

**RECOMMENDATIONS TO THE GOVERNMENT OF
MONTENEGRO FOR ECONOMIC POLICY IN 2013**

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I. INTRODUCTION

The first half of 2012 was very unfavourable for Montenegro. Observed y-o-y, many sectors trended down, problems with liquidity in the real economy boosted, the current account deficit increased, FDI inflow declined, a high fiscal deficit was registered, and the public debt uptrend continued.

The aforesaid crisis is not only characteristic for Montenegro. Recession is forecasted for many EU countries and many countries in the region like Croatia, Slovenia, Serbia, Hungary and others. Montenegro is a small and open economy so the crisis in the EU and the region, coupled with internal weaknesses, spilt over to Montenegro fast.

In the conditions of a euroised and small economy like Montenegrin, both adjustment instruments and available funds are largely limited. Thus, economic policy in 2013 should aim to promote growth and development and creating stability. The most important economic policy measures should involve fiscal consolidation, a gradual change of the growth model, the real sector restructuring, improving competitiveness of the Montenegrin economy, intensifying negotiations with the EU, continuation of privatisation, passing systemic laws compliant with best international practices, continuation of deregulation, removal of business barriers and the like.

The key policy and reforms should be in the fiscal domain. A high fiscal deficit and a growing public debt over the past five years were the result of anti-cyclic fiscal policy and declining public revenues. However, we are at the point where a further growth in the public debt could be a serious impediment to future growth. Public debt servicing is becoming more and more expensive, since interest rates in international financial markets have been trending up. These conditions require fiscal consolidation, i.e. adjusting public expenditures to possibilities. If the existing budget revision does not give satisfactory results, this will call for additional consolidation measures, including the VAT increase. The low VAT rate is a potential reserve and its increasing should not be refrained from, if necessary, particularly considering the global VAT increase trend. Thus, such a measure would not greatly undermine the business environment, although it would affect the living standard decline to a lesser extent.

With a view to ensuring a long-term fiscal viability, it would be also necessary to adopt binding fiscal rules to cover sanctions for their violation. Such rules would ensure a long-term viable fiscal policy, increase the Government's credibility and positively affect Montenegro's credit rating. We should recognize a significant progress made in drafting these rules in the previous period.

The Government has to finally decide on Aluminium Plant's (KAP) destiny. The best option would be to find a serious strategic partner. However, in current circumstances and considering the condition of equipment and KAP's financial situation, this would not be easy at all. The remaining two options include its closing or reaching the national consensus on subsidising its production. Taking into account the KAP's low contribution to net exports and GDP creation, as well as significant subsidies allocated to this company, the option of KAP's closing and all positive and adverse effects thereof should be seriously considered.

The problem of the real sector illiquidity additionally deepened. The numbers of frozen accounts and blocked amounts have been trending up. Still, we have to note that there are over 7000 companies with over 2400 employees with accounts blocked for more than three years. This raises a doubt that these companies have found alternative methods of operations. Thus, for the purpose of creating all necessary preconditions, we believe that it would be necessary to introduce automatic bankruptcy in companies whose accounts have been blocked for more than three years, with one-year grace period. This could have a positive effect on companies' fiscal discipline, and could also have positive implications to financial stability. Moreover, with regular servicing of its obligations, the state should contribute to mitigating the liquidity problem.

High illiquidity in the real sector has adverse effects on the country's financial stability. Although banks' balance sheets had been largely "cleaned" last year, NPLs started to grow again this year. The cleaning was largely done by displacing non-performing assets, which means that the problem was only partly solved, as long as the real sector gets "sound balances". A high NPL level has adverse effects on banks' solvency, as well as on lending activity. Thus, it would be necessary to implement the restructuring programme in solvent companies with liquidity problems. It would be important that the Government participates in this programme that is prepared jointly by the CBCG and the World Bank.

Extremely high interest rates that may be classified as "usurious" interest rates are prevailing in the Montenegrin financial market. Some countries in the region (Croatia and Macedonia), many EU Member States and the USA have prescribed contracted interest rate caps. We believe that Montenegro should prescribe this cap by amending the Law on Contracts and Torts.

The obtaining of the accession negotiation date with the EU was certainly one of the biggest successes in the current year. Therefore, we should be fully committed to achieving the long-term strategic objective - the fulfilment of all state's obligations as soon as possible.

A particular problem is the lack of any clearer development vision and thus we find the creation of an economic development strategy as the priority task.

In the first half of this year, FDI inflow showed the year-on-year decline. Nevertheless, it may be assessed as satisfactory taking into account the external circumstances. Montenegro's potential to attract FDIs is still high and tourism and energy remain particularly attractive industries. Taking into account the current situation, it would not be realistic to expect FDI inflow similar to the one recorded during the boom years, but this period should be used to create preconditions for the new FDI wave after the crisis, these involving the completion of spatial plans, resolving land ownership issues, speedy issuing of construction permits, promotion of investment opportunities, and the like.

Tourism proved to be the most vital sector of the Montenegrin economy and the main instigator of economic growth and development. Therefore, we should start with a gradual diversification of tourism offer and separating tourism areas for masses from high-end tourism areas in the upcoming period. Due attention is to be paid to improving tourism infrastructure which has become a chronic issue. The promotion strategy should be focusing more on promoting specific types of tourism offer and less on the general promotion of Montenegro.

Pursuant to its legal obligation, the Central Bank of Montenegro (CBCG) proposes Recommendations to the Government of Montenegro for Pursuing Economic Policy in 2013. The analysis of the selected areas contains short background, the analysis of the most important possible risks in the upcoming period, strategic development directions, and the proposed operational measures for their implementation. The recommendations are grouped into the following areas:

- Recommendations concerning institutional environment and deregulation;
- Recommendations concerning agriculture and forestry;
- Recommendations concerning industry;
- Recommendations concerning the service sector;
- Recommendations concerning education and the labour market;
- Recommendations concerning fiscal policy;
- Recommendations concerning the financial system;
- Recommendations concerning economic foreign relations and international integration;
- Recommendations concerning ecology and sustainable development; and
- Recommendations concerning other areas.

II. INSTITUTIONAL ENVIRONMENT AND DEREGULATION

Background

A sound business environment and favourable investment climate are crucial for economic development and they are of utmost importance for the transition process. Investment climate and business environment have gradually improved in the past years, but there is still significant room for improvements.

Within its activities, the Council for Regulatory Reforms and Improving the Business Environment (CRRIBE) has implemented activities creating preconditions for establishing the one-stop shop system for registration of companies under the Central Registry of Business Entities. Moreover, on-line registration of companies was also introduced. In addition, many reforms and activities were performed referring to simplifying procedures of issuing construction permits, increasing efficiency of cadastral offices, simplifying procedures for alien employment, reforming business licensing, reducing administrative taxes, expanding credit registry (pursuant to the new CBCG Law), and the like.

Additional activities were performed on the project “Guillotine of Regulations” in 2011 and 2012, and the last phase included giving opinions, recommendations for amending and cancelling some legislation. The analysis of regulations covered some 690 legal acts, 320 administrative procedures and some 1,750 recommendations were prepared.

In 2012, the CRRIBE passed the new Action Plan for Business Environment Improvement, which defines the implementation of short-term and long-term activities. Moreover, the Plan for implementation of recommendations under the “Guillotine of Regulations” was also passed.

A new Law on Enforcement and Securing of Claims and the Law on Public Enforcement Officers were passed, aimed at removing deficiencies in the existing execution system, reflected through significant number of unsolved cases, lengthy proceedings, disputes in the collection of claims, and the like. These laws should improve the issue of future enforcement through public enforcement officers as well as to implement the Council of Europe’s recommendations.

The Bankruptcy Law defines basic bankruptcy principles and affirms the principle of bankruptcy proceeding’s urgency and efficiency, which has been achieved by defining precise and shorter deadlines for acting of all bodies involved in bankruptcy proceedings, in particular a bankruptcy judge and a trustee in bankruptcy.

The inspection system reform started with a view to consolidating inspection bodies into a single agency and aiming to uniform inspection services work, reduce shadow economy and make inspectors' work more efficient.

Aiming to increase operational transparency in Montenegro, as of July 2012 the CBCG has been publishing lists of undertakings which accounts have been frozen for more than 30 days and where the frozen amount exceeds EUR 10,000. This was preceded by the harmonisation of data between the Central Registry of Commercial Court (CRCC) and the CBCG, and accompanied by amendments to the Law on National Payment Operations.

In 2012, the Government adopted the Operational Plan for Combating Grey Economy with the objective of providing more quality data exchange, coordination of competent authorities' activities and intensifying all forms of inspection controls aimed at a systemic resolving of the shadow economy problem.

Moreover, with a view to suppressing shadow economy, the Government passed the draft Law on Amendments to Excises Law, which implementation shall enable more efficient control and reduce space for frauds present in practice.

Ending of all preparatory reforms in 2011 opened the conditions for introducing Regulatory Impact Assessment (RIA) into Montenegrin regulatory system as of 1 January 2012. From the aspect of business barriers, the Department for Business Environment Improvement has issued some 90 opinions to draft legal acts and accompanying RIA forms during the period from the introduction of RIA to H1 2012. The Ministry of Finance and USAID organised three joint trainings for some 60 public servants, while four trainings will be conducted by the end of the year.

With a view to shortening deadlines and simplifying procedures for obtaining construction permits and consequently to business improving, the Law Amending the Law on Spatial Development and Construction of Structures was passed. The amendments contain a set of reforms of the construction permits issuing, with the ultimate objective of simplifying procedures, reducing costs and gaining more efficient public administration. The new law introduce

s the one-stop shop system, which implies that the relevant authority for issuing construction permits issues conditions necessary for compiling technical documentation, i.e. the compliance to be issued the technical documentation. Legal reform also included the following laws: Law Amending the Law on Geological Explorations, Law Amending the Law on Electronic Communication, Law Amending the Law on Water, Law Amending the Law on Agricultural Land, and Law Amending the Law on Protection and Rescue. The result of the abovementioned amendments is the reducing of the number of procedures for obtaining construction permit from 14, as counted by the World Bank, to 2.

Aiming to launch a website enabling citizens to submit electronic petitions, the Government of Montenegro and the UNDP signed the cost-sharing agreement for the implementation of the “Citizens’ Voice – E-Petition” project in 2012. The introduction of e-petitions would enable the public demands of different social factors to be articulated in a constructive and socially responsible manner towards the resolution of concrete social problems. Each adult citizen of Montenegro or a foreigner with permanent residence will be allowed to file an e-petition¹ in any field within the Government’s remit.

The new Labour Law enabled more flexibility to employers in outsourcing and easier dismissal of workers due to unaccomplished expected tasks and objectives.

In accordance with the Open Government Partnership (OGP) principles, the Government adopted the action plan in 2012.² The initiative aims to assist governments in being more transparent, efficient, and responsible. To become an OGP member, a country must adopt the Open Government Declaration, which the Government of Montenegro has done, and to deliver the Action Plan drafted in accordance with OGP principles, consult the civil society for opinion, and deliver independent opinions on the progress achieved through the Action Plan measures.

The Action Plan was presented at the OGP Annual Conference which took place in Brasilia in April 2012. During the conference, the delegation presented the country’s activities on increasing labour transparency, i.e. improvements in public services, efficient public resources management, creating safer communities, and increasing public integrity and corporate responsibility.

Two business areas were established in Montenegro, in Berane and Kolašin. Aiming to foster SMEs’ development on the planned and infrastructure-equipped land with benefits to be obtained from their local administration, the Government and the Investment-Development Fund, the Government of Montenegro has passed the Business Fostering Programme with local administration of these two municipalities.

Despite significant progress in the last several years, domestic and foreign investors still criticize Montenegro. Many business barriers are still present, these being slow and long-lasting procedures, particularly on local levels. Foreign investors find barriers and high municipal taxes and fees to be significant barriers. High real sector’s illiquidity is also significant. Although direct illiquidity indicators are still

¹ If supported by at least 6.000 citizens’ signatures, the relevant ministry will be required to turn such a petition into a formal initiative, which is then to be considered by the Government, and, if necessary, submitted to the Parliament.

² Aiming to develop democracy, the Open Government Partnership (OGP) is a multilateral initiative aiming to secure concrete commitments of governments to promoting transparency, empowering citizens, combating corruption, and harnessing new technologies. The OGP was launched in September 2011.

unavailable, the number of blocked accounts and frozen amounts could serve as valid indicators. Bearing in mind that there are over 7,000 companies with frozen account for more three years which employ some 2,400 people, there is a serious doubt that some of these companies have found alternative ways to operate in order to avoid “account freezing”.

Shadow economy aggravating stable business environment poses a significant problem.

Main risks

- Inefficiency and slow administration in implementing legislation
- Slow court procedures in resolving commercial disputes
- Difficulties in collection
- Insufficient inspection surveillance and presence of shadow economy
- Highly monopolised market
- Possibility of unfair competition
- Relatively high contributions for pension and health insurance limiting investments
- High public utility taxes in the construction sector
- Presence of corruption
- Local barriers (multiple and high communal taxes and fees)
- Insufficient labour force mobility
- Lack of qualified staff
- Further deepening of real sector illiquidity
- Disobeying of legislation

Development strategy

- a. Increase public administration efficiency, particularly on local levels
- b. Increase efficiency in implementing enacted legislation and improve the exercising of the rule of law
- c. Open market to all segments with limited competition providing equal rights to all participants
- d. Aiming to attracting investors, each local administration unit should create facilities programme
- e. Improve anti-monopolistic policy functioning
- f. Continue creating “business areas” in other large local administration units (Podgorica, Bar, Bijelo Polje, Nikšić, and Cetinje)
- g. Continue the application of Regulatory Impact Assessment (RIA) methodology in passing new legislation

- h. Continue combating shadow economy by strengthening inspections and imposing stricter penalty measures
- i. Sanction all investors breaching contractual obligations;
- j. Speed up the resolution of commercial disputes
- k. Improve efficiency in implementing the executive procedure
- l. Strengthen entrepreneurship development as growth and development generator
- m. Introduce automatic bankruptcy;
- n. Strengthen financial support in creating new and developing existing SMEs through the Investment and Development Fund.

Operational measures

Aiming to reduce possibilities for corruption, the authorities should implement activities towards further removing of barriers and ensuring better conditions for the rule of law. More efficient court proceedings and efficient implementation of the law are the precondition for attracting foreign investors.

Many laws aiming to improve business environment were passed in the past few years but there is some inconsistency in their application. With a view to removing business barriers and maintaining a stable business environment, the relevant authorities have to provide efficient application of enacted laws. With a view to increasing the public administration's efficiency and acquiring skills, competences and providing continuous training, the authorities should improve the public administration officer's training system to match corporate and individuals' needs. Moreover, administrative procedures should be improved, implying shorter deadlines for acting, collecting documents ex officio, and determining real fees in accordance with administration costs.

Regulatory adjustment should result in prohibiting founders of corporate entities with frozen accounts during enforcement collection procedure and their family members—natural persons to establish new corporate entities. From the moment of freezing their accounts during a enforcement collection proceeding, corporate entities and entrepreneurs should also be prohibited to collect their claims and settle their obligations by contracting changes of creditors and/or debtors in the specific obligation (assigning, cession, takeovers, assumption or assignment of debt, etc.), offsetting (compensations), securities transfer and/or any other way aiming to avoid the collection of claims or settlement of their obligations over account, unless otherwise stipulated under the law governing tax administration.

Efforts should be made in establishing better quality corporate management, focusing on principles of protecting minor shareholders and “social responsibility” (stakeholder corporate management principle).

There are many instances of new owners non-adhering to all provision of privatisation contracts, sometimes generating additional costs to companies and the state budget. The authorities should keep systematised records of contracts’ implementation and timely respond by taking appropriate actions. The protection of minority shareholders’ rights is of particular importance.

The application of the **RIA methodology** should be continued. Its implementation is essential, since it is a complex tool aiming to enable *ex ante* evaluation of new legislation (laws and secondary legislation). For the purpose of ending the project, recommendations given under the “Guillotine of Regulations” project should also be implemented.

Aiming to develop some local administration units and attract foreign investors, each local administration should create its facility programme for foreign investors, thus also improving business environment. The package of measures might include tax facilities to new investments, establishing business areas, creating municipal urban plans, efficient local administration and the like. For the purpose of speedy and more efficient procedures, local authorities should establish working bodies to be available to investors. Moreover, the government should introduce tax facilities for employing certain categories of unemployed persons in underdeveloped local administration units.

Since foreign investors pointed to “ambiguous legislation and conflicting laws, procedures and secondary legislation”, it would be necessary to make detailed analyses of some laws for the purpose of removing uncertainties and limiting possibilities for misinterpretation and misapplication by companies.

Montenegro is a small country so it is not unusual that many companies behave as monopolists or oligopolies. However, such a situation could be highly unfavourable from the aspect of consumer welfare so it is necessary to prevent any misuses of domination. Thus, it would be necessary to completely open the market in all segments where competition is limited by fostering investments into these areas and creating more favourable investment conditions. Thus, one may have an impression that prices of some services are more expensive in Montenegro than in other countries in the region.

Taking into account the significant share of foreign labour force, the procedure of obtaining working permits should be shortened. In addition, it would be useful to examine the possibility of interim working permit being valid from the period of

filing the application to the period of issuing the permit. The government should also examine a more restrictive policy of issuing working permits in sectors with available labour force in the Montenegrin market.

Shadow economy is widespread in Montenegro. It acts as unfair competition to companies settling their tax and other obligations. The objective should be its reintegration into legal flows, wherever possible. The operational plan for combating shadow economy should prescribe stricter penalties, which would help in suppressing shadow economy and reducing irregular operations, simultaneously creating preconditions to gaining more fiscal revenues.

The collection of bad corporate debts in Montenegro is within the jurisdiction of courts. Thus it is necessary to ensure appropriate environment for the work and functioning of public enforcement officers.

It would be useful to implement the so-called “opentable system” (a fiscal cash register receipts per individual order instead of a cumulative receipt), which would enable the issuing of fiscal receipt at a guest’s request. The precondition for the implementation is the development of adequate software that would disable the principle being used to avoid fiscal receipt issuing.

With the purpose of mitigating the illiquidity problem, the automatic bankruptcy principle should be introduced. Thus, the real sector would be cleared and the financial sector’s stability would be improved by transferring mortgage claims into banks’ equity. In order to give companies sufficient time to eventually exit the blocking on one side, and to prepare all necessary preconditions on the other side, we believe that the abovementioned law should be passed with the grace period of one year. In the upcoming period, the key precondition should be performing intensive training of trustees in bankruptcy which would mitigate potential unemployment increase resulting from failure of some companies. Bankruptcy should be financed from assets of economic entities in bankruptcy. The state should also contribute to mitigating the illiquidity problem through regular settlement of its obligations.

III. RECOMMENDATIONS CONCERNING AGRICULTURE AND FORESTRY

Background

According to available data, services dominated in Montenegro's economy in the last ten years. The share of output sector including the agriculture trended down. The share of agricultural sector (agriculture, hunting, forestry and water) had the average share of 9.2% of gross value added (GVA) in total GDP for the period 2000-2010, whereby the share of this sector decreased by 3.6 percentage points in 2010 relative to 2000 when the calculation of GDP according to SNA93 and ESA95 methodologies has started.

Low productivity resulting from insufficient mechanical equipment, too many small holdings and large area of low fertility soil are some of the main causes of low competitiveness of Montenegro's agriculture. Due to unfavourable economic and social situation, agricultural holdings cannot individually provide sufficient funds to modernise their production. Neglected agriculture brought about other adverse effects. The first one being growing food imports that contributed to significant deterioration of the already high current account deficit. The second one was significant migration from rural areas to Podgorica and the coast. This resulted in excessive pressures on infrastructure of these towns and increased social problems since most of the people arriving from rural areas could not get employment; and all this resulted in a further deepening of regional differences. The third one was an extremely significant GDP decline during the global financial crisis. To wit, the crisis showed that the service sector recorded a sharp decline, while agriculture recorded a positive GDP growth.

The mainstream agricultural activities in the middle- and long-term should be increasing the agricultural output volume and creating village revitalisation incentives. In the period 2007-2010, the share of arable agricultural land in total agricultural land decreased by 2 percentage points. The number of employees has been constantly declining both as per administrative source and the Labour Force Survey (LFS). Although being significantly lower before, wages without taxes and contributions were higher than the Montenegrin average in the last three years (2009 – 2011). Except the wage increase, these indicators are disincentive, but it is clear that Montenegro has sufficient potential and good preconditions for developing agricultural production and the entire sector.

The agricultural sector has made progress towards the legal framework strengthening. Acting as the basis for IPARD support (IPA programme component V), the Ministry of Agriculture and Rural Development worked hard during the period on adopting the

key systemic documents, the most important being the 2009 *Law on Agriculture and Rural Development*, the *National rural development programme* as of November 2008, and *draft 2011 and 2012 Montenegro IPARD programmes*.

