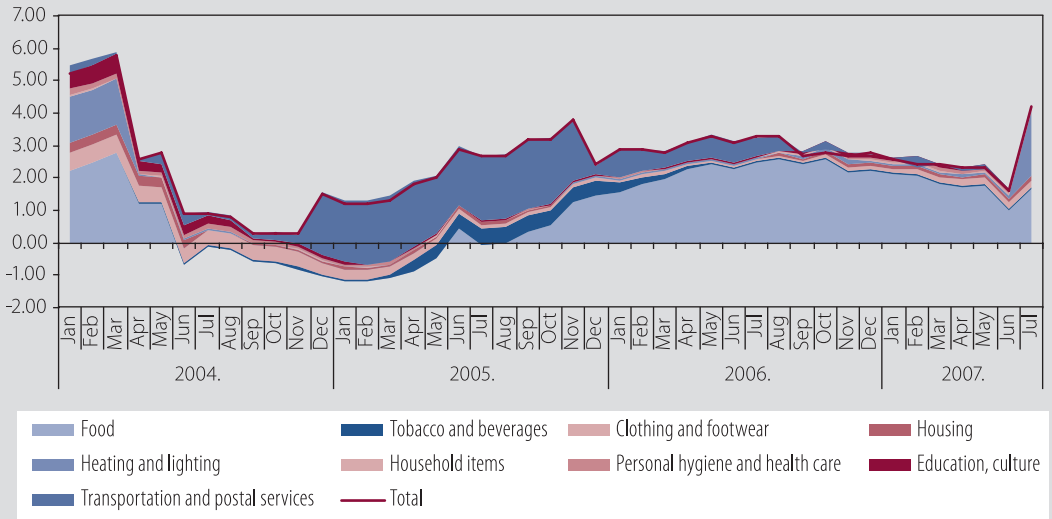
Source: Monstat and the CBM calculations

Graph 2 – Oil prices, monthly growth rate



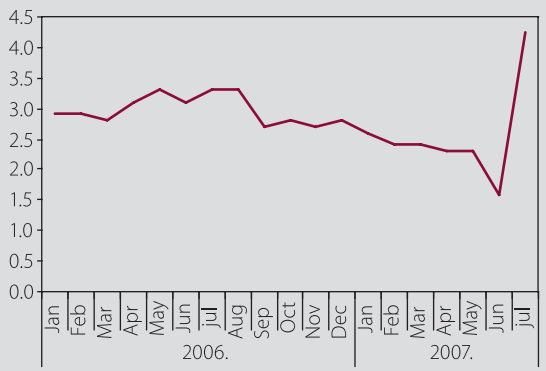
Source: Monstat and "Monthly Oil Market Reports", OPEC

Graph 3 – Cost of living index components: Contribution to annual growth rate (index points)



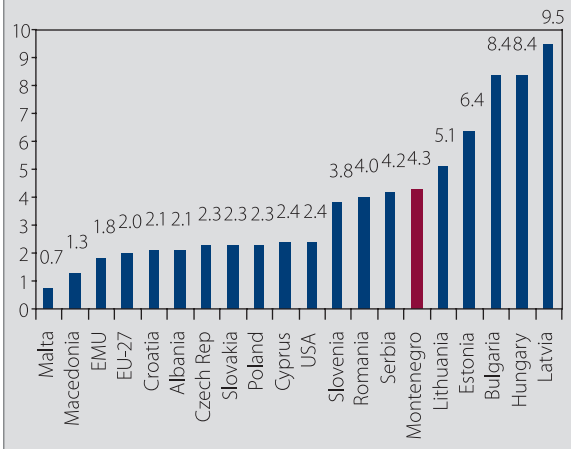
Until July, the cost of living annual growth rate gradually decreased, declining from 2.6% in January 2007 to 2.4% and 1.6% in March and June, respectively. The reason for the decrease is a slower price growth of food products, i.e. a somewhat higher comparison base. Namely, the introduction of VAT on certain food products at the beginning of 2006 made the comparison base high, which resulted in a decrease in the overall annual index. In addition, the prices of agricultural product increased at a slower pace, i.e. the recorded drop in vegetable prices of 10.6% in June affected a decrease in the annual growth rate. However, the recorded electricity price growth in July had such a huge influence that the annual inflation rate in that month reached 4.3%.

Graph 4 – Cost of living, annual growth rate



Source: Monstat

Graph 6 – Annual inflation in selected countries, July 2007



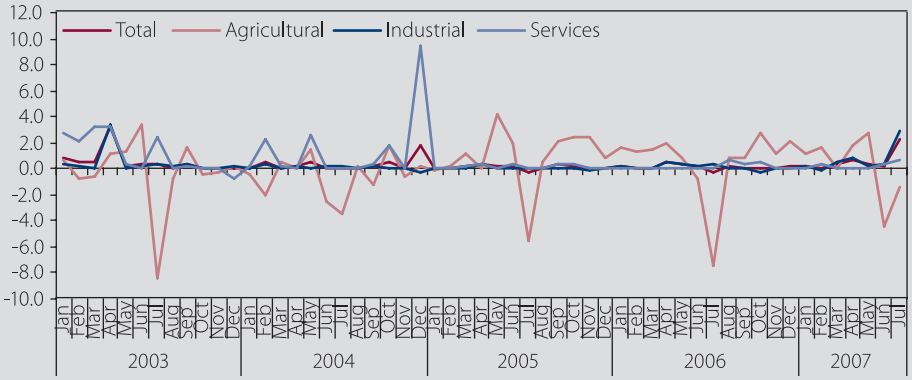
Source: National Statistical Offices and the ECB

Retail prices increased by 3.5% during the period April – July 2007 due to a growth in industrial products prices of 4.4% (primarily electricity prices) and an increase in the services prices of 1.2%, while the agricultural products prices were 1.4% lower. The annual growth rate of retail prices was 4.7% in July.

Producers` prices of manufactured products increased by 1.7% during the second quarter of 2007. Compared to end- and June 2006, this growth amounted to 5.8% and 6.6%, respectively.

