DOCUMENT OF THE EUROPEAN BANK
FOR RECONSTRUCTION AND DEVELOPMENT

STRATEGY FOR MONTENEGRO

As approved by the Board of Directors at its meeting on 3 May 2017

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EXECUTIVE SUMMARY

Montenegro is committed to and applying the principles of multiparty democracy, pluralism, and market economics in accordance with the conditions specified in Article 1 of the Agreement Establishing the European Bank for Reconstruction and Development ("EBRD", the "Bank").

In the period since the adoption of the previous Strategy, Montenegro's efforts towards European Union (EU) approximation have remained the main external anchor for comprehensive reforms, and it is currently the most advanced country in the Western Balkans region in its integration into the EU.

Economic growth remained steady in 2016 and is forecast to increase further in the short term, helped by continued strong foreign direct investment (FDI), growth in the important tourism sector and the impact of large infrastructure projects underway, but the economy faces a number of structural constraints and deficiencies. Montenegro's business environment has improved over the years but remains hampered by problems in such areas as issuance of construction permits, access to electricity and registration of property. Access to finance for many businesses and SMEs is difficult and the legacy of non-performing loans continues to hold back credit growth. Agriculture is one of the most important sectors of the economy, but productivity in the sector remains at a relatively low level, as land ownership is fragmented and forward linkages to other sectors are underdeveloped. Montenegro's ability to leverage its comparative advantage as a tourism destination remains constrained by the underdeveloped transport and municipal infrastructure.

Montenegro has significant growth potential and the Bank's strategy is ambitious in its support of the country's development agenda, as outlined in the Montenegro Development Directions (MDD) and Montenegro's Economic Reform Programme 2017-2019 (ERP). This domestic impetus to accelerating reforms, combined with Montenegro's EU accession progress (and related EU funding available), are set to provide additional support for the Bank to deepen and expand its engagement in the new strategy period.

The Bank will focus on the following three strategic priorities:

- **Priority 1: Enhance *Competitiveness* of the private sector, including by developing agribusiness value chains and backward linkages in the tourism sector.** As Montenegro aspires to membership in the EU, it needs to develop a more resilient, innovative private sector that will help accelerate the country's convergence with its EU peers in terms of productivity. The Bank will thus seek to support local companies in fostering innovation and adopting best operational skills and managerial practices, including by leveraging Montenegro's comparative advantages through *inter alia* developing agribusiness value chains and promoting linkages to the dominant tourism sector through a combination of investment and small business advisory. Improving access to finance to SMEs and underserved segments will remain a priority, including through the Women in Business programme (WiB). To this end, the Bank will continue providing long term funding directly and through partner financial institutions (banks, as well as leasing and factoring companies) to privately-owned local companies, including on a risk-sharing basis.

- **Priority 2: Improve connectivity and regional *Integration* by expanding cross-border transport and energy links.** Deficient road network and obsolete rail infrastructure, their inadequacy exacerbated by Montenegro's mountainous topography, inhibit cross-border integration, making the regional objective of improving connectivity in the Western Balkans particularly relevant for Montenegro. The Bank, in co-operation with the European Investment Bank (EIB), will support key projects in road infrastructure, especially those that serve to improve the country's connectivity with the rest of the region, including upgrading main internal roads that connect to cross-border links. To increase energy connectivity, the Bank will continue to promote the creation of a regional energy market, leveraging ongoing initiatives, including the work of the Coordinated Auction Office (CAO) in South-Eastern Europe, established by the region's transmission system operators with the support of the Energy Community, European Commission (EC) and the EBRD. In addition, the Bank will continue to support development of the new high voltage underwater electrical cable, connecting Italy and Montenegro as part of the wider Trans-Balkans Corridor, through investments in high-voltage electricity transmission infrastructure to its various points of connection.
- **Priority 3: Continue to foster transition to a *Green* economy, including sustainable tourism.** As Montenegro marks 25 years since its proclamation as a "green" state, the Bank will support the shift towards a greener and more sustainable economy through selected investments in industrial waste disposal, water resource management and sustainable energy. Montenegro's energy intensity remains high and there is a need to make progress on the implementation of the legal framework for supporting sustainable energy projects, as well as on reducing losses in the networks and, subject to political will, developing efficient generating capacities and renewable energy sources and promoting smart grids. Furthermore supporting sustainable tourism, which minimises negative social and environmental impacts and generates more inclusive economic benefits for local people, is also crucial in the context of Montenegro, whose tourism industry generates its main export product and, as such, is the most reliable driver of economic growth. Upgrading the existing hotels stock through privatisation, addressing the seasonality issue by promoting development of congress tourism and health tourism facilities, and modernisation of related infrastructure are the areas of potential Bank engagement.

The new strategy provides continuity with the Bank's ongoing engagement, and the new strategic directions do not represent a material departure from the previous strategy's priorities. Rather, they imply deepening the engagement and sharpening its focus based on lessons learned. Investments and policy dialogue activities across the three strategic priorities may be further adjusted within the context of i) progress in EU-related reforms providing a better context for scaling up the Bank's investments; ii) the extent of sovereign fiscal headroom which could constrain EBRD investments in the public sector; iii) demand drivers in the corporate sector, in particular progress with the privatisation agenda and the NPL initiative which could create additional opportunities for private sector investments. Continued coordination with the EU, IFIs and bilateral donors, in particular under the Western Balkans Investment Framework (WBIF) will be essential.

1 OVERVIEW OF THE BANK'S ACTIVITIES

1.1 The Bank's current portfolio

Private sector ratio: 56.5 per cent*, as of 31 January 2017

Sector Group	Sector Team	Portfolio no of operations	Portfolio (€m)	% Portfolio	Op Assets	% Op Assets
Energy	Natural Resources	0	0	0%	0	0%
	Power and Energy	4	165	47%	98	46%
		4	**165**	**47%**	**98**	**46%**
Financial Institutions	Depository Credit (banks)	6	21	6%	19	9%
	Insurance, Pension, Mutual Funds	0	0	0%	0	0%
	Non-depository Credit (non-bank)	5	36	10%	5	3%
		11	**57**	**16%**	**25**	**12%**
Industry, Commerce & Agribusiness	Agribusiness	2	14	4%	12	6%
	Equity Funds	2	2	1%	0	0%
	ICT	1	1	0%	1	0%
	Manufacturing & Services	3	4	1%	4	2%
	Property and Tourism	2	19	5%	19	9%
		10	**41**	**11%**	**36**	**17%**
Infrastructure	Municipal & Env Inf	3	19	5%	10	5%
	Transport	8	72	20%	44	21%
		11	**91**	**26%**	**54**	**25%**
Summary		**36**	**353**	**100%**	**213**	**100%**

*5-year rolling ratio
Source: EBRD

1.2 Implementation of the previous strategic directions

The Bank is currently operating in Montenegro on the basis of the Country Strategy approved in October 2013 with the following three strategic priorities:

- expanding the economic base through enhancement of competitiveness
- supporting sustainable tourism, property and associated environmental and infrastructure needs, and
- promoting energy security and efficiency, and regional integration of energy markets.

The above priorities were broadly consistent with those outlined in the government's development plans, including the National Program for Integration (NPI), outlining the reform agenda required for eventual EU membership, as well as the 2009-2012 Economic and Fiscal Program (EFP) calling, among others, for promoting SMEs growth and reforming the business climate.

The implementation of the Strategy took place in a somewhat volatile economic environment as the country was recovering from the sharp economic contraction partly caused by the effects of the global financial crisis, with rising public debt and delays in the preparation and implementation of key privatisation and infrastructure projects. Notwithstanding, the Bank has significantly increased its activities during the current strategy period, accounting for around half of the total €510 million of investments in the country to date. The Bank signed 34 projects for a total value of €190 million, out of the total portfolio of €354 million and overall investments in 54 projects to date, with the highest Annual Business Investment (ABI) per capita among the Bank's countries of operations (CoOs) in 2015.

The five-year rolling private sector's share of portfolio has increased from 45.5 per cent in the 2010-2014 period to 56.5 per cent in the 2012-2017 period, despite the much larger size of projects in the public transport and energy sectors, thanks to sizable private sector projects, such as a €48.5 million loan to Krnovo Wind Farm in 2015, €10 million in quasi-equity provided to the general retailer Voli in 2015 and a €20.9 million loan to Hilton Podgorica in 2014.

The Bank's engagement in Montenegro to date has yielded many positive results and forms a basis for an even deeper and more strategic cooperation in the future, as follows:

Theme 1: Expanding the economic base through enhancement of competitiveness

The Bank's activities under this priority were carried out as Montenegro was striving to recover from a double-dip recession following the global financial crisis and the eurozone crisis.

The Bank supported scaling-up efforts of corporates outside the tourism sector through investment and advisory, and helped micro, small and medium-sized enterprises (MSMEs) directly and via partner banks, thus also seeking to alleviate the difficulties in MSMEs' access to finance:

- EBRD's €10 million convertible redeemable preferred equity stake in the general retailer Voli Trade amounted to the Bank's first equity investment in food retail in Montenegro, and served to increase competition in the sector. The proceeds were used to support construction of a new distribution centre in Podgorica and the expansion of the company's retail network with the opening of two new stores outside Podgorica.
- A €3 million loan arranged under the Direct Finance Framework (DFF) to Codra Hospital, the first private health provider in Montenegro, supported improvement in service quality, with the proceeds used to launch the first private maternity ward in the country and expand the hospital's capacity to provide intensive care and complex surgery treatments.
- Technical assistance and a €5 million loan under the Local Enterprise Facility (LEF) to Goranovic and a €4 million loan to Mesopromet, the two largest meat production companies in the country, contributed to enhancing productivity through the automation of the meat production and distribution processes and raised quality standards towards EU norms. EBRD also supported Mesopromet with the development of a new IT system.
- The Bank supported market expansion of the cosmetics retail chain MPM through a subordinate €1.5 million loan, as well as a €2 million convertible loan.
- In the aftermath of the financial crisis, the Bank further supported MSMEs via indirect financing through local partner banks, including two MSME credit lines (FIF - Alter Modus MSE Loan and WBCFF: Hipotekarna Banka MSME loan) to local banks and micro-finance institutions (MFIs). Between 2014 and 2016, Hipotekarna Banka disbursed €19 million while Alter Modus €15 million. In total the number of beneficiaries reached over the last year was 6,827.