In June 2012, a draft Law on Organic Production was prepared, which regulates the objectives and principles of organic production, rules of processing, control and certification in organic production, processing, labelling, import, and other relevant issues for the organic production. The Government of Montenegro also passed the Action Plan for Organic Production 2012–2017, which defines measures for supporting development of organic agriculture, measures for processing and consumption of organic products in the domestic market and as a part of the tourism offer.

A new Law on Agricultural Corporates in Montenegro is also significant as it is compliant with EU standards and International Cooperative Principles and which should be enacted by end-2012. By adopting contemporary legislation on cooperatives, farmers will have a chance to improve their position in the international market, get better prices without intermediaries, and more favourable loans and advisory services.

As the *Regional Development Strategy of Montenegro 2010 – 2014* indicates, the largest part of development potential is in the least developed areas. Agriculture, notably healthy food production and available forestry potential, will be the resources to be used and valued in the market in the upcoming period. Aiming to additionally improve agriculture, we should utilise all funds allocated for strengthening various agricultural segments, starting from administrative capacities through production to adopting standards. These funds are provided under the programmes and projects offered through the Instrument for Pre-Accession Assistance (IPA), the European Commission, the Government of Denmark and the like.

In the past few years, the following key documents regulating the forestry sector were passed: the National Forestry Policy, the Law on Forests, and the National Action Plan for Combating Illegal Activities in Forestry. Results of the first National Forest Inventory show that forests account for 59.9% of Montenegro's territory.³ The National Forestry Policy for Montenegro and Spatial Plan for Montenegro until 2020 served as the basis for the Inventory. Both documents focus on the need of conducting the National Forest Inventory, which has provided accurate data on forests for the first time in Montenegro's history. Forests are important for maintaining flora and fauna through net absorbing large quantities of carbon dioxide,

³ Ministry of Agriculture and Rural Development: National Forest Inventory of Montenegro - summary, Podgorica, 2011.

and for mitigating effects of climate changes, and preventing the land erosion. There are still doubts whether forestry in Montenegro is managed in a sustainable manner.⁴

Agriculture could be an important factor in reducing regional differences, and joined with forestry, it could represent an important segment of developing national economy. The analysis of financial statements showed that the rate of profit in agriculture is higher than the average for Montenegro's economy and that agriculture recorded profit in the period 2006-2010.

Main risks

- Migration of rural population and deagrarization resulting in depopulation of villages
- Insufficient labour force and training
- Undeveloped infrastructure in rural areas
- Domination of extensive production and production on small plots of land using inadequate equipment
- Breeding of inadequate assortment
- Excessive cutting of woods, improper forest management and danger from fire

Strategic development

- a. Complying with the sustainable development principle and increasing the agricultural production volume with particular focus on organic production and promotion of the Montenegrin food production specificities
- b. Improve agricultural production in the north of Montenegro
- c. Increase agro-budget funds
- d. Create long-term strategy of fishery development, taking into account Montenegro's negotiation position to the EU referring to exploitation limits and fish breeding
- e. Support investments into village development, including infrastructure through various Government subsidies
- f. Intensify production in restricted areas (greenhouses) reducing risks of unfavourable external effects and creating the possibility of expanding production of different crops, and strengthen organic production
- g. Increase livestock and the Government's participation in the cattle purchase
- h. Improve competitiveness through production modernisation
- i. Stimulate production development in family agricultural holdings
- j. Value forest wealth to a higher degree, adhering to the sustainable development concept

⁴ For more details, see the *Forests and Forestry* paper, published under the study "Montenegro in the XXI century in the area of competitiveness", published by Montenegrin Academy of Science and Arts (MASA).

Operational measures

In agriculture, Montenegro decided to follow the sustainable development concept with the primary objective of valuing its multifunctional role in the country's development. Such treatment of agriculture in macroeconomic policies should be continued. Since Montenegrin products receive awards at fairs (wine, honey, dairy products, etc), it is particularly important to promote specific products in both domestic and international markets. The trademark "Good from Montenegro" on some products contributes to recognising the Montenegrin brand (specific product). The fostering of organic production and recognisable brands is a consistent implementation of the very concept of ecological state.

Resulting from inadequate application of mechanisation and agro-technical measures, extremely low yields appear to be a particular problem in Montenegro's agriculture. International studies show that some 70% - 90% of agricultural production increase comes more from increase in yields rather than from growing agricultural land. This should be a clear guideline to the Montenegrin economic policymakers that this requires credit and technical support. Moreover, the World Bank indicated that increased mechanisation should support the key direction of yield increase in developing countries. They also suggested the leasing of equipment to reduce risks, and the World Bank had significantly increased earmarked credit support to these countries in the period 2010 – 2012.

The production structure should be changed in the upcoming period towards crops potentially bearing more profit, like cultivating early fruit and vegetables and increasing production in greenhouses. Introduction of clusters should also be an option since they gave good results in some countries, but none whatsoever has been created in Montenegro to date.

Compared to the coastal and central regions, the socio-economic indicators of the north are worse. In addition to energy, tourism and forestry, activities like agriculture should drive its development. Agriculture supported with more investments in healthy food production could be a particular potential of the north. As the Regional Development Strategy of Montenegro 2010-2014 indicates, investments in the north so far have been lower than investments in two remaining regions. Agricultural development would enable providing revenues, increasing employment in northern municipalities and simultaneously affecting revitalisation of villages and reduced population migrations. This recommendation is continuously supported by the allocation of agro-budget funds for production in rural areas. Future utilisation of funds of the remaining three IPA components is vital, particularly of the component V that refers to rural development.

Poor infrastructure characterises many rural areas in Montenegro. This has adverse effect on their economic and social status, contributing to depopulation of villages. By implementing the Measure for Improving Quality of Life and Spreading Economic Activities in Rural Areas, the allocated agro-budget funds for reconstruction and development of villages and the construction of rural infrastructure partially affect the promotion of agriculture and the improvement of conditions in the realisation of agricultural products (construction of road infrastructure, etc.). For the purpose of stimulating rural development, it would be necessary to continuously invest into agricultural infrastructure, roads and their maintenance. Appropriate use of funds under the Montenegro Institutional Development and Agriculture Strengthening (MIDAS) project (until June 2014) for agriculture strengthening and rural development is of extreme importance. The purpose of the project is also to assist in preparing institutions and agricultural producers to apply European agricultural policies, IPARD, CAP, etc.

The government must continue to support agricultural production, particularly the one of the most developed countries in the world. Otherwise, our agricultural producers would be in unfavourable position and uncompetitive. Also, bearing in mind that Montenegro is a small country and has limited available funds to support agricultural production, it seems inadequate to use budget funds to stimulate 34 different programmes. In that manner, scarce funds are too dispersed and they do not provide adequate support to most of programmes. Budget support should focus on those programmes in which Montenegro could attain comparative advantage, these being: viticulture, olive growing, production of fruit and early vegetables, livestock farming and production of ecological food. Montenegro has good natural conditions for developing these agricultural branches.

It would be important to resolve the issue of buying seasonal surpluses of agricultural products. This is very complicated in the situation where Montenegro lacks public warehouses for this purpose and commodity reserves. Thus, the country should start creating commodity reserves in the upcoming period.

At the same time, organic production compiling best environment protection practice should be strengthened. The production applies methods corresponding to the needs of consumers who favour natural products. The passed Action Plan for Organic Production 2012–2017 is a step forward in promoting and supporting organic production.

Meat production and processing accounts for an important share in the food, tobacco beverages and tobacco production subsector under total manufacturing industry. Montenegro is a large meat importer, despite good conditions for livestock production. The Strategy for Sustainable Economic Growth in Montenegro 2012-2016 has identified three potential clusters covering 39 producers with a total of

1,363 employees. For the purpose of enabling meat export to the European market and due to the available potential and the possibility to increase production, the continuous work should focus on finding solution for buying meat and increasing livestock, in parallel with adopting the relevant EU standards. For the purpose of getting subsidies, livestock should be increased before accessing the EU.

Agricultural production in family agricultural holdings should be more developed. The use of means for improving agricultural production (fruit, vegetables, meat, milk, meat products, etc) contributes to improving economic position of family holdings and living standards. Grants for purchasing equipment and modernisation of production and other investments into family households would result in attaining objectives of increased production, competitiveness, preserving the production of traditional products, and the like. Being in line with the Law on Agriculture and Rural Development passed in July 2009, agricultural holdings' development and their improvement is stimulated through the National Programme for Food Production and Rural Areas Development in the period 2009-2013. Establishment of the agricultural households' registry is of utmost importance. A sample-based triennial survey on the agricultural holdings' structure will be performed in 2013 according to the methodology used in the Agricultural Census 2010. Its results should be a good basis for directing funds (grants) to households' specific production.

Damages to agricultural products and crops, livestock and other resources regularly accompany agricultural production. Although producers may insure against some of these risks under the regular insurance system, they rarely use this possibility due to expensive insurance premiums and large scope damages exceed the producers' possibility of repair. Thus, instead of paying high amounts for contingent damages happening during the year, the state participation in insurance costs would be highly desirable.

In addition to production, ecological and social function, forests have multiple functions. Their importance is in maintaining natural balance and biodiversity, and simultaneously in economic development that may particularly stimulate growth of underdeveloped rural areas. Enabling creation of the national database on forests, the National Forest Inventory showed the high potential and evident increase in woods. Its periodic updating would enable conditions for more efficient planning and drafting more real macroeconomic plans. Its data would represent the basis for developing forestry science and practice, and for optimal multifunctional managing of state and private woods. The Law on Forestry emphasizes the importance of forestry noting that the ensuring of a sustainable forestry development is of public interest. The emphasized importance implies: exercising a more strict control of cutting by concessionaires in compliance with awarded concessions, prevention of illegal cutting, and afforestation for the purpose of providing forest fund. For the purpose of export of products of a higher degree of processing, wood sector potential

should be used for stimulating connections between wood producers with wood processors. Human resources in forestry should be continuously improved, using all available assistance of international institutions and projects. Implementation of the project “Support for Capacity Building in the Forestry Sector” to be completed by end-2013 is extremely important. This primarily IPA-financed project will enable the compliance of standards in the area.

Resources should be managed in an adequate manner, including: preserving the soil from contamination, preventing biodiversity endangering, sustainable and prudential use of genetic resources, and maintaining traditional production technologies.

IV. RECOMMENDATIONS CONCERNING INDUSTRY

1. Metal industry

Background

During the last few years, metal industry has been facing intensive problems. Privatisations have not resulted in their solving, while the global economic crisis only deteriorated the situation. Physical volume of industrial output – an industry severely affected by the crisis – decreased 2% and 32.2% in 2008 and 2009, respectively. However, it grew 17.5% in 2010, yet declining by 10.3% in 2011, mostly due to a drop in production in electricity, gas and water supply sector of 32.7%. This resulted in the change of industry weight structure and the reduction of its impact on total industry output from 43.1% in 2010 to 32.3% in 2011. In the last four years, the production of primary metals under manufacturing industry sector recorded significant decline in total output from 41.3% in 2008 to 25.9% in 2011. These declines resulted from insufficient and unprofitable KAP's output caused by the following factors: the global crisis, aluminium price in the global market, excessive number of employees, high output costs, and obsolete equipment. Maintaining of metal industry in Montenegro and continuing KAP's production imposes the need to restructure the company and take a set of measures.

Until recently, **KAP** was a set of independent production units integrated into a single company. However, by closing Alumina Plant, KAP reduced its operations only to primary aluminium output with Electrolysis and Casting Plants, the only remaining two plants functioning, in addition to Anode Plant, the consumables for output in Electrolysis. This has stopped the need of Bauxite Mine's operations for KAP, as well as stopping of operations in the Processing Plant (production of foil, roll, profiles, and household packaging) including also the Aluminium Cables Plant in Kolašin and finally the Forging Plant.

In October 2010, the Government signed the Settlement Agreement with KAP, thus providing a guarantee to the KAP's EUR 130 million worth loan and EUR 5 million for social programme. This aimed to solve KAP's problems of excessive debts to commercial banks and to optimise its operations. It enabled continued production of KAP that would otherwise be closed. According to the contract, the state acquired 29.36% share in KAP and the right of a representative in the Board of Directors with the right to veto all important decisions for KAP's operations: production, business plans, borrowing, etc.

In 2011, KAP increased production resulting in the manufacture of metals and products thereof subsector growth of 12.5%, and indirectly to manufacturing industry

sector's y-o-y increase of 9.7%. The aluminium price above USD 2,500 per tonne in the first half of 2011 and the social programme resulting in redundancy provided the possibility of operating without losses and real chances for investing into KAP's modernisation programmes and restarting the closed plants' operations. Still, KAP ran a net loss of EUR 10.1 million in that period.

As a result of a sharp decline in the global aluminium prices in 2012, KAP faced more difficulties in operations and Deutsche Bank called state guarantees amounting to EUR 23.4 million as a result of the Russian majority owner CEAC's defaulting. Total value of guarantees amounts to some EUR 132 million and, in addition to paid guarantee to Deutsche Bank, the remaining guarantees were given to OTP Bank and VT Bank Russia. In March 2012, the Montenegrin Parliament supported the Government's decision to assume EUR 22 million of KAP's debt to Deutsche Bank, terminate the agreement with the Russian owner Central European Aluminium Company (CEAC), takeover the KAP ownership and bring in new management. The Government initiated arbitration before a court in Vienna to prove that CEAC breached the 2010 Settlement Agreement when the Government retained 29.36% of KAP's shares into the state ownership. Aiming to avoid bankruptcy and in addition to resolution on debt assumption, the Parliament tasked the Government to hire a new management that would take measures with regard to electricity supply, resolving the social issues and debts. Simultaneously, the new management has to provide the independent study of aluminium output's viability, and to provide full and independent audit of KAP's operations from its privatisation.

Bauxite Mines directly share the destiny of KAP, its main consumer. The KAP's restructuring programme covers Bauxite Mines, also managed by CEAC, i.e. En+ group. According to the Settlement Agreement, the state acquired 31.8% of shares in Bauxite Mines and the right to a representative in the Board of Directors. This enabled bringing the restructuring programme to an end. The implemented social programme resulted in the optimisation of employees and their significant reduction. Due to a more favourable market price of alumina than the supply costs of the alumina supplier KAP, the production of bauxite stopped in 2009, while mine stocks were exported in 2010.

The production partially picked up in early 2011 in the surface pit Zagrad, and in early August at Štitovo, which had had no mine exploitation since December 2008. The company renewed the contact with a Hungarian purchaser on the annual export of 150,000 tonnes of bauxite, which was partially completed. This referred to contract renewal with old purchasers and negotiations on leasing Biočki stan pit.

However, operational conditions severely deteriorated in 2012, thus the production in Zagrad and Štitovo stopped in December 2011 and January 2012, respectively. Moreover, the purchaser from Hungary did not settle all his liabilities.

Steel Mill Nikšić has been facing severe difficulties in financing its production and unfavourable situation in the steel market in the last few years, which has resulted in significant output drop. Under the performed restructuring programme, the Government extended a EUR 26.3 million worth guarantee for the Steel Mill's loan for severance payouts, modernisation and mitigating the technical-technological lagging in production. A portion of loan was used to buy electric arc furnace installed in the middle of 2012 that has still not met technical criteria for operation, thus the production still uses obsolete technology.

For the purpose of being more market competitive and creating preconditions for operating without losses, the production needs modernisation. Aiming to resolve the issue of redundancies, a social programme was carried out. However, record losses in the last two years due to the company's poor operations and the owner's inability to settle creditors' claims resulted in bankruptcy initiated in mid-April 2011, and the Government had to repay the abovementioned loan in May. The bankruptcy also implied termination of the contract with the majority owner at the time.

Since May 2012, a Turkish reputable company Tosçelik became the owner of Steel Mill Nikšić and bought the Steel Mill's bankruptcy assets for EUR 15.1 million. It started production in July 2012. The owner planned to invest some EUR 35 million in the next three years, increase the staff from 308 to 550 and increase the output volume from 120,000 to 400,000 tonnes.

Main risks

- Significant export decrease of main products with deteriorated balance of payments position pressuring the unsustainable current account deficit
- Deteriorated fiscal position amid Government costs' increase in resolving metal industry's problems (subsidies, social programmes, guarantees to banks, etc.)
- Calling of other guarantees and its effects on fiscal misbalance
- Decline in metal industry products' prices with a particular focus on the aluminium price in global markets
- Growing electricity prices
- Lack of protection system in case of a new crisis and the strategy for the metal industry's long-term viability
- Quality of strategic partners in potential new privatisations
- Increased credit risk in the banking sector – impossibility to settle current obligations and repay debts to companies and employees
- Disobeying environmental operational standards

Strategic development

- a. Terminate contracts with the KAP's current majority owner CEAC Holdings Limited.
- b. Define clear strategic resolution on KAP's and Bauxite Mines' destiny
- c. Modernise metal industry to respect high contemporary ecologic standards compliant to the needs of domestic demand and exports and using energy-efficient production.
- d. Resolve present illiquidity and lacking working assets in the long term to provide production continuity.

Operational measures

The Government has to set a clear strategy for KAP and Bauxite Mines. The Government should end cooperation with the existing co-owners since they proved to be unreliable partners and unconcerned about improving production. If the Government provided new investors for KAP, it should also guarantee that future investors actually invested in local companies to make them successful companies that the state will benefit from in the future.

The preconditions for KAP's survival are the modernisation of production equipment and technology for the purpose of getting efficient products that meet international standards and are competitive in terms of prices, and the resolving of the issue of electricity supply. If it fails to find interested investors, the Government would have two options: to close or subsidise production whilst covering losses.

KAP is no longer important as it used to be as its contributions to GDP and net export are not high. At the moment, KAP is not an economic but a fiscal (due to high guarantees), social (due to many employees) and environmental (due to environmental pollution) problem. Continuous covering of losses does not appear to be a long term viable option and severance pays would probably be lower than KAP's annual losses. We should not disregard profit to be gained if electricity surpluses are to be exported. Still, a potential Government's decision to close KAP would be to reach an agreement with banks on assuming loan repayments to banks to which guarantees were issued (in order to avoid the calling of guarantees)⁵ or to enter into a credit arrangement with other creditors for the settlement of guarantees.

The third option would be the reaching of social consensus on continued production supported with fiscal subsidies.

⁵ In reality, this would be difficult since some banks have loans for which there are no guarantees.

The decision on strategic direction should be passed, in order to avoid inefficient use of state funds (only subsidies for 2012 and 2013 would be sufficient to cover severance pays to all employees).

Until reaching the abovementioned decision, KAP should reduce its production to at least half of installed capacities to minimise losses. It would be necessary to continue implementing economic output systems in all KAP's plants.

Simultaneously, solutions for renewing business activity in Bauxite Mines should be sought. The state should seriously discuss the option of taking over Bauxite Mines as per wages provided in the last period⁶ and that it should operate independently from KAP. Possible option may also be the repeating of the Steel Mill experience – introducing the bankruptcy and trying to find a new strategic partner during bankruptcy.

The Steel Mill Nikšić needs to modernise the output equipment for producing high alloyed steel as profitable products that may approach the market following the stringent international standards. In order to get high quality products with strong demand from the European market, modern equipment should replace the obsolete technology for steel production. However, this is the obligation of the new investor, and no longer of the Government.

The equipment for alumina unloading at the Port of Bar should be capacitated, so that the alumina loading/unloading capacity would generate less transport costs and enable low-cost maritime transport. Of course, these investments have to be realised only respecting high contemporary environmental standards.

2. Energy

Background

In the last few years, all Government's strategic and development documents have recognised that energy activity needs significant investments and strategic partners due to many reasons.

Montenegro is highly import-dependent on energy. Imported energy meets some 35% of total corporate and household needs. A high import of energy – particularly electricity – significantly contributes to country's deteriorated balance of payments. Imported electricity is expensive and tends to be more expensive in future, being a rare resource. On the other hand, two sectors being the largest energy consumers –

⁶ The Government provided funds for wages and bridging of service periods, and it allocated almost EUR 2 million for social programme in 2009 and 2010.

industry, comprising of 2 ferrous and non-ferrous metal companies, and households – are facing with significant irrationality in energy consumption. Energy efficiency improvement has become an important issue in reducing export dependence. Relatively low energy efficiency characterizes the entire energy chain from production through transport and distribution to final consumption. Households and corporate development needs are growing and production is insufficient, resulting in increased production and energy balance improvement becoming the strategic development objective. This is particularly noticeable with a view to energy sector being a significant instigator of economic growth generating multiplication effects on other activities such as metal industry, construction, ecology, tourism. Domestic and foreign investments into this sector strongly affect households through higher employment, higher wages, and better living standard.

On the other hand, huge unexploited energy potential – particularly of renewable energy sources – is waiting to be sustainably exploited. The largest part of the hydro potential, wind potential and coal mines is in the mountain regions of economically underdeveloped and demographically “neglected” north. If valued, these potentials could contribute to developing the northern area.

