Pursuant to Article 58 paragraph 2 of the Law on the Budget and Fiscal Responsibility (OGM 20/14, 56/14, 70/17, 04/18, 55/18, 66/19, 70/21, 27/23, 125/23), at its meeting of 24 December 2024, the Council of the Central Bank of Montenegro discussed the draft Medium-Term Debt Management Strategy for the Period 2025-2027, and thereby determined the

OPINION
regarding Medium-Term Debt Management Strategy for the Period 2025-2027

Given that the Medium-Term Debt Management Strategy for the period 2025-2027 (the Strategy) is key when public debt is high, and there is financial market instability against the backdrop of high interest rates, the Central Bank of Montenegro (Central Bank) has carefully analysed the set goals, identified risks and macroeconomic assumptions that served as the basis for shaping the debt management strategy for the upcoming three-year period.

The Central Bank supports adopting this document and states that the Strategy has been analytically improved and informatively strengthened and is a positive step forward compared to previous public debt management strategies.

The Central Bank appreciates the efforts of the Government of Montenegro (hereinafter: the Government) in finding ways to bring the public debt level within the sustainability limits with the Strategy. Such a strategic approach enables the Government to reduce and/or manage future borrowing costs, control debt-associated risks, and preserve investors' confidence. Therefore, the public debt management strategy is a technical tool and a key economic policy element, especially in challenging times when the system's stability and the debt's sustainability are of essential importance for preserving the macroeconomic balance.

The Central Bank points out that the Strategy is time-aligned with financing needs, which best contributes to implementing the public debt policy.

The Central Bank welcomes that the Strategy has explicitly emphasised the fiscal policy goal of balancing the current budget while recording a current spending surplus and borrowing only for capital investments. This recognises the public finance sustainability assumption, taking into consideration the real growth increase and the benefits of activating development potential.

The Central Bank highlights and considers it positive that this Strategy has recognised the main aspects of the public debt management strategy's importance, these being:

- *Controlling borrowing costs* - Interest rates often fluctuate due to financial market instability, which increases the risk of borrowing costs. The Strategy enables selecting favourable financing instruments (e.g. long-term versus short-term debt), thereby reducing total expenses;

- *Extending the average debt maturity* - Since the risk of refinancing is one of the key risks in the public debt portfolio, a large concentration of maturing debt in a short period, as in the next three years, creates serious challenges, especially in unfavourable market conditions when debt funds are expensive and/or market conditions reduce the possibility of securing funds. Extending the debt maturity date enables reducing the pressure on liquidity (reducing the need to provide a large amount of funds in the short term), avoiding unfavourable market conditions (postponing refinancing until market conditions improve), increasing creditworthiness (a more extended maturity period can reduce risk perception among investors), better coordination with the projects (availability of funds until the projects start generating income), and ultimately, avoiding insolvency (when the existing debt terms are a severe burden and when deadline extending can prevent the debt non-repayment scenario, and therefore preserve the country's reputation);

- *Diversifying financing sources -* The Strategy provides more stable financing, reducing dependence on one source of funds by introducing various instruments, accessing different markets and a more significant number of potential investors from different parts of the world;

- *Managing currency and interest rate risk* - Market volatility can lead to sudden exchange and interest rate changes, affecting external and internal debt servicing. The draft Strategy recognised this aspect and included goals that include using protection instruments, such as hedging, credit arrangements diversification and maintaining an adequate level of cash reserves to reduce exposure to these risks.

- *Increasing investor confidence* - A clearly defined and transparent Strategy signals responsible public finances and debt management, which contributes to the country's stronger attractiveness for foreign and domestic investors, even during a crisis.

- *Supporting public finances sustainability* - The Sustainable Strategy enables controlling public debt relative to GDP and prevents debt crises that can threaten economic growth and social stability. The draft Strategy aligns with the Fiscal Strategy 2024–2027, as an umbrella document for pursuing fiscal policy and thus contributes to achieving medium-term fiscal goals;

- *Flexibility in responding to crises* - The Strategy provides room for its adjusting following the market conditions changes and enables timely response to unforeseen financial shocks.

