MONTENEGRO

Highlights

- **Growth surprised on the upside in 2018, but has slowed in 2019.** GDP growth rose to 5.1 per cent in 2018 on the back of strong domestic demand. However, it slowed to 3.1 per cent year-on-year in the first half of 2019 as a consequence of the slowdown in investments.
- **Public debt has increased further from already elevated levels.** At the end of 2018, public debt, including guarantees, reached almost 75.0 per cent of GDP. This is mainly due to the large highway project, which is financed by a Chinese loan.
- **Two non-systemic banks went bankrupt over the past year.** The banking sector, however, remained stable, while the non-performing loan (NPL) ratio has dropped to 5.3 per cent.

Key priorities for 2020

- **Public debt sustainability should be further reinforced.** Achieving this will require, among other things, the maintenance of a primary surplus over the medium term, sustained efforts to strengthen budgeting procedures and public investment management and improved public and tax administration. Once the first phase of the highway project is completed, any further construction should be preceded by a careful cost-benefit analysis.
- **The private sector would benefit from less informality.** More comprehensive measures, focusing on underlying causes such as the regulatory burden, weak enforcement capacity and corruption, should be put in place in order to reduce unfair competition from the informal sector, which weighs primarily on local micro, small and medium-sized enterprises.
- **The financial system needs strengthening.** A bank asset quality review and stronger banking supervision would be welcome. In addition, the central bank should closely monitor the rapid growth of cash loans with long maturities in order to limit potentially negative systemic effects.

Main macroeconomic indicators %

	2015	2016	2017	2018	2019 proj.
GDP growth	3.4	2.9	4.7	5.1	2.8
Inflation (average)	1.5	-0.3	2.4	2.6	0.5
Government balance/GDP	-8.0	-3.4	-5.5	-3.5	-3.3
Current account balance/GDP	-11.0	-16.2	-16.1	-17.2	-17.0
Net FDI/GDP [neg. sign = inflows]	-16.9	-9.4	-11.3	-7.0	-9.0
External debt/GDP	166.2	160.9	159.2	167.5	n.a.
Gross reserves/GDP*	16.8	18.1	20.8	22.1	n.a.
Credit to private sector/GDP	49.7	48.7	48.6	49.5	n.a.

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Macroeconomic performance

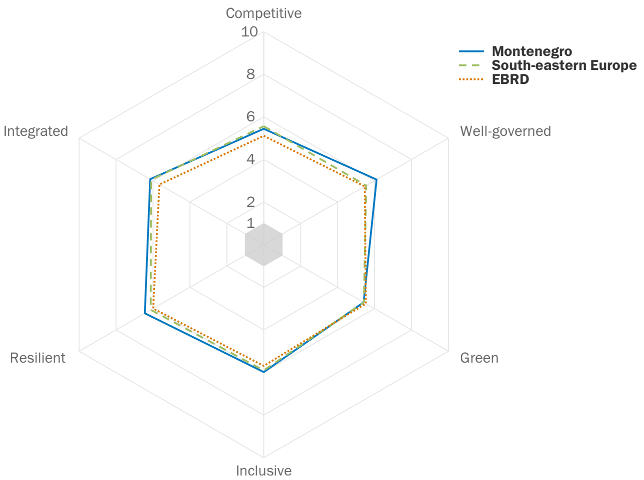
Growth stepped up to 5.1 per cent in 2018. The economy expanded strongly on the back of the highway construction, some coastal flagship real estate projects, an exceptionally strong tourism season and a further rise in private consumption. However, strong domestic demand and consequently higher imports caused the current account deficit to widen further, to over 17.0 per cent of GDP. In the first half of 2019 GDP growth slowed to 3.1 per cent year-on-year, primarily due to large investment projects (the Bar-Boljare highway and the power link to Italy) approaching completion. The first half of 2019 was also marked by poor industrial performance, due to declines in electricity production and manufacturing sector output. On the other hand, the tourism sector has continued to perform well.

Inflation has trended down. Price growth has slowed since the second half of 2018, primarily on the back of falling tobacco, clothing and footwear prices, but also due to decreasing transport prices, which is related to oil prices. As a consequence, the average inflation rate decreased from 2.6 per cent in 2018 to 0.3 per cent in the first nine months of 2019. The period from June to September 2019 has been marked by deflation (-0.2 per cent monthly on average).

Gradual fiscal consolidation has started to yield results. The budget deficit narrowed to 3.5 per cent of GDP in 2018 (from 5.5 per cent in 2017), but was above the target of 1.6 per cent in the original budget (2.2 per cent in the revised budget), and the public debt, including guarantees, reached close to 75.0 per cent of GDP by the end of 2018. The debt, which is expected to start declining in 2020, is also helped by phasing out highway-related spending. However, contingent liabilities and spending overruns may threaten the results. Further necessary fiscal reforms are planned, such as optimising public administration, introducing medium-term budgeting, improving tax administration and conducting the pension reform.