The Energy Development Strategy of Montenegro until 2025 passed in December 2007 and its accompanying 2008-2012 Action Plan were Montenegro’s energy policy strategic documents. Since 2012, there has been ongoing work on drafting the Energy Development Strategy until 2030 by the Danish COWI consortium. The main objective of the strategy is increasing investments in the energy sector to renew the existing and valuing new energy sources, create sustainable, safe and competitive energy offer from all available sources, and provide energy efficiency and growing use of renewable energy sources. The following reasons for passing the new Strategy refer to deviations from, delays in, and a lack of clarity of, some issues that were not covered in the previous Strategy:

- Need to make new and detailed assessments of potentials and possibilities of expanded use of other available renewable energy sources (biomass, sun energy, communal waste and the like).
- Need to clearly recognise technical and wider opportunities for international cooperation on the basis of planned 400 kV submarine interconnection cable between electric-energy systems (EESs) of Montenegro and Italy and additional interconnections with Bosnia and Herzegovina and/or the Republic of Serbia;
- Need to accentuate the energy efficiency importance and role in Montenegro’s Energy Policy complied with EU directives in energy efficiency, which application is obligatory in the Energy Community;

- Need to establish the national objectives for using renewable energy sources and complying the strategy to Action plans for energy efficiency pursuant to EU directives;
- Need to clearly recognise the role of the energy sector in the greenhouse gas emissions and the expected future international Montenegro's commitments, particularly in the post-Kyoto period after 2012, etc.

In order to harmonise the national energy legislation with the *acquis communautaire*, the state passed the Energy Law and the Energy Efficiency Law. The **new Energy Law** was passed on 22 April 2010.

The Energy Law incorporates obligations from the second energy package of Directives (2003/54/EC and 2003/55/EC for electricity and gas), as well as specific obligations from Directives on renewable energy sources (2001/77/EC and 2009/28/EC, except bio fuels), cogeneration (2004/8/EC) and partially on fuel reserves and oil derivatives (2009/119/EC). The Energy Efficiency Law incorporates Directives on energy end-use efficiency and energy services (2006/32/EC), on the energy performance of buildings (2002/91/EC), on labelling the consumption of energy and other resources by household appliances (92/75/EEC) and Directive establishing a framework for the setting of eco-design requirements for energy-using products (2005/32/EC).

Montenegro's legal system has not yet transposed the Directive on the promotion of the use of bio fuels or other renewable fuels for transport (2003/30/EC) or a part of the Directive on the promotion of the use of energy from renewable sources (2009/28/EC). The Decree on oil derivatives strategic reserves is being prepared.

The largest portion of work in the past period focused on opening possibilities for construction of small hydropower plants and wind power plants. Sun energy and bio masses are also important forms of renewable energy that Montenegro should rely on in the future. **Small hydropower plants** can become operative relatively fast, but there is a problem in planning documents since the envisaged locations for these plants are often far away from the distribution network. The construction of 23 small hydropower plants on 8 water flows has been foreseen to result in an annual electricity output of 200 GWh. Eight concession contracts have been signed with six concessionaires for the construction of small hydropower plants (at confluents of Lim, Tara and Zaslavnica near Nikšić). These projects are in the phase of acquiring construction permits. Small hydropower plants are not harmful to the environment unlike the big ones which result in significant changes in the ecosystem (freshwater fauna, harmful gas emissions during their construction, etc.). To that end, there is an ongoing project of revitalising small hydropower plants "Slap na Zeti" and "Glava Zete" owned by EPCG and NTE (Norway), which should be completed until 2013.

The construction of 4 hydropower plants on the Morača river has been foreseen to generate 238 MW and electricity output of 72 million KWh annually. The project is most likely economically cost effective and attractive to investors, but its effects to the region and natural balance have not been thoroughly examined. In addition, plunging of road parts is unacceptable without constructing an alternative road to the north.

Since 1 January 2009, the electricity market has become open to all consumers except households which, pursuant to provisions of the Treaty Establishing the Energy Community⁷, will be opened by 2015. Montenegro signed the United Nations Framework Convention on Climate Change and the Kyoto protocol in 2007, but it has not signed the GHG emission target and the pertinent policies. In cooperation with UNDP, the Government made the first National Report on Climate Change, which identifies main polluters.

Montenegro does not have access to international natural gas reserves, it has small coal reserves and it has to import oil. Oil retail is liberalised, and the liberalisation of the entire energy sector is in the early phase and the competition is still very limited, and the energy sector needs further strengthening.

Main risks

- Investment in the energy sector being the capital-intensive activity requires high initial investing both in realising investment and in examining energy sources and projecting energy capacity construction. The funding of this type of product is expensive and often hardly available, particularly in the period following the financial crisis escalation;
- Significant delays and deviations from the 2007 Energy Development Strategy, which also includes the construction of the second block of thermal power plant Pljevlja (TPP Pljevlja II), and its foreseen commencement of operations in 2011; delay in constructing and foreseen start of operations of the first hydropower plant at Morača (HPP Andrijevo) in 2013 and the remaining hydropower plants in the chain; delays in the construction and foreseen commencement of operations of the first hydropower plant Komarnica (2015).
- Selection of a reputable strategic partner which should be a reputable company in this industry with a long business history, transparent operations and availability at international capital markets;
- Insufficiently examined environmental impact of constructing new hydro power plants;

⁷ Montenegro has become an adhering party to the Treaty Establishing the Energy Community as of 2005.

- Situation in the South Eastern Europe (SEE) in the conditions of delayed construction and reduced planned new capacities in the region, posing a risk and challenge to Montenegro's more active participation in the regional energy development;
- Inadequate "know-how" in energy, particularly research, activities and insufficient ability for operational activity (construction of primary and environmental facilities);
- Quality of investment project analyses. Each investment analysis should be thoroughly examined and explained from the aspect of cost-efficiency and usefulness to avoid failed investments;
- Business barriers disabling free market operations in the entire economy and separately in the energy sector;
- Despite the enacted Energy Efficiency Law, Montenegro still does not have financing mechanisms and sources (grants, budget sources, international organisations, etc.) which would enable long-term consideration of energy development possibilities pursuant to principles under the Energy Efficiency Law;
- Additional capital price increase at international markets, which would make energy projects financing sources more expensive.

Strategic development

- Energy development should follow the principles of providing full energy independence, increasing energy efficiency, environmental protection, and contributing to accelerated economic development;
- Increase efficiency in energy companies operations by decreasing operational costs, technical and commercial energy losses, with justified return on investments;
- Continue the restructuring of EPCG AD and CGES AD following the principles of relevant energy legislation in the EU and timely pass further development plans;
- Construct new capacities in cooperation with reputable strategic partners either through private or public-private investments. The construction of a new facility is also important from the aspect of providing energy efficiency and decreasing the current account deficit;
- Increase energy efficiency in energy production (generation, transmission, distribution) and final consumption, primarily in the industry sector, services, transport and households;
- Increase the use of alternative energy sources (solar energy, wind energy, biomass, etc);

- Implement the project of strategic 90-day reserves of oil derivatives in accordance with the EU energy policy;
- Work on improving heating and/or cooling systems in facilities by substituting direct transformation of electric energy into heating energy and using new technologies acceptable from the environmental protection aspect;
- Continue the energy reform respecting the sustainable development and market operations principles by applying and complying with new laws passed in this area;
- Regulatory, legislative and operational integration in the EU accession process in the field of energy and environment, including integration into the Energy Community of South East Europe (ECSEE) and the EU Energy Market;
- Determine the potential for expanding international cooperation based on the planned 400 kV submarine interconnection cable between the EESs of Montenegro and Italy and additional interconnections with Bosnia and Herzegovina and/or Republic of Serbia;
- Gradual transition to lower energy intensity as the primary indicator of energy efficiency (the amount of energy used for creating a new value unit) which is six times higher in Montenegro than in the EU;
- Define electricity prices in a transparent manner and continue the social welfare programme under the energy sector reform process to protect the living standard of the most deprived population.

Operational measures

The mainstream policy to be followed in 2013 refers to constructing new capacities in renewable energy sources, particularly using hydro potentials due to high differences in altitude, current water regime and narrow and deep canyons, suitable to construct dams.

The option of Montenegro' gasification should be reviewed. Potentials for gas delivery include connecting to the Adriatic-Ionic gas pipeline and to gas pipeline that will pass through Serbia and Bulgaria.

The following measures should be implemented regarding energy efficiency:

- Development of the Energy Management in Public Sector project in the following year should be paid due attention, focusing on management education through cooperation with the German GTZ. Therefore, pursuant to the Energy Efficiency Law, it is assumed that all government and local administration bodies and large consumers would independently develop IT reporting systems on the use and demand for electricity, which would give a clearer picture on the needs of large consumers in the upcoming period;

- Cooperation with the Slovenian Government through the Official Development Aid (ODA) on creating quality consumption IT system should be continued. To wit, it is necessary to create an IT system that would monitor the structure and characteristics of demand and consumption of electricity in the household and corporate sectors in the quality manner;
- Continue realisation of the revitalisation programme of HPP “Piva” in cooperation with KFW and the revitalisation programme of HPP “Perućica” (end of phase II), which further postponing in the medium term may lead to energy misbalance;
- Continue revitalisation of TPP “Pljevlja” in constructing a new waste transport system, landfill cultivation and building in “DESOX” system;
- Continue the project of developing a transmission network at the regional level. The 400 kW (Podgorica 2 – Tirana) distribution line with Albania should be established during the next year;
- Create the programme for using and developing renewable energy sources compliant with the Energy Law, which means transposing the EU Directive 2009/28/EC on the share of renewable energy sources. The programme should define the dynamics of developing renewable energy sources in the electricity sector and greater use of solar energy;
- The Energy Efficiency Action Plan should particularly develop the information base and statistically support consumption and distribution in a quality manner;
- Protect the state and consumers from potential concessionaires’ careless behaviour and make concessionaires commit to regularly repair and maintain objects by introducing statutory provisions into concession contracts;
- The Law does not foresee the existence of an energy efficiency fund, which would manage the funds allocated to granted projects. Its establishing is necessary to ensure the disbursement of allocated funds in a rational manner.

With a view to better utilisation of renewable energy sources, it would be necessary to:

- Continue activities on valuation of the hydro potential of Montenegro;
- Create a new Action Plan for the Energy System Development 2012-2016 complied with the new Energy Development Strategy until 2030;
- Pass necessary secondary legislation based on the Energy Efficiency Law to enable its full implementation;
- Under secondary legislation, create transparent and clear criteria and manner for selecting potential investors into the energy sector;
- Involve many different experts from the phase of selecting the micro location for constructing the facility to the commencement of the HPP’s operations, with a view to examining the complete effects on the environment and the ecosystem, performing the project cost-benefit analysis particularly due to

- possible costs of electricity storage, and in the potential construction of dams and accumulations that have strong environmental impact;
- The problem will be in spreading and connecting to the network in the north where most of places for small HPPs are located, since distribution network is outdated and on the brink of technical capacities. It would be necessary to provide financial funds for constructing supporting facilities (substations, trunks), which will be the concessionaire's or the operator's responsibility. Moreover, it would be necessary to define the most cost-efficient and the most functional connecting point to distribution or transmission network;
 - Work on developing the distribution network so that the awarded and upcoming projects would easily fit into the distribution system, with the minimum losses in storing energy. In addition, it would be necessary to reconstruct the distribution network, especially in rural areas;
 - Speed up the development of municipalities' spatial urban plans and simplify procedures for issuing construction permits on the government and local levels to start the awarded projects for constructing small HPPs;
 - The project of constructing small HPPs must contain maintenance projects because the state will ultimately become the owner after concessions expire and so it is interested in their condition to maintain them operable as long as possible. Gross hydro-energy potential on small water flows is assessed to 800-1000 GWh, of which some 400 GWh are really usable. This potential should be fully exploited;
 - Aim to use alternative energy sources, solar energy, wind energy and biomass to a greater extent. There is large potential for using wind energy along the Adriatic Sea coast, and on many inland locations. With 2000-2500 sunny hours per year, the Montenegrin coast has a good solar energy potential, primarily for water heating. Consider making the construction permits issuing subject to solar energy use requirement (at least on the coast) and construction of energy efficient facilities;
 - Examine the possibility of revaluation and cost-efficiency of HPP Lijeva Rijeka which has not been in function since 1991.

In the upcoming period, agreements should be made with neighbouring countries on optimal use of joint hydro potential and on constructing new interconnections. It would be necessary to continue exploiting oil and gas on the Montenegrin coast, of coal in the Berane area, and of the remaining available hydro potential.

Work on creating conditions for implementing the strategic 90-day reserves of oil derivatives in accordance with the EU directive.

By implementing planned activities in the energy sector through programmes and projects, Montenegro has a chance to become an important participant in the regional energy market. Montenegro could take advantage of its current low corporate tax rate

of 9% and other favourable conditions to attract significant investments into the energy sector. Still, some business barriers have to be removed, particularly in simplifying administrative procedures, issuing construction permits and licences (partially done), etc.

V. RECOMMENDATIONS CONCERNING THE SERVICE SECTOR

1. Tourism

Background

Being a part of economy, tourism is becoming ever more recognisable driver of economic activities worldwide. According to the UNWTO report *Tourism Highlights 2012*, tourism has gone through significant diversification in the past six decades and it has become a fast-growing sector of global economy. It is also becoming more and more important for Montenegro's total economy, as evidenced by the highest growth in tourism industry GVA in 2010 (specifically hotels and restaurants) relative to 2000 by six times compared to other sectors' GVA. Observed as a share of tourism's GVA in total Montenegro's GDP and the fact that its GVA grew from 2.5% recorded in 2000 to the respective 3% and 5.2% in 2004 and 2010 supports this sector's importance.

Since the Montenegrin economy largely depends on trends in *hotels and restaurants* industry, it would be necessary to provide quality and internationally comparable data and/or information that would be the basis for passing quality development decisions. Sets of data from tourism satellite accounts (TSA) published by Monstat, enabled presentation of more macro aggregates like tourist industries' GVA, tourism direct GVA, internal tourist costs and internal tourism consumption etc. which, combined with data on tourist consumption volume, are important for improving total tourism and its components. Tourism statistics improved resulting from available data on Foreign vessels on cruise in Montenegro, data series on nautical tourism (number of foreign vessels for entertainment, sport or recreation), introducing the module of surveying household tourist offer in Montenegro and the like. Despite the set of statistical data on the *hotels and restaurants* industry and for the purpose of better assessment of tourism revenues, it would be necessary to perform a survey on foreigners' consumption⁸ which would serve as a basis for performing better quality assessment of total revenues from tourism, which would result in Monstat improving tourism statistics, particularly GVA statistics in national accounts.

As an economic industry, tourism has justified the status of a particularly important component of Montenegro's overall economy. This industry's potential makes it a most perspective and most dynamic for future economic development. At the same time, tourism is a complex system interwoven in many industries that jointly create overall Montenegro's economy. According to the latest World Travel & Tourism

⁸ To date, there has been only the publication "Guest Survey 2010" that presented results of the tourist survey directed towards developing quality tourist product for the needs of the National Tourist Organisation of Montenegro and the Ministry of Tourism and it was conducted by the selected company CEED Consulting in cooperation with GTZ.

Council (WTTC) forecasts, in the next 2012-2022 decade, Montenegro will experience the fastest growth in total contribution of travel and tourism to GDP of 11.8% per year compared to the world average of 4.1%. After unfavourable and stagnating indicators in 2009, Montenegro's tourism picked up pace relatively quickly. Observed through statistical data on tourist arrivals and overnights, good results were recorded in the period 2010 - H1 2012. Therefore, promoting and valuating unique potentials that would foster development of coastal and other Montenegro's regions⁹ should be continued, including the development of areas where tourism was marginalised or gave modest contribution to generating income and total gross domestic product. Rural tourism has been noted as a growing chance for the overall tourism's success which, in addition to agriculture, could contribute to the strategic objective of the Montenegrin government – equal regional development.

The implementation of significant infrastructure projects aimed at raising the quality of offer is of utmost importance for a further development of tourism. The Master Plan of Tourism clearly defines objectives to be implemented so that Montenegro's tourist offer would follow international development and be internationally competitive. Mountaineering, hiking, cycling and nature vacation are the most popular activities in the European tourist market.

Implementation of measures of the Montenegro's Development Strategy until 2020 may ensure long-term tourism development, but there is still need for measures to improve the quality of services, create quality management of tourism companies and adjust price levels depending on the occupancy of capacities and overall financial results in the tourism sector.

Problems being continuously present refer to insufficient number of parking lots, heavy traffic jams, problems in cleanliness and waste management, overcrowded beaches, too-short season, and the like.

Main risks

- Short season
- Lack on high-quality hotel capacities and other quality commercial accommodation facilities
- Insufficiently developed offer to target tourist groups, particularly in the period between winter and summer tourist season
- Unsatisfactory public utility and local infrastructure
- Inadequate price and quality competitiveness

⁹ Conditionally a region, since the whole Montenegro is presented as a single statistical region at all three levels pursuant to NUTS legislation (more detailed information are available at the Monstat's website – NUTS classification)

- Insufficient highly qualified domestic staffing, particularly at the management level in the tourism industry
- Problem in collecting residential tax

Strategic development

- a. Find a balance between valuing mass and high-end tourism;
- b. Foster investments into construction of hotel capacities and modern facilities which will possess organisational and technical infrastructure aiming to develop high-end tourism and satisfy more demanding tourist market;
- c. Intensify additional efforts to promote Montenegro's tourist potentials and, besides natural beauty, focus on other types of tourism other than summer tourism;
- d. Work on MICE tourism capacity building and its promotion;
- e. Continuously work on revitalising rural areas (develop rural, agro, eco and other types of tourism) since they are the natural capital and unused potential;
- f. Continuously raise the quality of Montenegro's tourism through education of new and professional training of existing staff;
- g. Work on improving road and accompanying infrastructure (water supply, electricity, waste water, solid waste, parking);
- h. Perform a more rigorous control of residential tax collection.

Operational measures

It is evident that mass tourism had significant role in promoting this economic industry in Montenegro in the previous period. This type of tourism fostered the development of many municipalities that had had modest development possibilities to affirm some other production or service activity. Overall economic development imposes the need of profiling tourist product towards mass and/or high-end tourism or their combination. Up-to-present development of tourist economy which mostly relied on massiveness (tourists' arrivals) should be gradually modified towards high-end tourism and clients. Montenegro does not have enough space to develop mass tourism. Master Plan of Tourism Development has foreseen raising the offer's quality and construction of accommodation facilities, which would enable transition from mass to high-end tourism.

High-end tourism requires exclusive accommodation facilities with all accompanying infrastructural objects. Since Montenegro tends to develop high-end tourism, it would have to lift up the existing offer to higher level, i.e. existing available capacities should be improved to meet the expectations of high-end tourists. Although there are hotel capacities with extremely high standards which are mostly compliant to high-end tourism standards, they still have to be complemented with contents justifying the attribute of high-end hotel or destinations. It is important to note that high-end

tourism not only includes appropriate offer and infrastructure, but also the educated staff that would be able to present the facility and the service accompanying the high-end tourism. The authorities should also consider drafting of special strategy which would focus only to high-end tourism and which would clearly define places (natural resources) for possible development of high-end tourism. Clearly defined strategy would retain the shore's exclusiveness and protect natural resources, i.e. preserve a part of coastal and mountain regions that still have the chance to be developed and for the construction of high-end capacities. Moreover, the authorities should not issue licences for installing temporary objects near high-end facilities that may jeopardise the location's exclusiveness.

Promotion of Montenegro's recognisable image "Wild Beauty" was updated with historical, cultural and religious segments that have gradually become a constituent part of overall tourist product. A set of brochures and panoramic maps has been published showing, in a unique way, Montenegro's cultural-historical heritage through centuries, with the panoramic view including the outlook of hiking and biking maps. Although being established, the promotion of tourist product to target groups – mountaineers, bikers, divers and tourists interested in wellness, sailing, and sport – should be intensified, since this type of Montenegro's tourist offer has been recognised since few years ago. This also includes religious and health tourism that has not been sufficiently valued. At the same time, Montenegrin national cuisine and the autochthonous food offer, particularly dealing with the tourist product of "eco villages" and the mountain tourism (offer of healthy food and own agricultural products) should also be promoted.

MICE (Meetings, Incentive, Conventions/Congresses, Events/Expositions) programmes would enable gradual tourism during the whole year, and organisation of congresses and business events would contribute to strengthening the destination brand's improving. Since Montenegro's tourist season mostly relies on summer-winter offer, this type of tourist offer would contribute to expanding the season and mitigate the tourism industry's seasonal character. The authorities should also consider the possibility to condition issuing construction permits for new hotels with constructing high category hotels.

Priority tasks in the area of sustainable tourism set out in the National Sustainable Development Strategy (NSDS) include the creation of more differentiated tourist offer like agro, eco, mountaineering, health and other types of tourism, particularly at the north of Montenegro. Development of eco-villages as a unique tourist product should tend towards increasing the number of tourist accommodation facilities in the central and northern region with the possibility of using the offer throughout a year. Rural tourism creates assumption for villages' faster economic and cultural transformation. Development of rural tourism will have multiple benefits to local population, because it will provide employment and increase revenues in addition to

revitalisation of villages and infrastructure. It will also affect the decrease in population's migration and increased agricultural production.