In addition to its key aspects, the draft Strategy includes developing the domestic government securities market through issuing retail bonds as a means of securing funds, which the Central Bank supports. Although the state relied on foreign sources of financing in the past, we see significant financial potential of natural and legal persons who could use their funds to invest in state securities without a negative impact on the banking sector's liquidity and lending activity sector. The household and business deposits with Montenegrin banks supported this fact, as they account for two-thirds of total bank deposits. Moreover, this type of stimulating savings can be interesting for investors (legal and natural persons) due to the currently low interest rates on deposits and savings, which could stimulate competition. Namely, the average deposit interest rate is 0.30% for the household sector (November 2024) and 0.20% for the economy sector (November 2024), while the return on invested funds through investment in government securities would be much higher. It would achieve a double benefit. On one hand, the state would provide the necessary funds on terms that are more favourable. At the same time, the economy and the population would record significant yields on the invested funds. Croatia and the Republic of North Macedonia could be examples, as they issued the so-called national bonds (with a maturity of two years) in 2023 and collected significant funds in this way with interest rates of 3.65% and 5%, respectively.

The proposed introduction of green bonds is also encouraging since they are a good way to attract new investors, especially from EU member states, who tend to invest in projects contributing to environmental protection and improving ecological standards. It shows Montenegro's commitment to the green economy and that it will pay great attention to aligning its fiscal policy with goals in environmental protection and climate change, i.e. sustainable development through the creation of "green" budgeting in the future. The Central Bank suggests that an economic policy aimed at sustainable financing should be a primary goal in conducting fiscal policy in the coming period, bearing in mind that the stated way of conducting fiscal policy aligns with the goal of fulfilling the benchmarks in the negotiation chapters in Montenegro's accession the EU.

The Central Bank suggests that the Government carries out media campaign activities to actively promote retail and green bonds and primarily inform the population and the business sector about their advantages and safety. It would indirectly affect the population's general knowledge about the financial market elements and their possibilities and improve financial education and literacy.

The macroeconomic framework does not deviate significantly from the one referred to in Fiscal Strategy and the draft 2025 Budget Law. In this case, we point to potential macroeconomic risks that may affect the planned values:

- Uncertainty about achieving the planned GDP growth rate of 4.8% in 2025 due to the global economy slowdown or potential shocks in key sectors such as tourism, energy and exports that may threaten the realisation of income and these projections. The decrease in the number of non-residents may affect spending and/or the realisation of income in the current year, while the announced multi-month overhaul of the Pljevlja Thermal Power Plant may increase the foreign trade deficit;

- The increase in the VAT rate on hospitality services from 7% to 15%, with last year's impact of inflation on the tourist services prices, may adversely affect price competitiveness in tourism and result in a decreased demand from issuing markets (especially countries in the region) and potentially lower tourist spending in Montenegro and lower collection of VAT on hospitality services. The aforesaid may also affect the increase of the non-observed economy in tourism;
- If combating the non-observed economy is not sufficiently effective, it could result in the lower collection of public revenues (and the economic growth slowdown) and weaken the economy due to unfair competition (considering that the budget has planned VAT revenues following the implementation of the Action Plan to suppress the non-observed economy);
- Postponing the implementation of structural reforms and projects, which would affect macroeconomic trends and projections on which planned budget revenues are based;
- Climate changes and unfavourable weather conditions can also challenge dynamic growth, notably affecting tourism, energy and agriculture.

The Central Bank welcomes a clear way of presenting the collection of the missing funds in the three-year period, which represents an improvement to the Strategy. It suggests considering the issuing of government bonds on the international market with a longer maturity (up to 10 years and not creating a concentration of due debt in the short term).