The comparison of inflation (the annual inflation rate in July) in Montenegro with the recorded inflation in the South-East European countries and the new EU member states shows that Montenegro is located in the upper part of the scale, while among the observed EU countries, Lithuania, Estonia, Bulgaria, Hungary and Latvia had higher inflation rates than Montenegro.

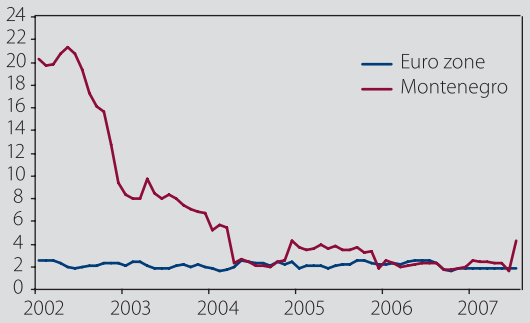
Graph 5 – Retail prices, monthly growth rate



Source: Monstat

In addition, the annual inflation rate in Montenegro in July was above that recorded in the Euro zone, measured by the harmonized consumer price index (HCPI). In the Euro zone, annual price growth of 1.8% was recorded in July.

Graph 7 – Inflation in the Euro zone and Montenegro since the introduction of EUR (annual change)



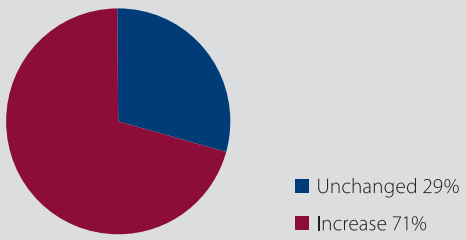
Source: Monstat and the European Central Bank

3. INFLATION FORECASTS

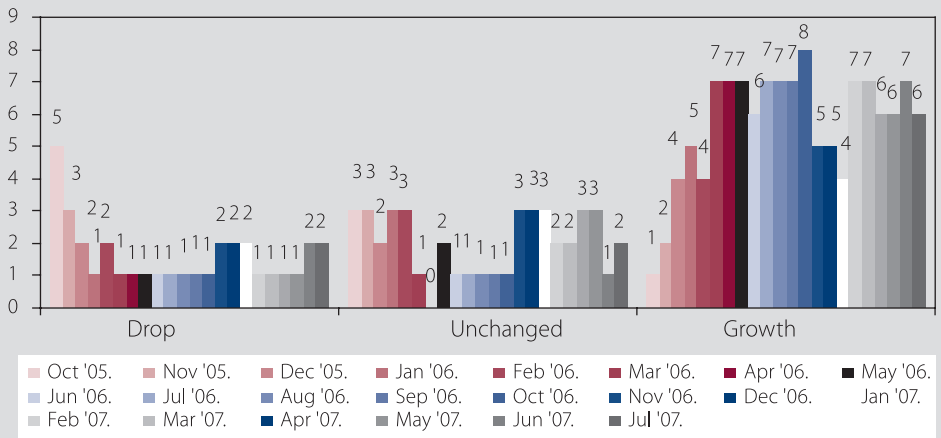
In July 2007, inflation forecasts of commercial banks` managers were at somewhat lower level when compared to the first quarter of 2007. Namely, two banks expected a drop in July, i.e. the unchanged level of inflation in relation to the previous year, and six banks expected inflation growth. (Graph 8)

When it comes to forecasts by companies listed on the stock exchange, none of the surveyed companies forecasted a lower inflation rate in June 2007, 29% forecasted the same inflation rate level, while 71% forecasted inflation higher than that in 2006 (Graph 9).

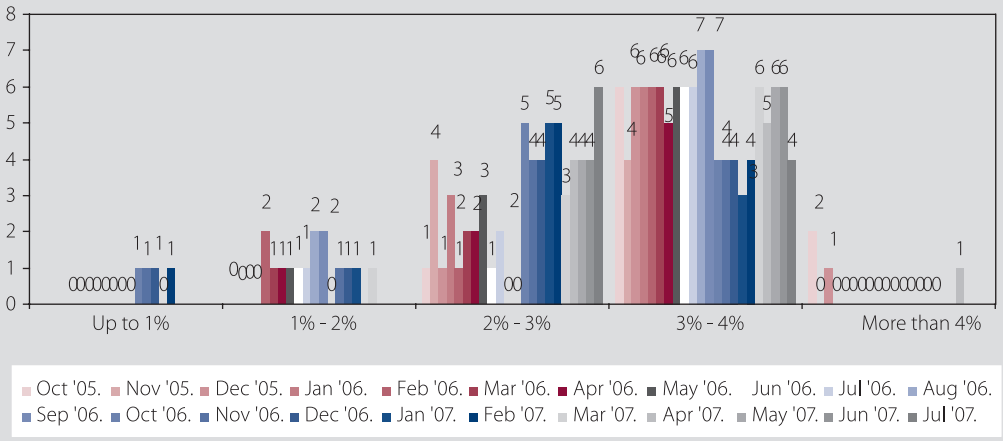
Graph 9 – Inflation forecast (sample of enterprises listed at the stock exchange)



Graph 8 – Inflation forecasts (banks)



Graph 10 – Forecasted inflation rate level (banks)

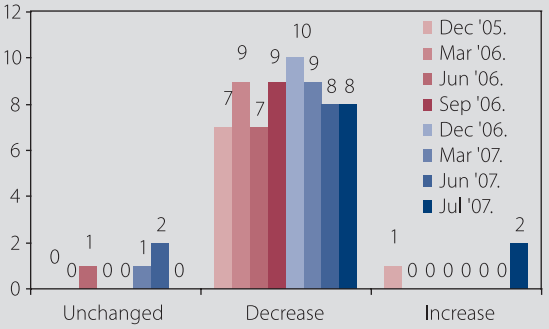


As for the inflation rate level, six banks forecasted the inflation rate to be between 2% and 3% while four banks forecasted the inflation rate to be between 3% and 4%. (Graph 10)

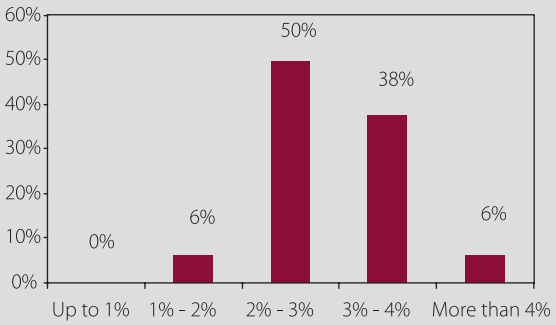
Most of the companies forecasted the inflation rate to range between 2% and 3% (Graph 11). If both subject groups were observed, then the forecasted inflation rate in 2007 would most probably be between 2% and 4%. The inflation rate within this span is forecasted by 100% of the surveyed banks and 88% of surveyed enterprises.