Lack of quality staff – particularly managerial – is becoming more and more the key factor in tourism development. Moreover, there is insufficient number of staff with lower qualification structure – chefs, waiters, housemaids, etc. – “imported” from the countries of the region. There is increasing need from year to year to engage seasonal labour force in the hotels and restaurants industry mostly for lower qualification structure occupations. Montenegro Tourism Development Strategy to 2020 foresees somewhat higher need for posts directly related to tourism (in hotel management, tourist agencies, etc.). Aiming to educate staff of required profiles, it would be necessary to strengthen cooperation between tourist offer and the education system. Increase in accommodation capacities opens the need for new staff, thus it would be necessary to continuously organise trainings for professional education and qualification of staff that would satisfy all specific requests and types of offers in the tourism sector. The application of this measure might result in declining of total unemployment rate significantly, and specific tasks in the tourism sector would be “left” to experts.

Investing into road structure would enable better availability of Montenegro as a tourist destination and of destinations inside Montenegro. Safe road and railway transport means quick and comfortable transfer of tourists from one to other tourist resort, affects creation of adequate conditions for developing tourism during the whole year. In addition to continuous investments into road infrastructure, investments into parking lots, arranging beaches and bathing lots, promenades and green areas should also be fostered aiming to improve the space for tourists' resting and entertainment, and raise supply to the level offered in competitive tourist destinations. A good example is the project “Improving Water Supply and Treatment of Waste Water at the Montenegrin Coast” which includes construction of joint Wastewater Purification Plant for municipalities of Tivat and Kotor. The construction of plant, which would significantly raise the infrastructural quality in these municipalities, should end in 2015. The priorities remain the need of prohibiting construction during the summer season and the prevention of illegal construction and complete concreting of the coast.

2. Transport

Background

Transport is an extremely important industry since it is closely related to development of many other industries starting from tourism, trade, output industry, goods transit, and the like. Sustainable, safe, efficient, quality and EU integrated

transport system contributes to the country's economic development. However, significant limitations for development of economic activities in Montenegro include insufficiently developed road network, outdated vehicles and infrastructure, low utilisation of Port of Bar's capacities and poor transport connections to the region.

Transport development in Montenegro is defined in Transport Development Strategy of Montenegro, but transport is a rare service industry with stagnant share in GDP during the last decade. Economic crisis and the declining economic activity had the additional adverse effects to transport capacities use in 2012. The last available data for the first seven months of 2012 show evident problems in all segments of freight transport, particularly in road and maritime transport. Passenger transport recorded the seasonal increase in road and air transport.

Despite negative indicators, progress was made in maritime transport and in development of nautical tourism. In 2011, Montenegro received the co-operating member status at the Paris Memorandum of Understanding on Port State Control, thus raising the inspection surveillance of sailing to higher level pursuant to the European Maritime Safety Agency (EMSA) regulations. In addition, the project of introducing the software for registering Montenegrin sailors and their sailing was implemented.

Implementation of the first phase in constructing Porto Montenegro opened the possibility to attract many foreign yachtsmen which have been offered complete service during the whole year. This opened the possibility to expand activities of the Adriatic Shipyard Bijela, i.e. repairing yachts and mega-yachts and removing the poisonous waste grit. Increased use of the Port of Bar capacities has benefited from making contract on transporting the Fiat cars and from revitalisation of the marine fleet started with the delivery of two ships for bulk cargo.

In the area of air transport, the Government passed the Master Plan for the Development of (state company) Airports of Montenegro in 2011, which sets out the strategy for infrastructure development of Podgorica and Tivat airports in the period 2011-2030, aiming to improve capacities and service quality in air transport. The Master Plan outlines a long term management of airport facilities, which would enable efficient, economical and environmentally acceptable air transport.

The process of restructuring railway system in Montenegro continued also in 2011 and it is performed pursuant to principles and objectives set out in the Strategy for Restructuring Railway of Montenegro from 2007. The restructuring of railways applied the principle of separating the infrastructure management from passenger and freight transport. The process of restructuring is currently near the end of phase II which means further segmentation of new joint stock companies and their

privatisation by selling the state package of shares. The delivery of three electric-motor trains to operate at the railroad Podgorica-Nikšić is expected in 2012.

From the safety aspect, conditions at Montenegrin roads are not satisfactory with many car accidents, dead and injured persons in road transport. According to Monstat data, 917 traffic accidents happened in Montenegro in July 2012, showing y-o-y decline of 4.7%. Aiming to raise safety, the Government of Montenegro passed the Action Plan for 2012 in 2011 under the implementation of the Strategy for Improving the Safety in Road Transport (2010-2019). The activities of this plan will contribute to developing functional transport system, creating conditions for safe transport and successful risk mitigation for all participants in the system.

During the previous period, the programme of regular maintenance, eliminating bottlenecks, repairing of black spots, the reconstruction of crossroads, and implementation of digital tachographs was implemented. From the aspect of safety in railway transport, it is important to implement project of placing optical and energy cable along the Belgrade-Bar railroad by implementing video-surveillance at the whole railroad.

The abovementioned facts point to evident progress, also noting that all forms of transport infrastructure should be paid due attention and additional investments. It would be necessary to work on more efficient use of existing capacities, improved safety in transport, providing conditions for implementing investment projects, raising the quality of services and offering new services.

Main risks

- Financial sustainability, taking into account extremely high amount of required funds for modernising road infrastructure and rather unfavourable relief
- Many traffic accidents resulting from unsatisfactory transport safety in Montenegro
- Deficit in domestic labour force and professional staff
- Non-compliance with international standards
- Impossibility to find strategic partners and implement large infrastructure projects during the crisis period;
- Poor transport connection with the region;
- Increased adverse transport's effects on environment.

Strategic development

- a. Improve the quality of transport infrastructure and services in all transport types
- b. Increase transport safety
- c. Improve competitiveness of domestic transport economy i.e. conditions of transport capacities
- d. Consider continuing activities on implementing large infrastructural projects
- e. Implement the reconstruction of railroad and other investments into rail infrastructure
- f. Continue implementing the programme of solving bottlenecks, eliminating black spots, and finishing the construction of started roads at the primary network of motorways and regional roads
- g. Improve the process of regular public roads maintaining
- h. Initiate the realisation and/or ending the restructuring and privatisation process of transport companies
- i. Pass measures for developing and improving the combined transport
- j. Strengthen institutions and administrative capacities
- k. Provide mechanism for protecting space and environment

Operational measures

Since traffic safety in Montenegro is low, it would be necessary to work on raising the level of traffic discipline and on maintaining existing and developing new road infrastructure. In road transport, it would be necessary to fully implement the Plan of Regular and Investment Maintenance, Reconstruction and Constructing Public Roads which includes works on repairing roadways, repair of landslides, reconstruction of crossroads, removing of landslips and protecting endangered areas from them and maintaining horizontal and vertical signs. The construction of ring roads in problematic areas would be necessary to eliminate black spots and to solve bottlenecks issue.

The economy would largely benefit from implementation of capital infrastructure projects, taking into account their strategic importance for developing all economic industries and efficient flow of goods and passengers. Organisation of such large public works may positively affect the start of economic activity in the largest part of economy. Still, taking into account serious fiscal difficulties, the justifiability of postponing the implementation of these projects should be also considered.

Efforts should be gradually made into improving infrastructure in other types of transport, particularly in road transport. The privatisation of the last phase in the rehabilitation of the railway infrastructure – i.e. privatisation of some parts of the railway system – should be finalised.

In air transport, continue to implement the *European Common Aviation Agreement* (ECAA) and to improve administrative and institutional capacities. Although air transport infrastructure is far ahead of infrastructure in all remaining transport types, it would be necessary to implement the Master Plan for the Development of Airports of Montenegro and to continue to modernise Montenegrin airports. It would be necessary to provide light signalisation at the Tivat airport, so that it can be used in night conditions. Podgorica Airport should be provided with all necessary conditions to regularly operate in snowy conditions and when temperatures are below 0°C. Moreover, both airports should be equipped with the technique for their regular operation in the foggy conditions. The security level should be raised at both airports, particularly at Tivat airport.

Possibilities to connect national airline as partner of a famous European national airline should be considered. The fleet should be modernised and the opening of only economically viable new lines should be considered. Since the state passed the Law on Ratifying the Multilateral Agreement between the European Community and the Republic of Montenegro (and other countries) on the establishment of a European Common Aviation Area (the ECAA Agreement), negotiations should be intensified with so-called “low-cost” companies, which would have positive effect to tourism sector and expanding offers for tourists’ arrivals.

In maritime transport, it would be necessary to continue the Port of Bar’s subsystems privatisation process, continuing to revitalise domestic maritime fleet and overseas ships for bulk cargo. Possibilities of introducing seasonal ship lines should be considered, and consequently the adoption of the Law on Transport in Line and Temporary Coastal Marine Transport.

Transport’s modernisation includes the issue of multi-modal transport. Montenegro has good infrastructure conditions for this type of transport taking into account the possibilities to combine maritime, railroad, road and air transports. Still, this type of transport has very low share in our economy and it is not legally precise. Thus, we should continue to implement the 2004 Memorandum of Understanding for the Development of Primary Regional Transport Network in South-Eastern Europe to solve the problems of goods transport over Montenegro’s territory. It would be necessary to pass measures regulating competition in different types of transport, through equivalent determination of fees based on infrastructure degrading and environment pollution, which would serve as the basis for promoting the rail transport and line sailing, the bearers of combined transport.

All types of transport are facing lacking professional staff, thus the work of organisations responsible for education for participants in transport compliant to the EU standards should be improved. Moreover, the authorities should work on

establishing joint transport policy with the EU countries and regional integration, primarily in joining the common railway alliance of Western Balkan countries and entering into contracts on road and air transport with other countries.

Modern transport system also imposes the need of sustainability from the ecological aspect, thus it would be necessary to develop the system that would minimise adverse effects to the environment. Therefore, non-motorised types of moving like cycling should be promoted and quality of services in public road transport should be increased. Since ship industry is one of largest environment polluters, standards regulated by the International Convention for the Prevention of Pollution from Ships (MARPOL) should be applied, and by cooperating with other countries, access to the Regional Marine Pollution Emergency Centre regional system for reacting in sea pollution should be provided.

VI. RECOMMENDATIONS CONCERNING EDUCATION AND THE LABOUR MARKET

1. Education

Current status

The reform of education in Montenegro recorded a certain progress, however, the implementation of the planned reform is rather slow and funds allocated for this purpose are modest.

Results of the 2011 census referring to population aged 15 and above examining the level of education, computer literacy and knowledge of foreign languages indicated that the educational structure of the population is inappropriate. To wit, 80.1% of the population aged 15 and above acquired elementary and secondary education, namely 28.2% acquired elementary education (partially or completely), and 51.9% acquired secondary education, while the population with higher education (old or new system) accounted for 17.1%. In addition, 2.2% of population aged 15 and above did not acquire any form of education.

Results of the census examining school attendance among population aged 6 and above showed that 24% of this population attended school; to wit, 50.4% attended elementary school, 23.8% attended secondary school, 16.5% attended basic academic studies, 3.8% attended basic applied studies, 1.9% attended postgraduate specialist studies, 3.1% attended postgraduate master studies, and only 0.5% attended PhD studies.

Of total population aged 15 and above, 34.5% referred to computer literate persons, 15.9% referred to partially computer literate, and 48.4% referred to computer illiterate persons.¹⁰ Of total population aged 15 and above, 45.3% speak a foreign language.

In addition, the results of the census examining literacy among population aged 10 and above showed that 1.5% of population was illiterate.

The usage of human resources and investing in their quality are the primary factors of development. Against the background of the strong impact of the economic crisis, an increase in productivity and flexibility of the labour force may be the main leverage of recovery.

¹⁰ Of total surveyed population, some 1.2% did not respond on computer literacy.

Despite the fact that the population with elementary and secondary education is continually increasing, there is still a misbalance between the needs of companies and knowledge of college graduates.

Risks

- Low or inadequate level of education and skills of population;
- Failure to implement adopted education system reforms, as well as the lack of a comprehensive approach to the creation of the educational system;
- Application of obsolete knowledge which does not follow the contemporary development and its needs;
- Incompatibility of the education structure and the labour market needs;
- Too high a focus on theory in the entire education system and the lack of specialist (expert) knowledge in certain fields of economy;
- Inadequate transfer of knowledge (the problem of education of teachers and trainers);
- Lack or a very low level of research and development in all education segments and in significant institutions;
- Budgetary limitations due to the negative crisis impact, limited funds from public and private sources for education, research and development.
- Delay of education reform in relation to the needs of the market.

Development strategy

- a. Establishment of a modern educational system which will follow the labour market and economy needs and reduce current discrepancies;
- b. Improvement of the harmonisation of educational system results with the requirements of the labour market;
- c. Harmonisation of the implementation of educational policy at micro and macro levels;
- d. Promotion of a lifelong education concept;
- e. Promotion of social inclusion;
- f. Raising the level of educational structure and the level of population knowledge.

Operational measures

Development of education in Montenegro should be based on a consistent application of a systemic reform which shall consider national solutions within a wider European context.

Promote and improve the interaction and dialogue between partners at the national and local levels as well as to promote private interest in investment into education. Funds allocated for the education system are insufficient and it is necessary to accept the view that investments in education should not be deemed expenditures but investments in the future.

Initiate the harmonisation of education programmes for primary, secondary and higher education through the reduction of voluminous syllabuses thus making room for the development of problem-solving skills, collaborative learning and acquiring applicable skills.

PISA testing in secondary schools should be continued in order to initiate changes (motivation of teachers and students) on the basis of test results.

General material conditions for education should be improved in order to increase motivation of all the participants in the educational process to implement contemporary education programmes, in the light of tendency to join the EU.

Development of lifelong education should be stimulated in order to overcome the gap between needs of the economy and the labour force offer.

Develop non-tertiary, post-secondary education in order to create new profiles needed in the labour market and in the economic development of the state.

Harmonise all levels of education into one whole, so that all the levels and types of education, from elementary to high, and later through training and specialisation processes, support each other, i.e. complement each other as a logical knowledge upgrade. To this end, schools should be assigned the role of a guiding and change driving factor and thus reinforce the capacities at this level so that they could formulate and implement policies.

To use the available funds from European and other funds so as to organise workshops and provide advice for teachers and lecturers. This would help identify the priorities and harmonise programmes aimed at improving the quality of training for teachers and lecturers, so that the population knowledge level is raised at each consecutive education cycle.

Continue the improvement of teaching curriculum at all education levels, aiming to correspond to new global market demands as well as to the needs of the Montenegrin economy, offering skills such as communication, critical opinion, self-confidence, scientific and technological education, etc.

Develop a reliable mechanism for short-term and medium-term forecasting of trends and development of needs in order to reduce the mismatch in human resources supply and demand.

In order to educate staff required in the economy, it is necessary to increase the degree of cooperation between the corporate and the education system. Therefore, it is necessary to create professional standards for professions required by the labour market. Educational institutions should establish expert councils, which would function as advisory bodies that would also include representatives of the corporate sector in order to secure the harmonisation of educational profiles with the requirements of the economy and the harmonisation of admittance policy with the requirements of the economy.

Access to information and communication technology should be additionally improved since this enables distance learning, training of teachers and flexible and more advanced education models of lifelong learning.

The educational institutions in Montenegro should be subject to oversight.

Special attention should be paid to education of disabled children and improve skills of teachers working with this group in order to achieve social inclusion.

The national vision on the importance of ecological education for the sustainable development should be developed.

2. Labour market

Current status

The global economic crisis has had a significant impact on the labour market. A decrease in the number of persons in employment was recorded in particular in the industrial sector which suffered the greatest consequences. However, in 2011 and H1 2012, indicators in the labour market gradually improved. In 2011 the average number of persons in employment increased 0.8% y-o-y, while in H1 2012 the y-o-y growth amounted to 1.3%. The number of unemployed persons in 2011 declined 3.1% y-o-y. The number of registered unemployment persons in H1 2012 averaged at 30,876, which is a 3.3% y-o-y decline. The unemployment rate, as per the Employment Agency data, amounted to 12.68% in June 2012, which is 1.1 percentage points more than in June 2011. The reason for the increase of this rate lies behind the new number of active population (data from 2011 Census) which is included in the calculation as of March 2012.

In order to create a more flexible labour market and improve business environment, the Law on Amendments to the Labour Law was adopted which regulates institutions and relations harmonised with ILO conventions and EU regulations in a more flexible manner. The Law on Amendments to the Law on Employment and Exercising Rights Pertaining to Unemployment Insurance which shall improve the status of unemployed disabled workers was also adopted.

The Parliament adopted the Law on Prohibition of Abuse at Work that regulates all the rights, obligations and responsibilities of the employer and the employee regarding the prevention of abuse at work (mobbing), as well as other questions of significance for the prevention and protection against mobbing.

The Labour Market Reform and Workforce Development Project was completed at the beginning of 2012. This Project was a continuation of activities aimed at the improvement of labour market and human resources in Montenegro started through CARDS Programme in 2006. This was the first project approved for Montenegro from the IPA programmes in the field of employment and labour market. The results showed that Montenegro requires resources, staff, and capacities, especially in the EU accession process.

The following six strategies were created during the implementation of the Reform: National Strategy for Employment and Human Resource Development 2012-2015, National Strategy for Lifelong Career Orientation 2011-2015, and four local employment strategies for Berane, Mojkovac, Bijelo Polje and Pljevlja. Manuals and guidelines for other municipalities were made to help create local projects aimed at fostering employment. Five centres for information and professional counsel (Career Guidance Centres) were opened in Nikšić, Pljevlje, Berane, Bijelo Polje and Mojkovac. Psychologists and professional career orientation consultants employed in these centres were trained during the realisation of the project.

In 2012, the realisation of the Innovative Program for Continued Stimulation of Employment and Entrepreneurships continued. In the period between January and June 2012 37 loans in the amount of EUR 235,000 were granted for the creation of 47 new jobs. Majority of loans, namely 12 were granted in Bijelo Polje followed by 8 loans granted in Podgorica. Loans for agriculture and fishing accounted for the main share of 37.8% of the loans granted, while the hospitality industry and tourism accounted for 18.9% each.

The implementation of the Subsidized Employment of Youth on Seasonal Jobs Project started in 2011 and continued in 2012 as a result of the increased share of young people in the Employment Agency records. The project aimed at reducing the youth unemployment rate which significantly exceeds the average unemployment rate. In 2011 this Project resulted in the increase in the share of domestic workforce

in seasonal jobs (25% more than in 2010), as well as in the decline in shadow employment and fostering of tourist economy. Therefore, it was reasonable to continue the realisation of this programme in 2012 with subsidy for the employment of one person amounting to EUR 100 for young people with no years of service or EUR 80 for young people with recorded years of service.

With the aim of total employment increase and the improvement of labour force offer quality, the Employment Agency continued conducting determined forms of work with the unemployed, such as interviews with all the newly registered persons, information-motivation seminars (workshops), structural interviews with based on the individual employment plan for every unemployed person, etc.

Main Risks

- Problem of structural unemployment;
- Mismatch of labour force offer and demand especially in highly qualified staff;
- Limited possibilities for maintaining the level of employment in some companies;
- Reduced potential for the creation of new jobs due to deceleration in economic growth;
- Low activity rate, especially regarding the female labour force.
- High share of long-term unemployed persons;
- High youth unemployment;
- High level of unregistered employment;
- Inflexibility of the education system and mismatch with the economy needs.

Development strategy

- a. Make efforts aimed at reduction of unemployment.
- b. Adjust the education system to the market needs, which will affect the decline in the number of unemployed persons, increase the employment rate i.e. eliminate structural unemployment.
- c. Increase the level of the cost of labour flexibility and labour force mobility.
- d. Introduce tax incentives for new employment and investments in undeveloped regions.
- e. Make sure that the focus of employment be on the domestic labour force.
- f. Provide continuous financial support for the realisation of adopted employment strategies' objectives and lifelong career orientation.
- g. Continue the realisation of started training programs, through retraining and additional training of unemployed persons.
- h. Continue the stimulation of employment via the `Job for You` programme and Subsidized Employment of Youth on Seasonal Jobs Project.

Operational Measures

A new *National Strategy for Employment and Human Resource Development 2012-2015* adopted as a part of the realisation of labour market reform, aims at improving conditions for the creation of new jobs and investing in human capital in order to raise the level of employment and improve Montenegro's economic competitiveness. Considering the negative impact that the global economic crisis had on almost all of the indicators of the success of the previous Strategy (2007-2011), it is necessary to provide continual financial, professional and personnel support in the process of fulfilment of the goals set by the new Strategy.