The Bank's Advice for Small Businesses (ASB) programme played a significant role in supporting these enterprises and other SMEs in Montenegro. Over the period 2014-2016, 114 enterprises received advice delivered through local consultants or international industry experts in areas such as financial reporting, environmental and quality standards, marketing, strategy, and information technologies thus contributing on average to increasing turnover by

56 per cent, the number of employees on average by 59 per cent and productivity increase by 38 per cent.

In addition, the Bank worked to help restart bank lending to businesses. In particular, the Bank contributed to addressing the issue on non-performing loans by commissioning an NPL Diagnostic Study with the aim to provide concrete solutions for resolving the high level of non-performing loans (NPLs) in the country, as well as to assess opportunities for the EBRD to get involved in specific restructuring cases in the SME sector. The Bank's support and policy dialogue has led to the enactment of the law on Voluntary Restructuring of Loans (the so-called "Podgorica Approach") providing tax relief for voluntary debt restructuring between creditors and debtors.

The NPL initiative also proved complementary to the support for the development of a factoring market in Montenegro. Authorities want to approve the leasing and factoring framework, drafted with EBRD assistance, as a joint package sometime in 2017 in order to simplify SME applications for factoring with the view to expand factoring in the country and facilitate further development of credit.

The Bank's Women in Business (WiB) programme was also launched in the current strategy period. Under the WiB, the Bank currently provides technical assistance to these companies and searches for partner financial institutions to support access to finance for women-led enterprises, as well as for training in financial management and mentoring. Between 2014 and 2016 a total of 27 women-led ASB projects were started.

Theme 2: Supporting sustainable tourism, property and associated environmental and infrastructure needs

The Bank provided significant support for cross-border and national transport infrastructure (roads, railway, airport and ports) and municipal utilities sector.

- A €25 million loan to help support the reconstruction of a local road and reduce travel time from northern Montenegro to Podgorica and the country's coast. This will also ease access to Montenegro's coast from Serbia and Kosovo. Also in the road sector, the Bank supported the introduction of procurement standards aligned with EU Directives and the introduction of important measures such as the Road Safety Audit and performance-based management contracts preparation for roads maintenance.

- Furthermore, the Bank engaged with the Privatisation Council to support the privatisation of the Port of Bijela and the Health Institute in Igalo, in particular providing technical assistance to the government to support the preparation of the tender for the Port of Bijela, including the environmental and social impact assessment related to the redundancy of the workforce and environmental clean-up of the port.

- The Bank also provided technical support for the preparation of the preliminary design of the terminal building and manoeuvring areas of the Tivat Airport, as well as for procurement of the tender for detailed design and construction of terminal building and reconstruction of manoeuvring areas. Finally, at the request of the Ministry of Sustainable Development and Tourism, the Bank provided a study for reform of the water supply sector in the coastal part of Montenegro.

Theme 3: Promoting energy security and efficiency, and regional integration of energy markets.

In the power sector, the Bank signed in 2013 the largest single investment in the country to date, aimed at strengthening Montenegro's own energy security, as well the regional integration of energy markets. The €60 million sovereign and corporate loan to the power transmission company CGES supported the construction of the Lastva (on the Adriatic coast) - Pljevlja (in northern Montenegro) high voltage transmission line connecting the new undersea cable (from Italy to Montenegro) with Pljevlja, and from there further on with Serbia, and Bosnia and Herzegovina. Another milestone investment in the sector was a €48.5 million loan to help finance the Krnovo wind farm project in 2015. This was the first ever private renewable and wind energy project to begin commercial operations in Montenegro and one of the first in the Western Balkan region (excluding the EU countries Croatia and Slovenia). It will be highly visible and likely to prove the catalyst for attracting commercial banks to finance similar projects in Montenegro and elsewhere in the Western Balkans region. Once operational, the wind farm is set to represent 8 per cent of the total installed capacity and 6 per cent of total electricity production in Montenegro.

In addition, a €30 million loan was provided to the power utility EPCG to support further implementation of its smart metering program for the improvement of energy efficiency, revenue collection and reduction of losses in the distribution network. The Bank also signed the first IFI-financed small hydro power plant (SHPP) project in Montenegro under WeBSEDFF in December 2015.

Overall, EBRD more than doubled its investments in sustainable energy to €118 million over the strategy period contributing to the reduction of energy intensity of the economy, raising private companies' competitiveness as well as benefitting the environment. Over 2014-2016, projects signed in Montenegro have resulted in an expected Greenhouse Gas (GHG) emissions' reduction of 232 kt CO_2 per year, while expected energy savings are 2,886,961 GJ per year. Renewable energy generated in 2015 amounted to 189,768 MWh, while 316,259 MWh were installed in total since 2010.

The Bank also provided technical assistance to the CAO in 2015 to support further integration and trade of the regional electricity markets. It provided assistance to the Ministry of Economy with the aim to support the revision of the tariff system and modelling achievement of the national renewable energy goals. The Bank also supported the development of an enabling regulatory framework for sustainable energy efficiency investments. Finally, the Bank supported the implementation of technical and feasibility studies managed through the WBIF, principally the development of the national Gas Master Plan with the Ministry of Economy and the electricity network expansion project with the transmission company CGES.

1.3 Key lessons

- Difficult reforms have caused some delays in programme implementation while client ownership has not been always consistent across the Bank's engagement. Ensuring full commitment and buy-in to difficult reforms at the political level will be crucial in maintaining efficiency and effectiveness in the upcoming Strategy Period. The Bank's engagement will have to strike a balance between being flexible enough to nimbly adapt to changing circumstances, and staying the course with respect to supporting Montenegro in implementing difficult reforms, including by maintaining high-level political dialogue on the ground.

- The Bank's traditional on-lend SME frameworks were rendered less attractive by the high level of liquidity in the banking system, coupled with the risk-aversion stemming from the NPL overhang. The Bank needs to offer specialised products, such as risk mitigation, as well as targeted frameworks, such as Women in Business. Further to this end, the Bank has offered additional support to keep the momentum in the NPL resolution process.

- The inherently long lead-times of large public sector projects, which account for a large portion of the portfolio volume, are reflected in a relatively high undrawn portfolio share (39.4 per cent as of December 2016). However, the high undrawn portfolio share also reflects the weak local implementation capacity suggesting the need for the Bank to provide policy advice and hands-on technical assistance to local partners.

- The Bank's efforts to scale up direct lending to local corporates have been constrained not only by the inherently small size of Montenegrin companies, but also by informality, that is endemic in the local private sector. In that regard, support under Advice for Small Businesses to SMEs will be needed to continue improving corporate governance and financial management, business planning, accounting, and focusing on inclusive growth, enhanced competitiveness and trade promotion.

- Contrary to the original expectations, privatisation of the remaining SOEs has made little progress during the strategy period, with a few exceptions, such as the privatisation of the Container Terminal and General Cargo Company in 2013 with the Bank's support, while involving the private sector in the infrastructure projects has proved another challenge. Although appetite from foreign investors is still present, political and administrative barriers continue to delay the privatisation process, while prioritisation of infrastructure projects needs to be carefully assessed within the context of the tight fiscal space and the role of other IFIs in the country. Cognizant of these considerations, the Bank will remain alert to bankable opportunities to support privatisation as they arise.

2 OPERATIONAL ENVIRONMENT

2.1 Political context

The country is governed by a pro-reform pro-European Democratic Party of Socialists (DPS), which has dominated Montenegrin political scene for more than 25 years and led both the pro-independence movement and subsequent efforts toward the country's integration into the EU. The ruling party won the plurality of the votes in all four post-independence general elections (2006, 2009, 2012 and 2016). DPS's candidate holds the Presidency; the party is also in majority in most of the municipalities. The current government of continuity was established on 28 November 2016. Besides DPS, the coalition government includes political parties representing ethnic minorities (Albanian, Bosniak and Croatian) and a smaller centre-left party of Social Democrats. While the current parliamentary majority is very narrow, the governing coalition benefits from the lack of ideological or other major disagreements within it.

Although political environment remains challenging, highlighted by difference of views among the public on the questions related to NATO membership, as well as along the ethnic lines, the long tenure in power of the DPS has led to consistency and continuity in the policies of the successive DPS-led governments.

Montenegro's key weaknesses, which are common to all Western Balkans countries, include the tenuous rule of law and relatively low capacity of public administration. Regarding the latter, it should be also noted that the modern Montenegrin state is not only among the youngest in the region, but is also by far the smallest.

Continuing EU approximation remains a key external anchor for reforms. Montenegro is currently the most advanced country in the Western Balkans region in its integration into the EU. Since the EU accession negotiations were formally launched in 2012, Montenegro has opened 26 negotiation chapters, including the critical chapters related to the rule of law. In May 2016, Montenegro signed NATO accession protocol and is likely to become a fully-fledged member of the Alliance in 2017, pending ratifications by member states. Further progress on both tracks may not only boost investors' confidence due to increased stability, but should be also conducive to the strengthening of the rule of law.

See Annex 1 for a detailed political assessment in the context of Article 1.

2.2 Macroeconomic context

Montenegro has the highest GDP per capita in the Western Balkan region but is still below half the EU average. Such gap reflects many years of under-performance, but also illustrates the convergence potential. In the period from 2009 to 2014 the country had to face two recessions, with an average growth rate in this period of just 0.4 per cent. Montenegro's economy is faced with all the characteristics of a small and open economy, including 1) volatile growth rates and 2) high level of dependence on international markets and the inflow of foreign investment.

The economy rebounded strongly in 2015 and remained steady in 2016. GDP growth in 2015 was 3.4 per cent, a significant increase on the 1.8 per cent recorded in 2014. The government implemented a fiscal stimulus to support the economic recovery, including a large public investment package led by a major highway project. The revival of economic activity was also driven by a good tourism season and investments in real estate and the energy sector.

According to preliminary data, the economy grew by 2.5 per cent in 2016 at 2.4 per cent. This is lower than the previously projected growth of 4.1 per cent, mainly due to delays in construction of the highway.

