



## MONTENEGRO: Staff Concluding Statement of the 2019 Article IV Mission

June 28, 2019

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A Concluding Statement describes the preliminary findings of IMF staff at the end of an official staff visit (or ‘mission’), in most cases to a member country. Missions are undertaken as part of regular (usually annual) consultations under [Article IV](#) of the IMF's Articles of Agreement, in the context of a request to use IMF resources (borrow from the IMF), as part of discussions of staff monitored programs, or as part of other staff monitoring of economic developments.

The authorities have consented to the publication of this statement. The views expressed in this statement are those of the IMF staff and do not necessarily represent the views of the IMF's Executive Board. Based on the preliminary findings of this mission, staff will prepare a report that, subject to management approval, will be presented to the IMF Executive Board for discussion and decision.

*An International Monetary Fund mission visited Podgorica from June 17 to 28 to conduct the 2019 Article IV consultation.*

### Main Points

- *Economic growth has been strong, and fiscal adjustment has improved budget balances. But high public debt limits the government's room to counteract possible future downturns. With global growth prospects increasingly uncertain, government debt needs to be further reduced.*
- *The costs and benefits of completing further phases of the Bar-Boljare highway in the near term need to be carefully analyzed. A credible new feasibility study is essential before any decisions on financing mechanisms are made. A rush to complete this project could also entail large fiscal costs. The burden of these costs would leave the economy much more vulnerable to shocks.*
- *The materialization of such a scenario would prevent the allocation of fiscal resources to other productive uses, such as more investment in education, health, and critical public infrastructure that offer superior rates of return.*

- *Additional efforts are needed to strengthen the financial system so that it can better support higher investment and living standards. The current structure, tools, and processes for bank supervision and Anti-Money Laundering (AML/CFT) need further enhancement. The central bank is moving in the right direction to address these issues. Forceful and effective implementation of reforms in these areas, as well as the implementation of the planned asset quality review (AQR) of the banking system by end-2020, will be critical.*

***Continuation of strong economic growth requires careful prioritizing and sequencing of public spending.***

**Economic growth is projected to moderate in the near term from recent highs.** The economy is projected to expand 3 percent in 2019, down from almost 5 percent in 2018. In the absence of further reforms, growth is expected to average just under 3 percent in the next five years. There is still much untapped potential in tourism. However, there is a limit beyond which small-sized economies like Montenegro can expand tourism in a sustainable manner. The authorities are rightly focusing also on renewable sources of energy production, given the country's natural endowments. Rapid progress in these areas could raise growth above our projections. Yet, there are also many risks of lower growth, notably from a worsening of global trade, financial conditions, or geopolitical tensions.

**Sustained higher growth requires more efficient and carefully sequenced public spending.** The long-term goal is to generate growth that touches all citizens. Public spending needs to be focused on where it delivers the highest rates of social and economic returns. Greater investment in education and health, alongside labor market reforms, would improve the employment and earning prospects of the young and help in the creation of a more productive workforce. The focus of public infrastructure spending needs greater emphasis in areas where society benefits most—in alleviating congestion in more densely populated and visited areas. With time, such public investments will generate dividends that can be channeled to more ambitious projects whose benefits are more uncertain.

***Fiscal adjustment has progressed but must be sustained.***

**Public debt must be reduced from current high levels.** In conjunction with a long-term growth strategy, the ratio of public debt to GDP needs to be reduced in the nearer term. This balancing act is essential to cope with possible changes outside Montenegro. As broader global conditions are becoming increasingly uncertain, the government needs to maintain room to counteract a downturn if a shock from the outside were to materialize.

**The authorities have made progress in the last two years in this regard.** Excluding highway spending, the primary fiscal balance (the budget balance excluding interest payments) has swung from a deficit of 1 percent of GDP in 2016 to a surplus of 2 percent in 2018. This was not an easy achievement, and the authorities are to be commended for it. However, general government debt including guarantees stood at 79 percent of GDP in 2018 (71 percent of GDP excluding guarantees), a level that is still too high. The maintenance of

currently projected primary surpluses over the medium term of 2 percent of GDP is critical to reduce the level of public debt. Under current policies, general government debt with guarantees is projected to decline to 61 percent of GDP by 2024 (53 percent of GDP without guarantees).

*Choices regarding the Bar-Boljare highway project should be weighed against other alternatives.*

**The authorities need to proceed very carefully with plans to complete the Bar-Boljare highway.** Construction of the first phase has been expensive, requiring the authorities to adopt difficult fiscal adjustment measures. The remaining phases could also be expensive to the public sector. At this stage, the economic benefits of the project as a whole are uncertain, and the fiscal resources could be put to alternative uses. Moreover, studies conducted several years ago raised questions about the economic viability of the project. The authorities recently commissioned further studies to re-evaluate the project based on updated information. If the new studies do not adequately dispel earlier doubts, we understand that the authorities will revise their investment plans, moving forward once public finances are sufficiently strengthened.

*More fiscal space can be safely created if deeper fiscal reforms are fully carried out.*

**Stronger budget procedures will help sustain recent fiscal gains.** The authorities plan to implement a medium-term budget framework beginning with the 2021 budget. Medium-term expenditure limits need to become more binding, with deviations from established limits requiring justification. To make budgeting procedures even stronger, the authorities could consider an overall expenditure limit that governs the medium-term budget. Any legislation with budgetary consequences should require a fiscal impact assessment by the Ministry of Finance.

**Over the next few years, strong progress in three specific areas will further build fiscal space.** One very important reform would be on pensions – aligning them with increasing lifespans and making future benefits fairer to today’s youth. Overhauling public employment to enhance the efficiency of the public sector is another high priority reform. Progress in these two areas has stalled and needs to be reinvigorated. A third area where the authorities do envisage near-term progress is eliminating wasteful tax exemptions. If efforts are redoubled in these areas, there will be strong long-term rewards, and the fiscal situation would provide a much more robust foundation for ambitious projects.