Growth is likely to slow down in the short term. With the completion of large investment projects, growth is projected to moderate significantly, to 2.8 per cent in 2019 and 2.6 per cent in 2020. Still, private investment in tourism and energy is expected to stay high. The risks to the projections mainly relate to weaker growth in the European Union. Besides improving public finance management, growth risks could be mitigated by reforming the labour market and public administration, as well as by strengthening economic institutions.

Assessment of transition qualities (1-10)



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Major structural reform developments

Montenegro continues to advance in EU approximation. Over the past year, the country has opened one new chapter, bringing the number of opened chapters to 32 in total (out of 33 chapters) since the opening of accession negotiations in June 2012. Three chapters have been provisionally closed. According to the 2019 European Commission's country report, further progress in negotiations will primarily depend on meeting the interim benchmarks set in the rule-of-law chapters (23 and 24).

Business conditions have improved somewhat. An action plan for the implementation of the 2018-22 strategy for the development of micro, small and medium-sized enterprises, envisaging over 200 activities, was adopted in December 2018. Furthermore, in 2019 three important laws were approved: the law on administrative fees, eliminating or reducing 18 per cent of existing taxes; the law on fiscalisation, allowing a real-time transfer of data from the taxpayers' POS terminals to the Tax Administration and supporting the fight against the informal economy; and the law on domestic trade, making Sunday a mandatory non-working day for the majority of businesses. An e-cadastre is being developed, with notaries and public bailiffs being the first to get access in July 2019. However, there is still room for improvement, especially in the area of getting electricity (as suggested by World Bank's *Doing Business 2020* report, where the country ranks 134th among 190 countries) and with regard to infrastructure (as suggested by the World Economic Forum's 2019 Global Competitiveness Index, where Montenegro ranks 83rd out of 141 countries).

Public administration reform is advancing slowly and with some setbacks. The public service in Montenegro is relatively large and often politicised. In November 2018, a new Law on State Administration was adopted, rationalising its organisation and addressing the main issues related to accountability lines between institutions. However, it was followed by a very rapid reorganisation of many bodies, without sufficient transition or enough time for stakeholders to adequately prepare for changes. Also, before the optimisation plan 2018-20 was adopted in July 2018, additional staff were hired, which partly undermined the reform results.

Important infrastructure concessions have been granted, while further legal changes are envisaged. In November 2018, a 30-year concession for the bankrupt shipyard, Bijela Adriatic, was approved. Also, in July 2019, following a delay, the government adopted a plan to award 30-year concessions for the country's two main airports (in Podgorica and Tivat). Besides these, work is ongoing for concessions on a ski resort, public forests and agricultural land. However, in order to align the legislation with EU rules and comply with principles of transparency, competition, equal treatment and non-discrimination, amendments to the law on public procurement and a new public-private partnership law are under consideration. Their adoption was envisaged by mid-2019 but faces delays. On the privatisation side, there has been some progress in 2019. Negotiations to sell the health institute in Igalo have started, and the asset restructuring (prior to the sale) of the hotel group Budvanska Rivijera has been completed. In addition, calls for privatisation have been published for another two companies from the 2019 privatisation plan. Conversely, the government proceeded with the buy-back of shares of the power utility (EPCG) from the minority Italian shareholder (A2A), raising its stake to close to 77 per cent in July 2019. The national flag carrier (Montenegro Airlines) and the national railway operator (ZPCG) continue to face financial issues due to accumulated debt.

Works on the transport and energy infrastructure continue, albeit sometimes with delays. The two big investments in recent years have been the construction of the Bar-Boljare highway, and the power link to Italy. The third large investment planned (the construction of the second unit of the Pljevlja thermal power plant) was cancelled in September 2019 due to environmental concerns. While the power link (a largely undersea cable that measures 455 kilometres) is in a testing phase and expected to be fully operational by the end of 2019, the construction of the 170-kilometre long highway, financed by a Chinese loan, has suffered delays and cost overruns. The first section of the highway, which was supposed to have been completed by the end of May 2019, is now planned for completion in September 2020 and will cost 10 per cent more than initially planned. The latter is also due to the unfavourable US dollar-euro exchange rate developments, as the loan is US dollar-

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denominated. In July 2019, the power utility EPCG issued a tender for an ecological revamp of the existing unit at the Pljevlja thermal power plant. The government and the EPCG have committed to increasing the share of renewables in the energy portfolio, as indicated by the recent approval of several large-scale solar and wind projects.

The banking sector remains stable despite two banks going bankrupt. In 2018, three out of 15 banks had operational problems, two of which closed due to bankruptcy, while the third has been recovering. Despite the freeze on deposit withdrawals from the two bankrupt banks, there was no negative spillover to the banking sector as a whole. The majority of the guaranteed deposits from the bankrupted banks have returned to the system. The sector remains liquid and well capitalised, with the capital adequacy ratio in June 2019 at 19.5 per cent. NPLs kept trending down to 5.3 per cent in June 2019. In July 2019, Montenegrin Commercial Bank (CKB), owned by Hungarian OTP Bank, completed the purchase of 90.6 per cent of the local unit of Société Générale, and the Azerbaijani-backed Nova Banka was sold.