The more dynamic economy had a positive, although small, impact on the labour market. As of December 2016 the unemployment rate was 17.5 per cent compared with 18.1 per cent two years before, but long-term unemployment (i.e., unemployed for more than one year) is exceptionally high, at more than 70 per cent of the total unemployment. Skills-mismatch is among the major obstacles for more inclusive economic growth, particularly in the sectors of construction and hospitality, as much of the labour force comes from the neighbouring countries.

The tourism sector's performance was particularly strong in 2015, levelling of in 2016. The Montenegrin economy is heavily dependent on tourism, with receipts from foreign tourist arrivals accounting for ca. one fifth of the annual GDP. In 2015, the number of foreign tourists increased by 16 per cent in comparison to 2014, reaching 1.6 million, with Russian tourists and those from the neighboring countries (Serbia in particular) accounting for about two-thirds of total arrivals. While arrivals from Russia declined by 6 per cent y/y (due to a deteriorating situation in the country and depreciation of the ruble), arrivals from the Western Balkan region, especially from Serbia and Bosnia and Herzegovina, increased considerably, possibly as a result of increased uncertainties in other tourist destinations. Steady growth in the sector continued into 2016 as well, with tourist arrivals growing by 6 per cent compared to 2015.

A further pick-up in growth is expected in the short term. Growth in the period 2017-2020 is expected at an annual rate of 3-4 per cent. The latest government projections (from the draft of Economic Reform Programme 2017-2019) are 3.2 per cent in 2017, 4.4 per cent in 2018 and 2.6 per cent in 2019. This growth is expected to be mainly investment-driven and supported by 1) public investment in transport and energy infrastructure where the construction of the north-south motorway is the key project; and 2) flagship foreign direct private investments, particularly in the tourism sector.

However, the public finances face significant risks. Public debt (as of end September 2016) amounts to ca. €2.4 billion or 65 per cent of the estimated 2016 GDP (€3.7 billion). According to the baseline scenario of the latest public debt sustainability analysis published by the IMF (March 2016), gross government debt will increase further in the next few years and it is projected to reach 80 per cent of GDP by 2018 as the government has decided to pursue debt-financed construction of the first part of the motorway. In addition, large-scale infrastructure projects, especially in such a difficult terrain, frequently overrun anticipated costs. With public finances already stretched, additional financing for the remainder of the project may be difficult to obtain and the long-term ability of Montenegro to monetize this project is uncertain. A further complication for the country's public finances could come from a possible activation of state loan guarantees which are equivalent to about 9 per cent of GDP. In December 2016, together with the budget for 2017, the parliament adopted the Public Finances Recovery Plan covering the period 2017-2021, which outlines the measures that will be taken to put the public finances on a sustainable path.

Construction of a major motorway was launched in 2015. The motorway is a major public investment in transport infrastructure, which should have positive spillover effects in the economy (although the direct multiplier may be limited, as the investment has a high import component and heavily relies on foreign labour force). It links the Adriatic port of Bar in the south of Montenegro and the border with Serbia in the north. The Chinese construction company CRBC was selected for the construction of the 44-km long priority section (about one-third of the total motorway), at a cost of US$ 1.1 billion. At the time the construction contract was signed (Feb 2014), this amount was equal to €809 million, or 23 per cent of 2015 GDP. The project is mainly financed (85 per cent) by a 20-year loan from China Exim Bank of US$ 944 million, with a six-year grace period (the repayment of the principal will start from 2021) and a 2 per cent interest rate, while the Montenegrin government has to provide the remaining amount. The Chinese loan was signed in US dollars and therefore carries significant currency risk to public finances, as a weakening of the euro (which is the country's legal tender) brings an increase in the cost of servicing this loan. Under the Law on the Highway, the project is exempt from taxes and custom fees, while at least 30 per cent of the work should be assigned to local companies.

The banking system's health is gradually improving, but risks remain. Credit to the real economy turned positive again in April 2015 and the overall credit activity of the banking sector appears to be improving gradually, on average 3 per cent year-on-year ever since. The recent trend of declining interest rates has supported the revival of the credit activity. The non-performing loans ratio declined from 25 per cent in 2011 to 10.2 per cent as of end-December 2016, but many of the bad assets were shifted to factoring companies that are fully owned by the originating banks, making the extent of effective relief for the banks unclear. Also, the "Podgorica approach" under which banks and companies were supposed to engage in voluntary restructuring and out-of-court work-outs, has attracted limited interest so far, and is under revision. With 15 banks currently operational, the country of ca. 620,000 people seems overbanked, and some consolidation in the sector can be expected during the strategy period. The bulk of the deposit-taking banks are EU owned: Hungarian OTP, Slovenian NLB, Austrian Erste and Addiko, French Societe Generale and Italian Hipotekarna banka. Elsewhere in the financial sector, the proposal of a new all-encompassing law covering factoring, leasing, micro-crediting and credit guarantee operations is in the process of preparation and is envisioned for parliamentary adoption in 2017.

Underlying vulnerabilities stem from the following factors: The economy is concentrated in a few key sectors, notably tourism which is vulnerable to external shocks, in particularly those regarding demand in Russia, the EU and the Western Balkans. Also, the economy suffers from large twin deficits: government deficit and current account deficit. The current account deficit, at 15 per cent of GDP, is the highest in the region, and is expected to rise during the next period as the country enters a new investment cycle, with several major projects in tourism, energy and infrastructure in the pipeline. The government deficit has increased, not least due to recently adopted increases in social spending, and will also be difficult to contain, although, as noted above, the government has adopted a recovery plan to eliminate the deficit, excluding the spending on the highway, by 2018. Also, the external debt of Montenegro (public and private), estimated at 152 per cent of GDP, is higher than in regional comparators, with around two-thirds of it being private, and is forecasted to rise to 159 per cent of GDP by 2020.

2.3 Structural reform context

Montenegro has significant challenges remaining in a number of areas including business sophistication, i.e. lack of well-developed businesses, truncated value chains and endemic informality.

Montenegro's economy is small and overwhelmingly service-oriented, with tourism as a principal driver. Public administration, including defence, education and social services, is large and accounts for ca. one-fifth of economic activity. The country is import-dependent on a variety of goods as its comparatively narrow industrial base comprises mainly utilities, basic metals, agribusiness and forestry.

Progress on improving the business environment has been uneven. Over the years, Montenegro has established a track record of business-friendly legislation and openness to foreign investors, with the country regularly topping the regional list of countries in terms of FDI per capita. The country ranks 51st out of 190 countries on the 2017 World Bank's ease of doing business score with the most problematic areas being access to electricity (167rd place), obtaining construction permits (93st) and registering property (78th). However, investor surveys, such as the latest Foreign Investor Council White Book, point to dissatisfaction with areas such as the rule of law as well as tax policy stability and flexibility. Addressing rule-of-law and corruption issues will also be needed for further EU approximation.

Montenegro's economy is characterised by endemic informality. Competitors' practices in the informal sector are among the largest obstacles to conducting business in Montenegro. According to the latest Business Environment and Enterprise Performance Survey (BEEPS), from 2013/14, the share of firms that reported to compete with firms in the informal sector was 52.4 per cent, almost double the figure reported in the survey's 2008/09 round. This may include practices by registered firms, such as paying part of the wages informally, contributing to informal employment. In order to address some of these issues, the Government of Montenegro is aiming to introduce electronic fiscal invoices, as one of the measures to suppress the informal economy, which would provide information on trade in goods and services in real time.

Persistently high unemployment and low labour force participation, especially among the youth, middle-aged men and women, indicates that a large share of the population does not benefit from labour market opportunities. In order to increase shared prosperity Montenegro needs to invest in an inclusive growth model, via providing better opportunities to the low skilled sections of the labour force and raising the skill levels. Minority populations, including Roma, Balkan Egyptians and Ashkaelia are particularly vulnerable and lack economic opportunities. There are also significant differences between the relatively more vibrant coastal zones and the poorer northern regions with higher unemployment. In particular, employers in the tourism industry in the coastal area often prefer to hire informally migrant workers from lower-cost Western Balkans countries (Serbia, FYR Macedonia, Bosnia and Herzegovina, Albania, Kosovo) rather than formally hiring Montenegrins from the rural Northern region, also due to mismatches between supply and demand for skilled labour as well as economic disincentives for active labour force participation.

Despite high liquidity of the banking system, access to finance is a major problem for many small businesses due to elevated risk-averse lending by banks, partly due to a still relatively high level of non-performing loans, as well as high levels of informality and the lack of institutional capacity at the SMEs level. Inadequate levels of financial literacy as well and weak corporate governance standards further prevent many SMEs from securing finance and hinder the development of the sector. The financing gap, in particular, is a major obstacle in enabling women to start a business, as shown in the World Bank's Global Financial Inclusion database[1].

Weak linkages between the predominantly coastal tourism and the local agribusinesses located primarily in mountainous inland areas dilute the country's comparative advantages in agribusiness and sustainable tourism. Primary agriculture is by far the largest activity of the rural population representing 8 per cent of GDP and the main or a partial source of income for 48,870 households. Key challenges include the prevalence of small and inefficient subsistence farms (with an average size of a holding of 5 ha) and limited availability of finance and low insurance coverage, contributing to outdated technology use, low yields and productivity and the country being a net importer of food products. Tourism, predominantly based in the coastal parts of the country, is the fastest growing sector in Montenegro, a major source of employment and economic growth (with 18 per cent of total employment generated in this sector and foreign receipts from tourism exports amounting to ca. 20 per cent of GDP). However, the local agribusinesses, located primarily in the inner (and more rural) parts of the country, engaged mainly in meat, dairy, fruits and vegetables production and processing, often receive very few economic benefits from tourism receipts. If anything, tourism tends to generate increased food imports, rather than stimulate local agriculture.

Key transition challenges in the infrastructure sector include fostering competition, commercialisation and improvement in contractual arrangements. Transport policies and technical standards of Montenegro (similar to other countries in the Western Balkan region) need improvement and harmonisation with EU standards. In the energy sector, a regional energy market through further strengthening inter-country linkages is needed. A key challenge is the development of a transmission grid infrastructure to allow for increased cross-border power trade. Regional integration is hampered by difficulties in trading across borders. Non-tariff trade barriers need to be tackled in order to encourage greater flows of trade across borders on the newly constructed transport infrastructure. Institutional capacity to design, select, procure and implement infrastructure projects is weak.