The Employment Agency project Traineeship for University Graduates was conducted in 2012. Via this program, 500 university graduates without work experience were employed for 6-month periods. Implementation of such programmes should be continued in order to provide an opportunity for future generations of university graduates to acquire knowledge and skills, as well as a possibility to get permanent employment in this way.

Continue to foster entrepreneurship through self-employment loans as a form of active employment policy. The Project gave positive results, because it provided unemployed persons with significant possibilities to start their own businesses, and even employ family members or other unemployed persons. Although the extension of these loans decelerated as a result of funding cuts due to the crisis, the continuation of this programme is recommendable due to its positive effect on employment, especially in northern municipalities.

It is necessary to intensify the activities through training in *virtual companies* as an efficient model of learning by doing, which is primarily intended for unemployed persons with secondary and high education, youth, and redundancies who plan to start their own businesses. As per Employment Agency biannual report, the share of unemployed persons with VI, VII and VIII education levels in the total number of unemployed persons in the first six months of 2012 recorded the y-o-y increase, thus further emphasising the necessity of continuation of this programme.

Bearing in mind the problem of structural unemployment, it is necessary to continue conducting unemployed workers training, retraining and additional training programmes. Reduction of structural unemployment could induce the decline in the total unemployment rate, i.e. enable higher engagement of domestic instead of foreign labour force.

In June 2012, Montenegro officially started the EU accession negotiations. In the forthcoming accession process the requirement for appropriate public administration personnel shall be more and more prominent. Therefore, in line with the appropriate

programmes aimed at reinforcement of administrative capacities, it will be necessary to continue the professional training of civil servants aimed at the improvement of work quality and efficiency.

The Law on Prohibition of Abuse at Work has been in force as of June 2012. This law focuses on the importance of efficient and timely protection from all forms of violation of rights in the labour market and prevention, detection and elimination of all forms of discrimination in employment, job preservation and promotion. Therefore it is necessary to intensify labour inspectorate in this field and strengthen the mechanisms controlling the implementation of the provisions of this Law.

The `Job for You` Project was successfully implemented over the previous years and it was welcomed by citizens who were very interested in some of possibilities this programme offered. Therefore, the continuation of this project is highly recommended.

It is necessary to open more Career Guidance Centres which would increase the accessibility of career orientation services in all municipalities as well as to increase the number of expert assistants in therein.

With a view to continuous encouragement of employment and entrepreneurship it is necessary to introduce tax reliefs and incentives for new investments and employment in underdeveloped regions and municipalities.

Due to a lower share of disabled persons in the labour market it is necessary to additionally motivate employers to employ hard to place workers and disabled persons through active employment policy programmes in order to increase their inclusion in the work processes.

In order to improve labour force skills it is necessary to additionally promote lifelong learning and training concepts as well as encourage cooperation between the economy and institutions providing formal and informal education.

In the aim of improving the labour market and getting closer to contemporary practice it is necessary to establish flexible employment reform through: part time employment, work from home contracts, etc.

VII. RECOMMENDATIONS CONCERNING THE FISCAL POLICY

Current Status

Since the euro was introduced as the legal tender in Montenegro, the countercyclical adjustment in economic policies has been the charge of fiscal policy. Several years of negative crisis impact on Montenegro's economy and the necessity to reduce its effects have induced significant and continuous deterioration of fiscal stability indicators, and this deterioration was summarized and shown in the budgetary deficit, mostly financed through new borrowings which have resulted in the rapid increase of public debt. International crisis has made a strong negative impact on the real sector which was evident through a decline of economic activity and through the deterioration of recovery potentials and growth drivers. Insufficient accumulation of revenues in the corporate sector resulted in an insufficient budget revenue inflow in 2012; therefore, amending budget aimed at stopping the growth of budgetary deficit and public debt was adopted in May. In addition to the negative impact of the new wave of Euro area crisis, economic recovery was weakened by internal factors: lower volume of trade, lower amounts of FDI, calling of guaranties, tax arrears, very severe weather conditions, etc. This was an additional cause of the decline in economic activity and the deflection from planned public revenues collection as well as the significant budget imbalance.

The new budget envisages the introduction of a set of fiscal measures aimed at providing increase in the amount of revenues as well as reducing unproductive spending. On the expenditures side, the amending budget made no changes in the amounts planned for salaries, pensions and social allowances, while tax bases remained on the same level.

The global uncertainty risk, evident especially in the European Union, combined with the weaknesses of domestic system brings in a high degree of negative expectations and concern that the introduction of additional measures and conducted cost adjustments might not be enough to regain the balanced budget. Negative trends and the increase of pressure on the fiscal position shall require a more radical fiscal adjustment of positions in the budget which were fixed so far.

The above mentioned difficulties resulted in the growth of public debt which reached 51.2% of GDP at end-August 2012. Forecasts indicate that debt will additionally increase in 2012 due to the need for additional funds for settling certain obligations and covering deficit for 2012. Expensive sources of financing additionally burden the future obligation servicing potentially creating fiscal instability factors.

Public debt was followed by the increase in guarantees. Guarantees are always a potential public debt.¹¹ Even though the public debt remains below the Maastricht criteria, its growing trend is rather worrying and so is the danger of its becoming the factor limiting the economic growth.

In the past period, the Government conducted a number of measures aimed at budget restructuring. At end-2011, the Government and the trade union representatives signed the Agreement on Wage Policy for Public Sector. The Agreement defines the medium-term wage policy which at the correction of wages proceeds from fiscal differences and economic capacities. At end-2011 Amendments to the Excise Duty Law were adopted introducing excise duties on coffee and sparkling water and increasing excise duties on tobacco in the aim of harmonization with the EU standards. Changes in excise duties came into force as of the beginning of 2012. In the aim of public administration rationalization through the reduction of the number of authorities and their operating expenses, and creating conditions for the inclusion of the non-government sector into the decision-making process of public administration, in 2011 the Government adopted the Law on Amendments to the Law on State Administration. The new law will enable the introduction of “an authority within a ministry” institute, the institute of public competition in the process of appointing the heads of authorities, as well as the new categories of managers. These changes shall be justified if they help the decline of public expenditures.

Fiscal stability is a precondition of overall economic stability and a long-term economic growth. In fiscal policy scope it is important to make sure that the public spending is in line with objective abilities. Although the current public spending expenditures declined, it is expected that even more rigid fiscal measures will be needed in 2013.

The following year will be a year of great challenges. Sustainability of public finances, competitiveness of the economy and finally the living standard shall depend on the implementation of the current measures.

Main Risks

- Multiannual budget deficit and the manner of its financing;
- Continuation of the public debt uptrend (the risk that the amount might exceed the Maastricht Criteria) and issued guarantees which pose a threat to fiscal sustainability;
- The appearance and spillover of new exogenous shocks due to the development of instability the Euro;

¹¹ This does not refer to issuing guarantees to new credit lines to investments to the IDF, which has strong development component with relatively low risk of non-performing loans level and/or loss from eventually inefficient placements.

- Limited access to capital markets and expensive sources of financing;
- The need for financing or co-financing large infrastructure projects may additionally burden the fiscal position and threaten fiscal sustainability;
- The decline of import as a basis for accounting the most important tax revenues categories;
- High illiquidity of the corporate sector, high level of tax arrears and unserviced fiscal obligations;
- Realization of issued state guarantees;
- Increase in subsidies and transfers;
- Potential pressure on wages and pensions growth;
- EU accession process requires the allocation of significant funds for these purposes, although Montenegro relies on the funds acquired through pre-accession aid funds (IPA) to a certain extent;

Development strategy

- a. Continue the consolidation of public spending and pursuing restrictive fiscal policy in line with the existing macroeconomic environment;
- b. Continue gradual reduction of the public expenditures share in GDP as well as the reduction of public debt;
- c. With a view to securing a long-term fiscal sustainability, it is necessary to intensify activities in the field of standardization and implementation of fiscal rules and fiscal responsibility;
- d. Improve fiscal supervision and reinforce implementation of internal and external audit of all spending units of the Budget;
- e. Invest more effort in fighting shadow economy in the aim of increasing the budget revenues;
- f. Take measures aimed at improving taxpayers' tax awareness, increasing fiscal discipline and reducing tax evasion;
- g. Develop appropriate mechanism for gradual reduction of the amount of tax arrears;
- h. Stop (limit) the issuance of government guarantees, to the level of possible recorded losses arising from inefficient placements, except for projects with strong development component such as credit lines to Investment and Development Fund bearing a low risk;
- i. Perform rationalization and adequate personal expenses management in the budget;
- j. Increase the level of public spending transparency at all levels, especially at the municipal level;
- k. Gradually reduce the share of current budget and prioritise the increase in the share of capital budget;

1. Pursue adequate policy of domestic and foreign borrowing so as to avoid exposing the country to public debt crisis;

Operational measures

Due to the aggravated conditions in domestic and international markets, Montenegro's fiscal policy in 2013 should take a more prudent approach, restrictively created budget, allocating sufficient reserves for contingencies such as state guarantees calling and new global negative shocks spillover.

It is important to ensure expenditures and revenues harmonization as soon as possible, leaving a slight VAT increase as a reserve possibility in case that revenues and expenditures are not recorded in line with the plan. Montenegro has a low VAT rate and its slight and temporary increase would not cause large negative implications. In addition, this is a prevailing trend applied in a large number of European countries.

The stabilization of economic situation should be followed by pursuing the policy of gradual reduction of public expenditures in GDP.

In order to achieve economic development and improvement of living standard and in order to prevent additional borrowing, public spending must be adapted to the tax capacities of the corporate and household sectors. Public debt and issued guarantees trended up rather rapidly over the previous period which is a trend that should be stopped in order to achieve macroeconomic stability and fiscal sustainability. Repayment of the principal and high interests may threaten economic growth in the following period.

Public procurement is suitable for cost cuts to reduce unnecessary spending and setting priorities the full implementation of which shall materialise these advantages.

In order to increase budget revenues, Montenegro should intensify supervision and prescribe more severe penalties for failing to issue fiscal receipts.

The largest expenditure category in the budget still refers to public administration employees. As a result, the high share of the wage fund poses a threat to the competitiveness in the international market and puts further pressure on the budget. Wage cuts remain the alternative mechanism for adjustment. It is also necessary to continue the implementation of the Staffing Plan which defines restrictive employing. In addition, it is of high importance to conduct rationalisation which includes the reduction and rationalisation of the number of employees in the public sector.

Financial sustainability of the Pension and Disability Insurance Fund of Montenegro represents yet another important factor of fiscal consolidation. Pensions account for approximately one quarter of fiscal expenditures and little over 10% of GDP. Regardless of well-designed reforms conducted in this area over the previous period; the demographic structure, migration and consequently the increase in the number of pensioners are the actual risk.

A working group for drafting fiscal rules formed by the Ministry of Finance with the involvement of CBCG, did a significant portion of work, however the most important part of transforming the fiscal rules into a binding legal framework has not been completed. The best option would be to adopt a separate Law on Fiscal Responsibility which would introduce legally binding rules on the maximum allowed level of public debt and budget deficit in terms of percentage of GDP. Sanctions should be envisaged for the violation of these rules, because otherwise they will not have the expected effect, which is proved by the experience of a large number of countries. Fiscal rules would restrict any possibility of irresponsible pursuing of fiscal policy and make a favourable effect on the credibility of the Government and country's credit rating.

The following amendments to the Budget Law should also be implemented: categorisation of consumer unit; introduction of spending limits and reserves; introduce the obligation to draft and adopt a fiscal strategy; define responsibilities and prescribe sanctions at all levels of pursuing fiscal policy; introduce conducting financial supervision of the legality and purpose of budget funds usage. Observed negative practice in the payout of certain budgetary items from the positions they had not been envisaged for should be completely eliminated to ensure a consistent utilisation of funds for the purposes they were planned for. Redirection of funds from the capital to the current budget must not be allowed.

Activities should be started on drafting a new Law on Public-Private Partnerships in order to increase the efficiency of the limited strategic resource – capital, in both public and private ownership. The Europe 2020 growth strategy encourages the combination of public and private financing and the creation of innovative instruments for financing the necessary investments, because it is evident that the global financial crisis has reduced the capacities of governments/ states as well as private companies in the area of investments and innovation. In addition, the concept of public-private partnership also includes the presence of the private sector not only in the realisation but also in the formulation of public policies.

It is also necessary to intensify activities on the strengthening of supervision and improvement of the internal control systems at all levels. This implies the implementation of the Law on Public Internal Financial Control System and consistent activity of independent department for internal audit of the Ministry of

Finance when auditing all budgetary beneficiaries at the state level. In addition, it is necessary to intensify the control of public funds beneficiaries on the local level as well.

Appropriate management and maintenance of efficient control of budget revenues are of high importance. In order to achieve this goal it is necessary to:

- a. Continue conducting efficient collection of public revenues, simultaneously increasing the supervision of taxpayers and the application of the legal measures upon the taxpayers who do not meet their obligations in line with the positive regulations;
- b. Mitigate the expansion of illiquidity in the corporate sector in a manner that the government, central as well as local self-governments meet their obligations toward the corporate sector. This way the corporate sector shall be relaxed while at the same time setting into motion the payment spiral among the companies.
- c. Improve the efficiency of taxpayers' tax receivables collection in order to increase tax revenues;
- d. Reprogram tax and non-tax debt in order to settle them in a more easy and efficient manner.

Debt management is a very important factor in the creation of sustainable economic growth and development, therefore in order to appropriately manage public debt it is necessary to take the following measures:

- a. An evident increase in the share of loans with variable interest rate was recorded in H1 2012. Therefore, it is necessary to maintain the policy of high share of debt with fixed interest rate as well as dominant borrowing in euros from those institutions which offer a choice of borrowing currency;
- b. Ceasing the issuance of public guarantees excluding the exceptional circumstances when the excessive amount may threaten fiscal sustainability, at the same time bearing in mind that there is a real risk that some of the earlier issued guarantees shall be at the expense of the state;

An in-depth analysis of all projects shall be necessary as well as paying special attention that their realisation does not threaten fiscal sustainability. Capital budget should be based on the multi-annual projections of Montenegro's capital investments, based on which Montenegro Budget Law should be proposed.

It is necessary to establish a transparent data base for the projects connected to the budget, which would help achieve a high quality analysis of fiscal risks, which would primarily help in the process of efficient decision making when deciding upon priority investment projects. In line with the Budget Law, it is necessary to intensify

monitoring of investment projects in progress, in order to keep track of the spending of planned funds.

Establishing regulatory bodies and agencies resulted in significant costs for the budget and/or corporate sector. It is necessary to consider that after the application of the specialisation principle, their centralisation i.e. the reduction of their number should start.

Implementation of the OECD instructions regarding transfer prices (referring, *inter alia*, to the tax evasion) should be conducted. International companies often evade legal tax burdens by using the system of transfer prices in cross border transactions. Via this mechanism they shift the profit into a country with lower tax rates, in order to pay lower corporate profit tax. OECD gave a series of recommendations which need to be implemented and which refer to: intensification of rules on reporting on foreign investments; abolishment of tax contracts made with tax havens and securing a more efficient exchange of information, etc.

VIII. RECOMMENDATIONS CONCERNING THE FINANCIAL SYSTEM

1. Banking and non-banking sector

The suspense in the global economic scene and the deepening of debt crisis in the Euro area have led to downtrends in financial flows outside of the European Union, which resulted in the economic activities standstill in the countries closely connected to the member countries by goods and financial flows. The negative impact spilt over to the banking sector via transmission channels, primarily through capital and trade flows.

The banking sector with the prevailing share of foreign capital in its equity structure is no longer able to in any given moment provide funds from the parent banks, in the required amount and under the most favourable conditions, and the availability of funds is dependent on the ability to draw capital from the domestic sources. Banks' focus on strengthening the deposit potential which is currently the most important and cheapest source of financing with limited availability resulted in the increase of lending as well as deposit interest rates which caused a drastic reduction the number of creditworthy borrowers. Liquidity spiral in the real sector is still one of the key problems in the Montenegrin economy, therefore, the lending activity which is supposed to be the main driver of economic development remains below the expected level. Considering that a further collapse of the real sector could backfire and have a negative effect on the banking system as well, the banks shall need to take stock of their interests regarding providing the support for the financing of new development projects.

The problem of the increasing toxic assets in the banks' balance sheets is in focus again after the period of successful recovery in the previous year when three banks displaced non-performing assets in the amount of EUR 316.8 million into the parent banks' balance sheets and/or factoring companies. Therefore the credit risk which was very prominent in 2012 will be significant in 2013 as well. It is reasonable to expect that the banks will continue to pursue prudent crediting policy in the following year, with the aim of establishing their business on sound foundations and full application of international banking standards.

Regardless of all the uncertainties and risks the financial system is faced with, it may be concluded that the situation in the banking system at end-Q2 2012 is stable, which is indicated by the liquidity and solvency ratios which remain considerably above the prescribed minimums. However, a further non-performing assets increase might have a negative impact on the banking system.

In the first six months of this year loans recorded a slight increase, yet they recorded the annual decline. Non-performing loans recorded a significant annual decline, however, in the first six months of this year, they increased again. Considering that past due loans followed the same trend, it is reasonable to expect that the workout of deteriorated asset quality problem in some banks in the following period shall result not only in the restructured loans increase but in securing fresh capital (recapitalisation). The encouraging fact is the increase in the deposits with banks in relation to end-2011 as well as over the past twelve months, which resulted in the increase of the loan-to-deposit ratio. In H1 2012 the banking sector was marked by high level of liquidity. Restrictive lending policy has led to the increase in cash and cash equivalents and the level of liquidity in general. Nevertheless, the increase in undeployed liquid assets resulted in certain banks' redirection of activities towards the area of services and revenues from fees.

Even though lending interest rates recorded downtrend in 2012 they remain extremely high due to the country's high risk premium and consequently more expensive sources of financing, non-performing assets uptrend, client risk and overall business climate. Considering the limited access to the sources of financing, banks turned to domestic sources which they secured by offering higher deposit interest rates which resulted in high interest margins.

Microcredit Financial Institutions (MFIs)

Total assets and liabilities of microcredit institutions (MFIs) at end-Q2 2012 amounted to EUR 37.0 million, recording a EUR 7.3 million or a 16.6% decline in relation to end-2011. At end-Q2 2012, the main share in MFIs' assets referred to gross loans with the share of 87.3% and amounting to EUR 32.2 million, which is EUR 1.2 million or 3.6% lower than at end-2011. Loan portfolio structure shows the main share of loans extended to the services, hospitality industry and tourism (33.8%) and loans extended to the sector of agriculture (32.8%). The past period was marked by extremely high effective interest rates approved to clients, in some cases exceeding 40% at the annual level.

MFIs' capital at end-Q2 2012 amounted to EUR 20.3 million, i.e. 54.8% of total liabilities. At the aggregate level, at end-Q2 2012, MFIs reported a profit of EUR 1.2 million.

Insurance Market¹²

Twelve insurance companies currently operate in Montenegro and 24 legal persons¹³ perform insurance agency activities and insurance brokerage activities and provide other insurance services. Five companies are engaged in non-life insurance and seven insurance companies are engaged in life insurance. Foreign equity (84.97%) is dominant in the equity structure of capital of insurance companies. Six insurance companies are 100% foreign owned, one insurance company has over 95% share of foreign capital, while other companies are with mixed equity structure.

Total assets and liabilities of insurance companies amounted to EUR 142.2 million at end-June 2012, recording a 5.0% increase in the current year. Insurance companies' solvency was satisfactory. Guarantee fund to solvency margin ratio at end-Q2 2012 amounted to 169.93%.

Non-life insurance made up 87.2% of total gross premium. Compulsory insurances had the largest share in non-life insurance (55.5% of non-life insurance). Life insurance made up 12.8% of total gross insurance premium. The share of life insurance of 82.7% was the highest in life insurance.

The fact that the number of active life insurance policies at end-Q2 2012 declined in relation to end-2011 is worrying and it is explained by the financial crisis impact and the decline of living standard. To wit, in current year the insurance companies were faced with problems in premium collection which resulted in cancellation of a large number of policies and the increase in the number of requests for redemption of policies.

At end-June 2012, insurance market reported gross profit in the amount of EUR 2.2 million. Positive results were reported by six out of twelve insurance companies.

Lease market in Montenegro¹⁴

Lease companies' policy for Q1 2012 was aimed at the collection of receivables as well as increasing prudence in approving new contracts. This market was characterised by the y-o-y decline in the number of delivered contracts and the decline of business activity in relation to end-2011.

¹² Preliminary data. Source: *Report on Insurance Market Situation in Montenegro in 2010* and *Report on Insurance Market in Montenegro in Q1 2012*

¹³ Fifteen insurance agents and two brokers - entrepreneurs perform insurance agency activities, six insurance brokers perform insurance brokerage activities, while one legal person performs other insurance services.

