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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 continuously 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 the country, it still contains certain standard components. Unfortunately, Montenegrin statistics is still in its 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.

Nowadays, different indicators can be used as inflation indicators: RPI, the cost-of-living index, CPI, and others. These indices could be observed as annual, average annual, etc. The use of different indices provides for different inflation rate calculations. Probably the best inflation indicator, used by most central banks, is the consumer price index (CPI), but Monstat still does not publish that data. Its publishing is planned to start during 2008. Therefore, the CBM uses the cost-of-living index as inflation indicator because it is the most similar to CPI.

Being in dilemma which inflation indicator to use, either the annual (end-year) or the average cost-of-living index movement, we opted for the annual (end-year) index because we believe it has several advantages in relation to the latter.¹ First, this index provides for the comparison of real prices level at a year-end with the corresponding level at the end of the next year, whereas the average rate concept uses an average price of the observed item which does not have to match the real price in any time period. Second, the forecasting of inflation rate using the average annual rate of inflation requires not only a forecast of price increases of some products, but also the exact month in which this increase will occur. This is particularly difficult in condition when administratively controlled prices represent a significant inflation factor. This does not mean that monitoring of the average annual cost-of-living index should be neglected either, but for the purpose of »Inflation Report« we shall use the annual cost-of-living index as the inflation indicator.

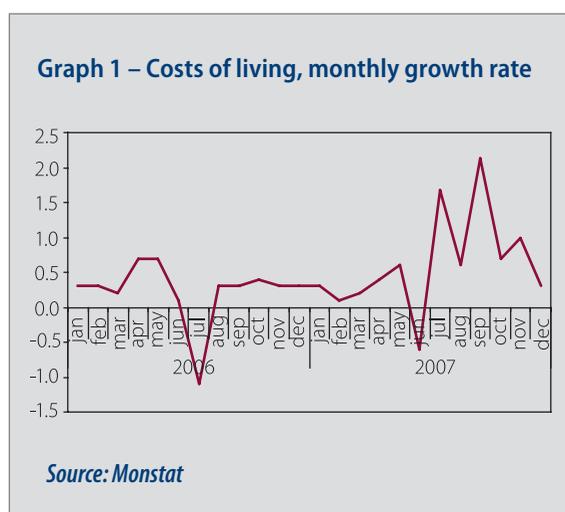
¹ For more details about the differences between these two indices see *Chief Economist's Report - Third Quarter 2007*.

2. INFLATION INDICATORS²

Annual inflation measured by costs of living amounted to 7.7%, while the growth of costs of living in the fourth quarter was slightly slower compared to the third quarter (2.04%). The average annual inflation rate amounted to 4.2%, being the same as the average annual rate of the retail prices.

During the fourth quarter of 2007, the growth was recorded in average prices of the categories mostly influencing calculation of the total living costs index with its weighting structure. As well as in the previous quarter, prices of food products, prices from the category „housing“, as well as prices from the category “post and telecommunication services” had the highest increase in the observed period.

Food products prices increased by 2.7%, but participation of these prices in total living costs amounted to 65.5%. This share of food in total costs was mostly influenced by the prices of fresh and processed vegetables, which rate of 8.3% influenced high share (25.5%) in total cost of living. Average prices of other important groups of products also increased. Besides the group of fresh and processed vegetables, the highest share



in total inflation was recorded by products from groups “fats” (21.9%, increased by 15.2%), products from group “fresh and processed milk” (6%, increased by 1.6%) as well as products from group fresh and processed meat (5.6%, increased by 0.9%).

Table 1 - Inflation, %

	2006.				2007.			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Change to end of the previous year	0,8	2,3	1,7	2,8	0,6	1,1	5,5	7,7
Annual change	2,8	3,1	2,7	2,8	2,4	1,6	6,5	7,7
Quarterly change	0,8	1,5	-0,5	1,0	0,7	0,4	4,4	2,0

Source: Monstat

² Inflation rates in July 2007 are overestimated, due to the methodological error which Monstat made while calculating the price of electricity.

In the category „housing“, higher electricity prices had the strongest influence on total inflation. Besides a significant increase in the third quarter, they also increased in the fourth quarter by 5.8% and their ratio in the total inflation amounted to 17.3%. Due to increase in prices of electricity, the category “heating and lightning” had the total growth of 5% and its share was 18%.

In the category “post and telecommunication” prices of liquid fuels and lubricants, which increased by 5.7% and with the share of 11.2%, had the highest influence on total inflation. Prices of post and telecommunication services significantly increased in the third quarter and therefore their level was not changed in the fourth quarter. Other groups of products “tobacco and beverages” and “personal care items” did not record important changes in prices, so their share in total costs amounted to a mere 2.4%.

During the fourth quarter prices of services were stable, and there were almost no changes compared to the third quarter. Their share in total costs amounted to 0.25% and the increase rate only 0.05%. All important increases, such as the increase of telephone impulses and subscription, that determine the growth of services, were recorded in the third quarter.

Prices of liquid fuels and lubricants, mostly influenced by fluctuations of oil prices on the world market, had the rate of 5.7% and their share in total inflation amounted to 11.2%. Their increase or decrease during the whole year was mostly followed by small fluctuations of the oil prices in the world market.

The increase of oil prices during the whole year on the world market was mostly influenced by the global increase of demand followed by long-lasting political risks and uncertainties. Prices of oil recorded extreme growth since the beginning of the year except the decrease that happened in August. OPEC reference basket price which in January amounted to 50.7 US\$/barrel, received its record in November when the average OPEC reference basket amounted to 88.99 US\$/barrel. Average OPEC reference basket price in December amounted to 87.19US\$, and the price of the “brent” oil in December amounted to 91.25US\$/barrel.

Table 2 – Share of inflation for certain groups of goods and services in total inflation

	weight	XII 07/ IX 07	Growth rate	Contribution	Share in total
TOTAL	10,000	102.04	2.04	2.04	100.00
Food	5,046	102.65	2.65	1.34	65.50
Fresh and processed vegetables	629	108.27	8.27	0.52	25.46
Tobacco and beverages	694	100.25	0.25	0.02	0.85
Clothing and footwear	845	100.23	0.23	0.02	0.95
Housing	1,259	103.22	3.22	0.41	19.85
Electricity	605	105.84	5.84	0.35	17.30
Tobacco and beverages	712	100.18	0.18	0.01	0.63
Education and culture	460	99.97	-0.03	0.00	-0.07
Transportation and postal services	984	102.21	2.21	0.22	10.64
Liquid fuels and lubricants	400	105.72	5.72	0.23	11.20
Transportation and communication	414	100.00	0.00	0.00	0.00
Goods	8,994	102.27	2.27	2.04	99.75
Services	1,006	100.05	0.05	0.01	0.25

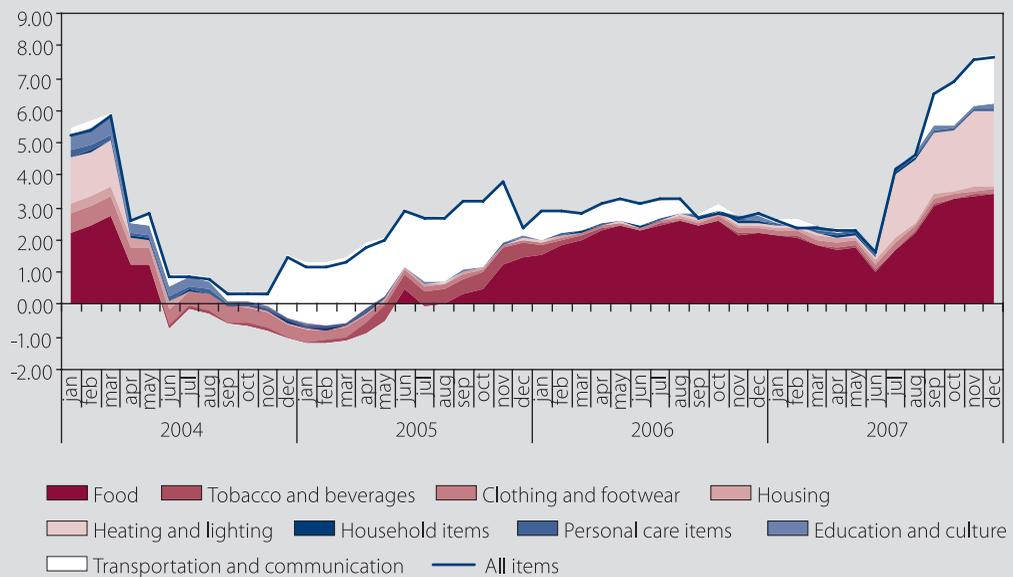
Source: Monstat and CBM calculations

Graph 2 – Oil prices, monthly growth rate



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

Graph 3 – Components of cost of living index: contribution to annual growth rate (index points)



Observing from the beginning of year, the annual rate was the same until June, when it decreased from 2.6% (in January) to 1.6%. However, July had the abrupt increase of the rate to 4.2% due to the price of electricity, as well as later in September and October when, due to important increase of food prices, the annual rate reached 6.9%. Despite the already mentioned increase of post and telecommunication services, this rate

again increased which was influenced by prices of food products that considerably determine the total growth of cost of living thus making the rate at the year-end 7.7%.