Further improvements are needed for the development of a green economy, including in improving energy efficiency and renewable energy. The main challenges in sustainable energy include i) progressing on the improvement and implementation of the legal framework for supporting sustainable energy projects and ii) strengthening the policy framework and institutional capacity for implementation of climate change adaptation initiatives. Energy and carbon intensity are still high in Montenegro and above EU average. The new draft law on energy efficiency has yet to be adopted. Cost reflective tariffs are applied but environmental costs are not included in energy prices. There are significant challenges in the municipal infrastructure, the state of which is also often an obstacle for sustainable tourism development. The challenges are particularly large in the water and wastewater sector. Improving building standards, including energy efficiency and sustainability remain key challenge in the sustainable tourism sector.

Although most SOEs had been sold, little progress has occurred recently as regards the privatisation agenda and selected key assets are still in the state's hands. The Privatisation Plan envisages the continuation of privatisations of nine companies in areas

[1] The Global Findex Database, 2014 http://www.worldbank.org/en/programs/globalfindex

such as tourism (i.e. Hotel and Health Institute Igalo, Hotel Groups - „Budvanska rivijera" and "Ulcinjska rivijera"), manufacturing and agribusiness (i.e. Tobacco company "Novi duvanski kombinat", the Ferrous Metallurgy Institute and Montepranzo Boka Product land holdings), as well as of the nation's airline company, Montenegro Airlines, the rail freight operator, Montecargo, and the Port of Bar. However, there has been little progress in selling these assets since the plan was announced. The privatisation plan envisages also the valorisation of various tourism locations through public private partnerships.

However, certain reforms are already underway:

- The country has adopted three main policy objectives, namely Smart, Sustainable and Inclusive growth in the **Montenegro development Directions (MDD) 2015-2018**. The MDD identifies tourism, energy, agribusiness and rural development, as well as manufacturing industry, as the main priority sectors, recognising the need to increase productivity and enable job creation.
- **Montenegro is the frontrunner among its neighbours in terms of EU accession** having opened 26 negotiating chapters (out of 35), and has provisionally closed two chapters: science and research; and education and culture. Concerning the country's ability to assume the obligations of EU membership, the latest EC Progress Report issued in November 2016 assesses the country as being moderately prepared in many negotiating chapters, with a few areas where the country is assessed as having a good level of preparations, such as foreign policy and external relations, transport and energy policy, company and intellectual property law. However, Montenegro is at an early stage of preparation regarding fisheries and budgetary and financial provisions and at some level of preparation in the area of freedom of movement for workers, statistics, social policy and employment, environment and climate change.
- The country is currently in the process of drafting its new ERP covering the period 2017-2019. The **associated EU funding**, in particular an allocation of €270.5 million under the new Instrument for Pre-Accession Assistance (IPA II) for 2014-2020, is aimed at providing assistance in aligning with EU norms and standards in the areas of energy, transport, competitiveness, agriculture, climate and environment action, as well as regional cooperation. Strengthening further the country's institutional capacity is also necessary for a successful absorption of these funds.
- The country has established a **track record of business-friendly legislation** and openness to foreign investors, with the country regularly topping the regional list of countries in terms of FDI per capita.

2.4 Access to finance

Private sources of capital

Montenegro has been recently downgraded with a negative outlook by several major credit rating agencies because of rising levels of public debt. Both Moody's (B1) and S&P (B+/B) have published negative outlooks, largely due to the fiscal impact of cost overruns on road building projects, the crystallisation of guarantees (Aluminium Plant, KAP) as a result of the global financial crisis and the low level of domestic savings. Meanwhile, in March 2016, Montenegro sold €300 million on its sovereign five-year Eurobond, at a yield of 5.75 per cent, almost two percentage points higher than in March 2015 when the country issued a five-year Eurobond of €500 million.

The financial sector in Montenegro is dominated by foreign owned banks. There are 15 banks in the financial system, where foreign bank subsidiaries control 79 per cent of the sector's assets. Corporate sector and households, each represent around 38 per cent of the bank's total loans. NPLs remain significant (10.2 per cent as of December 2016) and there is a high level of loan concentration at several of the banks. Whilst banks remain relatively liquid there is increased risk aversion to lending in the private sector. The insurance industry is small with total premium of the insurance sector is at 2 per cent of GDP divided in life insurance and non-life insurance. The life insurance sector is small, and the non-life insurance sector is dominated by the motor third-party liability insurance which is mandatory in the country. The insurance sector consists of 11 insurers, among which 9 are foreign subsidiaries, writing 95 per cent of total premiums. The leasing market is small and has been in decline since the 2008 crisis with the number of leases standing at 0.4 per cent of GDP as of end 2014.

Public and private equity funding markets are underdeveloped and constrained by factors such as small market size, limited new capital market issuances and low free float of listed companies. The theoretical market capitalisation of the Montenegro Stock Exchange (MNSE) stood at €2.87 billion whereas the total annual turnover was €115.2 million in 2016, mostly driven by domestic investors. The market remains illiquid. Since December 2013, Borsa Istanbul has been a significant shareholder (currently 24.39 per cent) of the exchange, only second to Atlas Mont – an investment fund entity that owns 33.52 per cent of MNSE.

The bond market remains underdeveloped and underutilised as a financing option. In 2016 the overall bonds trading turnover stood for €83.8 million and represented 72.7 per cent of the total turnover on the exchange. The largest share in the total bond turnover stems from the primary sales bonds of the Republic of Montenegro with €80.4 million.

Total turnover of government bonds was EUR 2.3 million in 2016 whereas the corporate bond turnover stood for EUR 1 million.

Montenegro's small population, unilateral adoption of the euro and lack of diversification in the economy argues against the potential for developing a standalone capital market. Connectivity and regional integration provide potential solutions for the presently undeveloped financial sector. Perhaps recognising this, Montenegro Stock Exchange is looking to join Bulgaria, Croatia and Macedonia in Stage 2 of the SEE-link project, linking respective regional exchanges with the goal of pooling liquidity and attracting foreign investment. Boosting the long term domestic savings rate will remain challenging while there is a limited range of investment options locally.

Multilateral and bilateral development bank finance and the EU[2]

A number of multilateral development banks (MDBs) and bilateral financial institutions are active in Montenegro, with varying investment levels and priorities, including the EU, UN Agencies and Organization for Security and Cooperation in Europe (OSCE), with the EU playing by far the largest role. There is also a number of other IFIs, such as the World Bank Group (WBG), the European Investment Bank (EIB) and Kreditanstalt für Wiederaufbau Development Bank (KfW).

Under the **EU**'s Instrument for Pre-Accession Assistance, the funding allocated to Montenegro for the period 2014-2020 amounts to €270.5 million across the following priority sectors: agriculture and rural development (€52.4 million), rule of law and fundamental rights

[2] This section focuses on large scale financing, whereas other donor and TC activities are captured in Annex 6.

(€52.3), democracy and governance (€46.9 million), environment and climate action (€37.5 million), transport (€32.1 million), education, employment and social policies (€28.1 million) and competitiveness and innovation (€21.2 million).

EIB lending activities in the country amount to over €440 million. In 2015, the Bank signed loans of €50 million, of which €40 million via local banking partners for small and medium scale projects to boost the local economy. In addition, a €10 million loan will support the rehabilitation and construction of water and waste infrastructure in municipalities across the country.

The **World Bank** currently supports four operations in Montenegro at a total value of US$ 120.25 million. Areas of support include agriculture and rural development, higher education, energy efficiency, and industrial waste management, while the operation in land administration in the amount of US$ 16.20 million successfully closed on February 29, 2016. In addition, the portfolio contains an Institutional Development Fund (IDF) grant, Capacity Building for Effective Audit Oversight (US$ 0.5 million), and two EU-supported trust funds in agriculture and rural development (US$ 9.6 million total). At the end of 2015 additional EU funding to the Trust Fund has been processed to support increasing capacities of both institutions and industry in the agro-processing. The Bank is also currently preparing a project related to revenue administration reform.

Montenegro became a shareholder and member of **IFC** in 2007. Since then, IFC's investment in Montenegro totalled US$ 86.8 million in 7 projects across a variety of sectors. IFC focuses its investment services in Montenegro on increasing access to finance by supporting the development of local financial institutions, particularly ones that lend to small and medium enterprises. IFC also invested in the country's retail sector and is looking into opportunities offered by the country's dynamic economy. IFC's advisory services in Montenegro aim to improve the investment climate, performance of private sector companies, and to attract private sector participation in development of infrastructure projects.

KfW has been mainly active in the energy sector, municipal infrastructure, supporting micro, small and medium-sized enterprises, and providing municipal credit lines, investing an average of €7.4 million from 2013 to 2015. Under the Energy Efficiency Program, KfW supported lowering energy consumption of schools and day care centers. KfW is also funding the modernization of two hydropower plants that play a key role in Montenegro's energy supply, and has been providing support to improve the water supply and water quality and reduce water losses in the coastal communities of Herceg Novi, Kotor, Tivat, Bar, Ulcinj, and Cetinje. KfW has also invested in improving the sewage system as well as construction of new sewage treatment plants and sewer systems, and provides microentrepreneurs' access to financial services by working with a local micro-finance institution.

UNDP's focus on promoting sustainable human development is also aligned with Montenegro's EU accession priorities. There are a number of areas of common focus with UNDP, such as support to overall reforms in the country, enhancing employment, providing support in environmental management, e-governance and ICT. UNDP's recent human development reports have addressed issues such as resource efficiency and informal work providing recommendations on tackling informal labour in priority economic sectors. Through the Joint Government and UNDP programme – Centre for Sustainable Development – UNDP supports Government on energy, climate change, eco-system management, and low carbon tourism. UNDP is currently finalizing a new Country Program Document for the period 2017-2021.

2.5 Business environment and legal context

Business Environment
Progress on improving the business environment has been mixed. Montenegro needs to further improve governance and the rule of law. Over the years, Montenegro has established a track record of business-friendly legislation and openness to foreign investors. The country ranks 51st out of 190 countries on the World Bank's ease of doing business score. At the same time, the latest Foreign Investor Council White Book points to areas such as the rule of law and property development as problematic areas in the past year.