¹⁴ Data refer to Q1 2012. Source: *Ministry of Finance Bulletin XXVI, April – June 2012*

In the reporting period, five providers of leasing services operated in Montenegro of which three leasing companies held the status of legal persons and two were banks. The largest number of active contracts was signed with legal persons (54.3%), followed by contracts signed with natural persons (45.3%), while contracts signed with entrepreneurs made up 0.4% of total realised contracts. Financial leases accounted for 98.9%, while the operating leases accounted for mere 1.1% of the number of contracts signed.

Observed by the value of contracts concluded, 86.6% of total value of concluded contracts referred to purchase of passenger's vehicles, 10.4% referred to purchase of commercial vehicles, 1.9% referred to purchase of building machinery and equipment while only 0.7% referred to purchase of real estate. The analysis of contracts active as at 31 March 2012 showed that passenger vehicle category accounted for the main share of 75.2%.

Main risks in the financial sector

- Uncertainty still present in the global market, especially in the Euro area spills the risks over via transmission channels, thus influencing the level of overall economic activity and situation in the financial markets;
- Difficulties faced by some of the parent banks in their domicile markets;
- Further deepening of the real sector's illiquidity and the decline in financing from external sources result in a prudent approach to bank crediting. Instead of directing the funds to financing new projects, restrictive lending policy resulted in the increase of undeployed liquid assets and in redirection of certain banks' activities towards services and collecting revenues from fees;
- Real sector illiquidity worsening poses a huge threat to the banking sector and the main source of credit risk. The share of past due loans in the corporate sector at end-Q2 2012 remains really high compared to the share of the household sector, 15% against 7.3%, respectively;
- Unfavourable maturity match of funds and sources of funds, primarily deposits and loans, deprives the real sector of long-term loans for financing development projects under favourable conditions;
- Insufficient degree of integration of certain segments of financial market;
- Underdeveloped offer of securities in the secondary market;
- Decline in demand for insurance services and aggravated insurance premium collection due to the decline of living standard and difficult economic situation.

Development strategy¹⁵

With regard to the fact that with the adoption of institutional and the national contingency plan one of the key recommendations for 2012 was implemented, which consistent application shall ensure the intensification of the resistance of financial system on endogenous and exogenous shocks and defining at the same time contingency activities and instruments, the following strategic aims of financial sector development are recommended for the 2013:

- a. Create a stimulating business environment and remove business barriers in order to start economic activities;
- b. Conduct restructuring programs prepared by CBCG in cooperation with World Bank in companies which are solvent but have liquidity issues;
- c. In cooperation with CBCG undertake activities on the creation of regulatory framework which refers to the establishment, operation and supervision of factoring companies, and activities on the improvement of the current legal framework regarding the supervision of lease companies operations;
- d. Ahead of the forthcoming EC screening activities, in cooperation with CBCG the ongoing activities on drafting a payment system law aimed at harmonising current solutions with relevant EU directives shall be continued;
- e. Regulate maximum contractual interest rate by amending the Law on Obligations (OGM 47/08 and 04/11);
- f. Promote insurance market growth mechanisms as one way of securing additional inflow capital to the system.

Operational measures

Creation of a more competitive economy and attraction of foreign investments, against the background of relatively high indebtedness of Montenegro's economy, must be prioritised in the country's economic activities. Regardless of Montenegro's undisputable comparative advantages, business environment and investment climate must be upgraded in the aim of improving economic activities and banks' lending activities in order to support long-term development projects.

Although the banks reduced the level of bad loans in the previous period, their level increased again in 2012. As a result of difficulties they faced in their domicile markets, a number of parent banks' abilities to incur bad loans declined. This is why it is necessary to create a restructuring programme for companies that are solvent yet have liquidity issues. It is of high importance that the Government takes part in this programme that the CBCG is preparing in cooperation with the World Bank.

¹⁵ Development strategy and Operational measures do not contain measures which are not the responsibility of the government, but are under the CBCG's competence.

Factoring companies operations must be regulated and the oversight of lease companies operations must be standardised. To that end, the Government should cooperate with the CBCG in adopting a new law on factoring companies operations. The issues of lease and factoring companies` oversight and supervision should also be resolved in cooperation with the CBCG.

Activities should be continued on the drafting of new Payment Systems Law which shall harmonise the current Law on National Payment Operations with the Directive 2007/64/EC on payment services in the internal market (the so called PSD), Directive 2009/110/EC on the taking up, pursuit and prudential supervision of the business of electronic money institutions and the Directive 98/26/EC on settlement finality in payment and securities settlement systems. It should be taken into account that in October of 2012 negotiation chapters in the area of economics will be opened which will be followed by the so called screening process in the following three years with EC representatives with the aim of detailed review of the current level of national legislation harmonisation with *acquis communautaire* in this area. This gives reasonable grounds to shift the deadline for the adoption of this law (December 2012) to 2013.

Extremely high interest rates present in some MFIs and small number of banks may be described as usurious. Bearing in mind that some countries in the region, as well as some EU countries and the USA, prescribe the maximum contractual interest rate, Montenegro should implement the "best international practice" in this area. The Law on Contracts and Torts does not regulate the maximum contractual interest rate, which shall be done by amending the legislation.

Regardless of the fact that the insurance sector does not have much influence on financial stability due to its relative size, it is necessary to intensify the activities aimed at promotion of growth and development of the insurance market as a whole. Higher gross premiums and insurance companies` balances understand more money in the system to be placed towards other financial intermediaries, eventually enabling the revival of economic activities in the country. In this context, it is necessary to intensify education and promotion activities in the aim of better positioning of insurance activities in the financial services market (leaflets, TV shows, etc.). Taking into account the personnel deficit in the area of actuary services, it is necessary to promote education of necessary actuaries and implement standards for their licensing.

2. Capital Market

Current status

In the first six months of 2012, the Montenegro Stock Exchange recorded a turnover of only EUR 10.0 million, which is a 62.9% y-o-y decline. Simultaneously, the

average monthly turnover amounted to only EUR 1.7 million (EUR 4.9 million in the same period 2011). The entire turnover was recorded through secondary trade, with the highest turnover recorded in companies' shares (81.9%), mutual investment funds' shares (12.4%) and various types of bonds (5.7%). Negative trend of the investment funds' index, the Monex PIF, recorded as of the beginning of 2011 continued into 2012. After trending up in Q1, the Monex20 index recorded monthly decline throughout the entire Q2.

Market indicators show that the impact the economic crisis had on Montenegro's economy is also evident in the capital market. Domestic and international uncertainty of the economic recovery negatively influences the inclination of investors to place their funds in Montenegro. Montenegro's capital market recovery is rather dependant on the recovery of the international economy, higher investments within the national possibilities, which does not seem optimistic at this moment.

Main risks

- Low market liquidity as a result of high operational losses and unresolved debtor-creditor relationships;
- Shallow market in terms of types of trading instruments;
- Inadequate minority shareholder rights protection;
- Insufficient level of transparency and quality of financial statements of companies with shares quoted in the exchange market;
- Negative aftermath of the capital market price bubble bursting which has a negative impact on the risk sensitivity and investors' confidence;
- Poor management of funds' property;
- Further deceleration of privatisation of remaining big companies.

Development strategy

- a. Continue with the harmonisation of regulations with the EU practice in the aim of fostering the creation of a more complex market structure and market material, as well as the increase in market liquidity;
- b. Continue the intensification of connection of the market with regional and European markets, in terms of volume and the quality of trading instruments;
- c. Improving the minority shareholder rights protection and the compliance with the basic principles of corporate management.
- d. Implementation and compliance with international financial reporting standards;
- e. Intensify education activities of the population.

Operational measures

Adopt a new Law on Money and the Capital Market which would implement the EU regulations and the recommendations of the best business practice in this area. In legal solutions, implement the Directive 98/26/EC on settlement finality in payment and securities settlement systems;

Improve the trade oversight system, through the establishment of a proactive system which uses statistical tests and is able to identify trade irregularities in the early stages. Simultaneously, strengthen the Commission's administration capacities for intensified oversight activities in order to ensure consistent application of regulations by participants in the capital market;

It is necessary to take appropriate activities for the development of the secondary market of short-term T-bills, corporate bonds and new initial public offerings (IPO). This would increase the possibilities for debtor finance of the business entities in cases when borrowing from the banking sector is made difficult and too expensive. Intensify activities on the education of participants in the market on the possibilities of regional connecting in the exchange market, in order to promote trade, deepen the market, increase information flow, reduce the investment risk, etc.

Fully implement international standards of financial reporting within the reform of the accounting system, in order to eliminate speculative activities resulting from asymmetric information flows.

It is necessary to improve the quality of exchange market reports regarding the information provided, primarily the parts referring to the shares' risk level indicators in order to adequately inform the market participants on the risk/yield ratio of certain trading instruments.

Regardless of a certain progress recorded in raising the level of corporate management quality in companies with shares quoted in the exchange market achieved by encouraging the companies to accept and implement the Corporate Management Code, this area still requires improvements. It is necessary to promote the application of these principles.

IX. RECOMMENDATIONS CONCERNING FOREIGN ECONOMIC RELATIONS AND INTERNATIONAL INTEGRATION

1. Balance of payments and the competitiveness of Montenegro's economy

Current status

After the three-year period (2009-2011) in which the current account deficit had continually declined, in H1 2012, the deficit recorded an increase. The main current account deficit generator is the goods account deficit, i.e. the values of import of goods significantly exceeding the values of export of goods. In the period 2006-June 2012, the average annual degree of coverage of import by export of goods amounted to 23% which is indicative of a very low coverage which is a result of Montenegro's economy structural problems. The structure of the economy and the structure of export, based on the low processing level products and low diversification, over the past years could not generate sufficient export growth which could compensate for extremely high domestic demand for consumption and production goods, which is indicative of an evident problem in the real sector. In addition, the decision of the Government and Aluminium Plant in Podgorica (KAP) management to reduce production in a situation when the cost price exceeds the selling price¹⁶, shall induce the additional decline in export, and thereby the deepening of the foreign trade imbalance. High growth rate volatility and the flexibility of tourist demand influenced the increase in tourism revenues, somewhat mitigating the current account deficit, however the balance in the other current account subaccounts was not sufficient to cover the extremely high foreign trade deficit. Deficit financing is still achieved through FDI inflow, along with increased foreign borrowings.

Considering that the goods account deficit continuously appears in Montenegro's economy over the past several years, it is evident that the main focus should be on strengthening positions in this account, thereby not neglecting the importance of other current account subaccounts. The issue of increasing the export of goods is undoubtedly one of the most important in Montenegro's economy. Low export basis, poor differentiation of export and high dependency on import indicate a weak bearing in mind that it is not possible to achieve long-term economic growth determined by consumption and import growth, with a simultaneous decline in production and investments, it is necessary to take measures aimed at increasing competitiveness as soon as possible. With the appropriate intervention of the state and the direction of cash towards the promotion of export and competitiveness, Montenegro's external situation might improve already in the medium-term.

¹⁶ This decision is fully justifiable from the economic perspective.

Main risks

- Decelerated economic recovery;
- High domestic consumption and production dependence on import;
- Underdeveloped export sector with rather unfavourable structure (dominant low processing level products);
- Poor diversification of export and high dependence on aluminium industry;
- The growth of energy-generating and food products prices in the global market with a direct impact on the increase of import and imported inflation;
- Threat from the increase of import without a significant development component (higher import of consumer goods and lower import of capital goods);
- High foreign trade deficit financed by borrowing;
- Insufficient competitiveness of local products for placement in the international markets;
- Slow adoption of international quality standards;
- Threat of price competitive imported products;
- Insufficient orientation on export production;
- Real sector liquidity issues and the vulnerability of the financial system;
- Decline in the FDI inflow and limited access to international sources of financing;

Development strategy

- a. Strengthening the export sector and changing its structure;
- b. Intensified promotion and stimulation of export;
- c. Increasing the price and cost competitiveness of products;
- d. Increasing the volume of export and the “creation” of new exporters;
- e. Pursuing import substitution policy;
- f. Financial support of new exporting businesses;
- g. Assistance in the creation of domestic brands and the adoption of international quality systems;
- h. Investment in strategic branches of Montenegro’s economy – tourism, agriculture and energy industry;
- i. Reduction of electricity import dependency and the utilisation of renewable sources of energy;
- j. Reduction of food import through the creation of favourable conditions for the development of agricultural and food industry and substitution of agricultural and food products import;
- k. Better economic connection within and among regions with the usage of certain regions’ comparative advantages and improvement of infrastructure;
- l. Attraction of foreign capital into the production activities and export production;

- m. Utilisation of advantages provided by free zones and grouping into clusters;
- n. Improving the tourist offer quality.

Operational measures

With a view to strengthening Montenegro's export sector and raising the competitiveness of the economy, it is necessary to continue the intensive promotion and stimulation of export. The current Export Promotion Strategy was adopted against the background of global economic expansion; therefore it is necessary to draft a new one, adapted to the current economic situation and new global trends.

The current structure of Montenegro's export is rather unfavourable. The major part of Montenegro's export products are resource and labour intensive products (intermediate goods and raw materials). It is necessary to change the export structure by increasing the export of high level processing goods based on new technologies and innovations, i.e. increase the level of technology intensive goods. Export based mainly on technology intensive goods would significantly improve country's economic perspectives due to the fast growing global demand for such goods. However, this is a very complex goal and it cannot be achieved in a short-term. Greater product finalisation guarantees considerably higher prices of export products, higher competitiveness, along with a series of other positive effects on the economy. To achieve this, it is necessary to encourage exporters to achieve higher finalisation of finished products, in order to achieve better effects of the export of raw materials and intermediate goods, which currently prevail in Montenegro's export. In order to change the export structure it is necessary to provide additional funds for such as soft loans for purchase of equipment, development of new products and processes and the application of new technologies. Promote and encourage private investments in modernisation and innovations aimed at raising the overall level of product competitiveness.

For a successful export, it is necessary to continue the ongoing promotion of Montenegro in the international markets, participation in fairs, economic forums, etc. Exchange of information with national economic and diplomatic representative bodies would be useful.

Increase funds earmarked for export promotion. Increase funds available to the Investment and Development Fund earmarked for credit placements. Additional encouragement of investing in export production and starting new businesses can be achieved through activities of the Fund. The Directorate for Development of Small and Medium Sized Enterprises should continue its activities on the development of regional and local support centres for small and medium sized businesses and

improve certain special programmes, such as the development of franchising, technology parks, business incubators, clusters.

Strengthening competitiveness is one of the main strategic goals of Montenegro's economy. Montenegro adopted the Strategy for Enhancement of Competitiveness at the Micro Level 2011-2015 which defines measures and activities for the development of companies' competitiveness. It is necessary to ensure the implementation of this strategy as planned, so that Montenegro's small and medium sized businesses sector's strength and competitiveness could be improved.

Growth of export may be achieved by increasing the volume of export or export prices, or the combination of the two. In Montenegro's case, the most natural option would be to increase the volume export production. To that end, it is necessary to create a base of exporters of export products in order to have precise data on the exporters and the type and amount of the exported goods. This would establish a strong information basis according to which decisions could be made and goals quantified. In order to encourage new exporters it would be useful to conduct a survey or form workgroups among current big exporters, so as to acquire useful information on international markets, possible obstacles in export, conditions in the foreign markets, best markets for product placement, etc. To that effect the work performed by the Trade Information Service is very important and its activities need to be further improved.

Continue the application of the Strategy for Development of Small and Medium Sized Enterprises 2011-2015. Consistent implementation of this strategy would induce an accelerated development of the small and medium sized business sector and their redirection to export. Special focus should be put on new credit lines for business starting. In addition to financial support measures, export oriented companies could also benefit from non-financial support measures such as: expert and consulting support, counselling, etc.

It is necessary to conduct an analysis of imported goods in order to get the insight into what actually needs to be imported, and what could be substituted. Certain part of imported goods, such as oil, machines and equipment cannot be substituted. However, a large part of consumer goods could be substituted. Pursuing such policy would reduce country's dependency on import, promote domestic production and preserve jobs.

The availability of cheap sources of financing is a necessary precondition of growth and development of every economy. To this effect emphasis should be on providing financial support for companies with intentions of entering new markets, and it would be of importance to widen the scope of financing instruments and programmes, insurance and banking guarantees for entering new markets. Allocation of additional

funds within the Investment and Development Fund for financing, insurance and guarantees of export operations for all new exporters, as well as providing assistance in entering new market should be made priorities. Improve the guarantee schemes model developed by the Investment and Development Fund. Consider the possibility of establishing a separate Export Credit and Insurance Agency.

Continue the branding of Montenegrin products and promotion of protected designation of origin (PDO) “Made in Montenegro”. Branding enables the differentiation of a product from other products, ensures product consistency and achieves better price. Provision of financial support for companies so that as many of them as possible would attain the shared brand name “Good from Montenegro”. One possibility is also cutting the current costs of meeting the claims or the lowering the amount annual remuneration for the right to use the trademark, in order to enable more companies to attain this trademark.

For a safe and facilitated placement of domestic products in the EU market and other markets it is necessary to adopt and implement numerous international and European standards. Food industry is particularly requires compliance with the remaining set standards. It is necessary to enable better implementation of Food Safety Law and Food Safety Strategy. Provide financial encouragement for companies in the aim of a more rapid introduction of certain quality standards such as HACCP and Halal standard. Such support would be particularly important for small sized businesses because it would give them the opportunity to place their products abroad. Conditions should be created for product certification co-financing and provision of subsidies for all producers and companies which accept a certain standard. Companies should be proposed measures for subsidising a fixed quality standard introduction cost. Continue providing information on certificates, technical standards, rules on products origin and protection of producers in the EU market to companies and natural persons, bearing in mind the importance of this market for Montenegro and its future processes of integration. Reinforce the product quality control infrastructure which would guarantee the quality and the safety of the product.

Budget funds for the promotion and the development of strategic sectors of Montenegro’s economy, such as tourism and agriculture and food industry need to be redirected and increased. The attraction of FDI into these activities would be of strategic significance for the economy which would have multiple positive effects in the long-term. Favourable geographical position, climate and terrain configuration provide Montenegro with significant comparative advantages for tourism development. Although the main share of revenues from services is recorded exactly in this sector, there is still sufficient room for its improvement. It is necessary to provide higher quality infrastructure, create new accommodation capacities, implement planned big investments (Ada Bojana, Velika Plaža, Luštica, etc.), raise the quality of accommodation and food services, and so on.

The security of electricity supply from domestic sources should be increased and dependency on import reduced through building new production capacities. Create conditions for the strengthening of competitiveness through the improvement of the energy sector and gradual increase of production capacities with the usage of renewable energy sources. Ensure further implementation of the Energy Development Strategy of Montenegro by 2025.

Increase available funds so that the state could continue to subsidise Montenegrin producers, in line with the WTO rules. Particular increase is needed in subsidies to agricultural producers as well as opening of new credit lines. The implementation of Institutional Development and Agriculture Strengthening (MIDAS) Project should be continued. Montenegro's primary is not sufficiently competitive due to the low productivity and inadequate technical and technological equipment and land fragmentation. Strengthening the domestic agricultural production could considerably reduce the import of food which by far exceeds its export. Using IPA funds resources is one way to increase production and employment in the agricultural sector. Strengthening the agricultural sector, through national support programmes as well as through using EU pre-accession funds, shall require a higher engagement of the competent ministry's professional services.

FDI inflow structure in the past several years can be rated as rather unfavourable. Currently, the highest FDI inflow is recorded on the basis of real estate sale. Such structure does not have a development character and it is not sustainable in the long-term. What is lacking are major foreign investments in new companies, which would make a more positive and long-term impact on the economy. In addition to opening new jobs and launching production, FDI as a rule, bring new technologies, transfer of knowledge and high quality management and better product competitiveness. Within Montenegro's strategic commitment which states the necessity of improving export, additional efforts should be invested in the attraction of FDI into export production. The adoption of business plan and the development of science and technology parks, provision of utility and other infrastructure for production companies, consignment of state owned unused real estate, the development of business zones and creation of generally better conditions for foreign investors would be of high importance for the increase of export in Montenegro.

Continue the expansion of Business Zones Development Plan. Business zones should include business incubators, technology parks and industrial zones. Business zones should be predicted and defined for the municipalities in which this has not been done. Special business terms applied in the free zones, in combination with attractive tax rates, make free zones very attractive for FDI. In addition to attracting FDI, free zones offer a lot of other advantages such as: increase in employment, increase in revenues, better educational structure of workers, transfer of know-how, etc.

Development of small and medium sized companies clusters should contribute to the increase of competitiveness of Montenegro's economy. It is necessary ensure the application of the Strategy for Sustainable Economic Growth through the Introduction of Clusters 2012-2016. Straightforward cluster development strategy set in the following period represents a solid basis for their further development and improvement. For small and medium sized companies, association into clusters would enable the access to new markets, introduction of new technologies, more efficient performance, and product quality improvement. Therefore, it is necessary to promote regional clusters formation more actively.