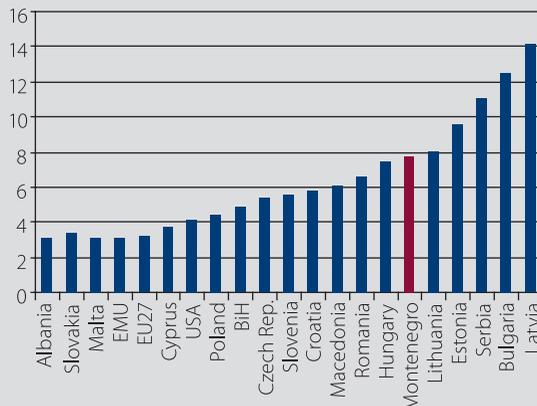
Average annual living costs growth rate was 4.2%, being the same as the average rate of the retail prices.

Graph 4 – Cost of living, annual growth rate



Source: Monstat

Graph 6 – Annual inflation rate in selected countries, December 2007



Source: National Statistical Offices and Eurostat

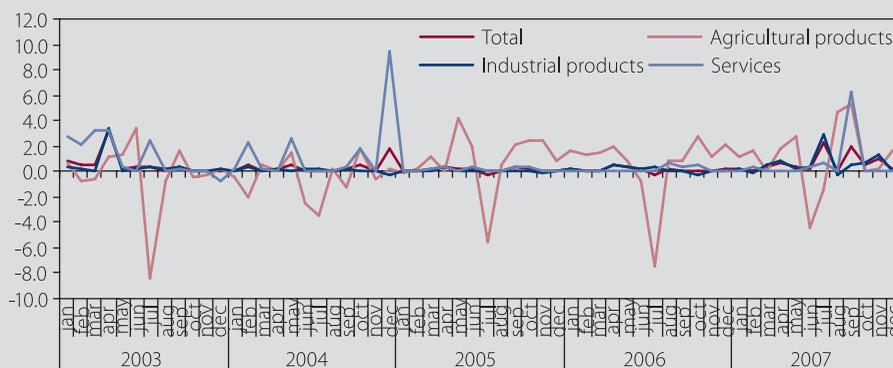
During the fourth quarter of 2007, **retail prices** increased by 1.8%. As well as in the living costs, retail prices also had slight instability of the prices in the fourth quarter. The highest growth was in agricultural products (2%), while industrial non-food products which increased by 2.9% had the share in total retail prices by 41.4%. Prices of services in the fourth quarter had no considerable changes, so their share in total retail prices amounted to 0.4%. The annual growth rate of retail prices in 2007 amounted to 8%.

Producers' prices of manufactured products in the fourth quarter 2007 increased by 4.6%. The highest growth was in the prices

of the electricity, gas and water supply (11.1%), while prices in the manufacturing sector increased only by 0.5%. The annual increase of producers' prices of manufactured products amounted to 14.5%.

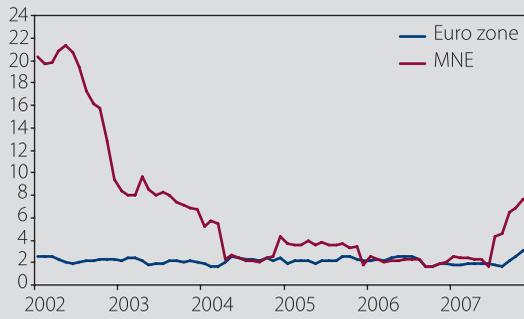
Comparing annual inflation in Montenegro to the inflation in the selected countries and to new EU member states indicates that Montenegro (amounting to 7.7%) is placed between Hungary (7.4%) and Lithuania (8.1%). Serbia (11%), Bulgaria (12.5) and Latvia with the high inflation rate (14.1%) are at the bottom of the list. Published data about HICP and CPI were used as the indicator of inflation.

Graph 5 – Retail prices, monthly growth rate



Source: Monstat

Graph 7 – Inflation in EMU and Montenegro since introduction of euro (annual rate)



Source: Monstat and European Central Bank

The annual growth, measured by the harmonized index of consumer prices amounted to 3.1%.

3. INFLATION FORECASTS

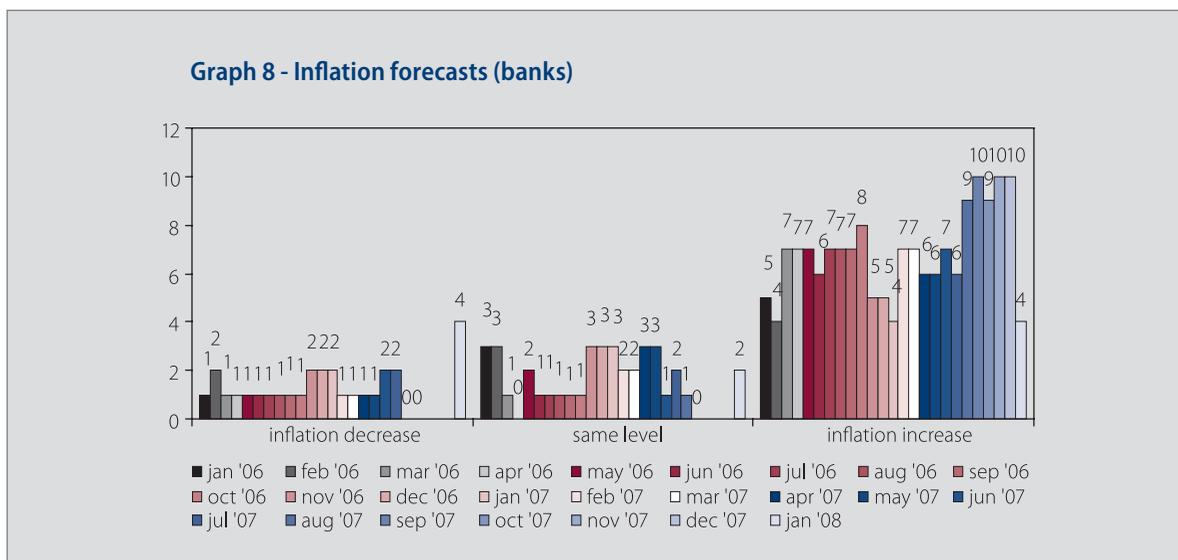
Banks expectations

In December 2007, inflation forecasts of commercial banks' managers were at somewhat lower level when compared to the end of the third quarter of 2007. Namely, four banks expected a drop in December 2007, two banks expected the unchanged level and four banks higher inflation rate in 2008 in relation to the previous year. (Graph 8)

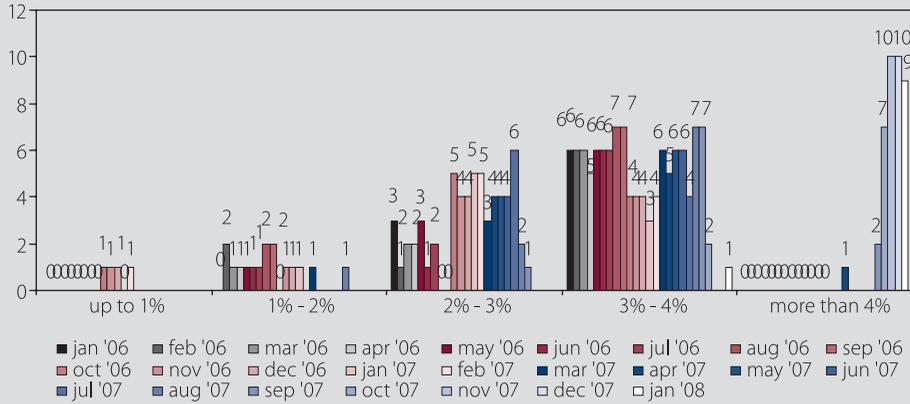
As for the inflation rate level, banks do not expect considerably lower rate in 2008, compared to 2007. Therefore, all banks forecasted the inflation rate in 2008 to be higher than 3% while seven banks (70% of all banks) forecasted the inflation rate to be higher than 5%.

