MONTENEGRO

Highlights

- **Montenegro has joined NATO and steady progress is being made on EU accession negotiations.** NATO membership is an important milestone in the country's Euro-Atlantic integration. In the EU negotiations, Montenegro has opened 28 out of 33 negotiating chapters, and has provisionally closed three.
- **Construction of a major motorway project has advanced.** The government has issued almost all necessary construction permits, and plans to invest €200 million in 2017. The construction of the priority section of the highway was launched in 2015 and is expected to be finished by mid-2019.
- **Progress on large-scale privatisation has been sluggish.** Most of the economy is in private hands but some key companies are still publicly owned. Investor appetite for these assets is limited, judging by the lack of interest in recent attempts to sell them.

Key priorities for 2018

- **Competitiveness in the private sector needs to be enhanced.** Montenegro should focus on key sectors with high potential, including the development of value chains in the agribusiness sector and the promotion of backward linkages in tourism.
- **Cross-border transport and energy links are crucial for further growth and investment.** In addition to the major highway project under way, the authorities should take steps to improve the standard of regional roads and to strengthen the functioning of the regional energy market.
- **Fiscal policy needs further strengthening.** Recent measures to rein in spending are welcome but the country's rising public debt and heavy capital spending needs warrant greater efforts to control non-productive spending and put public debt on a downward path.

Main macroeconomic indicators %

	2013	2014	2015	2016	2017 proj.
GDP growth	3.6	1.8	3.4	2.9	3.7
Inflation (average)	2.2	-0.7	1.5	-0.3	2.1
Government balance/GDP	-4.5	-0.7	-5.9	-6.0	-6.4
Current account balance/GDP	-14.5	-15.2	-13.3	-19.0	-20.2
Net FDI/GDP [neg. sign = inflows]	-9.6	-10.2	-17.1	-9.8	-10.3
External debt/GDP	153.5	163.1	163.1	166.8	n.a.
Gross reserves/GDP*	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	56.4	54.1	53.1	54.7	n.a.

*Montenegro uses the euro as its legal tender.

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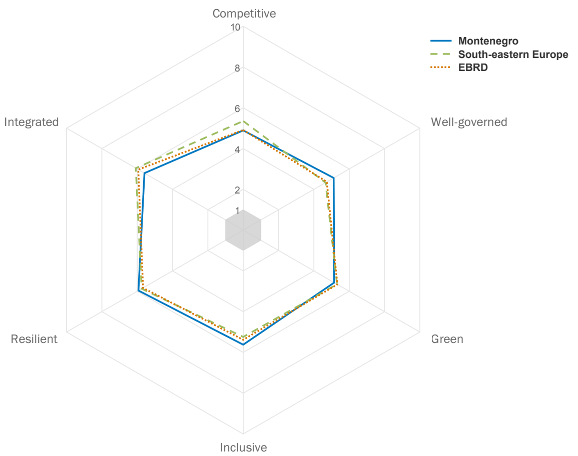
Macroeconomic performance

The economy performed below expectations in 2016. GDP growth in 2016 was 2.9 per cent, compared with 3.4 per cent in 2015, and was lower than expected, despite high pre-election spending and increases in public sector wages, pensions and social benefits. High imports related to the major highway project, as well as to the construction of the wind power plant, fuelled the trade deficit and caused a significant drag on growth, almost offsetting the positive gross capital contribution. The tourism sector, on which the economy depends heavily, as receipts from foreign tourist arrivals account for about one-fifth of annual GDP, has continued to perform well. The country experienced a record year for tourism in 2016 and is heading for another record in 2017. The number of foreign tourist arrivals in 2016 increased by 7.0 per cent, reaching 1.7 million (almost three times the size of the country). The economy accelerated in the first half of 2017, and the growth in this period is estimated at 4.2 per cent year-on-year.

The government is tackling growing fiscal pressures. The estimated 2016 fiscal deficit was 6 per cent of GDP, smaller than expected but only because capital spending was just 5 per cent of GDP instead of a previously projected 12 per cent, due to delays in the highway investment project. To combat growing fiscal pressures, a new Fiscal Strategy was adopted in June 2017. It contains a number of measures, including: (i) a VAT increase from the current 19 per cent to 21 per cent as of January 2018 (the lower 7 per cent rate remains in place for certain essential goods and tourism services); (ii) an increase in excise duties on cigarettes, alcohol, sugary drinks and coal; and (iii) a reduction in the salaries of senior public employees (by 8 per cent). The main goal of the strategy is to achieve a budget surplus from 2019 onwards. This should put public debt, which has been rising rapidly in recent years to 67 per cent (of projected 2017 GDP) as of mid-2017, on a downward trajectory. The government has also reduced benefits to mothers of three and more children by 25 per cent, reversing a measure introduced the previous year. In addition, with the aim to improve tax collection, the government has given the opportunity to companies to ask for tax debt reprogramming: 5,500 requests were submitted for €185 million.