As for the nominal interest rate movements, eight banks expected it to be on a downtrend and two banks envisaged an increase in nominal interest rates (Graph 12). Besides, eight banks expected a decrease, and two banks expected an increase, in effective interest rates (Graph 13).

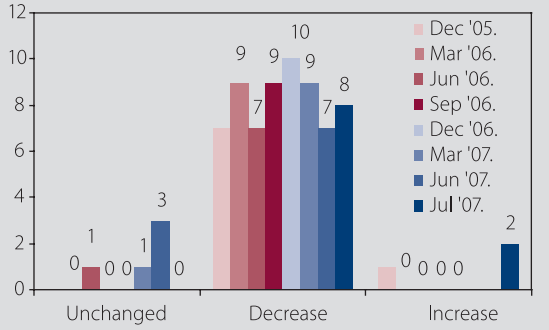
Graph 12 – Nominal interest rate movement forecasts



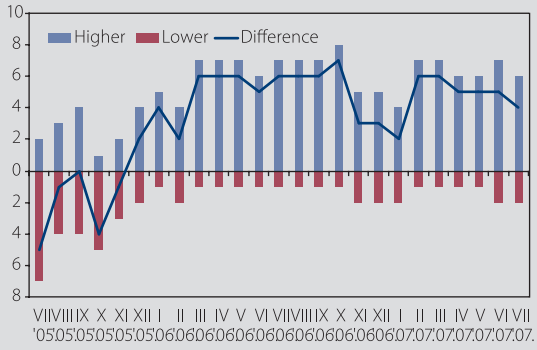
Graph 11 – Forecasted inflation level (sample of enterprises listed at the stock exchange)



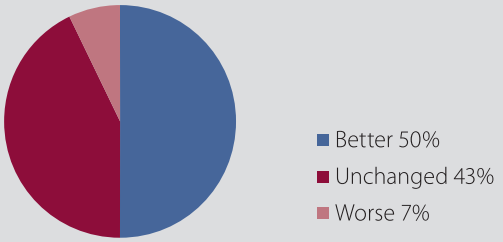
Graph 13 – Effective interest rate movement forecasts



Graph 14 – Market indicator

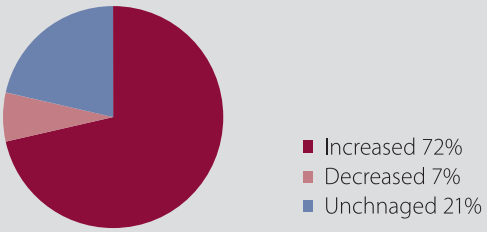


Graph 15 – Forecasted business environment for 2007



For the purpose of calculating inflation forecasts we use market trend indicator (blue line in Graph 14). It is calculated as the difference between the number of banks expecting an inflation increase (blue columns) and the number of banks expecting an inflation decrease (red columns). If the market trend indicator has a negative value, a decrease in the inflation rate is expected in the upcoming period. If it has a positive value, then an increase in the inflation rate can be expected. If it has a zero value, then an unchanged inflation rate can be expected in the upcoming period. The more negative value, the lower inflation forecast, and vice versa. The graph clearly shows that the inflation forecasts were significantly higher in the period February – July 2007 than at end-2006 and January 2007, and that they were at somewhat lower level than during most of 2006.

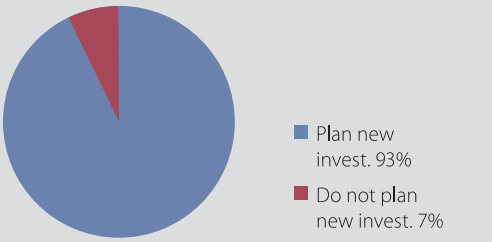
Graph 16 –Forecasted level of production volume (providing services) for 2007



The company survey results show that most of the surveyed companies expect an improved (50%), i.e. an unchanged (43%), business environment in the forthcoming period, while only 7% of the surveyed enterprises expect an aggravation of the business environment (Graph 15).

As for the forecasted output volume, 7% of the surveyed companies plan to reduce their activity, 72% expect that the production volume (service provision) will increase, and 21% believe that the production volume will remain unchanged in the upcoming period (Graph 16).

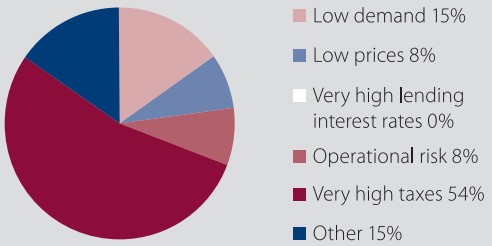
Graph 17 – Forecasted new investments for 2007



Most of the surveyed companies, 93%, also plan new investments. (Graph 17).

Most of the respondents see very high taxes (54%) and low demand (15%) as the main obstacles to increasing their activity, including low prices (8%) and operational risk (8%). (Graph 18)

Graph 18 – Obstacles to activity volume increase



4. INFLATION DETERMINANTS

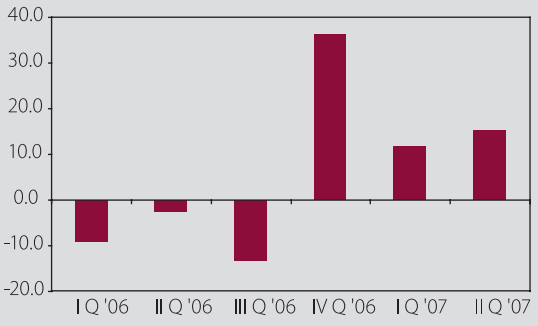
4.1 DEMAND

The aggregate demand level and growth rate were higher in the second quarter of 2007 in relation to those recorded in the previous quarter.