As for the lending interest rate trends, six banks expected the unchanged level, two banks expected the downward trend and two banks envisaged an increase in nominal interest rates and effective interest rates in 2008, in relation to 2007.

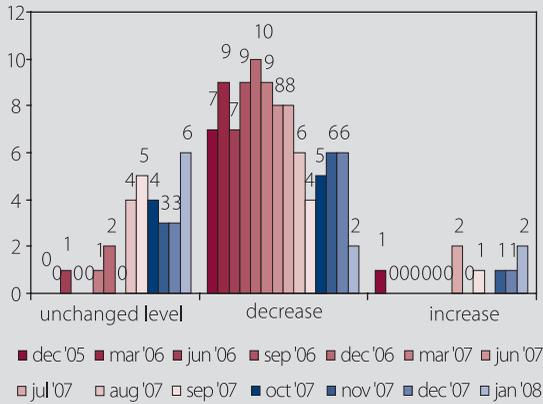
Concerning the expectations on the movement of deposit interest rates, five banks stated that they expected the unchanged level, one bank expected the downward trend, and four banks expected the increase of deposit interest rates in 2008, in relation to 2007.



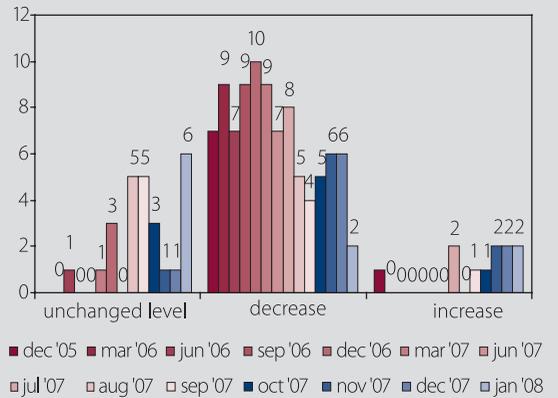
Graph 9 – Forecasted inflation rate level (banks)



Graph 10 – Nominal interest rate movement forecasts

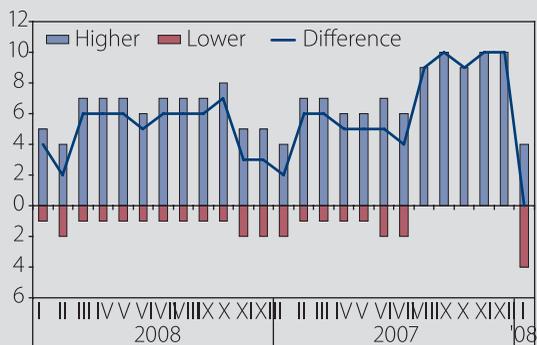


Graph 11 – Effective interest rate movement forecasts

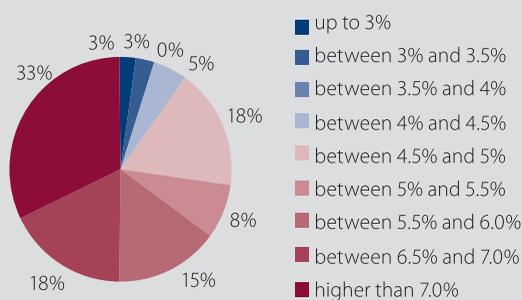


For the purpose of calculating inflation forecasts we use market trend indicator (blue line in Graph 12). It is calculated as the difference between the number of banks expecting an inflation increase (blue columns) and the number of banks expecting an inflation decrease (red columns). If the market 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 lower in the 2007 year-end in relation to the third quarter of 2007.

Graph 12 – Market indicator



Graph 14 – Forecasted inflation in 2008

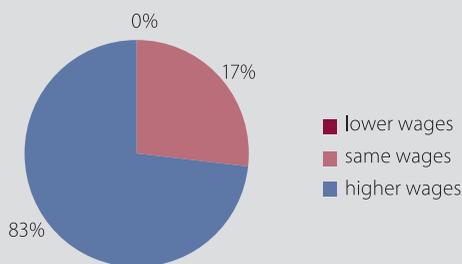


Expectations of economy (except banks)

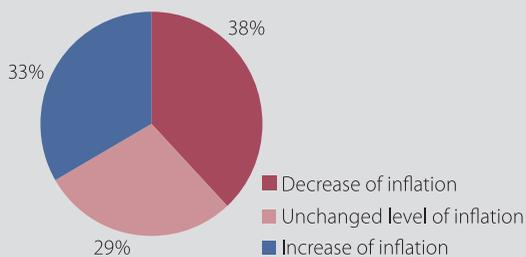
Inflation

The company survey results show that 33.3% of companies expect that rise of inflation, 26.8% believe that there will an unchanged level, while 38.1% believe lower inflation rate in 2008, in relation to 2007. Besides, 90% of surveyed companies believe that the inflation in 2008 will be more than 4.5%. The majority of surveyed companies in 2008, in relation to 2007, expect higher salaries of their employees, higher value of price of the production inputs which they use, as well as the higher prices of their products (services).

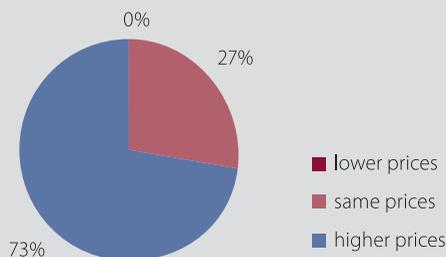
Graph 15 – Expected level of salaries in 2008 in relation to 2007



Graph 13 – Forecasted inflation in 2008, in relation to 2007 (responses by percentage ratio³)

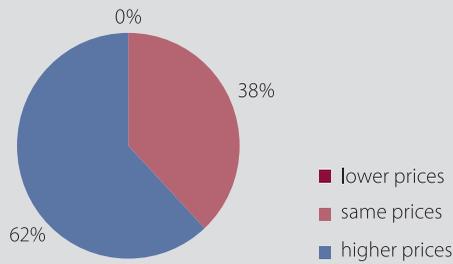


Graph 16 - Expected level of prices of production inputs in 2008 in relation to 2007

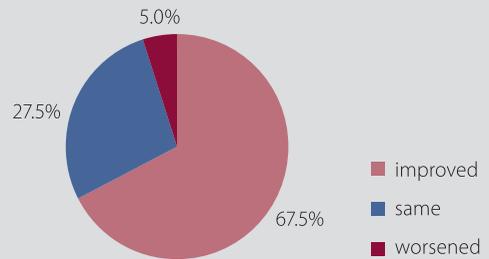


³ Responses to all questions from the survey on companies are presented as ratios, which hereinafter will not be specially indicated.

Graph 17 - Expected level of prices of products (services) in 2008 in relation to 2007



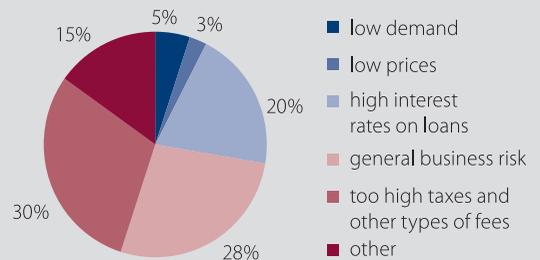
Graph 18 – Forecasted business environment for 2008, in relation to 2007



Business Environment

The company survey results show that 68% of the surveyed companies expect an improvement in business environment, 28% expect an unchanged business environment, while only 5% of the surveyed enterprises expect an aggravation of the business environment in 2008, in relation to 2007. Besides, 32% of surveyed companies expect lower level, 63% the same level, and only 5% higher level of lending interest rates in 2008, in relation to 2007. As far as the business barriers are concerned, the majority of respondents see very high taxes and other fees as obstacles, operational risk and high lending interest rates.