The Central Bank highlights the continuous growth in public debt absolute amount in the medium term from 4.56 billion euros at the end of 2024 to 5.66 billion euros at the end of 2027, i.e. from 61.4% of GDP in 2024 to 64.6% of GDP in 2027. It points to the risk that the public debt parameters would be less favourable than planned if achieving the projected nominal GDP in the observed period fails. Considering the aforesaid and that the budget deficit is planned to exceed 3% of GDP during the same period, the Central Bank suggests that the Ministry of Finance proposes measures to reduce the deficit and public debt if risks to economic growth materialise and bring the debt and deficit exceeding the levels defined by the Law on Budget and Fiscal Responsibility to bring deficit and public debt within the sustainability limits in accordance with the Law. The draft Strategy does not envisage this possibility and/or the measures to reduce public debt in the case of both scenarios (baseline and lower growth scenarios). The Central Bank suggests making a clear plan to meet the Maastricht criteria, which refers to bringing the budget deficit to 3% and the public debt to 60% of GDP, which will simultaneously meet the Maastricht criteria and ensure fiscal policy stability.

In this regard, the Central Bank suggests that the Strategy defines additional short and long-term measures and activities that will work to reduce the public debt in the future that are not included in the Strategy, such as: basic fiscal consolidation (reducing non-productive spending), social and structural reforms (pension system, public administration reform), encouraging economic growth through improving the business environment (reducing business barriers, combating unfair competition), supporting small and medium-sized enterprises (incentives contributing to employment and economic growth), more efficient tax collection while suppressing tax evasion, and tax debt collection.

Concerning state guarantees, the Strategy states "*domestic guarantees mainly include support to companies for implementing capital projects, and support to implementing rehabilitation plans of local governments. On the other hand, external guarantees are intended for implementing various projects in energy, transport and railway infrastructure, shipbuilding, and supporting the development of small and medium-sized enterprises"*. The Central Bank suggests that the Government continuously analyses the risks of issued guarantees and, consequently, classifies and risk exposure of all issued guarantees to form provisions for their timely potential activation.

The Central Bank welcomes defining potential risks recognised in the Strategy. However, it points to additional ones that may threaten public debt sustainability and increase borrowing costs:

1. *Risk of high borrowing costs*;
2. *Risk of the economy's external dependence and non-diversification* - The exchange rates' volatility can increase the cost of servicing this debt. Since Montenegro is mainly import-dependent, changes in currency parities can adversely affect the fiscal space and, thus, the debt level. Montenegro's dependence on tourism causes the risk that disruptions in this sector threaten the debt servicing capacity;
3. *Fiscal risk* - High public debt limits the space for reacting to unexpected shocks (e.g. climate and other natural disasters, recessions, etc.), which additionally burdens the budget;
4. *Risk of borrowing for non-productive purposes* - Inefficient use of funds, i.e. if borrowed funds are not allocated to projects that increase GDP and fiscal revenues, may jeopardise the implementation of the planned goals defined by the Strategy;
5. Ultimately, overwhelming reliance on international financial institutions or private loans can limit fiscal autonomy.

The risks of Montenegro's borrowing in the medium term stem from internal economic challenges and external market uncertainties. Effective debt management, diversifying funding sources and strengthening fiscal discipline are key to risk reduction. In addition, focusing on reforms and increasing economic growth can help reduce dependence on borrowing in the future and establish a tendency for the public debt to fall in absolute terms. Reducing all risks requires consistent reforms, long-term strategic plans, political and legal security, and economic diversification.

At the end of this part of the opinion, the Central Bank reiterates the importance of this document and welcomes its adoption, considering that the section of the Programme of Accession to the European Union 2024 – 2027 related to the negotiation chapters 17 - Economic and Monetary Union and the Action Plan for harmonisation with the EU *acquis* in the area of economic and monetary policy has planned its drafting in 2024. This Action Plan is a strategic document of Chapter 17. At the same time, implementing the activities defined by the Action Plan is the first recommendation of the European Commission's Report for Montenegro and contributes to the fulfilment of the closing benchmark 4 ("*Montenegro has fulfilled the criterion of being a functioning market economy*") for the temporary closure of this chapter.

Moreover, to improve the draft Strategy Proposal, the Central Bank proposes to consider the following suggestions, which refer to specific parts of the proposed text of this document.