The incumbent Government plans to further simplify the issuance of construction permits, strengthen contract enforcement, and improve state asset management through privatization and state-owned enterprise (SOE) restructuring. In addition, addressing NPLs resolution, enforcing collateral collection and lengthy court proceedings, and strengthening banking sector supervision are needed in support of new, healthy credit growth.

Significant improvements have been made in public procurement. A new Law on Public Procurement was adopted in 2011 to create a framework for the further streamlining of public expenditures and improvements in governance through the centralized approval of procurement plans.

Legal Context
Montenegro continues to upgrade its legislation with a view to making it EU compatible. Progress has been uneven in the various fields of commercial law. In EBRD's Secured Transactions Assessment (2014) which examined the practices and effectiveness of collateralising different types of assets, Montenegro scored higher than the overall average of all EBRD countries of operations, reflecting a relatively advanced system for taking pledges and mortgages. However, a similar study looking at factoring law in the EBRD countries of operations (2016) identified significant areas of Montenegro's factoring institutional and legislative framework which need upgrading. The EBRD Corporate Governance Assessment (2015) highlighted a framework in need of reform in most areas under consideration.

Based on the European Commission recent reports[3], Montenegro made progress in the field of judiciary, specifically as regards the improvement of the capacity of the Judicial and Prosecutorial Council. However the legal framework for strengthening the independence, accountability and professionalism of the judiciary is yet to be fully implemented in practice. While the Judicial Training Centre has become an independent institution following the adoption of the relevant law in September 2015, it reportedly relies heavily on donor support and its administrative capacity needs to be enhanced. The overall length of court proceedings and the backlog of court cases remain significant, as well as the backlog of old enforcement cases; enforcement of some court decisions (including civil case decisions) remains problematic. Available alternative dispute resolution (ADR) methods include court settlement, arbitration and mediation, however the overall significance of ADR is low, and the number of cases referred to and solved through mediation in 2015 significantly reduced compared to 2014.

[3] Commission Staff Working Document, Montenegro 2016 Report https://ec.europa.eu/neighbourhood-enlargement/sites/near/files/pdf/key_documents/2016/20161109_report_montenegro.pdf

In 2014, the EBRD published an Insolvency Officeholder Assessment which evaluates the insolvency office holder (IOH) profession's state of development and performance in 27 countries of operations. The IOH Assessment found that the Montenegrin IOH framework needs improvement in a number of key areas including work standards and ethics, and IOH regulation, supervision and discipline. On a positive note, Montenegro has recently introduced improvements to its insolvency legislation.

In the electronic communications sector, competition in fixed voice telephony and broadband services remains low, and most of the competitive safeguards introduced have not yet produced visible changes in the market. The concessions and public private partnership legal and regulatory framework is being gradually aligned with that of the EU.

Despite delays with transposing the EU Third Energy Package, with the adoption of the Law on Cross Border Exchange of Electricity and Natural Gas in June 2016 Montenegro completed the transposition of the relevant acquis. Montenegro achieved significant progress with the implementation of the Law on Efficient Use of Energy and the adoption of a package of by-laws. Furthermore, the country approved its third Energy Efficiency Action Plan in June 2016.

See Annex 4 for a more detailed assessment of the legal environment in specific areas relevant to the Bank's investment strategy.

2.6 Social context

Montenegro ranks 49th out of 188 countries, placing it in the category of countries with 'very high human development' on the UNDP 2015 Human Development Index (HDI). Life expectancy at birth in Montenegro is 76.5 years, with a gender gap of 2.4 years in favour of women. The population in Montenegro is expected to fall by 8.3 per cent from 0.63 million in 2016 to 0.57 million within the next four decades, mainly due to low fertility rates forecasted by the UN to remain around 1.6-1.7 between 2015 and 2050.

Youth unemployment and women's economic participation are among the most pressing social issues in Montenegro. Young people between the ages of 15 and 24 years face high levels of unemployment (39.5 per cent), with over 16 per cent not in education, employment or training. The low quality of education is partially responsible for bottlenecks in Montenegro's labour market. Although a child of school entrance age can expect to receive 15.2 years of schooling (if current patterns of enrolment persist) skill acquisition remains low. According to PISA 2015, 52 per cent of 15 year olds do not possess basic numeracy skills (compared to 32 per cent in Croatia, and 53 per cent in Albania) while only 1.5 per cent of students in this age bracket exhibit advanced mathematical skills (compared to 5.6 per cent in Croatia and 1.1 per cent in Albania). Additionally, graduates of both, vocational education and training (VET) and tertiary education programmes, lack practical skill sets required by private sector employers. As outlined in the Economic Reform Programme submitted to the European Commission in 2015, the government's objective is to reduce skills mismatch by aligning education and labour market needs and to develop qualifications which reflect employer requirements (including an identification mechanism for skill needs).

Gender inequalities exist in relation to economic participation including in employment, entrepreneurship, labour practices and access to assets and finance. In 2014, female labour force participation in Montenegro was 52 per cent compared to 66 per cent at EU[4], while the gender pay gap was 16.1 per cent[5], slightly better than 16.7 per cent in EU-28[6]. Women entrepreneurship is also low with only 12 per cent of women being entrepreneurs, compared to 22 per cent of men. According to the BEEPS V, out of 150 firms surveyed in the country, 24 per cent had women amongst their owners, 19 percent had at least 50 percent women ownership, and only 19 per cent of firms had women within top management positions. Access to assets is also limited and the World Bank emphasises the lower asset ownership of female headed households as a major factor affecting women's ability to access banking services and start businesses.[7] In 2014, less than half of women (48.9 per cent) had an account at a financial institutional, compared to 61.9 per cent of men.

There are substantial regional discrepancies in relation to the availability of (formal) employment. The EU highlights in its Assessment of the Labour Market in Montenegro that the average unemployment rates between 2004 and 2010 was 48 per cent in the central region of the country and 35.9 per cent in the northern region, compared to 16 per cent in the southern region. Concerns are also raised by the EU regarding the increase in the number of "hard to employ" individuals, including poorly educated, long-term unemployed, unemployed in less developed areas as well as lack professional competencies.[8]

2.7 Resource efficiency and climate change context

Montenegro's energy intensity (GDP at PPP basis) is almost 40 per cent above the EU average. The residential sector consumes the highest share in total final energy consumption (39 per cent), followed by transport (27 per cent) and industry (19 per cent). Montenegro has been carrying out the transposition and implementation of the EU climate and energy legislations as part of its EU accession process, including receiving support from the EU to develop its new Energy Development Strategy. Following the adoption of the new Law on Efficient Use of Energy (OG of Montenegro 57/2014) in December 2014, the Ministry of Economy prepared a new package of rulebooks in December 2015. The new law enabled a more efficient implementation and further development of related by-laws. The priority is to adopt missing secondary legislation, as well as establish specific programs and implementation tools to promote energy efficiency. Energy savings potentials are particularly foreseen in public buildings and railway projects, as well as in the electricity transmission and distribution networks (including via implementation of smart grids and metering).

The National Renewable Energy Action Plan (NREAP) for Montenegro was adopted with the target of 33 per cent in the share of energy from renewable sources in gross final consumption of energy by 2020. A number of large and small hydro projects are projected to be developed, taking advantage of Montenegro's significant hydro potential. Currently,

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[4] The World Bank Group. 2014. Labour force participation rate, female (% of female population ages 15-64). http://data.worldbank.org/indicator/SL.TLF.ACTI.FE.ZS

[5] Foundation for the Advanced Economics. Gender Pay Gap in the Western Balkan Countries: Evidence from Serbia, Montenegro and Macedonia. http://www.rrpp-westernbalkans.net/en/News/Research-Results--Gender-Pay-Gap-in-the-Western-Balkan-Countries--Evidence-from-Serbia--Montenegro-and-Macedonia/mainColumnParagraphs/0/text_files/file0/Policy%20briefs_gender%20pay%20gap.pdf

[6] Eurostat. 2014. Enlargement countries – labour market statistics. http://ec.europa.eu/eurostat/statistics-explained/index.php/Enlargement_countries_-_labour_market_statistics

[7] Montenegro Gender Diagnostic: Gaps In Endowments, Access To Economic Opportunities And Agency, World Bank, June 2013.

[8] Assessment of the Labour Market in Montenegro, European Commission Directorate-General for Employment, Social Affairs and Equal Opportunities. 2010.

hydropower takes up around 65 per cent of the total electricity produced in Montenegro, and has the potential to produce up to 10,000 GWh per year from small HPPs. There is also a consistent interest to take advantage of the ideal climatic conditions for wind, solar and further biomass projects. The Government has introduced feed-in tariffs and privileged producer status for RES power plants, obligations for new buildings to utilise RES in heating and cooling, subsidies for installing solar systems in buildings, among others. However, data inconsistencies with respect to biomass consumption calls into question Montenegro's original RES target, and there is a general need for the assumptions of future NREAP projections to be made more explicit. Lack of administrative capacity is considered the key bottleneck to further promotion of renewables, while connection to the grids and market integration for new renewable energy power remains critical in the country. It also needs to set up a new legal framework in order for it to fulfil the 10 per cent target for renewable energy in transport by 2020.

Montenegro's material productivity in the industrial and agricultural sector ranks under the 35th percentile of the world distribution. Industrial waste accounts for around 60 per cent of total waste production in Montenegro, and the rest is municipal. Electricity generation accounts for most of the industrial waste generated in the country, in weight terms, and there is a potential to further increase the share of waste utilisation for energy generation. Most of hazardous waste is generated by manufacturing - from oil wastes (55 per cent) and thermal processes (30 per cent). Waste collection covers 75 per cent of the population. Actual bill collection is low with collection rates at 63 per cent for households and 80 per cent for companies. There are no landfill taxes, gate fees are low, and illegal dumping is rampant. The enforcement of the waste management regulations remains a critical challenge in Montenegro, despite appropriate regulatory measures being in place (most of EU Waste Framework Directive has been transposed). The Law on Waste Management contains targets in line with the EU (e.g. 50 per cent recovery of MSW), but strategic policy tools, such as the updated strategy and waste management plan for 2014-2020 have not yet been adopted and there are no other binding strategic goals or targets in effect.