**More improvements to tax administration will also help generate additional revenues by reducing the grey economy.** The Montenegrin Tax Administration (MTA) has adopted a reform program, supported by IMF technical assistance. There has been a steady improvement in core processes, evidenced by a significant reduction in tax arrears. The government has also granted autonomy to the MTA. In the future, audit activities should focus more on major tax risks. Legislative changes to the interest and penalty regime are necessary to induce greater tax compliance.

**More robust investment management and PPP frameworks are essential.** For all investment projects, it is important to establish a strong legal and institutional framework to identify viable projects and avoid those that risk imposing an unaffordable fiscal burden. The authorities' draft Law on PPPs contains welcome provisions, including a strong role for the Ministry of Finance in ensuring that approved PPPs are only those that are economically viable and fiscally sustainable. Commensurately, the expertise to analyze fiscal risks needs to be enhanced. In addition, it would also be prudent to establish ex-ante limits for PPP-related fiscal liabilities, including for municipal governments.

***Banking and Anti-Money Laundering supervision need further enhancement.***

**No spillovers have been observed to the broader banking sector from recent interventions in two non-systemic banks.** Despite a freeze on deposit withdrawals in these two banks, system-wide deposits have been stable. The system-wide capital adequacy ratio is comfortably above the regulatory minimum, liquidity remains high, and overall system is profitable. Following the closure of these two banks, non-performing loans (NPLs) declined to 4.7 percent in April 2019. Private sector credit growth has strengthened.

**However, recent events highlight the need for stronger banking supervision.** The current structure, process, and tools for credit risk supervision need further improvement. Supervision within the Central Bank of Montenegro (CBM) would be strengthened further by the establishment of a supervisory committee to better support decisions by senior management. Off-site supervisory capacity needs to be strengthened, including with well-qualified and adequately compensated staff. The CBM is moving in the right direction to address these issues and deserves the country's support in these efforts. The focus needs to be on increasing effectiveness, not just on the administrative enactment of measures.

**A thorough review of banking sector health is essential and must be completed by end-2020.** The CBM should ensure the completion of a bank asset quality review (AQR). This review would help to understand the true value of assets on bank balance sheets, the valuations of collateral, and the adequacy of provisioning against potential losses. To ensure the integrity of the process, the AQR should be carried out by reputable international assessors. Timely completion of the AQR would contribute to the credibility of banking supervision in the eyes of the international community.

**The CBM should take decisive action to mitigate any remaining banking sector risks.** Any other weak banks in the system need intense scrutiny with effective action plans that are enforced in a timely fashion. The CBM should also continue to closely monitor the rapid growth of uncollateralized consumer lending and implement macroprudential measures as needed to mitigate possible systemic risks.

**Forthcoming changes to the financial sector regulatory framework will harmonize banking laws with pertinent EU directives.** Legislative approval is expected later this year. The CBM should also ensure adequate consultation with stakeholders on the drafting and implementation of secondary legislation. Under the draft legal framework, banks will be

required to develop clear recovery plans, and the CBM will establish a resolution fund to be financed by banks. The deposit insurance fund will also be permitted to use its resources to finance the transfer of insured deposits from unhealthy banks to healthy ones. The authorities have also made progress in modernizing the credit registry.

**Money laundering related risks require swift attention.** The new AML/CFT law has improved the legal framework. The CBM is working to improve staffing and capabilities in this area. However, actions are needed to strengthen AML/CFT supervision by developing risk-based tools and procedures for offsite monitoring and onsite inspections. The “fit and proper” tests for banks’ managers and owners need to be further enhanced through full formalization and by ensuring consistent application.

**The investor citizenship program may also create financial integrity and reputational risks.** To mitigate these risks, the authorities should ensure implementation of comprehensive due diligence measures on applicants, including on their source of wealth, as well as good transparency practices, including publication of the names of the citizens-beneficiaries of the program.

*More inclusive growth can be achieved by modernizing labor markets.*

**Although employment has grown recently, labor market outcomes need much improvement.** Labor force participation is low, the unemployment rate is still high at 15 percent, and the informal economy employs an estimated quarter of the labor force. The authorities are working on two areas to incentivize formal employment, both steps in the right direction.

- *Tax wedge:* At nearly 40 percent, the labor tax wedge — the sum of personal income tax and social contributions — is the second highest in the Western Balkans. A large labor tax wedge reduces incentives for employment in the formal sector, particularly for low-wage earners. The authorities appropriately intend to reduce employers’ social contributions by 2 percentage points. Yet, the loss of budget revenues must also be offset. This could be achieved through the reduction of tax exemptions. The authorities could also reconsider their decision to revert to a flat tax of 9 percent on personal income.
- *Labor Law:* More than 30 percent of workers are employed on temporary contracts. These employees usually experience less job security and development opportunities than their counterparts on open-ended positions. The draft labor law appropriately aims to narrow the gap between the two types of contracts, with the aim of making employers’ use of open-ended contracts more attractive by easing excessive rigidities embedded in them.

**Future decisions on the minimum wage need to balance competing considerations.** The minimum wage will rise 15 percent in July, the first increase since 2013. The ratio of the

minimum to the average wage is estimated to increase from 38 to 42 percent, near the regional average. For the future, the authorities are advised to assess the impacts of prior minimum wage increases and consider a broad set of indicators (including the poverty line and trends in average wage growth and productivity).

*The mission would like to thank the authorities and other interlocutors for their generous hospitality and for the candid and constructive discussions. The IMF looks forward to maintaining a regular dialogue and strengthening relationships with all counterparts to help Montenegro meet future challenges.*