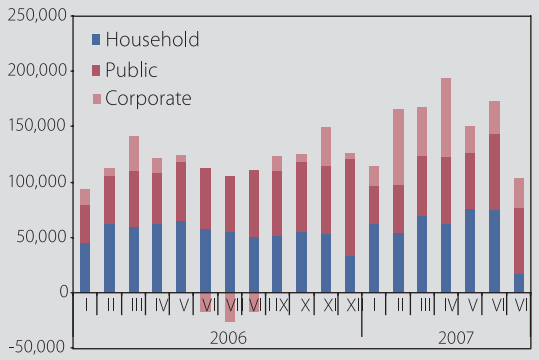
Observed by sectors, an increase was recorded in public consumption and household, while the corporate sector demand was reduced in relation to the previous quarter.

Month-on-month, the highest level of aggregate demand in the first seven months of 2007 was recorded in April, due to an increase in corporate indebtedness in the said month and the public consumption growth. The lowest level of demand was recorded in July because all sectors reduced their demand in comparison with the previous month, especially the household sector whose demand was lower due to a high increase in deposits.

Graph 19 – Quarterly aggregate demand growth rates



Graph 20 – Aggregate demand (EUR thousand)



Box 1 – Aggregate demand calculation methodology

For the purpose of an in-depth monitoring of aggregate demand as the inflation determinant, the CBM has developed the aggregate demand calculation methodology. The starting point of this methodology is that the aggregate demand is the total demand by three sectors: personal consumption (household), investment consumption (corporate sector) and public consumption. However, taking into account the lack of numerous data necessary for calculating the aggregate demand, the existing data on

aggregate demand should not be treated as the indicator of the exact amount of aggregate demand, but as an indicator showing in which direction the demand is going in. In the existing methodology, a number of significant data is not available, such as corporate investments, revenues from selling shares, nonmarket income, shadow economy revenues, and the like. The methodology for aggregate demand calculation is shown in the following equation:

$$AD = C + I + G$$

C = sum of paid salaries + sum of paid pensions + paid frozen foreign currency deposits + net compensations to households – net savings by households (savings – loans granted)
I = net savings of economy (deposits – loans)
G = public consumption – paid pensions – salaries paid from the budget – net savings by the Government (deposits – loans – Treasury bills)
AD – aggregate demand, C – personal consumption, I – investment consumption, G – public consumption

4.1.1. Salaries and other Available Demand Determinants

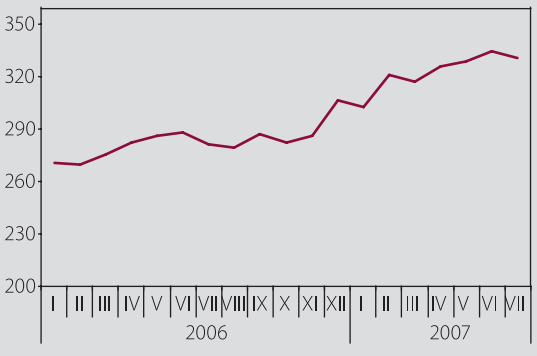
The growth in average salaries from the first quarter continued during the second quarter this year as well.

The average salary in Montenegro in the second quarter this year amounted to EUR 485 and the average salary without taxes and contributions was EUR 330. The latter increased by 5.2% in comparison with the first quarter. Besides the economic activity growth, salaries` growth was due to the increase in the minimum wage from EUR 52 to EUR 53 in the second quarter. In July, the average salary without taxes and contributions amounted to EUR 331 and was 1.2% lower than in the previous month.

If we take into account the cost of living, i.e. the movement of salaries in real amounts, then salaries recorded growths in all three months of the second quarter. Real salaries recorded a decrease in July.

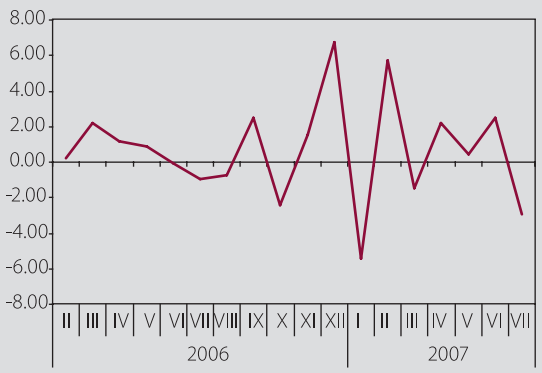
In the second quarter of 2007, an increase in household indebtedness on the grounds of bank loans taken continued, therefore, at the end of the second quarter, the level of loans was 74% and 31.8% higher than at end-2006 and the first quarter of 2007, respectively. The increase continued in July as well, resulting in 85.7% more loans disbursed to households at the month-end than at end-2006, while the annual growth rate was 200%.

Graph 21 – Average salaries without taxes and contributions



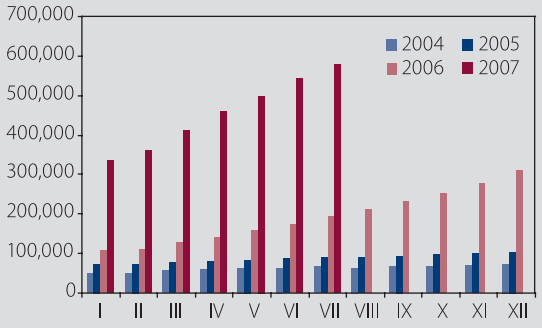
Source: Monstat

Graph 22 – Real salaries (monthly growth rate)



Source: Monstat

Graph 23 – Loans granted to private citizens, EUR thousand



Households owed banks EUR 541.4 million worth of loans at the end of the second quarter, i.e. EUR 577.9 million at end-July this year.

Besides banks` loan claims on households, this sector's debt with micro-credit financial institutions also increased, reaching the amount of EUR 43.1 million at end-July 2007.

Households` deposits also increased during the first seven months of this year, amounting to EUR 864.2 million at end-July (EUR 766.8 million in the previous month). The household sector thus continues to be the net depositor in the system, while the loan/deposit ratio for this sector was 0.67 at end-July (0.71 in June). Household net savings in banks were EUR 286.3 million at end-July and it was EUR 60.7 million higher in relation to the previous month.