The inclusion in multilateral trade and economic relations would give domestic products a chance to take up a better position in the international markets. The main portion of Montenegro's goods exchange is executed with EU and CEFTA countries. To this effect, it is necessary to resolve numerous open issues within the CEFTA Agreement, in order to remove non-tariff barriers and prepare the market for the EU accession. Trade liberalisation (facilitation of export and import through shortening customs procedures) and bilateral cooperation with the countries in the region should be continued.

2. Foreign Direct Investments

Current status

Against the background of general macroeconomic uncertainty and unfavourable trends recorded in the EU countries, FDI in Montenegro declined over the past two years. Nevertheless, regardless of the annual decline, FDI inflow recorded monthly increase in H1 2012. Investment in real estate increased, while the inflow arising from the investments in domestic companies and banks remained significantly lower in comparison to previous years. FDI structure is unfavourable and the level of sector diversification remains low. So far there is no significant greenfield investments, which are the most favourable form of FDI which make the biggest contribution to the economic development.

Bearing in mind that the FDI are the key drivers of Montenegro's economic development, the increase in the level of FDI into production sectors represents one of the future challenges. This will be possible only through continuous work and perseverance of state institutions in the aim of creating a better investment environment. The improvement of investment environment must be made priority in the following period.

A straightforward strategy of FDI promotion and attraction must be designed, and favourable investment conditions created. In order to attract more FDI, it is necessary to improve public and private sectors cooperation, improve the infrastructure and strengthen competitiveness. Building necessary infrastructure, accelerating the privatisation processes and resolving property issues are the key preconditions for improving FDI attraction. Foreign investors' interest in investing in Montenegro in the following period shall depend on the speed of reform implementation and the developments in the EU accession talks.

Montenegro's advantage in relation to other countries is that it did not introduce restrictive measures in response to the global crisis and made no changes in its tax policy and remained with the most competitive taxation system in Europe, all of which should be used for improving FDI attraction.

Main risks

Potential risks which may have a negative impact on the FDI inflow in the following period are:

- Negative trends in the EU countries and slow recovery from the crisis;
- Deferring the realisation of significant projects and unsuccessful state companies privatisation;
- Deferring the conclusion of privatisation processes and lack of foreign investors' interest in less attractive state companies;
- Decline in public and private investments due to the limited and expensive sources of financing, and increased prudence of the foreign investors;
- Investment hindering red-tape at local administration level – time consuming procedures for obtaining permits;
- Possible problems caused by low quality privatisations and a halt in the implementation of investments provided by contracts;
- Investors' disregard for contractual obligations referring to social and investment programs;
- Lack of good quality infrastructure as a limiting factor in the FDI inflow;
- Unresolved proprietary relations which decelerate the carrying out of investments;
- Lower competitiveness due to the reduced or halted FDI;
- Absence of a clearly defined investment promotion programme;
- Lack of post-privatisation investment.

Development strategy

- a. Attraction and maintenance of high FDI inflows;
- b. Improvement of FDI inflows and an increase in the share of greenfield investments;
- c. Attraction of FDI into production sectors which would generate GDP and export;
- d. Increased FDI contribution to the economic development through export and competitiveness increase;
- e. Creation of a competitive investment framework, stable economic and financial system;
- f. Attraction of strategic investments in energy industry projects;
- g. Finalisation of privatisation processes and increase in the greenfield investments inflow;
- h. Strengthening of the investment cycle through the process of investment in privatised companies;
- i. Promotion and utilisation of free zones' potentials;
- j. Development of infrastructure, especially in the areas of transport and energy industry.

Operational measures

Although it is not reasonable to expect any new big FDI wave in 2013, Montenegro shows large potentials for further FDI inflow. In the following period, it will be necessary to emphasise increased promotion of investment potentials and the creation of preconditions for a more rapid FDI inflow after the crisis (finalisation of spatial plans, micro-location studies, resolution of proprietary issues, obtaining all the required permits, etc.).

Adoption of the new Foreign Direct Investment Incentives Strategy of Montenegro is needed in order to attract more FDI. New investment policy should be implemented within the strategy in line with the new generation of global and national investment policies. Investment policy should comprehend the sustainable development goals, including not only the establishment, operations and protection treatment of investors, but clearly defined investors' responsibilities.

Creation of detailed programme for promotion of Montenegro is needed, including the analysis and selection of target markets for the promotion of investment potential. Focus should be put on the improvement of competitiveness of export oriented sectors. Investments should be directed towards the areas key for the development of production capacities and international competitiveness.

In the aim of increasing the foreign investors' interest in investing into production sectors it is necessary to provide investment-attractive and guaranteed terms of production and export business. Take advantage of Montenegro's joining the World Trade Organisation through promotion and strengthening of domestic producers' competitiveness. Work on identification of the best export-oriented products, improvement of their global positioning and protection of their competitiveness. Intensify greenfield investments promotion and tourist potential valorisation.

Focus on additional promotion of business environment in the aim of creating better and more favourable investment conditions. Improve conditions for new investments which shall lead to the increase in the FDI inflow. Montenegro's comparative advantage lies in the low tax rates and it should be utilised for the purpose of greater FDI attraction. In addition to various advantages Montenegro provides to foreign investors, possibilities for adopting economic incentives for companies applying modern technologies should be taken into consideration. Accelerate the reform of legal and red-tape barriers met by domestic and foreign investors. Improve post-investment services.

In the future privatisation processes basic cost-benefit analysis should be made, in order to get the insight in the investments' impact on the sustainable economic development and avoid big shocks in Montenegro's economy, especially in systems of key importance for the functioning of our economy.

Montenegro has not yet reached the satisfactory level of infrastructure development necessary for the acceleration of economic development and increased FDI inflow. Additional efforts should be invested into infrastructure development via public-private partnerships, since this area still hinders the realisation of Montenegro's market full potential. Initiatives regarding the development infrastructure and competitiveness as strategic priorities should be promoted, in order to create conditions for greater FDI inflow.

Other measures which may have positive effects on the attraction of FDI are: further develop and strengthen the institutions for promotion and attraction of FDI, promote the energy sector bearing in mind the comparative advantages, strengthen relations with the Diaspora in order to provide the emigrants with the incentives to invest in Montenegro, continue the intensive implementation of the Strategy for Development of Small and Medium Sized Enterprises 2011-2015, more precisely and institutionally regulate public-private partnership projects by creating primary and secondary legislation, continue cooperation with the Foreign Investors' Council and support their participation in the creation of business environment, intensify the promotion of free zones potentials, harmonise the educational system with the market requirements and promote investment in research and development.

3. Recommendations concerning international integration

In order to launch the EU accession talks, Montenegro needed to comply with all the obligations which preceded this phase. Stabilisation and Association Agreement was signed on 15 October 2007 and it came into force on 1 May 2010. Montenegro acquired a candidate country status on 17 December 2010. On 12 October 2011 when the Enlargement Strategy and Main Challenges 2011-2012 was presented, the European Commission recommended to the European Council to open EU membership talks with Montenegro. At the Council meeting held on 9 December 2011, Montenegro gained a tentative date for launching accession talks in June 2012.

The year 2012 was very important for Montenegro's European integration considering that in a meeting held in Brussels on 29 June 2012, the European Council confirmed the decision on launching the accession talks with Montenegro, previously adopted by the Council on 26 June 2012 in Luxembourg.

Accession talks include harmonisation of national legislation with legal, economic and value structures of the EU and mainly refer to meeting the third Copenhagen Criterion, i.e. the adoption of *Acquis Communautaire*.

The first stage of talks includes the screening process which includes the analysis of the degree of harmonisation between the candidate country's legislation and the EU legislation. The main goal of the negotiation process shall be to define the terms of Montenegro's adoption, implementation and conduction of the entire *Acquis Communautaire*.

Another key step for Montenegro in the process of integration into contemporary international economic relation and an important element of support in the process of internal economic report in 2012 was acquiring the status of a full member of the World Trade Organisation. To wit, after several years of negotiation on the accession which started in 2004, Montenegro became a 154th full member of the World Trade Organisation on 29 April 2012.

Success of the European integration process depends on the ability to meet the requirements for membership in other international and regional organisations, as well as on the ability to meet the obligations arising from membership in these organisations.

Main risks

- Political disunity within the EU regarding the pace of further enlargement;
- Insufficient administrative capacities for achieving efficient communication and coordination with the EU;

- Strict EU criteria for opening and closing of negotiation chapters;
- Lack of quality projects to qualify for the use IPA funds;
- Insufficient capacities and institutions' qualifications to meet the political, economic and legal conditions for EU membership;
- Violation of contractual obligations of CEFTA agreement by other member countries;
- Instable macroeconomic environment.

Development strategy

- a. The Government should additionally strengthen its capacities in order to provide consistency in *acquis* adoption and carefully monitor the implementation of law.
- b. strengthen the capacities and increase the efficiency of institutions in their compliance with the economic and legal criteria for the EU membership;
- c. Increase the efficiency in creating a decentralised system of EU funds resources management;
- d. National Programme of Integration of Montenegro (NPI) needs to be revised;
- e. Consistent compliance with the CEFTA Agreement provisions is necessary

Operational measures

With reference to the EU, priority directions at this stage refer to further harmonisation of the legal system with the *acquis communautaire* and to the regard of the dynamics of harmonisation with deadlines set by the strategic documents. Simultaneously, efforts should be invested in the reinforcement of capacities of institutions in charge of monitoring the implementation of law.

Appropriately prepare negotiation teams ahead of the talks launching. Identify areas in which there are departures from the *acquis* and areas which require prolongations of implementation deadlines or exceptions. For these strategically important areas it will be necessary to prepare analyses and strong arguments for the reasons of the required implementation prolongation or exceptions.

Continuous efforts should be investment in the strengthening of administrative capacities of employees engaged in European integration and coordination of the EU financial and technical assistance.

In the crisis period, it is necessary to focus on funds from the EU funds which may significantly contribute to the strengthening of the economy in order to match the competition in the EU single market. Other countries' experiences show that significant funds were left unused due to the lack of high quality programmes. It is necessary to form an operational structure as soon as possible and adopt the Strategic

Development Plan and the operational plans for the efficient use of funds available through the IPA component III – Regional Development, the component IV Human Resources Development, and the component V – Rural Development.

Montenegro achieved political consensus on the EU membership. However, the media, the civil sector and faculties need to work together and, through joint activities, increase the level of society's information on the membership. Intensification of the implementation of the Communication Strategy for Informing the Public on the European Union and Preparations of Montenegro for Membership 2010 – 2014 should be prioritised.

X. RECOMMENDATIONS CONCERNING ENVIRONMENT AND SUSTAINABLE DEVELOPMENT

Current status

Sustainable development became the concept of a global interest in the last decades. The following challenges, which the contemporary world is facing, contributed to this increasing interest: global warming, ozone layer decrease, more frequent natural disasters (tsunami, hurricane, earthquakes, floods, and the like), higher environment pollution, but also increasing awareness on environment protection importance.

Sustainable development concept in Montenegro has two decades long history. It originates from the Parliament's Declaration of Ecological State Montenegro from 1991. Certain elements of this Declaration were implemented in the Constitution, and five years ago, National Strategy for Sustainable Development (NSSD) was enacted. This Strategy foresees the following four goals:

- Economic growth acceleration based on the sustainable development fundamentals,
- Poverty reduction, protection of the most vulnerable groups and more equal distribution of the economic development,
- Environment protection and sustainable natural resources management, and
- Ethical goal referring to the implementation of coherence and solidarity principles, respect of human rights and transition from centralized principle of decision making to coordinated activities and decentralization.

From the abovementioned it can be concluded that social awareness in Montenegro is high, at least in assertive terms, but, despite this, there is a substantial part of the territory that is polluted.

Natural values of Montenegro are constantly exposed to the numerous negative pressures. The most important natural values are seriously jeopardized and available space for their ecological valorisation is decreasing due to unplanned and irrational exploitation of natural resources, converting natural settlements into semi-natural and artificial, intensive development in certain sectors (especially in tourism sector), followed by illegal and unplanned construction, pollution (waste water and waste) and the like. Key ecological problems in Montenegro are mostly generated from the use of old technology by certain large corporate sectors, inadequate disposal of communal and industrial waste, sewage of untreated waste water into rivers, Skadar lake and Adriatic sea and enormous increase in number of cars. Public health is directly or indirectly related to the environment condition, and data that one-quarter

or one-third of diseases is the consequences of the environment impact speaks in favour of this fact.

Environment represents important resource for development in Montenegro, and one of key preconditions for joining the EU is to solve problems of its protection, pursuant to the EU requests.

Montenegro has substantial natural resources. Total nationally and internationally protected territory of Montenegro currently makes up 26.3% of the state territory.

Significant part of the territory is included in international conventions or protected by international agreements. Thus, drainage basin of river Tara belongs to M&B UNESCO biosphere sanctuary, while National park „Durmitor” with river Tara canyon and Risan-Kotor Bay belongs to Natural World Heritage. National park „Skadar Lake” is marked as Ramsar site – List of wetland sites of international importance, especially important as water birds’ habitat. National network of protected sites in Montenegro covers 9.1% of the territory. Five National parks („Durmitor”, „Lovcen”, „Skadar Lake”, „Biogradska gora”, and „Prokletije”) have the highest share in protected natural territory (79.8%), while the rest refers to over 40 protected sites including monuments of nature, sites of special shapes and sanctuaries. However, large polluters are in their immediate vicinity.

Technologies applied in Montenegro are characterized by the high degree of environment pollution. These technologies, with significant negative impacts on environment are used in ferrous and non-ferrous metallurgy, plants for coil burn-out (boiler room, thermo-electric power plant), metal processing industry and mining, whereby there is no record on total emissions. Environment in vicinity of these plants is highly polluted and life-threatening. Analysis of the Environmental Protection Agency showed intolerable concentration of powder substances in many measuring areas. The fact that nothing has been done on decreasing of pollution emissions represent a special problem, and one gets the impression that *Declaration of Ecological State Montenegro* has been forgotten.

In relation to the period when it was declared the ecological state¹⁷, Montenegro made certain progress regarding the environment protection. There is a continuous improvement of institutional and legislative framework in this area, whereby main goal is the harmonization of national legislation with the EU legislation. By founding the Environmental Protection Agency, a base for better implementation of the laws from this area was created. Establishment of two Arhus centres (in Podgorica and Niksic) in 2011 was a large progress in raising the public awareness and providing information on issues regarding environment and stimulating public to participate in

¹⁷ Declaration of Ecological State Montenegro, September 1991

making decisions on issues important for the environment. Cooperation with numerous international organizations relevant for this area is realized.

However, development „boom” in Montenegro in the last five or six years contributed to the high pressure on the biodiversity. The most significant pressures refer to excessive use of natural resources, intensive and unbalanced development of individual sectors, conversion of natural habitats in semi-natural and artificial, (waste water, solid waste) and the like. During the last couple of years, biodiversity is highly endangered by increased urbanisation of the coast, illegal and excessive forest cutting, uncontrolled hunting and fishing, collection of eatable and healing plants, mushrooms and forest products, as well as illegal and excessive exploitation of pebble from riverbeds as well as inadequate protection from fire, which every year destroys habitats of some species.

Main reason for non-sanctioning of large polluters is the economic reasons. Apart from Thermal Power Plant Pljevlja, most of other polluters operate with serious difficulties for years. In such conditions, there is a concern that imposing of full ecological expenses on these companies would imply shutting down of most of them and “opening” of social problems, bearing in mind that these companies employ large number of workers. In practice this means that priority is given to those who are advocating the concept that ecological protection represents excessive economical expense. However, this policy is wrong for several reasons: it represents violation of positive regulations and may lead to the “role model” effect, that is, other companies may start to violate regulations; price of this policy is not paid only by citizens who live in the vicinity of these companies, because dangerous substances are transmitted through air, water and land, thus jeopardising flora and fauna as well as health of citizens; this increases expenses of the Health Fund and medical treatments.

Despite evident progress in legislative and institutional framework, insufficient efficiency in the implementation of enacted laws and regulations, as well as still insufficient public awareness on the environment protection importance represents the key problem in this area.

With a view to solving the ecological problems, concrete activities are continued in the previous period. Out of seven planned sanitary waste areas, one has been constructed in Podgorica, while the construction of one of them is ongoing in Bar. Activities on solving the problems of the dangerous waste disposal are conducted in cooperation with the World Bank within the Industrial Waste Management and Clean-up Project. The Project incorporates dealing with ecological “black spots” – Aluminium Plant in Podgorica (red mud basin and industrial waste disposal), Steel Mill in Niksic (industrial waste disposal), Shipyard Bijela (industrial waste disposal - grit), Thermal Power Plant Pljevlja (disposal of ash and cinder “Maljevac”) and Gradac Pljevlja (“Suplja stijena”). Construction of the waste water disposal facility has been started in Niksic and Herceg

Novi in 2011 and 2012, respectively, while by the end of 2012 construction of these facilities should start in Bar, Kotor and Tivat. The Project “Lake Skadar Ecosystem Management” has been implemented in cooperation with the World Bank aimed at enhancing mechanisms for the efficient cross border cooperation, protecting and managing the sustainable economic development of the Skadar lake region. In addition, there are also numerous activities and projects implemented in the environment protection area, but key risks and factors that jeopardize natural resources of the country are still very high.

Natural values represent the resource of a special interest for Montenegro, thus, it is necessary to provide their adequate protection. Securing and implementing of the maintenance and protection of the natural values is enabled by the establishment of an adequate legal framework and its further development, capacity strengthening in this area and providing continuous monitoring of the nature preservation. One important aspect in this area is the promotion of the environment protection, which goal is inclusion of the public, being an important factor in the protection of natural values.

Main risks

- Devastation of environment;
- Production of food at high pollution spots;
- Increased pollution of territory affected by the overwhelming use of agrochemicals in agriculture by agricultural producers, whereby coming to the transmission of poisonous materials to agricultural products;
- Pollution of locations full of water springs;
- Loss of biological diversity aquatorium due to high intensity of poaching;
- Degradation of the parts of coast as the result of pouring out untreated communal and waste water from hotel complexes, bad ecological behaviour, damages at oil tankers and other means of transport, not built marine infrastructure for accepting ballast and other waste water and solid waste and transported goods that may endanger the environment;
- Danger of pouring out oil derivatives into the aquatorium and danger of explosions and fire (oil derivatives tanks in the Bay of Kotor and in the Port of Bar);
- Uncontrolled disposal and inadequate treatment of dangerous and non-dangerous waste;
- Endangered ecological balance, resulting from non-planned and illegal construction at the protected areas;
- Unfavourable ecologically-spatial effects of the foreseen construction of hydro-energetic objects;
- Increased air pollution due to the use of old vehicles and vehicles without adequate protection systems;

- Due to unbalanced regional development, high migrations may appear, which may result in depopulation of rural settlements, decline in agricultural production, high “pressure” to infrastructure of cities, further social disintegration and the like;
- Frequent forest fires;
- Increased pressure to pension and health funds, as well as the reduced human capital potential, due to the aging population tendency.

Strategic development aims

- a. Strengthen the environment protection from devastation, pollution, poaching, degrading the aquatorium, negative influence of the climate changes, fire.
- b. Provide and promote sustainable waste management.
- c. Prevent illegal construction, especially at protected locations.
- d. Encouraging ecological awareness of citizens.
- e. Pay more attention to the production of organic food in Montenegro.
- f. Provide rational use of natural resources.
- g. Pay attention to renewable energy sources like energy of sun, wind, biomass and the like.
- h. Increase awareness on the environment protection into sectoral policies (spatial planning, energy, transport, agriculture, forestry) following the sustainable development principles.
- i. Promote anti-fire protection;
- j. Increase efficiency in the application of primary legislation regarding the environment protection and improve inspection efficiency.
- k. Pay more attention to balancing regional development.

Future actions

It is necessary to revise the status of the existing protected natural sites, set up a network of protected sites and integrates them into space and planning documentation. Nationally protected territory of Montenegro should be increased up to 10% and protect at least 10% of the coast zone.

With a view to protecting the environment from devastation, it is required to make plans on natural resources exploitation (forests, rivers, land and the like). It is necessary to create integral cadastre of environment polluters (air, water and land) and to work on the promotion of the policy instrument “polluter pays“. Creation of the strategy for the development of tourism in protected areas would be of a great importance.

It is necessary to enhance monitoring of all (realistic and potential) land polluters and to impose severe sanctions pursuant to provisions of the Law on Environment,

including dismissal of the production process until ecological requests are fulfilled. The map of locations in which there is a high degree of land pollution should be created, while the polluters should detoxicate abovementioned locations. Food production should be prohibited in polluted locations, while producers should be compensated by the polluters. Efficient measure against this problem would be tax stimulation of the production process development which meets ecological standards, as well as tax discentive of consumption of products causing damage to the environment and humans' health.

The overwhelming use of means of protection in the agricultural production may be transferred to agricultural-food products. Therefore, import and use of protection substances for plants as well as substances for the improvement of land quality should be severely controlled. This also requires a long-term harmonization of regulations with the EU directives. It is therefore necessary to work on improving the education degree on applying means of protection in the agricultural production. Special attention should be paid to the prevention of its overwhelming use.