Although there is no reliable data on water availability for Montenegro, generally the region is endowed with good water supply (cover of 85 per cent of population) with relatively low water abstraction rates. Most water is used by households (60 per cent), followed by industry (39 per cent) and agriculture (1 per cent). Only 5 per cent of all wastewater receives some treatment, and non-revenue water (NRW) rate (water that is produced and "lost" before reaching customer) reaches 60 per cent of total water produced on average. Montenegro currently does not have an active water strategy, resulting in a lack of strategic guidance, target setting and monitoring of water management in the country. Dedicated wastewater plans have been in place since 2005, but river basin management plans are at very early stage. This reflects the need to improve its preparedness for climate adaptation, particularly considering high reliance on hydropower. Metering of water consumption is above 90 per cent, but bill collection is on average 72 per cent and water loss is high. Combined water and sewerage tariffs are on average 0.67€/m3 for households and 1.87€/m3 for industries. Direct water abstraction is regulated in the 2008 Law on Water Management Financing (OG 65/08) and the decision (OG 29/09), and the fees, both for supplied and abstracted water, are considered adequate, but enforcement remains questionable.

Montenegro submitted to the UNFCCC its intended nationally determined contribution (INDC) towards the international efforts to avoid climate change on September 2015, which commits to 30 per cent emission reduction by 2030 compared to the 1990 base year. Montenegro is a non-Annex I country, vulnerable to climate change, with net per capita GHG emissions of 7.25 tCO_2eq (2010). At national level, the National Climate Change Strategy and the Energy Development Strategy of Montenegro are the policy backbones to drive the change by 2030, focusing on general improvement in energy efficiency and industrial technologies, increased deployment of renewables and power sector modernization.

3 STRATEGIC ORIENTATIONS

3.1 Strategic Directions

Leveraging the incentives provided by the EU accession, as well as the authorities' own reform momentum, the Bank will work to enhance Montenegro's competitiveness by leveraging the country's comparative advantages, promote green transition through greater use of renewable energy and enhanced energy and resource efficiency, and improve Montenegro's regional integration through increased transport and energy connectivity. To that end, the Bank will be pursuing the following strategic priorities:

- **Priority 1: Enhance *Competitiveness* of the private sector, including by developing agribusiness value chains and backward linkages in the tourism sector.** As Montenegro aspires to membership in the EU, it needs to develop a more resilient, innovative private sector that will help accelerate the country's convergence with its EU peers in terms of productivity. The Bank will thus seek to support local companies in fostering innovation and adopting best operational skills and managerial practices, including by leveraging Montenegro's comparative advantages through *inter alia* developing agribusiness value chains and promoting linkages to the dominant tourism sector through a combination of investment and small business advisory. Improving access to finance to SMEs and underserved segments will remain a priority, including through the Women in Business programme (WiB). To this end, the Bank will continue providing long term funding directly and through partner financial institutions (banks, as well as leasing and factoring companies) to privately-owned local companies, including on a risk-sharing basis.

- **Priority 2: Improve connectivity and regional *Integration* by expanding cross-border transport and energy links.** Deficient road network and obsolete rail infrastructure, their inadequacy exacerbated by Montenegro's mountainous topography, inhibit cross-border integration, making the regional objective of improving connectivity in the Western Balkans particularly relevant for Montenegro. The Bank, in co-operation with the European Investment Bank (EIB), will support key projects in road infrastructure, especially those that serve to improve the country's connectivity with the rest of the region, including upgrading main internal roads that connect to cross-border links. To increase energy connectivity, the Bank will continue to promote the creation of a regional energy market, leveraging ongoing initiatives, including the work of the Coordinated Auction Office (CAO) in South-Eastern Europe, established by the region's transmission system operators with the support of the Energy Community, European Commission (EC) and the EBRD. In addition, the Bank will continue to support development of the new high voltage underwater electrical cable, connecting Italy and Montenegro as part of the wider Trans-Balkans Corridor, through investments in high-voltage electricity transmission infrastructure to its various points of connection.

- **Priority 3: Continue to foster transition to a *Green* economy, including sustainable tourism.** As Montenegro marks 25 years since its proclamation as a "green" state, the Bank will support the shift towards a greener and more sustainable economy through selected investments in industrial waste disposal, water resource management and sustainable energy. Montenegro's energy intensity remains high and there is a need to make progress on the implementation of the legal framework for supporting sustainable energy projects, as well as on reducing losses in the networks and, subject to political will, developing efficient generating capacities and renewable energy sources and promoting smart grids. Furthermore supporting sustainable tourism, which minimises negative social and environmental impacts and generates more inclusive economic benefits for local people, is also crucial in the context of Montenegro, whose tourism industry generates its main export product and, as such, is the most reliable driver of economic growth. Upgrading the existing hotels stock through privatisation, addressing the seasonality issue by promoting development of congress tourism and health tourism facilities, and modernisation of related infrastructure are the areas of potential Bank engagement.

The new strategy provides continuity with the Bank's ongoing engagement, and the new strategic directions do not represent a material departure from the previous strategy's priorities. Rather, they imply deepening the engagement and sharpening its focus based on lessons learned. Investments and policy dialogue activities across the three strategic priorities may be further adjusted within the context of i) progress in EU-related reforms providing a better context for scaling up the Bank's investments; ii) the extent of sovereign fiscal headroom which could constrain EBRD investments in the public sector; iii) demand drivers in the corporate sector, in particular progress with the privatisation agenda and the NPL initiative which could create additional opportunities for private sector investments. Continued coordination with the EU, IFIs and bilateral donors, in particular under the Western Balkans Investment Framework (WBIF) will be essential.

3.2 Key challenges and Bank activities

Priority 1: Enhance competitiveness of the private sector, including by developing agribusiness value chains and backward linkages in the tourism sector

<u>Transition Challenges</u>

- **Montenegro's development model is still predominantly based on domestic consumption, facilitated by a high inflow of FDI** (around 16 per cent of GDP in 2015). The country is ranked 82th out of 140 countries in the latest World Economic Forum's Global Competitiveness Report (2016-2017), with significant challenges remaining in a number of areas including 1) market size, 2) business sophistication, i.e. lack of well-developed business clusters, shallow value chains and reliance on informal relationship rather than on professional management, and 3) goods and labour market efficiency.
- **Low level of added value in production and insufficiently diversified export** – The economy is facing a problem of external economic imbalances, reflected by the highest current account deficit in the Western Balkans region due to import dependency of the Montenegrin economy. The country has one of the lowest goods export-to-GDP ratios in the world - and low level of import coverage by export of goods. This is mainly due to the low level of added value in production, low quality of products and narrow production base.

- **Incomplete application of international business standards** – While access to the EU offers Montenegro a remarkable opportunity to connect to the EU and other markets beyond its borders, its firms and products are not competitive and often do not meet the necessary regulatory standards. It is crucial for Montenegro to strengthen export capacities and ensure better integration of the economy into global production chains and common EU market. Harmonization with the requirements of international standards and improving the quality of products and services are having major contribution in this process.
- **Limited access to finances by SMEs** - In the latest round of BEEPS, 36 per cent of surveyed firms described themselves as credit-constrained. This is both due to i) low lending by banks due to the weak economic environment, high levels of informality and the lack of institutional capacity at the SMEs level, ii) a still high level of non-performing loans and iii) high cost of financial intermediation. Growing risks in domestic banks and weaknesses in financial regulation and oversight also pose financial stability risks.
- **Insufficient business and managerial know how of entrepreneurs** - In addition to access to finance, SME growth is often constraint by a lack of internal capacities within many small businesses to improve their performance. Many SMEs remain family-owned and lack professional management experience. Insufficient financial management and accounting skills and poor corporate governance, but also a lack of understanding and knowledge to increase process and organisational efficiency, increase sales and exports and introduce innovation are major constraints to the development of the sector. Specifically women-led enterprises continue to face significant obstacles to further grow their businesses, and often face difficulties in accessing finance and professional consultancy services.
- **The agriculture sector** – which is an especially important driver of economic expansion in the country given its sizeable share in the overall economic activity (8 per cent of GDP and 8 per cent of total labour force in 2015) – has a strong potential for being one of the engines of growth over the short- to medium-term. It is also by far the largest activity of the rural population, with almost 50,000 families obtaining their income partly or entirely from agriculture (due to relatively equitable land ownership). However, it is fraught with systemic and structural challenges that need to be addressed to harness its competitive and growth potential (ERP 2016). At present, agriculture is characterised by (still) poor overall productivity, primarily due to:
    - The prevalence of small and inefficient subsistence farms in primary agriculture;
    - Limited availability of finance, contributing to outdated technology use and low yields;
    - Underdeveloped market infrastructure, insufficient training and expertise of farmers;
    - Low levels of vertical integration of primary agriculture and the processing industry. Consolidation and value chain integration are needed to boost productivity and quality standards necessary to improve local supply chains, help substitute imported products and reach new export markets.
    - Product differentiation and complying with higher standards including EU requirements are also recognized as prerequisites to widen export market opportunities and increase economic returns in the sector.

- **There is a weak link (and lack of integrated approach) between tourism and agribusiness**. Better sourcing of agricultural goods locally could make tourism-driven growth better anchored in the domestic economic base, as well as more inclusive. Developing income-generating backward linkages and value chains between the tourism sector and local food producers could thus i) generate jobs and growth of local suppliers and MSMEs linked to the tourism industry; ii) incentivise them to improve capacity and raise standards, contributing to an increase in the overall competitiveness as well as iii) extend the tourism season and give economic impetus to the poorer northern and central regions of the country.
- **Privatisation efforts have stalled** - Although most SOEs had been sold off, little progress has occurred recently and selected key assets are still in the state's hands. The 2016 Privatisation Plan envisages the privatisations of the nation's airline company, Montenegro Airlines, the rail freight operator, Montecargo, the Institute of Ferrous Metallurgy and tobacco company Novi Duvanski Kombinat. Key tourism assets are still in the state hands. The privatisation plan envisages continuation of implementation of the announced tender for the Institute Igalo. Tenders for the privatization of Marina Bar, as well as Hotel Group Budva Riviera and Hotel Group Ulcinj Riviera will be prepared and carried out. The plan also envisages public private partnerships in the tourism sector, including the Island Lastavica with fortress "Mamula" (entrance to the Bay of Kotor), Ada Bojana Ulcinj and many others across the country.