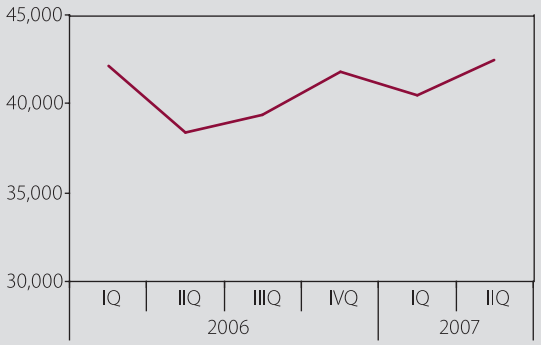
Another source for financing household consumption is the **inflow of foreign funds**.

The balance of payment statistics shows that the inflow of foreign funds to private citizens in the second quarter of 2007 was 4.9% higher than in the previous quarter. This inflow includes compensations to employees, pensions, remittances, and other transfers.

4.1.2. Budgetary Analysis

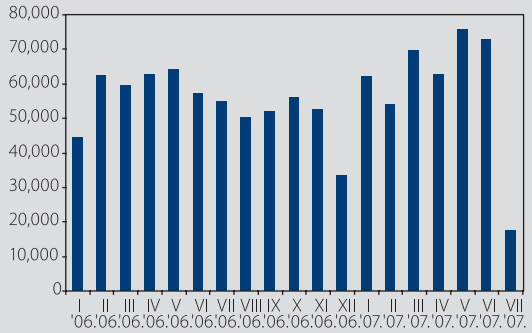
According to preliminary data of the Ministry of Finance, total budgetary revenues in the first seven months 2007 amounted to EUR 415.5 million and were 22% higher than planned for the same period. In relation to the comparative period of 2006, revenues increased by 39.3%.

Graph 24 – Inflow of foreign funds to private citizens (EUR thousand)



Source: CBM

Graph 25 – Demand of private citizens (EUR thousand)



In the structure of budgetary revenues, current revenues recorded dynamic growth (including revenues from loan repayment) amounted to EUR 410 million or 98.7% of total revenues. In comparison with the same period of the previous year, current revenues increased by 39%, as a result of a better collection of taxes, fees, compensations and other republic revenues. Revenues from the sale of property (financial and non-financial) amounted to EUR 5 million, or 1.2% of total revenues, which is 26% less than planned, yet 69% more in relation to the comparative period of 2006. The revenues from the repayment of loans taken by public companies, individuals and other institutions amounted to EUR 2.2 million, being 33% and 6.8% lower in relation to the plan and the same period of the previous year, respectively. In the first seven months of 2007, revenues from donations were insignificant and amounted to

EUR 8 thousand (2.4% of the plan), being 59% lower in relation to the same period of the previous year. The government borrowed only EUR 0.5 million or 5.4% of the plan in the period January-July. In relation to the previous year, borrowings and loans were 38% lower, which points to a declining trend.

In the period January-July 2007, current budget revenues arising from taxes increased mainly due to a better collection of all taxes, amounting to EUR 373.1 million or 91% of source budgetary revenues, and in comparison with the previous year these revenues were 39.5% higher. Revenues from fees (administrative, court, registration, residence and other fees) increased in relation to the same period of the previous year by 41%, but being 7% lower than planned.

According to preliminary data of the Ministry of Finance, in the first seven months of 2007, total expenditures of the budget amounted to EUR 341 million and were 18% lower than the revenues. The expenditures were 8.4% lower than planned, but 12% higher in relation to the comparative period of 2006.

In the structure of total budgetary expenditures, the main share, 51% or EUR 174.1 million, was of the current budgetary expenditures, which is 24% more in relation to the same period of the previous year. Expenditures for transfers to institutions, individuals, the non-governmental and public sectors, and social security amounted to 26.6% of total expenditures or EUR 90.8 million, which is 1.8% more in relation to the comparative period of the previous year. Transfers to social security accounted for the main share, EUR 25.5 million, being 14% higher in relation to the comparative period, while expenditures designated for social insurance were 2% lower and amounted to EUR 65.3 million.

Some EUR 21.1 million or 55.4% more in relation to the previous year was appropriated for capital expenditures, and the main share of these resources went on the public realm infrastructure, construction objects and investment maintenance, while less was spent on equipment and local infrastructure. However, these resources were 55% lower than planned due to inadequately planned monthly dynamics. We should stress that the implementation of the capital budget, from which big capital projects of strategic importance for Montenegro are financed through the Directorate of Public Works and the Directorate of Transport, has started as of 1 January, in accordance with amendments to the Law on Budget. The Government repaid EUR 48 million of public debt, which is 14% of total expenditures and 3.8% more in relation to the same seven-month period of the previous year. Borrowings and loans the Government disbursed were 28% lower in relation to the same period of the previous year and amounted to EUR 3.8 million.

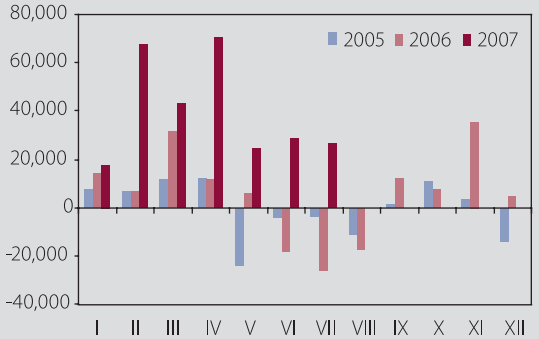
Observing the **surplus/deficit** as the difference between revenues and expenditures, whereby revenues are reduced for borrowings, transfers, donations and revenues from property sale, and expenditures reduced for principal repayment of loans taken in the country and abroad and issuing securities, the (primary) budget of the Republic registered a record surplus of EUR 117 million[2] in the period 1 January – 31 July 2007, instead of the planned EUR 24.5 million of deficit. If we observe the surplus as the difference between revenues and expenditures, then it amounted to EUR 74.5 million.

4.1.3. Corporate Sector

Due to absence of data on investments by the corporate sector, we can use net indebtedness of the corporate sector for demand approximation.