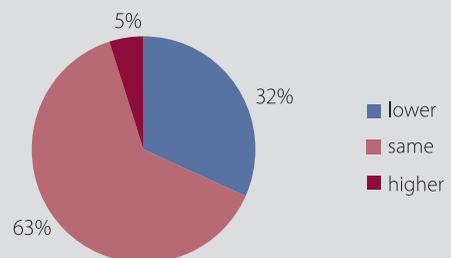
Graph 19 – Business barriers



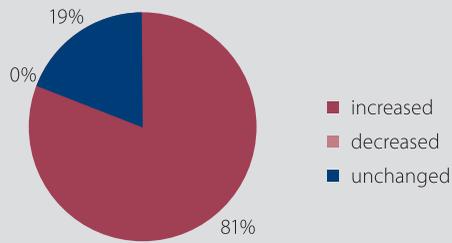
Investments

Planned volume of production (providing services) and investment activities for 2008 also show the optimism of companies. The majority of surveyed companies planned to increase volume of activity as well as they planned new investments in 2008, in relation to 2007. Therefore, majority of new investments in the first six months of 2008 would refer to investments in fixed assets. As the reasons for not planning new investments, companies equally stated low demand, insufficient utilization of existing capacities, unfavorable conditions of capital borrowings and high existing production costs.

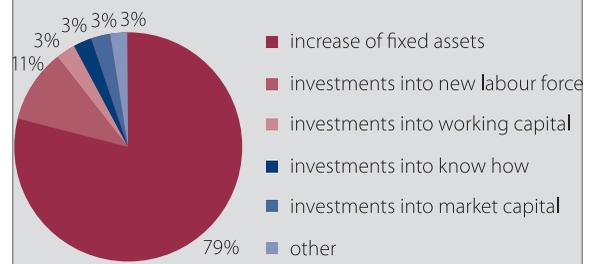
Graph 20 – Lending interest rate movement forecasts for 2008, in relation to 2007



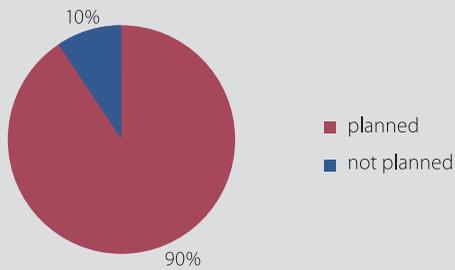
Graph 21 – Forecasted volume of activities in 2008, in relation to 2007



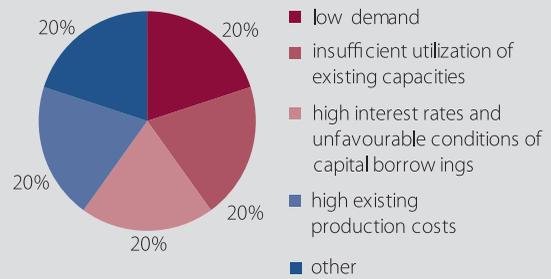
Graph 23 – Types of forecasted new investments in the first six months of 2008



Graph 22 – Forecasted new investments for 2008



Graph 24 – Obstacles to forecasted new investments in the first six months of 2008

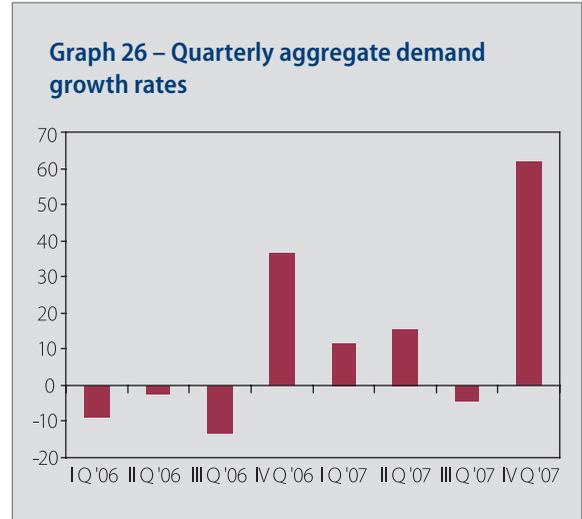
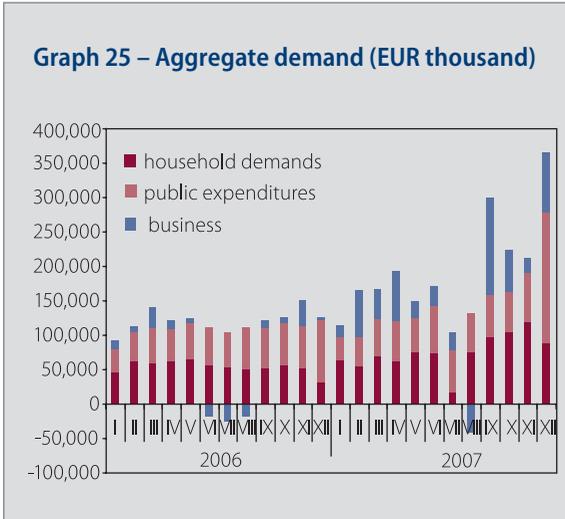


4. INFLATION DETERMINANTS

4.1. Demand

The highest level of the aggregate demand in 2007 was achieved in the fourth quarter, which is usual for the end of the year when overdue payments from companies and budget are paid. Thus, the fourth quarter shows a considerable increase of all three sectors (household, corporate and public sector). The highest level of aggregate demand was achieved in December, due to the increase of public consumption, as well as the considerable borrowings of business in this month.

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



Box 1 – Aggregate demand calculation methodology

For the purpose of an in-depth monitoring of the 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 the 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 average salary in Montenegro in 2007 amounted to EUR 497 and it was by 14.8% higher compared to the previous year. The average salary without taxes and contributions amounted to EUR 338, and compared to 2006 it was higher by 19.9%. Observing the quarters, the highest average salary without taxes and contributions was recorded in the fourth quarter, when it amounted to EUR 366 and was by 8.2% higher compared to the previous quarter. The lowest average of salaries was recorded in the first quarter and it amounted to EUR 314.

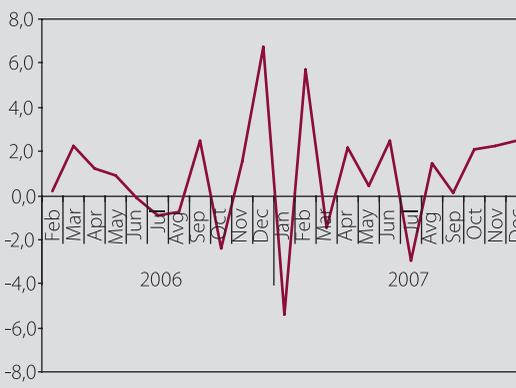
It must be mentioned that the increase of salaries in the fourth quarter, compared to the previous quarter, besides the growth of economic activity, was influenced by increase of salaries of employees financed from the budget, because signing of the branch collective agreements (health, culture and education) alongside with the high budget surplus in 2007 enabled increase of salaries in these areas.

Graph 27 – Average salaries without taxes and contributions in Montenegro



Source: Monstat

Graph 28 – Real salaries (monthly growth rate)



Source: Monstat

Taking into account the cost of living, i.e. salaries observed in real amounts, it may be concluded that real salaries had increase in all three months of the fourth quarter of 2007. The increase in household indebtedness on the grounds of bank loans taken constantly increased during 2007, with an monthly average of 8.2% (average monthly increase of loans to households amounted to 9.6%). The highest average increase of loans to households was recorded in the first and the second quarter, 9.7% and 9.6%, respectively.

At the end of 2007, the household indebtedness to banks amounted to EUR 795.0 million, which was by 155.5% more than at the end of 2006. Observed in absolute figures, loans disbursed to households during the year increased by EUR 483.9 million.

Besides banks' loan claims on households, this sector's debt with microcredit financial institutions also increased, reaching the amount of EUR 52 million at 2007 year-end.

Households' deposits also constantly increased in 2007, amounting to EUR 1,019 million at end-December and were considerably above the level of granted loans. The loan/deposit ratio for this sector was 0.78 at the end of 2007. Household net savings in banks amounted to EUR 224 million at 2007 year-end.