<u>Operational Focus</u>

- The Bank will seek to support investments that enhance links between SMEs in the agribusiness sector and aggregators, food processors and retailers through adoption of international best practices in supply chain management and logistics. To this end, the Bank will explore opportunities to support Montenegro authorities in the utilisation of the Instruments for Pre-accession Assistance for Rural Development (IPARD) Funds available for 2014-2020. Further to this, the Bank will seek opportunities to support development of local producers supply chains and value-added services with linkages to the tourism sector.
- The Bank will provide its partner local banks and microfinance institutions with medium- and long-term credit lines to support MSMEs, housing finance, tourism and agribusiness projects. In view of the banks' high liquidity and prevailing risk aversion, the Bank will emphasise targeted frameworks, first and foremost the Women in Business programme, as well as risk-sharing instruments, such as first-loss mechanisms and/or project-level credit guarantee schemes. Direct financing under the Direct Finance Framework (DFF) and the Enterprise Expansion Fund (ENEF) will continue to be made available.
- Under the Bank's Small Business Initiative, the EBRD will complement investments with advisory to SMEs in areas such as strategic planning, sales, export promotion, quality management, adoption of new technology and resource efficiency with a view to help companies to improve their productivity and, competitive position and scale up. The Bank will promote sound financial management and corporate governance standards to help small businesses access finance and become more attractive for investors.
- The Bank will explore avenues for contributing to addressing skills gaps and mismatches by engaging in vocational/post-secondary education initiatives that would link the output of vocational/post-secondary and tertiary education system more closely with private sector needs also leveraging with the World Bank Group and

other IFIs as well as the European Training Foundation (ETF) for potential policy engagement cooperation on the ground.

- The Bank will help strengthen incentives to work for vulnerable groups, by promoting formalisation of informal jobs and improved facilitation services for job seekers, as well as enforcing labour standards and levelling the playing field between local and migrant workers, also leveraging with the World Bank Group and other IFIs on the ground. To this end, the Bank is also conducting a study to assess the development of social entrepreneurship in the Western Balkans, including Montenegro, with the objective to explore how it could support the ecosystem of social enterprises as a vehicle to promote economic and social inclusion of vulnerable groups.
- The Bank will remain alert to bankable opportunities to support privatisations of SOEs in the tourism sector as they arise.

Policy Dialogue

- As a member of the Foreign Investors Council (FIC), the Bank will continue to actively participate in the improvement of the investment climate in the country in alignment with the government's measures envisaged under the ERP, and promote business development opportunities to foreign investors.
- Subject to genuine interest from credible potential investors, the Bank will assist them in tackling regulatory bottlenecks to their acquiring NPL portfolios. The Bank will also consider ways to support the authorities, subject to their commitment, in redressing weaknesses in the restructuring and enforcement of NPL-related procedures.
- The Bank may consider additional funding support to the Deposit Insurance Agency in Montenegro, in which case the Bank may help develop the Agency further and provide TC and policy dialogue to the Agency. This support could involve capacity building, the set-up of a resolution fund, aligning the existing regulation with the EU Bank Recovery and Resolution Directive (BRRD) and the modernization and strengthening of the Agency.
- The Bank will encourage and facilitate dialogue among producers, processors, retailers, industry associations, the government and other relevant stakeholders to support value chain integration in the agribusiness sector. This can be achieved through working with agribusinesses to improve quality standards and environmental sustainability in their own operations and along their supply chains. Support for smaller players particularly in agriculture and tourism to implement higher standards can include capacity building and training, business advisory, development of contract farming.
- The Bank will encourage transparent privatisation and the resolution of unresolved issues on existing assets. Restructuring of public sector companies and providing concessions for private participation in infrastructure and tourism will help to further the EU accession process.

Priority 1: Enhance *Competitiveness* of the private sector, including by leveraging agribusiness value chains and backward linkages in tourism.

	CHALLENGES	OBJECTIVES	ACTIVITIES	TRACKING INDICATORS
1.1	Competitiveness is hampered by lack of skills and limited internal capacity, as well as difficult business environment and red tape.	**Increase operational efficiency, productivity and intensified competition, including through adoption of best practices and know-how**	▪ Direct financing and on-lending via partner banks, including risk-sharing, to support SMEs' operational efficiency and innovation. ▪ Equity and debt products supporting private companies and know-how and technology transfers, including in processing industries and tourism. ▪ Advice for Small Businesses focused on improving operational and management standards and financial reporting, corporate governance (including equal opportunities in the workplace and transparency) and under the ASB pilot "Blue Ribbon" programme to support SMEs with high growth potential. ▪ Policy dialogue to improve the investment climate.	▪ Number/volume of outstanding loans of partner financial institutions incl. to identified target areas (women entrepreneurs, agri). (*Baseline – established at projects approval)* ▪ Number of clients supported through Advice for Small Businesses with increased turnover/productivity/number of employees *(Baseline – established at project approval)* ▪ Legal/institutional/regulatory reforms improving the investment climate (e.g. formalisation of informal jobs, improved labour standards) (*Baseline – N/A)*
1.2	The agribusiness sector faces increased competitive pressures from imports and shallow value chains and needs to adhere to EU product, health and safety standards, and improve efficiency and productivity through better equipment and business practices as well as strengthening the links with the predominantly coastal tourism.	**Enhance links between SMEs in the agribusiness sector and aggregators, food processors and retailers, as well as with the tourism sector, through adoption of international best practices in supply chain management and logistics**	▪ Investments and policy dialogue to promote improvement of the links between SMEs in the agribusiness sector and food processors, retailers and markets (e.g. logistics, storage capacities, equipment), including enhancing links between local producers and the tourism sector. ▪ Advice for Small Businesses as pre-and post-investment support, to improve competitiveness of the agribusiness by raising food quality and safety standards.	▪ Number of clients supported through Advice for Small Businesses with improved food quality and safety standards (*Baseline – N/A)* ▪ Improved agribusiness infrastructure (e.g., logistics, storage) (qualitative account) (Baseline – N/A) (*Baseline – N/A)*
	Impact indicator: World Economic Forum's Global Competitiveness 2016-2017 Report (Baseline: 82nd out of 138 countries)			

Priority 2: Improve connectivity and regional *Integration* by expanding cross-border transport and energy links

Transition Challenges

- **Poor quality of overall transport infrastructure inhibits business development and lowers international competitiveness of Montenegro**. According to World Economic Forum's Global Competitiveness Index, Montenegro is ranked 95th compared to the EU average of 40 in the area of transport infrastructure. The analysis of the sub-indices suggests that low rankings are driven by the poor quality of roads and low availability of air seats. As part of the EU agenda, namely the "Berlin Process[9]", regional connectivity is one of the priorities for the Government of Montenegro. Important infrastructure projects which Montenegro presented in the latest Economic Reform Programme include the Bar-Boljare highway, the Adriatic-Ionian corridor, the modernization and construction of the railway to Serbia and Albania, connecting power systems of Montenegro with Italy and strengthening the existing linkages with the neighbouring countries, improvement of municipal and rural infrastructure. In addition to these projects, the National Investment Commission adopted in December 2015 a unified list of priority infrastructure projects which has 64 projects that will be implemented in the period 2016-2025.
- **Transport policies and technical standards of Montenegro and other countries in the Western Balkan region need improvement and harmonisation**. This is crucial for realisation of cross-border investments in the regional transport infrastructure and extension of the Trans-European Network to the Western Balkans.
    - Institutional capacity to design, select, procure and implement infrastructure projects is weak (as reflected both by EBRD transition indicators and World Bank's World Governance Indicators). In addition, lack of management of the key risks present in the transport projects is a further weakness. For instance, financing for the first section of the key motorway was agreed in US dollars without appropriate hedging instruments.
    - Private sector participation in the provision of new transport infrastructure is limited. Key transition challenges in the infrastructure sector include fostering/opening to competition, commercialisation and improvement in contractual arrangements to enhance long-term sustainability, as well as the need to improve resilience to climate risks.
    - Poor quality of roads affects business development and the country's competitiveness.
- **Promoting creation of a regional energy market through further strengthening inter-country linkages is needed**. Insufficient connectivity of the energy system of Montenegro with the energy systems of the countries from the region and the EU has

[9] The "Western Balkans Six" process at the level of the Prime Ministers was de-facto launched at the Western Balkans Summit in EBRD HQ in February 2014. It received a strong political boost at the Western Balkans Summits in Berlin in August 2014 and Vienna in August 2015. This process promotes the need for better prioritisation and coordination of the major regional connectivity projects among the beneficiaries, as well as between the EC, IFIs and bilateral donors. The efforts, led by the EC, to prioritise a few major priority connectivity projects in areas of transport and energy culminated at the agreement, reached at the high level meeting between the EC and Western Balkans Prime Ministers in Brussels in April 2015, on the regional core transport network for the Western Balkans as an extension to the region of the Trans-European Network (TEN-T). It includes 11 major roads and 7 major railways routes. EC announced allocation of Euro 1 billion for the next seven years for funding these priority projects. Source: "China and South-Eastern Europe: Infrastructure, trade and investment links", p.7, EBRD Working Papers, July 2016.

adverse impact on security in supplying buyers in Montenegro and potential for export of available surplus electricity. It is one of the reasons why available energy resources of Montenegro cannot be sufficiently exploited in commercial terms and contribute more to economic development of the country. In this segment of the physical infrastructure, the country encounters some other challenges too, such as low efficiency of and insufficient investment in the existent energy capacities, losses in electricity distribution and high energy intensity, as well as climate risks (e.g. in relation to hydro power generation).

  - A key challenge is the development of a transmission grid infrastructure to allow for increased cross-border trade, a reduction in losses and an enhanced role for private sector operators in the electricity system, which is still mainly in state hands.
  - Other remaining challenges in the electricity sector include building of interconnectors, completing the unbundling of the EPCG, improving effective independence and institutional capacity of the regulator, and completing the alignment of legislation with EU directives on integration-related aspects.

- **Regional integration is hampered by difficulties in trading across borders** as non-tariff trade barriers - the removal of which will be incorporated in the conditionality of EU IPA grant co-financing – need to be tackled in order to encourage greater flows of trade across borders on the newly constructed transport infrastructure. Promoting shared customs controls, which would reduce customs control checks from two to one, would help the fight against customs corruption and would reduce travel time and costs.