These data show that loans disbursed to the corporate sector were significantly higher than their deposits, so the corporate sector represented the net debtor in the system. What is positive is that the share of long-term loans in total loans disbursed to this sector at end-July amounted to 63%, which means they were used for increasing the volume of economic activity.

Graph 26 – Net indebtedness of the corporate sector, in EUR 000



[2] *Methodology of calculation surplus/deficit "Official Gazette RM", 71/05*

4.1.4. External Demand and the Current Account

According to preliminary data, the current account deficit amounted to EUR 463.7 million or 50.3% of GDP in the first half of 2007, which is 42.8% more than in the same period of 2006. The coverage of the foreign trade deficit by surpluses recorded on other current account sub-accounts amounted to 20.4%, which is 3 percentage points more in relation to the same period of 2006.

Total volume of visible trade in the first two quarters of 2007 was 21.6% higher in relation to the same period of 2006. The recorded visible export/import coverage amounted to 33.1%, which is 8.6 percentage points less than in the comparative period.

The growing volume of services trade on the services sub-account from the previous year continued during the first half of 2007. **Total volume of services trade** amounted to EUR 276.3 million, which is 30.2% more in relation to the same period of 2006. **Revenues from services** amounted to EUR 178.5 million and increased by 65% in relation to the comparative period. The largest revenues were from travelling-tourism, EUR 88.1 million, then transport, EUR 30.3 million, construction services, EUR 27.6 million, and other business services, EUR 19.3 million. An increase in the number of tourists in the reporting period directly influenced an increase in revenues from tourism, and consequently, an increase in revenues from services. **Revenues from services** in the reporting period amounted to EUR 97.9 million and they were 6.3% lower in relation to the first half of 2006. Observing the structure of services, the largest revenues were from transport, EUR 25.1 million, followed by other business services, EUR 19.7 million, and construction services, EUR 18.9 million. In the reporting period, the services sub-account recorded a surplus of EUR 80.6 million. Observed by types of services, the largest surplus was reached in travelling and tourism, EUR 77.1 million, while the highest deficit was recorded in the field of insurance, EUR 5 million.

During the first six months of 2007, factor income revenues amounted to EUR 41.5 million, of which EUR 37.5 million were employees' salaries and EUR 3.9 million were revenues from international investments income. Income revenues in the reporting period amounted to EUR 29.3 million, which resulted in the surplus on this account of EUR 12.1 million.

A surplus of EUR 26 million was registered on the current transfers account in the first half of 2007. Total inflow from current transfers amounted to EUR 48 million, while their outflow was EUR 22 million.

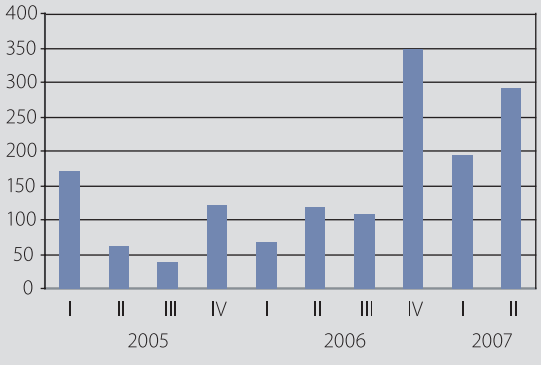
During the first half of 2007, favourable movements in the field of foreign direct investments continued. Net foreign direct investments amounted to EUR 290.3 million, which is 81.5% more than in the same period of 2006. According to available data, the FDI inflow in Montenegro in the period January-June 2007 amounted to EUR 493.8 million.

Observing the inflow structure, an uptrend in investments and business related to real estate from the previous year continued, resulting in real estate investments of EUR 254.9 million or 52% of total FDI inflow, which is 109.5% more in relation to the comparative period. Foreign investments in local companies and banks amounted to EUR 183.9 million or 37% of total FDI inflow, and EUR 54.9 million was in the form of intercompany debt.

The FDI outflow amounted to EUR 203.5 million. As for the outflow structure, EUR 156.4 million related to real estate, while EUR 34.2 million was the withdrawal of a share of foreign capital from local banks and companies. Of total outflow arising from real estate, EUR 136.4 million was the withdrawal of funds from the real estates sale by non-residents, while EUR 20 million related to real estate purchase abroad. Investments of local companies abroad amounted to EUR 12.1 million.

A net inflow of EUR 2.9 million was recorded on the portfolio investments account in the first half of 2007. An inflow of portfolio investments for the six months of 2007 amounted to EUR 76.4 million or 64.5 million more in relation to the comparative period of 2006. At the same time, their outflow amounted to EUR 73.5 million or EUR 65.2 million more.

Graph 27 – Inflow of foreign direct investments by quarters, in EUR 000 000



Source: CBM

An inflow of funds on the Other investments account, which covers loans, commercial loans, cash and deposits, amounted to EUR 442.8 million, being EUR 277.9 million higher in relation to the same period of 2006. Commercial banks and companies borrowed funds to the amount of EUR 442 million, which is 172.5% more in relation to the same period 2006, while their debt reduced by EUR 120.2 million. A net inflow of loans (use and repayment of taken short-term and long-term loans, foreign borrowing and debt repayment) amounted to EUR 295.1 million, which is 129.7% more in relation to the same period of 2006.

4.2. SUPPLY AND PRODUCTION

In the first six months of the current year, a real GDP growth of 6.9% was recorded, with GDP amounting to EUR 922.5 million.

The physical volume of industrial production in the period April-July recorded a fall of 17.4% in relation to the first quarter-end. The fall in industrial production of -10.5% was recorded in April, -2.9% and -4.9% in the following two months, respectively, whereas in July the lagging was only 0.1%.