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

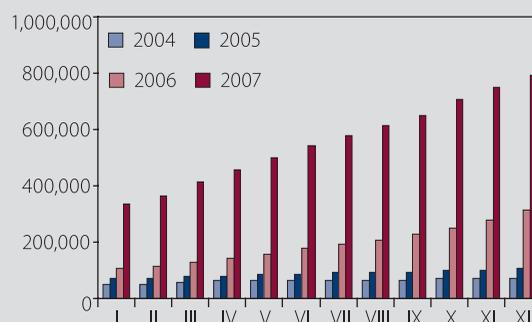
The balance of payment statistics shows that the inflow of foreign funds to private citizens in the fourth quarter of 2007 was 16.3% higher compared to the previous quarter. This inflow includes compensations to employees, pensions, remittances, and other transfers.

Observing the total demands of the household sector by months in the fourth quarter, the increased demand in October and November may be noticed, as well as the decreased demand in December as the result of considerable increase of household deposits.

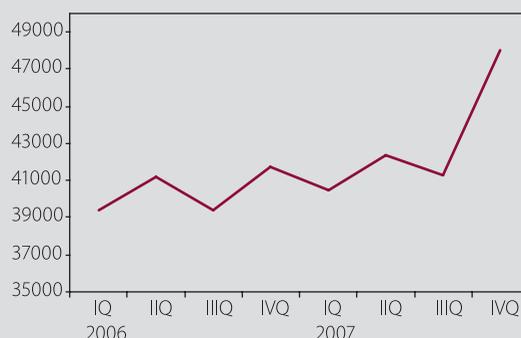
4.1.2. Budgetary Analysis

According to preliminary data of the Ministry of Finance, total budget revenues amounted to EUR 798.9 million (35% of estimated GDP for 2007) and were by 6.6% higher in relation to the plan (according to restatement) i.e. by 37.2% in relation to the previous year.

Graph 29 – Loans granted to private citizens, EUR thousand



Graph 30 – Inflow of foreign funds to private citizens (EUR thousand)



Source: CBM

Graph 31 – Demand of private citizens (EUR thousand)



In the structure of budgetary revenues in 2007, current revenues recorded dominant share (99%).

Current revenues amounted to EUR 791 million. In relation with the plan, these revenues increased by 8.1%, while the growth in relation to 2006 amounted to 39.5% as a result of a better collection of taxes, fees, compensations and other republic revenues.

The increase of current revenues was influenced by the growth of tax revenues which amounted to EUR 708 million in 2007. In comparison with the previous year, tax revenues increased by 42%, while in relation to the plan they were 8% higher. In comparison with the plan, tax revenues from the income of private individuals, property, value added, international trade and transactions and other taxes and excise recorded an increase, while, at the same time, tax revenues from legal entities profit decreased by 3%.

Revenues from fees (administrative, court, residence) amounted to EUR 18.4 million and they increased by 32% in relation to the previous year, i.e. 5% in relation to the plan. In addition, revenues from residence fee, which amounted to EUR 0.56 million, in 2007 increased by 54% over a year i.e. by 30% in relation to the plan, which is, in the first place, the result of the successful tourist season.

Also, within the frame of the current budgetary revenues, positive trend was recorded by compensation revenues and other revenues which amounted to EUR 59 million in total and were by 5.9% higher in relation to the plan and by 32% in relation to 2006.

Revenues from the sale of property (financial and non-financial) recorded a negative trend in 2007 and amounted to EUR 5.4 million (0.7% of total revenues) which is by 32% lower than the plan i.e. by 13.7% lower in relation to 2006. The revenues from the repayment of loans taken by public companies, individuals and other institutions amounted to EUR 5.5 million, being 16.4% higher in relation to the plan but 41% lower in relation to 2006. Borrowings and loans amounted to EUR 2.5 million being 71.4% lower than the planned, i.e. 71.2% lower in relation to 2006. Revenues from donations and transfers, planned in amount of EUR 600 thousand in 2007, were significantly lower than the plan and amounted to EUR 68.9 thousand. In relation to the previous year they increased by 56%.

According to preliminary data of the Ministry of Finance, total budgetary expenditures amounted to EUR 769.9 million in 2007 (33.8% of the

estimated GDP for 2007). Budgetary expenditures in 2007 were 32.79% higher in relation to the previous year, while in relation to the planned expenditures for 2007 they were by 2,8% higher. High expenditures were influenced by foreign debt repayment, obligations default from the previous years, as well as by the increase of gross wages in the public sector, capital investments in infrastructure and transfers.

In the structure of total budgetary expenditures, current expenditures have the highest share (46.1%).

Current expenditures amounted to EUR 354.9 million in 2007 which represents an increase of 35.4% in relation to 2006. Gross wages record the highest share in current expenditures (54.4%), while other current expenditures (other incomes and contributions to employees, expenditures for material and services, current maintenance, rent, interests, subsidies and other expenditures) made up 45.6% in total.

Expenditures for transfers to institutions, individuals, non-government and public sectors and social security amounted to EUR 173.4 million or 22.5% of total expenditures. In relation to the previous year, these expenditures increased by 9.6% which was influenced by the increased number of users of social and health protection and increased expenditures for redundancy.

In 2007, EUR 77.4 million was allocated to capital projects. Capital expenditures increased by 146.5% in relation to 2006, while, at the same time, they were 3.6% lower in relation to the plan for 2007. The main share of these funds went on the public realm infrastructure, construction objects and investment maintenance, while less was spent on equipment and local infrastructure.

Debt repayment expenditures amounted to EUR 147.4 million and made up 19% of total budgetary expenditures in 2007. In comparison with the previous year, these expenditures were 57% higher while in relation to the plan for 2007, they were 34.5% higher. The highest amount of these funds (EUR 84.1 million) was allocated to non-residents, which is six times more in relation to the previous year and 34% more in relation to the plan.

Borrowings and loans disbursed by Government amounted to EUR 6 million in 2007 and were 12.6% lower in relation to the previous year.

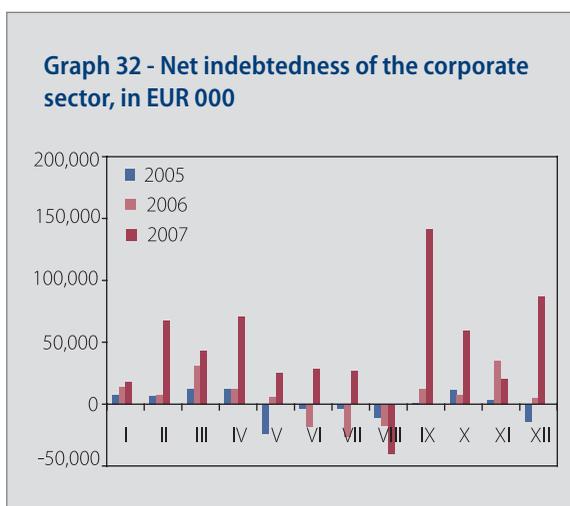
Observing the **surplus/deficit** as the difference between revenues and expenditures, whereby revenues are reduced for borrowings, transfers,

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 surplus of EUR 168.4 million⁴, which is by 87% more than the surplus planned by restatement (EUR 90 million). If we observe the surplus as the difference between revenues and expenditures, then it amounted to EUR 29 million.

4.1.3. Corporate Sector

Due to the 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-2007 amounted to 63%, which means they were mainly used for investments.



4.1.4. External Demand and the Current Account

According to preliminary data, the current account deficit amounted to EUR 1007.6 million or 44.2% of GDP in 2007, which is 89.7% 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 33.9%, which is 3.6 percentage points more in relation to the same period of 2006.

⁴ Methodology of calculation surplus/deficit "Official Gazette RM", 71/05

Total volume of visible trade in 2007 was 29.5% higher in relation to 2006. The recorded visible export/import coverage amounted to 29.2%, which is 14 percentage points less than in 2006. Increased domestic expenditures and demands for imported goods, as well as FDI inflow and the increase of investment expenditures influenced the growth of goods' deficit.

In 2007, the volume of services trade amounted to EUR 907.9 million or 42.1% more than in the same period of 2006. **Revenues from services** amounted to EUR 674.1 million in 2007 and increased by 61.2% in relation to the previous year. The largest revenues were from travelling-tourism, EUR 459.5 million, then transport, EUR 72 million, construction services, EUR 49.8 million, and other business services, EUR 46.8 million. **Expenditures from revenues** amounted to EUR 233.9 million and they were increased by 5.9% in relation to 2006. Observing the structure of services, the largest revenues were from other business services EUR 57.8 million, transport EUR 56.4 million and construction services EUR 35.8 million.