In the Introduction, we suggest rewording:

1. The primary goal of the Strategy: Namely, the existence of a medium-term strategy is not necessary to provide the missing funds for budget financing, so providing the missing funds for budget financing cannot be the Strategy's primary goal. Therefore, we propose that the wording of the primary objective reads "*The primary objective of the Medium-Term Debt Management Strategy is to create a stable and sustainable medium-term framework for providing the missing funds to finance the state budget.*"
2. The first key pillar of the Strategy: The first key pillar should include managing both refinancing and financing risk. Therefore, we propose that the wording of the first key pillar reads "*Managing financing and refinancing risk, primarily market, interest and currency risk, to minimise them ensuring an even distribution of debt maturities, reducing costs and preserving adequate financial reserves for emergencies.*"
3. The second key pillar of the Strategy: The second key pillar should refer to improving existing financing methods while developing new financing methods and instruments should be introduced as the third pillar. In this sense, we suggest determining the current third pillar of the Strategy as the second pillar and that it precisely indicates that it refers to international investors, which results from the Strategy's further text. Therefore, we propose that the wording of the second key pillar reads "*Diversification of the international investors' base by expanding their geographical coverage to ensure a stable and predictable demand for government bonds, including against the backdrop of global economic turmoil.*"

4. The third key pillar of the Strategy: As stated under point 3 - introducing new forms of budget financing (with new instruments and by new types of investors) is the essence of the draft Strategy's second key pillar, while the development of the capital market in Montenegro can only be a secondary result of introducing government bonds for the population as a way of financing the budget. Introducing new forms of budget financing should follow the management of financing and refinancing risks, i.e., the diversification of international investors, since these two pillars are key to implementing the Strategy's primary goal. Therefore, we propose that the wording of the third key pillar reads "*Diversification of domestic sources of financing, through issuing government bonds for the population, which would encourage the development of Montenegro's capital market.*"

The change in the three key pillars mentioned needs to be applied in the remaining text of the Strategy.

The macroeconomic and fiscal trends chapter does not clarify the basis for the expected growth of international transfers. If this expectation is based only on Montenegro's entry into SEPA, it could prove to be groundless. Namely, SEPA could only make money transfers in cash that are still being sent from abroad to Montenegro more visible, and it already represents a part of the demand able to be paid. Therefore, Montenegro's entry into SEPA will not necessarily effectively increase the amount of money in the country but only formally "recognise" it in financial channels. If there is another basis for predicting the growth of international transfers, it should be stated.

Segment B - Guidelines and strategic goal under B1. Risk management, i.e. under Refinancing risk, at the end of the first paragraph, states that "regular debt repayment led to a shortening of the remaining average term-to-maturity (ATM), which further complicates the situation." Such wording concludes that the Strategy authors consider regular debt repayment a wrong step, which is probably an inadequate interpretation. A more precise wording is necessary to ensure a correct interpretation.

We suggest a change in the same segment, under Objective 3 - Diversification of funding sources, under Activities, within the first mentioned activity, following the proposed change of the Strategy's third pillar. In this sense, we recommend that the wording of the first mentioned activity reads "*Actively work on creating alternative domestic sources of financing through issuing government bonds for the population on the Montenegrin capital market." The regular issuing of these bonds and their secondary trading on the Montenegrin capital market will contribute to its development, as well as through digitising the trading process, increased transparency and cooperation with domestic financial institutions.*"

In the same segment, under Objective 4 - Strengthening relations with international investors, as part of the Rationale, we suggest rewording to read "*Stemming from the* *fact that the international investors' confidence is key to the successful refinancing of existing debt, it needs to be actively improved and developed through transparency and consistent communication about the debt strategy.*"

Within the subtitle Interest risk, the existing name of Objective 3 - According to the given explanation, it would be helpful to replace it with: "*Increased financing with loans from international financial institutions that offer more favourable lending conditions with fixed and relatively lower interest rates and longer financing terms*".

According to the proposal regarding the change of the third key pillar of the Strategy, we propose changing the title of point B2 below Table 7 to read "*Develop new sources of domestic financing*" and changing that paragraph to reflect the new title.

Within point B2, Objective 1 should be changed to read "Expand the base of domestic financing instruments," and the rationale of this objective and the activities for its implementation should be adjusted accordingly.

COUNCIL OF THE CENTRAL BANK OF MONTENEGRO

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Podgorica, 24 December 2024

CHAIRMAN
G O V E R N O R

Irena Radović, m.p.