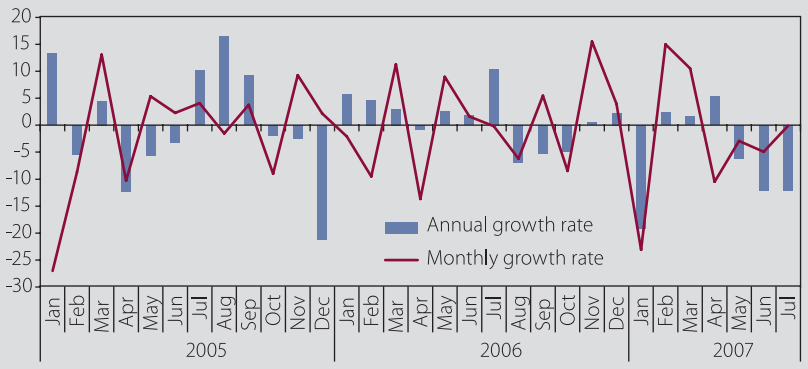
In the period January-July 2007 industrial production was 6% lower in relation to the comparative period of 2006. An increase in industrial production was recorded only in manufacturing industry, while the remaining two industries recorded lower output. Nine branches of manufacturing industry, which accounted for 58.2% of total industrial production, recorded production growths, while the remaining eight branches recorded lower output.

According to Monstat data, the total number of **tourists** who visited Montenegro in the first seven months of the current year amounted to 582 thousand, being 23.7% higher in relation to the same period of the previous year. Only in July, some 320 thousands of tourist arrivals were recorded, which is 17% more than in the same month of the previous year. In the structure of tourist arrivals in the reporting period, 85% were foreign tourists, while the remaining 15% were domestic tourists. In this period, there were 21% more tourists overnights in relation to the same period of the previous year.

Total production of **wood products** in the period January-July 2007 amounted to 99,715 m^3 and was 24.5% lower in relation to the same period of the previous year.

The value of construction work performed in the first two quarters of the current year amounted to EUR 77.7 million, which represents a nominal growth of 1.9% in relation to the same period of the previous year. Observed by quarters, the value of performed construction works in the second quarter this year was 46% higher in relation to the previous quarter, while in relation to the second quarter of 2006 it was 15.5% lower.

Graph 28 – Industrial production, monthly and annual growth rate



Source: Monstat

Monstat data on the volume of **transportation services** in the first seven months of 2007 point to positive trends with some types of transportation. All forms of transportation recorded positive results. Thus, road passenger and goods transport increased by 30.6% and 22.9%, respectively, and air freight and passenger transport rose by 23.4% and 35.9%, respectively.

In railway transport, the respective increases in passenger and cargo transport were 12.7% and 13.6%.

Data on maritime transport point to a 20.5% larger cargo transport in tonne miles, while the turnover in ports is at the last year`s level.

4.3. STOCK EXCHANGE INDICES

The capital market corrections led to a decline in the stock exchange indices in the last couple of months (June and July) after reaching their maximum values in April and May.

The Moste index recorded an absolute growth of 117.8 index points or 6.1% in relation to the previous quarter-end. At the same time, the NEXPIF index rose by 11.083,9 index points or 35.6%, while the NEX20 index recorded a decline of 373.8 index points or 0.9%.

Observed by months, the Moste and the NEXPIF indices recorded increases in April and May (the Moste index` respective growths were 18.5% and 0.2%, while the NEXPIF respective increases amounted to 34.1% and 9.1%). After that, the Moste index recorded a monthly fall of 4.2% in June and 6.7% in July, while the NEXPIF was 3.9% and 3.5% lower in June and July, respectively. The NEX20 index monthly growth of 15.3% only in April, while in the following three months it recorded declines of 9.5%, 3.3%,and 1.8%.

Graph 29 – Movement of the MOSTE index

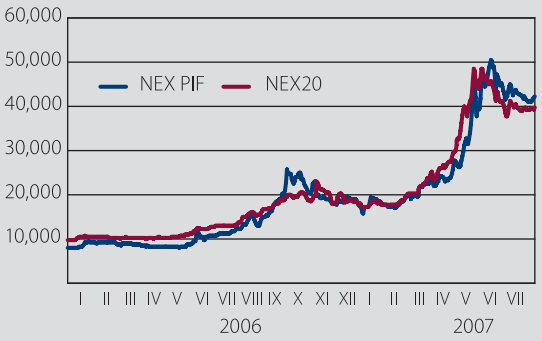
Source: Montenegro Stock Exchange

Table 3 – General data on indices

	MOSTE		NEX20		NEXPIF	
Value on 31 July 2007	2,042.97		39,718.79		42,242.86	
Absolute change (April-July) 2007	+117.8		-373.8		+11,083.9	
Initial value of an index	100.0		1,000.00		1,000.00	
Maximal value in 2007	2,455.4	07.05.2007				
Maximal historical value	2,455.4	07.05.2007	48,617.88	07.05.2007	50,584.09	23.05..2007
Minimal historical value	94.8	23.06.2004	918.57	14.04.2003	959.53	02.04.2003
Growth from 31 March 2007 to 31 July 2007	6.1%		-0.9%		35.6%	

Source: Montenegro Stock Exchange and Nex Montenegro Stock Exchange

Graph 30 – Movement of indices the NEX20 and the NEXPIF



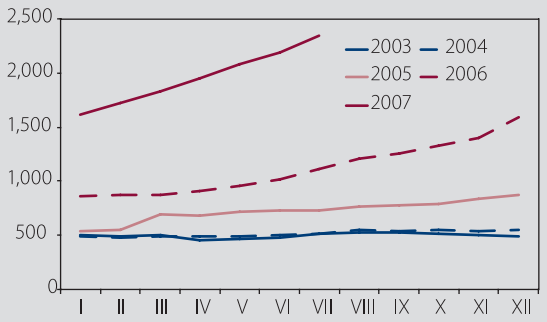
Source: Nex Montenegro Exchange

4.4. MONEY IN CIRCULATION

Money in circulation (broad money M21) increased at a monthly rate of 5.8% in the period January – July 2007, reaching the amount of EUR 2.345 million at end-July. The level of money in circulation at end-July of the current year was 47.9% and 111.4%. higher than those in December and July 2006, respectively.

Money supply M11, which accounted for 59.3% of the M21 structure, amounted to EUR 1.390,2 million at end-July, which was 26% more than at the previous year-end, while the annual growth rate amounted to 72%. Time deposits, which amounted to EUR 955.7 million, made up 40.7% of M21. Time deposits were 95.8% higher at end-July than at end-2006, while the annual growth amounted to 217%.