Factor income revenues in 2007 amounted to EUR 89.4 million or 36.9% more in relation to 2006. The compensations of employees in amount of EUR 80 million have the highest share in revenues which represents the increase of 30.3%. Income revenues from international investments amounted to EUR 9.5 million where the paid interests on term and demand deposits have the highest share in amount of EUR 8.3 million, while direct investments revenues amounted to EUR 1.1 million. Income expenses in 2007 amounted to EUR 72.4 million or 109.7% more in relation to the same period of 2006. Out of total income expenditures based on incomes, EUR 67.2 million referred to the international investments income. Most of the expenses were realized from the repayment of interests on taken loans. In the observed period, expenses from the repayment of interests on taken loans amounted to EUR 55 million which is by 85.3% more in relation to 2006. **Income balance** in 2007 was positive and it amounted to EUR 17 million which is by 44.8% less in relation to 2006.

Total inflow from the current transfers in 2007 amounted to EUR 100.8 million. Out of that amount, EUR 7.8 referred to the state sector and EUR 93 million to other sectors. Out of the total inflow of other sectors' transfers, EUR 63.2 million referred to employees' remittances from abroad. The inflow from other transfers (heritage, alimentation and other presents and aid) amounted to EUR 29.7 million. At the same time, the outflow of current transfers amounted to EUR 41.4 million of which other sectors accounted for EUR 35.5 million and state sector EUR 5.9

million. The increased outflow of current transfers from Montenegro (from heritage, presents and various aids) in amount of EUR 21 million was evident in the observed period.

The capital-financial account in 2007 recorded the continuation of favourable movements in the area of foreign direct and portfolio investments. Net inflow of direct investments (inflow minus outflow) amounted to EUR 524.9 million or 12.5% more in relation to 2006, which is more than the level projected by the economic policy for 2007. Total inflow of FDI in 2007 amounted to EUR 1.007.7 million which is by 56.4% more in relation to 2006.

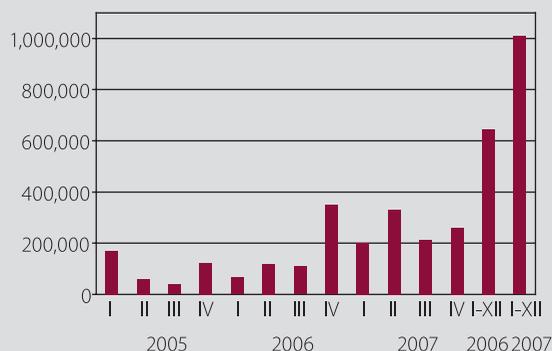
Observing the inflow structure, an uptrend in investments related to real estate can be seen, resulting in real estate investments of EUR 514.4 million or 51%. Foreign investments in local companies and banks amounted to EUR 377.6 million or 37.5% of total FDI inflow, and EUR 115.7 million was in the form of intercompany debt (loans, deposits and other receivables).

The FDI outflow amounted to EUR 482.8 million in 2007 which is by EUR 305.2 million more in relation to 2006. As for the outflow structure, EUR 364.1 million referred to real estate, while EUR 53 million related to the withdrawal of a share of foreign capital from local banks and companies. Investments of local companies abroad amounted to EUR 62.5 million. Of total outflow arising from real estate, EUR 52.5 million related to real estate purchase abroad while EUR 311.6 million referred to the real estates sale by non-residents.

A deficit of EUR 4.9 million was recorded on the portfolio investments account in 2007. The inflow of portfolio investments amounted to EUR 119.3 million or EUR 75.5 million more in relation to the same period of 2006. At the same time, portfolio investments outflow amounted to EUR 124.2 million.

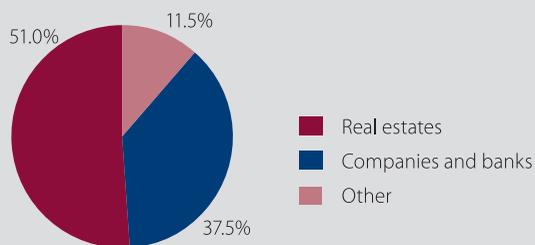
At the other investments account, which incorporates loans, trade loans, cash and deposits, the inflow amounted to EUR 1,157.3 million which is by EUR 722.6 million more in relation to the same period of 2006. Commercial banks and companies borrowed funds in the amount of EUR 1,145.2 million, which is 170.5% more in relation to 2006, while their debt decreased by EUR 311.4 million. The other investments outflow amounted to EUR 799.2 million. At the other investments account, net inflow in amount of EUR 358.1 million was recorded in the observed period.

Graph 33 - Inflow of foreign direct investments by quarters, in EUR 000



Source: CBM

Graph 34 – Structure of inflow of foreign direct investments in 2007



Source: CBM

4.2. Supply and production

According to the preliminary estimations⁵ in 2007, a GDP growth of 7% was recorded. GDP growth was mostly influenced by the growth in tourism, trade and financial intermediation sectors.

The physical volume of industrial production in the fourth quarter recorded an increase of 20.3% in relation to the first quarter-end.

⁵ Economic and fiscal programme for Montenegro for the period 2007-2010

In relation to the end of the first quarter, the increase in production was recorded in two industrial production sub-sectors. Observed by months, the growth of 19.1% and 6.1% was recorded in October and December, while the decrease of industrial production was recorded in November (1.1%).

Industrial production in the period January–December 2007 was only 0.1% higher in relation to 2006, while in December 2007 in comparison to December 2006 it increased by 7.7%. This movement of the industrial production level was influenced by the decrease in the electrical energy sector by 27.4%, while the increase of production in relation to the comparative period was recorded in manufacturing sector (9.3%) and in mining and quarrying sector (1.5%). In the manufacturing sector, eight industrial areas, which made up 51.4% of total industrial production, recorded growth of production, while nine areas recorded decrease of production.

According to Monstat data, the total number of tourists who visited Montenegro in 2007 amounted to 1.1 million, being 18.8% higher in relation to the previous year. Some 86.8% arrivals referred to foreign tourists and 13.2% to domestic tourists. Realized number of overnights in 2007 amounted to 7.3 million or 22.9% more in relation to the previous year. Overnights of foreign tourists made up 88.37% and overnights of domestic tourists 11.7% of total overnights.

Total wood production from public forests in 2007 amounted to 263,787m³ or 19.4% lower in relation to the same period of the previous year.

The value of construction works performed in 2007 amounted to EUR 197.6 million⁶ being 3.2% lower in relation to the comparative period. On the other hand, construction activity, measured by the effective working hours, decreased by 1.7%. The decrease of construction activities cannot be considered as worrying, bearing in mind extremely high base from the previous year.

The data on the volume of **transportation services** in 2007 point to positive trends with some types of transportation. All forms of transportation recorded positive results. Thus, road passenger transport and goods transport increased by 23.2% and 26.2%, respectively, and air freight and passenger transport rose by 23.5%.

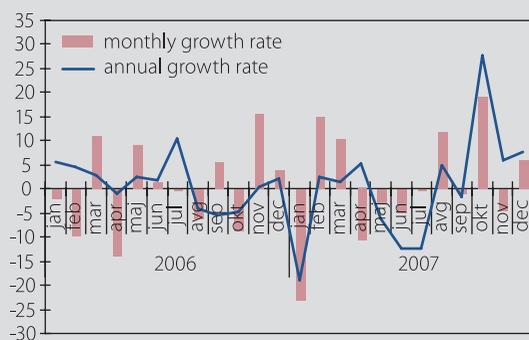
In railway transport, passenger transport was 16.3% lower, while cargo transport was 1.5% higher.

Data on maritime transport point to 7.6% larger cargo transport in tonne miles, while the turnover in ports was 3.7% higher.

4.3. Stock Exchange Indices

All three indices recorded significant growth in 2007. Moste index increased by 77.1%, NEX20 index by 89.3%, and NEX PIF index increased by 120.8%, in relation to the end of the previous year. Two indices reached the maximum value in May 2007 – Moste and NEX20 while NEX PIF reached the maximum value in August. In relation to maximum values, indices recorded the decrease at end-2007: Moste (33.7%), NEX20 (29.7%) and NEX PIF (22.7%).

Graph 35 - Industrial production, monthly and annual growth rate



Source: Monstat

⁶ Preliminary Monstat data.