Growth is expected to continue in the short term. The near-term growth rates, projected at 3.7 per cent in 2017 and 3.3 per cent in 2018, are expected to be mainly investment-driven and supported by public investment in transport and energy infrastructure, where the construction of the motorway is the key project, and flagship foreign direct private investments, particularly in the tourism sector. However, the downside risks remain significant, associated both with potential cost overruns on the highway project as well as the country's vulnerability to external shocks.

Assessment of transition qualities (1-10)



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Major structural reform developments

Montenegro became a NATO member in June 2017 and steady progress is being made on EU accession negotiations. On 5 June 2017 Montenegro became the newest, and the 29th, NATO member. This is a major milestone, as every eastern European country that has so far joined the EU had first joined NATO. Accession talks with the EU are progressing and, as of September 2017, Montenegro had opened 28 negotiating chapters (out of 33), and had provisionally closed three: Science and Research; Education and Culture; and External Relations. Initial benchmarks for the opening of four of the five remaining chapters have already been met and their opening is expected by the end of 2017. The one remaining chapter, on Competition Policy, may be opened once the Law on State Aid Control and the Law on Protection of Competition are passed.

Progress on large-scale privatisation remains sluggish. The 2017 Privatisation Plan envisaged the privatisation of the country's key transport companies – the Port of Bar and the rail freight operator, Montecargo. In addition, the privatisation of some major tourism assets still in state hands was also planned, such as the Institute Igalo, as well as preparation of tenders for Hotel Group Budvanska Rivijera and Ulcinjska Rivijera. Progress to date has been minimal. In October 2016 the government launched the sale of its 30 per cent stake in the Port of Bar and 51 per cent stake in Montecargo. However, this process for both companies was cancelled at its final stage in April 2017 as the government rejected the offer of the only bidder – the Polish OTL group. Also, a tender for the 30-year lease of Ucinjska Rivijera was launched in June 2017, but only one offer was received, from Karisma Hotels Adriatic Montenegro. Meanwhile the tender preparation for the concession of the shipyard's port – the Port of Bijela – is in the final phase. The consortium, which is comprised of the Dutch company Damen and the Adriatic Marinas, a company which operates the country's flagship investment Porto Montenegro, had expressed interest in obtaining concessions for the port for a period of 30 years, aiming to create a place for yacht building and repair.

The construction of the highway Bar–Boljare is advancing. The construction of the 42-km long priority section (Smokovac–Matesevo) of the highway Bar–Boljare, connecting the Adriatic Port of Bar to the border with neighbouring Serbia, was launched in 2015. The section is the most challenging part of the total highway, as it almost entirely consists of bridges and tunnels. The Chinese company CRBC is in charge of the construction of the priority section for a cost of US$ 1.1 billion. The investment is financed from a loan by the Chinese Export-Import Bank for US$ 944 million. Some €216 million had been spent on the construction by the end of 2016 and the government plans to spend €200 million in 2017. The priority section is set for completion in 2019.

An important renewable power project has been completed. The project is a commercial 72MW wind power plant, the first in the country. The investor, Akuo Energy of France, began constructing the plant in 2015 and completed the project (which is also financed by loans from the EBRD and KfW) in the first quarter of 2017. The wind farm represents 8 per cent of the total installed capacity and 6 per cent of total electricity production in Montenegro. In May 2017, the wind farm started its four months of final tests on all 26 wind turbines, after which it should be operational once tests are successfully completed. The launch of the project will help the country to achieve its target to raise the share of renewable energy to 36 per cent of its energy mix by 2020. The consortium is also interested in building Krnovo 2, which would mean installing more wind turbines at the same location.

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An electricity power market has been established. In June 2017 Montenegro's power firms signed an agreement on the establishment of a power bourse that would allow competition in its electricity supply market. Under the agreement, signed by power company EPCG, grid operator CGES and the Montenegro Electricity Market Operator (COTEE), the three firms are setting up a joint company that will have the status of a power exchange. Currently, EPCG is the only active electricity supplier in the country. The launch of the electricity exchange will help improve the competitiveness of the power market in Montenegro. Electricity will be traded more transparently and the stronger competition should lead to lower prices for consumers. The EU has called on the Western Balkans states to establish a regional energy market through the establishment of local power bourses. Currently only Serbia and Croatia have one. The EU aims to eventually integrate the regional power market into the single EU market. Also, Montenegro improved the reliability of electricity supply over the course of the previous year as CGES started to implement the Supervisory Control and Data Acquisition (SCADA) automatic energy management system, which improved significantly this area of doing business, moving the country's overall ranking in the World Bank's *Doing Business 2018* report up by nine places to 42nd out of 190 economies.

Banking sector stability and profitability have improved. The average growth of credit activity in 2016 was 3.7 per cent year-on-year, an increase from 1.6 per cent in 2015, and further accelerated to 6.9 per cent in the first half of 2017. The credit recovery has been helped by a reduction in non-performing loans from 25 per cent of all loans in 2011 to 11 per cent as of June 2017. The sector posted a net profit of €7.4 million in 2016, turning from a revised €3.3 million loss a year earlier. The banking sector is well capitalised. The capital adequacy ratio improved from 15.5 per cent in 2015 to 16.1 per cent in 2016, much higher than the regulatory minimum of 10.0 per cent.