Graph 31 – Monetary aggregate M21, EUR million



5. MONETARY POLICY

During the first seven months of the current year, there were neither changes in the existing, nor the passing of any new, decisions on CBM monetary policy instruments.

6. INFLATION FORECAST

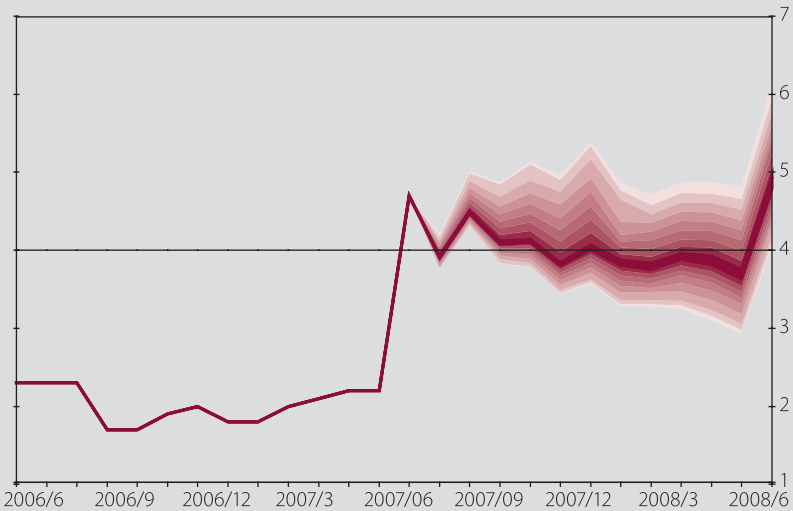
Bearing in mind that maintenance of macroeconomic stability and GDP growth represent the primary objectives of the Montenegrin economic policy, the Central Bank of Montenegro pays a special attention to projecting GDP growth, as well as the inflation rate movements, which at the same time represent the main indicators of macroeconomic stability.

Thus, starting with the Inflation Report for 2006, the Central Bank regularly publishes the „Fan Chart" inflation rate forecasts. As of January 2007, the Central Bank has started using the „Fan Chart" for the purpose of inflation forecast for one year ahead, at the monthly level. Moreover, in the subsequent quarterly reports, the Central Bank will perform the evaluation of the inflation forecast efficiency with measures for its quality improvement.

On the basis of ARIMA model, which is harmonized with the amendments to the Monstat methodology for the calculation of electricity prices, was obtained the central projection corresponding the distribution mode, with the average value of 3.07%, the skewness coefficient varying from 0,795 to 1,197, as well as the values of standard deviations on the left and the right side of the asymmetric distribution, **σ2=0,415 and σ1=0,138**, which indicates that the central band is in the lower part of the distribution, i.e. that the degree of uncertainty, supported by inflationary expectations, spreads the fan chart towards higher inflation levels (Graph 32).

The fan chart presents a 90% probability of inflation distribution. The central projection is usually in the deepest shade of the fan chart, i.e. in the central 10% of probability. The fan chart has an equal number of bands (eight) on either side of the central band, whereby each band is of the

Graph 32 – Projection of retail price index in Montenegro for 2007 and the first six months 2008, based on ARIMA model with changed Monstat calculation of prices of energy



same colour, both above and below the central band, cumulatively takes the inflation projection to the next 10% of probability. As the degree of uncertainty grows over time, so the fan chart spreads.

Montenegro's inflation fan chart, based on the ARIMA model for 2007, shows with a 90% probability that inflation, measured by the retail price index, will vary from 3.1% to 6.1%, but based on the fan chart's central projection, the same forecast with a 10% probability shows that inflation, measured by the retail price index, will range between 3.6% and 4.94%. As it can be seen, the probability range is wider than in the previous quarter, what points to greater uncertainty related to the increase in the spectrum of elements affecting the movement of the retail price index in the Montenegrin economy. At the same time, the central band of the retail price index fan chart moves toward higher levels in relation to the previous quarter, what can be explained by higher inflationary expectations, primarily due to the increase in the electricity prices in the third quarter, the expected further growth in real estates and liquid fuels prices, as well as an increase in the prices of agricultural products owing to the poor seasonal yields.

7. EXPECTED INFLATION IN 2007

The level of aggregate demand in the second quarter of 2007 was higher in relation to the previous quarter, as well as in comparison with the second quarter of 2006. On the other hand, the level of economic activity is on an increase. According to estimates, real GDP rose by 6.9% in the first six months of the current year. However, a higher than last year's inflation rate should be expected in 2007. The increase in the inflation rate will be dominantly influenced by the increase in the prices of electricity at the beginning of the third quarter. In addition to the direct, this will also have indirect effects because the prices of electricity are embedded in the prices of a great number of products.

Furthermore, it is reasonable to expect a somewhat more rapid increase in the prices of food and agricultural products, as due to the increased domestic demand, so as due to expected upsurge in the prices of some of these categories of products on the global markets, due to unfavourable weather conditions and expressed shortfalls. In addition, we have decided to use the cost of living index as the inflation indicator because the aforementioned category has almost twofold larger weight within the cost of living index, than in the retail price index. Oil prices on the global market reach record amounts, so such a movement will inevitably reflect on the movement of oil derivatives prices on the domestic market.

Due to all the aforementioned, inflationary expectations are high. However, our survey does not indicate any expectations on a substantial increase in the inflation rate, because most of the surveyed companies and banks, 88%, expect the inflation rate to range between 2% and 4%. On the other hand, most banks expect that both the nominal and effective interest rates will be on a downtrend, which will also have an anti-inflationary effect.

The Arima model shows with a 90% probability that inflation will range between 3.1% and 6.1%, and the central projection shows the inflation rate between 3.6% and 4.94%.

Our expert inflation forecast (based on Monstat data)[3] was corrected in relation to the first quarter-end mostly due to:

- The increase in the prices of electricity and fixed telephony in the third quarter,
- Price volatility on the global oil market;
- A potential growth in the prices of agricultural and food products, and
- The expected growth in real estate prices.

Table 4 – Inflation rate forecast

Optimistic forecast	Realistic forecast	Pessimistic forecast
4%	5%	6%

[3] A correction of miscalculated inflation would affect the correction of the estimated inflation rate to a lower level