Table 3 – Indices of Nex and Montenegro stock exchanges in 2007

Index	MOSTE	NEX20	NEX PIF
Value as of 31 December 2007	1,627.69	34,168.63	39,229.17
Absolute change in 2007	708,8	16,117.83	21,456.54
Percentage of change (in relation to 31 December 2006)	77,1%	89,3	120,8
Percentage of change (in relation to maximum value in 2007)	-33,7%	-29,7	-22,7
Maximum value	2,455.4	48,617.88	50,780.54
Minimum value	928.7	18,307.87	18,054.69

Source: Montenegro stock exchange and Nex Montenegro stock exchange

Graph 36 – MOSTE index in 2007



Source: Montenegro stock exchange

Graph 37 – NEX20 and NEXPIF indices in 2007



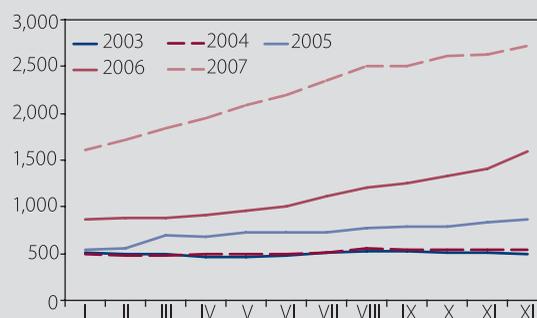
Source: Nex Montenegro stock exchange

4.4. Money in Circulation

Money in circulation (broad money M21) increased at a monthly rate of 4.7% in 2007, reaching the amount of EUR 2.728 million at end-December. The level of money in circulation at end-2007 was above the level from December 2006 (71.9%).

Money supply M11, which accounted for 57.1% of the M21 structure, amounted to EUR 1.557 million at end-2007, which was 41.7% more than at the previous year-end. Term deposits, which amounted to EUR 1.171 million, made up 42.9% of M21. Term deposits were 139.9% higher at end-2007 than at end-2006.

Graph 38 - Monetary aggregate M21, EUR 000,000



5. MONETARY POLICY

Within the context of monetary and financial stability overview, in 2007 CBM revised reserve requirement policy and enacted a set of measures for prevention of credit expansion which are supposed to contribute to maintenance of the security level and solvency of banks, improvement of financial discipline and better credit risk management.

New Decision on Bank Reserve Requirement to be held with the CBM, which entered the force as of January 2008, introduced significant changes in reserve requirement policy by broadening the calculation base and by correction of the reserve requirement rate on term deposits. Banks do not have the possibility any more to allocate a part of reserve requirement to treasury bills. For more details on reserve requirement policy see "Chief Economist Annual Report" for 2007.

Decision on Asset Classification, Provision for Loan Losses and Reserves for Credit Risk, which entered the force as of October 2007, provides new qualitative approach to credit risk estimations, based on the international standards (for more details see "Inflation Report for the third quarter of 2007").

Amendment to the *Decision on Minimum Standards for Credit Risk Management* foresees certain constraints in performing banks' credit operations. According to this Decision, a bank which has net loans in amount higher than EUR 200.000.000, can realize annual credit growth up to 30% in relation to the situation as of the end of the previous business year. A bank which has net loans from EUR 100.000.000 to EUR 200.000.000, can realize the annual growth up to 40%, while a bank with net loans up to EUR 100.000.000 can realize the annual growth up to 60%. These measures do not refer to new banks up to the end of the first business year, and they are applied as of 01 January 2008.

Amendments to the *Decision on minimal standards for bank capital* foresees that a bank which has annual growth of receivables on the basis of loans and leasing operations higher than 60% has to maintain solvency ratio at least at the level of 10%, while a bank which has annual growth of receivables higher than 100% has to maintain this ratio at the level of 12% at least. This Decision is applied as of 01 January 2008.

In order to reinforce the control system and financial discipline, aiming at transparency of the supervisor's function, CBM shall disclose information on measures against banks as well as the information on termination of measures, as of April 2008, according to the *Decision on Manner and Procedures of and Fees for the Bank Supervision*.

Decision on Amendments to the Decision on Micro Credit Financial Institutions, enacted as of December 2007, the current classification criteria for the MFIs assets items is kept (repayment past due), but past due periods and minimum reservations are determined on the new basis. Amendments to the Decision increased the current limit for MFIs borrowings. The amount of loans which MFIs grant for the first time also increased as well as the total amount of loans which can be granted to private individuals, entrepreneurs and companies. There are new provisions which regulate operative risk management in MFIs.

6. INFLATION FORECAST IN 2008

Selected ARIMA models, modified for the structural changes occurred in the second half of the year ARIMA1 (5,1,4)⁷ and ARIMA2 (5,1,4)⁸ (two models, with and without structural shocks), were used for the inflation forecast, i.e. their forecast were used as the values of the central projection of the Fan Chart index of retail prices for 2008. Obtained values represent the distribution mode, i.e. the values with the highest frequency in distribution of these time series.

The next step represents determination of the distribution average value, standard deviation (σ) and distribution skewness. On the basis of these data, the values sigma 1 (σ_1) and sigma 2 (σ_2) were determined. These values represent parameters of the left part of the N1 distribution (central projection, σ_1), i.e. of the right part of the N2 distribution (central projection, σ_2). If $\sigma_1 < \sigma_2$, distribution moves towards the values over the mode, i.e. correspondent central projection underestimated future inflation values, i.e. distribution is positively skewed to the left. Therefore, we have $Avg > Me > Mo$. On the other hand, if $\sigma_1 > \sigma_2$, distribution is concentrated above the mode, i.e. correspondent central projection overestimated future values of the inflation, i.e. distribution is negatively skewed $Avg < Me < Mo$.

In case of Fan Chart inflation in Montenegro, central projections on a monthly basis represent the distribution mode, i.e. their average values do not match with the mode value, which indicates the asymmetrical distribution, positively skewed.

If we observe the uncertainty level which determines the width of Fan Chart, it approximates over the distribution variation calculated by the model, so that the distribution of the inflation rate has the average value and variation:

$$E(RPICG) = \mu + \sqrt{2/\pi} (\sigma_2 - \sigma_1)$$

$$VAR(E(RPICG)) = (1-2/\pi) (\sigma_2 - \sigma_1)^2 + \sigma_2^2 * \sigma_1,$$

Where μ represents the distribution mode, σ_2 and σ_1 are standard deviations of the left, i.e. of the right side of the asymmetrical distribution, while γ represents the approximation of the distribution skewness expressed by the difference between median and mode. The correspondent distribution has the following layout:

$$f(RPICG) = RPICG \exp(- (RPICG - \mu)^2 (1+\gamma)/2\sigma_2), \text{ if } RPICG < \mu^9$$

$$RPICG \exp(- (RPICG - \mu)^2 (1-\gamma)/2\sigma_2), \text{ if } RPICG > \mu$$

⁷ ARIMA model is usually marked as ARIMA(p,d,q), where p represent the number of autoregressive variables, d refers to the level of depending variable stationarity while q represents number of variables, movable averages which are placed in the correspondent model.

⁸ Although it has the same ARIMA(p,d,q) structure, ARIMA2 model contains also two dummy variables which refer to the structural breakdowns in retail price index movements, becoming more sensitive to the potential future shocks.

⁹ For detailed explanation of Fan Chart please consult Britton, E, Fisher, P.G. and Whitley, J.D. (1998), 'The Inflation Report projections: Understanding the Fan Chart', Bank of England, Quarterly Bulletin, 38, pp. 30–37.