Issue of waste disposal represents one of the biggest ecological problems in Montenegro. To wit, activities on resolving problems of non-sanitary waste disposal locations should be continued. It is necessary to construct national plant for the safe disposal of the dangerous waste (from polluted locations and from the existing corporate branches), plants for processing of medical and veterinary waste, regional sanitary waste disposal location adjusted to EU standards, as well as planned recycling centres. Increase of the awareness and culture of citizens regarding proper waste disposal as well as stimulation of waste reuse and recycling, whereby media should have more important role, is of a great importance for the efficient dealing with waste issues.

Collection, recycling and restoring of the packaging waste are not properly developed in Montenegro. Functional recycling system should be set up, selective waste collection should be intensified and recycling plants network should be established. It is necessary to train public utility officers on proper reactions in cases of irregular waste treatment. It is required to stimulate production and use of biodegradable and ecologically suitable packaging. Thus, the Packaging and Packaging Waste Management Law should be enacted.

Since water shall be the key resource in the coming decades, it would be necessary to pay special attention to the ecological protection of locations rich with water springs, thus creating the comparative advantages in the future. Therefore in would be necessary to pass special secondary legislation to protect areas full of water resources. Cadastre of spring waters and river sources (realistic and potential) should be created. It would be useful to create a strategy on protection of waters or strategy on water monitoring promotion, with the recommendation for the long-term capacity

development. As per water monitoring, it should be pointed out that this is not a part of the Program of Environmental Monitoring in Montenegro, since systemic examination of surface and underground waters is conducted on the basis of the program of the Ministry of Agriculture, Forestry, and Water Management, pursuant to the Law on Waters. Therefore, it would be necessary to harmonize the Law on Waters with the Law on Environment aimed at establishing the integral environment protection system.

There are no protected sea or coast areas in Montenegro. Thus, activities on their protection should be intensified. Adequate regulations governing the sea ecosystem protection should be enacted, as well as the Strategy for the integral sea property management based on the sustainable development principles, and clearly define key strategic goals at sea and coast.

The aquatorium is being degraded due to the spilling of waste water and chemicals from land facilities and vessels. With a view to preventing this occurrence and protection of the sea from harmful substances, organizational and technical capacities for the protection of the sea from the pollution from ships should be enhanced in accordance with international agreements. It would be useful to create National plan for interventions in case of unexpected sea pollution from vessels. With a view to implementing laws on the sea, protection of people and marine aquatorium from ecological accidents, coast guard of Montenegro should be established. Coast guard should be the supreme institution in charge for the safety at sea. It is necessary to improve ecological protection systems in ports and marinas, system for the protection from pouring out of oil derivatives in the aquatorium as well as systems for the protection from explosions and fire in oil houses derivatives in the Bay of Kotor and Port of Bar.

In order to protect biological diversity of the aquatorium from the excessive poaching, more severe control and implementation of the sanctions and other measures stipulated by the law should be enhanced, as well as encouraging measures focused on the change of the catch structure.

Waste waters represent one of the key and largest surface and underground water pollution sources. With a view to maintaining and improving the water quality and implementing the EU standards, construction of planned plants for waste waters purification. At the same time, this requires timely solution of a problem of treatment of waste waters purification products.

Aimed at preserving and improving the air quality and preventing and decreasing harmful impacts on the environment, it is necessary to create National strategy for air quality management with the Action plan for its implementation. It is required to set up national network for air quality monitoring (in accordance with the EU standards).

In addition to stationary pollution, motor vehicles represent a large air polluter. This especially refers to vehicles without appropriate filters. Transportation sector is recording constant growth, thus, air pollution will also increase unless acceptable environmental models are to be developed and promoted. Therefore, measures for the stimulation of public transport use should be implemented and, consequently, improve costs and quality of the public transport, as well as its accessibility in majority of Montenegrin municipalities. In addition, regulations and measures which would stimulate the purchase of cars with lower emission of harmful gases and hybrid vehicles should be enacted. This could be done by decreasing the registration price of these vehicles. At the same time, regulations governing environmental and energy protection should enable use of bio fuels and other renewable fuels used for transport.

Aimed at increasing protection of the environment from fire, adequate legal framework should be created as well as plans for the protection of forests from fire. Special attention should be given to the prevention of deliberate fires as well as fires as a result of gross negligence. A possibility of creation of regional anti-fire centre and joint purchase of anti-fire airplanes and helicopters should be considered. Degraded forests should be renewed and recovered. Thus, forestation and forest recovery plans should be created.

Pursuant to the Environmental Law, national plans for special environmental areas should be enacted, such as the National plan for climate change mitigation and National plan against desertification and land pollution. Standards from series ISO 14000 should be implemented. In addition, environmental protection plans at the level of local administration should be created.

Illegal and unplanned construction on protected sites should be prohibited, and undertake measures for the removal of consequences of such construction. To wit, it is necessary to increase the control of construction and implement “emergency” measures in case of illegal construction.

Special attention should be paid to the use of the EU funds and funds of other institutions focused on renewable energy sources and provide stimulation measures for their use.

Environmental awareness of Montenegrin citizens is still very low. Its improvement requires organization of various campaigns by government and non-government sectors as well as public debates with a view to informing the public on environment protection issues. Education system should be introduced, whereby target groups should be business sector, non-government organizations, media, local communities and schools. Providing active participation of all citizens in making decisions in the environment protection area is very important.

Aimed at establishing a sustainable financing system in the area of the environment protection, it is required to set up an Eco fund dedicated to operations related to financing and implementation of the programs and projects in the areas of maintenance, sustainable exploitation, protection and promotion of the environment, energy efficiency and use of renewable energy sources as well as efficient implementation of the “polluter pays” principle.

In order to improve efficiency in the implementation of regulations, it is necessary to increase institutional and staff potential for the implementation of obligations related to legislative and strategic framework, and improve coordination of the institutions in charge for environment protection and implementation of relevant laws. It is necessary to work on training and connecting of municipality services for the efficient dealing with challenges in all environment protection areas. Also, integrated approach to the environment management system should be provided, bearing in mind that the Ministry of Sustainable Development and Tourism is not in charge for all elements regarding environmental protection. Aimed at mitigating negative activities’ impacts on the environment, it is necessary to intensify supervision of the ecological inspection. In order to increase the entire environment protection system, it would be useful to establish the Ombudsman of the Environmental protection Agency. Continuous activities on improvement of scientific, academic, business and administrative capacities are required as well as the establishment of sustainable statistical system.

More attention to measures focused on balancing of the regional development is needed. There are three clearly defined regions in Montenegro with different development degree – continental, central and coast region. Aimed at adequate distributing of funds to all parts of the country and fair implementation of the priority investments, it is necessary to continue with the creation of secondary legislation aimed at providing consistency of interest of local communities and general development framework. Continuous capacity and plans for the social-economic developments at the local level should be implemented. Special attention should be focused on use of the EU funds for balanced regional development. Thus, program and project capacities for applying for the international funds should be enhanced. It would be useful to conduct a statistical division on regions, thus, their development could be statistically monitored. Aimed at efficient conducting of the regional policy, statistical system should start to produce key indicators according to the regional principle.

The population is becoming one of the key factors for the development. Most of projections indicate that the Montenegrin population will be facing the aging trend in the forthcoming period. Thus, it is necessary to start timely implementation of the population policy as well as creation of the strategic document to cover this issue.

XI. RECOMMENDATIONS CONCERNING OTHER AREAS

1. Statistics

Current status

During the previous period, a progress was evident in several statistical areas. Special attention should be paid to the progress concerning the implementation of international *classifications*. First, it is a *classification of activities* providing statistical data comparability with the European and international data *as well as the standard classification of occupations* which represents obligatory standard (pursuant to international standard ISCO 08 classification) and enables expressing unique data on kinds and groups of occupations at the state level. Monstat started to publish HICP (Harmonized Index of Consumer Prices) as of the beginning of 2011, as a pilot project, and as of the beginning of 2012, it has become a part of the regular survey.

Montenegro joined the GDDS - General Data Dissemination System, which supports the implementation of good methodological principles and strict practice in data collection, respecting the procedure which affirms objectivity and professionalism in reporting. By joining the GDDS, along with the implementation of the IMF standards, official statistical data, as well as methodological explanations, became available to wide range of users. Activities on joining the SDDS system (Standard Data Dissemination System), has been initiated. In addition, upon the suggestion of EUROSTAT-a, bilateral cooperation between Monstat and Statistics Austria has been defined aimed at assisting Montenegro in faster integration of the Montenegrin statistical system into the European Statistical system (ESS).

System of data publishing has been improved on a monthly, as well as quarterly level. New layout of releases could provide more methodological notes besides the tables and data, especially if those are methodological amendments, implementation of new classifications and the like.

Statistical Office of Montenegro made significant progress with the assistance of different financing programmes (CARDS, SIDA, IPA). Past, as well as current projects have a common goal – institutional capacity strengthening, development of sustainable statistical system, improvement of quality of surveys in different statistical areas. Although the progress is visible in the national accounts statistics, price statistics, labour market statistics and the like, these, as well as other statistical areas require additional effort in reaching quality.

Since Montenegro became an EU candidate country, this substantially increased requests of all beneficiaries and participants in standardized, methodologically harmonized statistics according to the *Acquis Communautaire*. Continuation of the IPA technical assistance is of a special importance for statistics because workshops, trainings, internships shall provide good preparation for the integration in the European Statistical System. Thus, the main goal of the IPA project is the preparation of the statistical institutions in the candidate countries for the EU membership, harmonization of methodologies with the *Acquis Communautaire* and their integration in the European Statistical System. Multi-use IPA 2007 and IPA 2008, was used by MONSTAT aimed at improving several statistical area such as external trade statistics, price statistics, national accounts, preparation for the Agricultural and Population censuses and the like. Multi-use IPA 2009 (planned duration – December 2010 – December 2012) is focused on external trade, prices, national accounts, labour cost survey, dissemination and the like. In the upcoming period, Statistical Office should increase efficiency in using the offered funds, primarily by focusing on priority areas.

In March 2012, Parliament of Montenegro enacted the Law on Official Statistics and Official Statistical System which prescribes organization and competences of the official statistics system, collection, processing, and protection of statistical data, as well as other issues of importance for the official statistics. The Law enforced the role of Monstat in the entire statistical system, role of the director, revised list of producers and other.

In the document “Enlargement Strategy and Main Challenges 2011-2012“, the European Commission pointed out that Montenegrin statistics made progress but also that it needs further significant efforts in dealing with certain weaknesses. At the same time, statistical infrastructure needs improvement aimed at reaching satisfactory level of harmonization of the existing statistics with the *Acquis Communautaire*.

Main risks

- Insufficient number of professional, qualitative and motivated statisticians in Monstat and other institutions producing statistics;
- Unsatisfactory general operating conditions for employees, the lack of working space, small salaries, which may result in qualified personnel drain and deceleration of development of statistical process and statistical system;
- The lack of the proper indicators (agro-monetary statistics, income from agriculture, expenses, and the like) for the agricultural sector based on which a good quality assessment of agricultural GDP and its contribution in total GDP could be performed, despite the fact that agriculture becomes more important in the total GDP calculation;

- Nonexistence of the adequate general index for the transport sector, which may affect an incorrect assessment of contributions in the total GDP;
- Nonexistence of the multi-year data series of the quarterly GDP calculation by individual sectors, as well as lack of the quarterly GDP data by individual sectors, which may affect adoption of low-quality recommendations in the economic policy for individual sectors,
- Although the quality is improved, the external trade statistics is still insufficiently reliable, which affects the level of GDP calculation, poor credit rating of Montenegro and the creation of incorrect inputs for the economic policy.

Strategic development aims

- a. Use of all types of technical support and programmes by Monstat with a view to producing high-quality staff that could respond to the requirements in the process of accepting EU standards.
- b. Hiring new staff in Monstat and providing adequate spatial and financial possibilities for better functioning.
- c. Continuous improvement of the tourism statistics (physical and financial indicators) by introducing survey on consumption of foreign citizens, as well as other types of consumption (for example navigation experts), pursuant to IRTS 2008 standards (International Recommendations for Tourism Statistics).
- d. Set up a compilation of satellite accounts in tourism and define periods for the processing of key aggregates.
- e. Create database of agricultural sector (besides number of individual farms, total land used, livestock and the like, based on agricultural census) on income and expenses of individual farms (if possible, calculate – estimate data) in order to use it for the calculation of added value and intermediary consumption of agricultural sector in total GDP.
- f. Produce quarterly GDP with added value by sector in current and permanent prices by consumption categories.
- g. Produce deflators value by consumption parts (personal consumption, government consumption, as well as for other consumptions in GDP).

Future actions

Key activities should refer to the provision of qualified staff that would be able to respond to all statistical researches. In addition, new employees should be hired for vacant job positions. Adequate spatial, technical and material conditions should be provided for successful functioning of the researches. Inadequately paid employees are not encouraged to improve the quality of statistical researches.

Attention should be paid to continuous improvement of agricultural, transport, tourism statistics and other.

Establishment of accounts in agriculture and agro-monetary statistics based on which total agricultural production should be implemented. Data on production at individual agricultural holdings and total production of business entities, with adequate price statistics should contribute to high-quality indicators necessary for the GVA calculation in the agricultural sector.

After a certain calculation and publication of the first TSA (Tourism Satellite Accounts) pilot project with 2009 data which provided internationally comparable assessment of contribution of tourism in the total Montenegrin GDP, it is necessary to continue the promotion of statistics in this area. Namely, it is required to set up the dynamics of production and processing of some indicators shown in basic TSA tables, which would enable better calculation of GVA (Gross Value Added) of tourism activities and DGDP (Direct GDP) in tourism.

There are statistical indicators on transport in different transport areas, but there is no unique indicator for the entire transport sector. It would be important to create general transport index which would provide total movements in the transport sector and which could be used for the assessment of movements and contribution of this sector in total GDP for the certain period of time over the reference year. Indicator i.e. index which would be used for the GVA assessment and the share of transport in total GDP, is becoming more important due to the fact that, according to the latest available data, the transport sector has over 9% share in the total Montenegrin GDP.

The goods index should be published separately from the services index from the total CPI since it can be used for the assessment of GAV in individual sectors (for example: trade).

The quality of monthly and quarterly statistical surveys should be constantly improved with a view to creating quarterly GDP and improving calculation of the annual GDP in constant prices by expenditure categories.

2. Accounting and auditing standards

Current status

Implementation of the accounting and auditing standards in the practice of Montenegrin companies is insufficient, despite the efforts towards the creation of new legislative solutions. At the same time, further amendments to the existing regulations should provide a higher level of harmonization with the EU directives.

In 2006, World Bank (WB) representatives visited Montenegro. After the visit, the WB prepared the Report on Observance of Standards and Codes (ROSC), referring to accounting and auditing in Montenegro. The ROSC formulates internationally related and consistent recommendations aimed at improving financial reporting in Montenegro.

Following the ROSC recommendations, the Ministry of Finance established the National Council for Accounting and Auditing. The objective of this Council is to create a better environment for improvement of accounting and auditing regulation and practise in Montenegro. With the assistance of the WB, the Strategy and Action plan for the promotion of the financial reporting quality was created. The Strategy covers systematic program of measures for the improvement of the legislative framework, institutions and accounting profession, especially in a part referring to the quality of the accounting practice, auditing and business culture, aimed at reaching high-quality financial reporting. The Strategy and Action plan are aiming to recognize and formulate steps and instruments leading to the harmonization of the regulatory framework of the financial reporting with the *Acquis Communautaire*, including the preparation of the consolidated financial statements, regulations governing work or audit companies, centralization of the annual accounts base, electronic publishing of the financial statements, improvement of the financial statements publishing and the like.

In 2012, there were delays in the implementations of the Action Plan pillars, especially regarding the establishment of the body for the public oversight of auditors, as well as creation of centralized financial statements data base. At the same time, amendments to the Accounting and Auditing Law (OGM 32/11) prescribe that financial statements shall be submitted to the Tax Administration. Although the existing legal solution implies electronic reporting, implying also the possibility of electronic submission of financial statements of legal persons directly into the common electronic base, this form is reduced down to submission of scanned statements on CD and memory cards.

On the other hand, the Institute worked hard on continuous education and organization of seminars and courses for the professional training in 2012, which significantly contributes to the quality of the accounting-auditing practice. Also, as of November 2011, the Institute of Certified Accountants of Montenegro is an associate member of the IFAC.

Main risks

- Inconsistent implementation of the Law amending the Accounting and Auditing Law (OGM 32/11), in the part referring to full implementation of International Accounting Standards and International Financial Reporting Standards;
- Inconsistent implementation of the Law amending the Accounting and Auditing Law (OGM 32/11), in the part referring to the obligation that legal persons are obliged to submit financial statements in hard and electronic copy not later than by 31 March of the current year for the previous year;
- Lack of cooperation of the Institute of Accountants and Auditors of Montenegro and the Institute of Certified Accountants of Montenegro;
- Poor-quality control mechanism of oversight of the quality of operations of accountants and auditors;
- Recent and »ad hoc« meeting of the Accounting and Auditing Council;
- Regular report on the implementation of the Action plan for the promotion of accounting and auditing standards was not created in the previous period;
- Implementation of the Action plan for the promotion of accounting and auditing standards is slowed down;
- Uncoordinated chart of accounts as well as forms of financial statements reporting IFRS;

Strategic development aims

- Amend the existing Law and enactment of the new Law amending the Accounting and Auditing Law which will be fully harmonized with the EU directives;
- Develop mechanisms of oversight of quality of performing accounting and auditing operations;
- Develop system of external control of quality of auditors' activities;
- Develop accounting and auditing profession up to the level that meets quality standards and implementation of ethical standards and codes of conducts, as well as harmonized reporting quality;
- Provide coherent international cooperation with IFC and WB in accomplishing technical assistance and inclusion in the work of relevant bodies dealing with accounting and auditing standards;
- Higher education, being the base for launching high-quality accountants and auditors should focus more on disciplines such as accounting, auditing and business finance, modernization of programmes of these disciplines, staff improvement (professors and assistants) regarding the number of employees as

well as their scientific, professional and educational level and on conditions for performing their activities.

Future actions

Amendments to the existing Accounting and Auditing Law with enacted amendments should primarily refer to establishment of a body for the public oversight of auditors, revision of the implementation of accounting standards (clear division of legal persons who are obliged to submit financial statements pursuant to IAS/IFRS, which legal persons are obliged to implement - IV, VI and VII EU Directives). The existing proposal of the Law, which is, at the moment of creating this text, in the Parliament procedure for adoption, represents improvement in a part referring to definition of conditions for the establishing an auditing company, more precise definition of conditions for issuing and revoking the authorized auditor licence, shortening the deadline for decision making of the authorities for issuing the working permit for the auditing company. However, the Law is not harmonized in a part referring to the implementation of the 2006/43/EC and 2006/46/EC Directives as well as regarding the treatment of consolidated balance sheet.

In 2013, the implementation of the “Strategy and Action plan for the improvement of the financial reporting in Montenegro” should be continued while the option of unifying of two currently existing institutes - Institute of Accountants and Auditors of Montenegro and the Institute of Certified Accountants of Montenegro in one institute aimed at increasing operational efficiency should be taken in consideration.

The ROSC (Report on the Observance of Standards and Codes) delegation should be invited to perform a follow up of the implementation of the May 2007 recommendations, as well as the revision of the accounting and auditing practice progress in Montenegro, and to provide recommendations in a new Report and to create a Report on corporate management progress in the shareholders` associations in Montenegro.

Activities within the REPARIS project aimed at improving educational standards and certification for accountants and auditors within competent authorities should be continued.

New balance sheet schemes (financial statements) in the electronic form, which would be available at the web site of the Ministry of Finance, Securities and Exchange Commission and Tax Administration, should be drafted, while centralization of the balance sheet base should be created.

It is necessary to continue and accelerate work on the FIRST initiative with two main tasks: provide technical assistance to the Government of Montenegro in setting up the priorities within the National action plan for the financial reporting improvement for the period up to end-2013 and provide technical assistance to the Accounting and Auditing Council in expanding National action plan in mid- and long-term.

Regional cooperation, institutional and supervisory networking in accounting and auditing, especially in translating and explaining IAS/IFRS standards should be enhanced.

Establishment of an organizational part/unit within the Ministry of Finance should be considered. This unit would be in charge of the supervision of adjustment of financial statements with normative base used for their compilation.

Higher transparency level in operating and reporting of the insurance and reinsurance companies, investment funds, NGO, stocks and brokers/dealers should be provided, with the special emphasis on the transparent approach to financial statements, as well as information on board of directors members, in particular in the part referring to their share in the ownership structure as well as management earnings.

Publishing of financial statements of the shareholder associations which are at the stock exchange listing on the SEC website should be updated.

Control of auditors by a special body – an Agency which would be in charge for the supervision and evaluation of the auditors' work should be organized.

All companies which do not submit financial statements within the prescribed timeframe should be sanctioned.