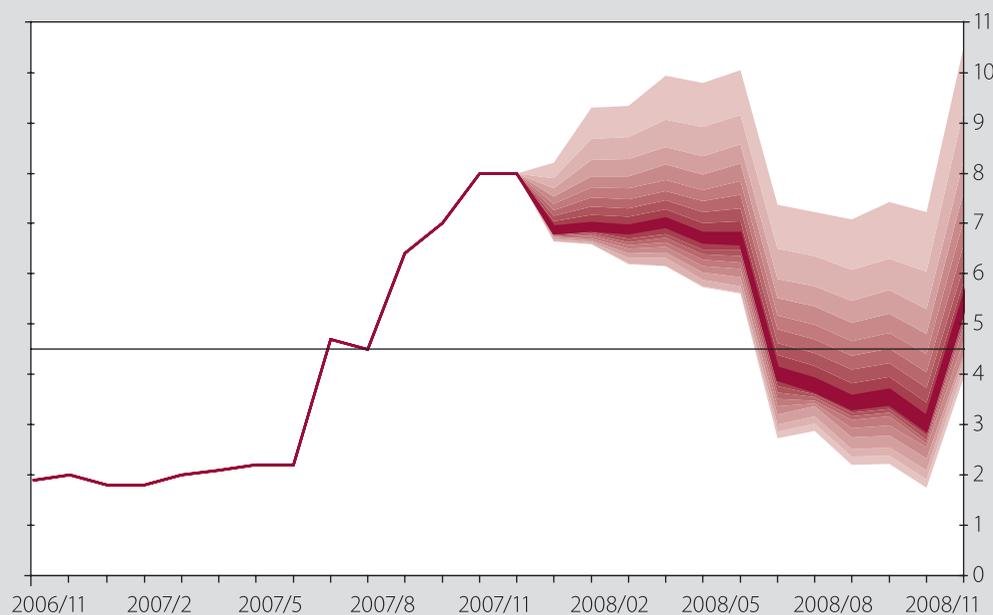
On the basis of ARIMA1 model, central projection which corresponds to the distribution mode is obtained, with the average value of 4.91% of the skewness ratio ranging from 0.6 to 0.23, as well as with the standard deviation values of the layout from the left, i.e. right side of the asymmetric distribution $\sigma_2=0,151$ and $\sigma_1=0,076$, which indicate that the central band placed at the lower part of the distribution, i.e. that the level of uncertainty, influenced by the inflation expectations widens the Fan Chart towards the higher levels of inflation (graph 39).

Fan Chart explains 90% of probability of the inflation distribution. The central projection is usually in the deepest shade of the Fan Chart, i.e. in the central 10% of probability¹⁰. The Fan Chart has an equal number of bands (eight) on either side of the central band, whereby each band is of the 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 2008, which implies the absence of external nature shocks (growth of prices of electrical energy, oil and oil derivatives), shows with a 90% probability that inflation, measured by the retail price index, will vary from 2.1% to 10.5%, 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% and 8.09%. Although this range seems very wide, the Fan Chart have to be observed on the monthly basis, i.e. according to the optimistic model which excludes the possibility of external shocks in the next year, inflation decrease could be expected in the second half of 2008, and by the end of the year it could be reduced to the level between 4.5% and 5%.

On the basis of ARIMA 2 model, which implies scenario of further external shocks in 2008, central projection which corresponds to the distribution mode is obtained, having the average value of 7.13%,

Graph 39 - Projection of retail price index in Montenegro for 2008, based on ARIMA1 model



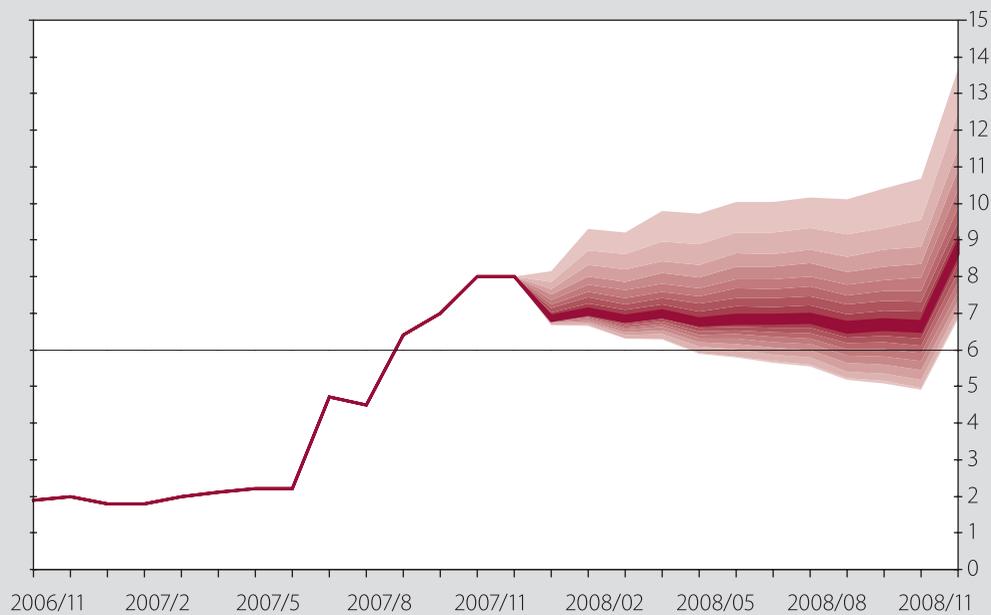
¹⁰ Usually the values of mode (central projection) are placed in the deepest shade of the band. However, if there is a significant risk level, it could happen that central projection does not cover neither of these values (Britton, E, Fisher, P.G. and Whitley, J.D. (1998), 'The Inflation Report projections: Understanding the Fan Chart', Bank of England, Quarterly Bulletin, 38, pp. 30–37.)

skewness ratio ranging from 0.129 to 1.27, as well as with the values of standard deviations of the layout from the left i.e. right side of the asymmetric distribution $\sigma_2=1,236$ and $\sigma_1=1,347$, which indicates that the central band is placed at the lower level of the distribution, i.e. that the distribution represents a probability of inflation movements concentrated above the mode value (Graph 40).

Montenegro's inflation fan chart, based on the ARIMA2 model for 2008, with a 90% probability shows that inflation, measured by the retail price index, will vary from 5% to 13.6%, if during 2008 external shocks of prices growth, similar to those in 2007, do not occur. At the same time, the central band of Fan Chart shows that with a 10% probability it could be claimed that inflation, measured by the retail price index in 2008, will range between 6.5 and 9%.

At the end we should bear in mind that the absence of sufficiently long time series, numerous shocks over the past years, absence of some statistical indicators and insufficient level of liability of other statistical indicators may influence the lower degree of model forecasts liability in comparison to some other countries. Also, we should consider the fact that the forecast was done for the annual inflation rate, and not for the average annual inflation rate which is mostly lower than the annual rate.

Graph 40 - Projection of retail price index in Montenegro for 2008, based on ARIMA2 model with structural breakdowns



7. EXPECTED INFLATION IN 2008

The level of aggregate demand in the fourth quarter of 2007 was significantly higher in relation to the previous quarter. This is the highest level of aggregate demand ever since this Report is disclosed for the first time. We should expect the high level of aggregate demand over 2008 as well, but CBM measures directed to the limitation of credit expansion will influence slowdown of the aggregate demand growth.

On the other hand, the level of economic activity is on an increase. According to estimates, real GDP rose by 7% in the previous year. According to the expectations of surveyed businessmen, high growth of the economic activity may be expected in 2008 as well. Namely, 81% of surveyed businessmen expect the increase in volume of activities and 90% plans new investments. High growth of economic activity will partially absorb the aggregate demand growth.

This year will be characterized by the growth of business uncertainty and risk at the global level, as a result of still present financial crisis, growing inflation pressures, instability at some key global markets (energy, agriculture and food products), recession of US economy, still present political tensions etc. These factors will influence the growth of global inflation which will inevitably be transferred to Montenegro as well.

Inflation expectations are lower in relation to the previous quarter, and cyclical indicator shows the stagnation of the inflation. Over 90% of the surveyed companies consider that the inflation rate will be higher than 4.5% and one third of the surveyed companies (the biggest group) expect the inflation rate to be higher than 7%.

However, the expected inflation rate is higher in relation to 2006, when the realized inflation rate was the lowest according to the Maastricht criteria. We expect that the inflation in 2008 will dominantly be influenced by the external shocks (prices of agricultural and food products, oil derivatives) and administratively controlled prices (first of all the prices of electrical energy).

Bearing in mind that the presence of external shocks and continuation of price disparity are expected in 2008, we consider that more realistic scenario is shown by ARIMA 2 model in relation to ARIMA 1 model. According to this model with a 90% of probability it is expected that inflation measured by retail price index will range between 5% and 13.6%. The central band of the Fan Chart ARIMA 2 model shows that with a 10% of probability it is expected that inflation in 2008, measured by retail price index, will range between 6.5% and 9%. This central band forecast is considered as more realistic with certain assumptions, like, that in relation to 2007 oil derivatives and electrical energy prices will not increase more than 10%, and that there will be no significant changes of other administratively controlled prices.