Operational Focus

Given the limited fiscal space and borrowing sovereign capacity of Montenegro, the Bank will emphasise promoting commercial solutions and private sector participation to the maximum extent possible, and will consider sub-sovereign projects for income-generating public infrastructure (e.g., ports and airports). The Bank with thus seek to:

- Continue to develop a project to finance construction of a new terminal building and manoeuvring area at Tivat airport, which will serve to promote tourism by making the country’s coast more accessible. To this end, the Bank has already provided technical support for the preliminary design and is considering providing procurement support for the tender.
- Continue to support development of the high-voltage energy interconnection to Italy through investments in high-voltage electricity transmission infrastructure to various points of connection to the new undersea cable between Montenegro and Italy (under construction).
- As Montenegro is completing the gas master plan, in co-ordination with WBIF, will further support preparation of the proposed 5 bcm Ionian Adriatic Pipeline (IAP) which will make gasification of Montenegro possible by connecting existing transmission system of Croatia's gas and the Krk LNG terminal via BiH (offshore), Montenegro and Albania to the Trans Adriatic Pipeline System Project (TAP). Depending on the project progress, the Bank will provide financing for the development of the pipeline.
- Continue to support cross-border trade through its Trade Facilitation Programme, as well as through business advisory to small businesses on export readiness. Through its Advice for Small Businesses initiative the Bank will support trade promotion to facilitate linkages to the EU market.

In the road sector, while seeking to promote such commercial solutions as PPPs, and in the railway sector the Bank will consider participation of limited magnitude in sovereign projects in support of the regional Western Balkans connectivity programme, of which Montenegro is a key building block, in order to:

- In close co-operation with the EIB, seek to continue financing the upgrading of Montenegro's main internal roads and bypasses, particularly those feeding into trunk cross-border corridors, and will consider supporting upgrading the connection between Montenegro and Bosnia and Herzegovina (EU has already financed the feasibility study of the project), as part of the country's 2017-19 main roads reconstruction programme. The Bank will also consider supporting developing of additional sections of the highway to Serbia, subject to further assessment of available options for the Bank's involvement.
- Consider supporting modernization and construction of the railway link to Serbia and Albania, which is a key priority for the government.

Policy Dialogue

- In cooperation with other IFIs, the Bank will work with the government to prioritise infrastructure projects that are vital for regional integration while ensuring the efficient allocation of fiscal space and resources committed to implementation of such projects.
- The Bank will work with other stakeholders to support enhancement of soft measures which are supposed to facilitate movement of vehicles and goods on the newly constructed transport infrastructure, such as improved road safety, medium term maintenance planning and deployment of intelligent transport systems across the core network.
- The Bank will provide support for development of a new Transport Strategy of Montenegro.
- The Bank will leverage its regional presence and continue to promote activities of the regional Coordinated Auction Office in developing a regional power market, while including measures to integrate the energy market in the region in its power connections financing projects.

Priority 2: Improve connectivity and regional *Integration* by expanding cross-border transport and energy links.

	CHALLENGES	OBJECTIVES	ACTIVITIES	TRACKING INDICATORS
2.1	Critical regional transport cross-border infrastructure for a small–size economy remains insufficiently developed.	**Promote integration and sector reform through supporting the development of key regional transport infrastructure**	▪ Financing for projects and initiatives that strengthen connectivity of regional roads and rail lines (e.g. the Ionian-Adriatic route). ▪ Loans to support national road rehabilitation and upgrade. ▪ Debt financing of a new terminal building and manoeuvring area at Tivat airport. ▪ TCs to government authorities for appropriate investment prioritisation, enhancement of procurement capacity and road safety. ▪ Support enhancement of soft measures to facilitate the movement of vehicles and goods on the newly constructed transport infrastructure.	▪ Target infrastructure network connection (regional transport) extended as measured by net increase in throughput *(Baseline – N/A)* ▪ Institutional/regulatory/legal improvements aimed at facilitating movements of goods and vehicles. *(Quantitative, qualitative account - Baseline – N/A)*
2.2	Need for further integration of energy sector in the larger regional market.	**Strengthen regional energy market integration through cross-border power connections and gas pipelines**	▪ The Bank will support further development of the planned regional interconnections that form part of the Trans-Balkan Electricity Corridor. ▪ The Bank will continue to support preparation of the proposed 5 bcm Ionian Adriatic Pipeline (IAP) and depending on the project progress provide financing for development of the pipeline.	▪ Target infrastructure network connection (cross border energy) extended as measured by net increase in throughput *(Quantitative/qualitative account - Baseline – N/A)*
2.3	Difficulties in trading across borders remain, while investments across the region need to be encouraged.	**Support trade and investments flows with the extended region**	▪ Trade finance credit lines ▪ Advice for Small Businesses on boosting export potential of small companies.	▪ Trade finance business volume (loans and guarantees) of partner financial institutions)*(Baseline – established at projects approval)* ▪ Number of clients supported through Advice for Small Businesses with export increase (Baseline – 0)
	Impact indicator: Δ Montenegro Trading Across Borders Rank (Baseline 2016: 43). Source: Doing Business 2016 (World Bank Group)			

Priority 3: Continue to foster transition to a *Green* economy, including sustainable tourism

Transition Challenges

- **The state of general environmental infrastructure, and in particular municipal infrastructure, is often an obstacle for sustainable tourism development.** Montenegro is bound to pay special attention to the enhanced environmental sustainability which is essential for attracting and retaining sustainable tourism and other private investments.
    - Problems in the area of utility infrastructure include its worn-out condition, high costs of capital investments, inadequate planning and financial resources which, although limited, are spent for inadequate investments. Local self-government units and utility enterprises have an important role in this process given that they take part in the implementation of the most important infrastructure projects, related to waste water treatment, water-supply, municipal, sanitary and other waste.
    - The challenges are particularly large in the **water and wastewater sector**, including the need to (i) develop a water strategy and river basin plans; (ii) improve institutional coordination; (iii) reduce water loss; (iv) improve monitoring and enforcement of water use, discharge and tariffs. For instance, although metering is above 90 per cent, bill collection is on average only 72 per cent and water loss is high. Water fees are adequate but enforcement is questionable. Sewerage tariffs are combined with water supply tariffs. Effluent discharge fees are volumetric, but vary according to industry in order to proxy for pollution content. Monitoring is incomplete and the infrastructure for wastewater treatment is in its infancy.
    - Although industrial production is stagnant, **industrial waste** is constantly increasing and poses a threat to the environment as existing industrial waste disposal sites containing lead and other heavy metals pose risks to the public health of surrounding communities, in particular the surroundings of Skadar lake where the Aluminium Plant KAP is located. Some of the polluted sites are located nearby the country's most valuable natural resources, including national parks, tourist centres and UNESCO sites.
    - **Building standards**, including energy efficiency and sustainability remain a key challenge in the sustainable tourism sector.
    - The **impacts of climate change** affecting tourism development need to be accounted for. There is still limited climate proofing of tourism-related policies and development plans, as well as limited climate vulnerability assessment of the coastal and mountain areas that are primary tourism destinations.
- The Montenegrin economy has **high energy intensity**, measured as energy used per unit of GDP. This is mainly due to significant electricity consumption in the industrial sector (aluminium production accounting for a significant share of industrial energy use) but also to inefficient energy consumption among households and public buildings, which among other factors, is aided by low electricity prices. Despite comparatively low energy prices, household energy expenditures in Montenegro are estimated to amount to 15 per cent of average household income, the highest level in the WB region. Further improvements are needed in the **energy sector** in order to improve efficiency and resilience of the energy system and increase the share of renewables in the total energy mix. Reducing energy intensity and increasing

renewables energy production are essential for enabling sustainable growth and reducing public expenditures. The main challenges for the country's transition to a green economy include:

- **Progressing on the implementation of the legal framework for supporting energy efficiency projects**;
- **Strengthening the institutional capacity to support further renewable energy deployment**. Feed-in tariffs and secondary legislation to promote renewable energy were introduced during 2012, but their practical implementation remains challenging because of the limited administrative capacity in place. Exploitation of Montenegro's extensive small hydropower potential has been held up by permitting and planning issues although progress on adopting the necessary secondary legislation has been achieved. The current framework is also limiting the development of large scale solar power plans.
- **Public sector action on improving energy efficiency also serves to increase awareness of energy efficiency** among the local population and demonstrate the benefits of energy savings. Cost reflective tariffs are applied but environmental costs are not included in energy prices. The government adopted the Energy Development Strategy of the Republic of Montenegro by 2025 and the 3rd Energy Efficiency Action Plan for 2016-2018. However, concrete programs and implementation instruments to promote energy efficiency are yet to be established.

Operational Focus

- The Bank will selectively consider opportunities to support projects that promote resource efficiency and environmentally sustainable practices in tourism, including development of low-density, high-quality tourism sites. Investments in quality reconstruction of the existing hotel and marina assets will be considered.
- Subject to the government's capacity to provide sovereign guarantees, the Bank will seek to support municipal water, waste and materials efficiency investments, particularly in the tourist areas. The Bank will try to do this through working with the Regional Water Supply Company and local partner banks. The Bank's consultants will develop a plan for assessment and reorganization and new institutional setup of the water sector on Montenegro's Coast.
- Subject to the authorities' commitment, the Bank will assist the Ministry of Economy in updating support mechanisms other than feed-in tariffs when considering new investments in renewable energy projects – hydropower and wind and solar in particular – through direct lending or dedicated credit lines with local financial institutions. Execution of these projects will require implementation of best market practices and environmental and social standards, and will encourage Montenegro to align its renewable energy legislation with EU requirements.
- The Bank will support rehabilitation and improvement of assets in the energy sector with the aim to increase energy and resource efficiency and to address climate resilience of the existing generation capacities and reduce losses in the electricity distribution and transmission networks.
- The Bank will encourage investment to further strengthen and expand the grid combined with smart grid tools that should attract additional private investments in RES and stimulate additional cross-border trading of green energy.
- The Bank will support green economy investments in the private sector or when engaging with public sector companies as part of its direct lending operations as well

as lending via partner banks, while also providing access to advice to SMEs to support introduction of energy efficiency standards through Advice for Small Businesses.

- The Bank will explore opportunities to deploy financing products to support investments in buildings' energy efficiency. Residential sector will be addressed under the new Green Economy Financing Facility (GEFF) providing credit-lines to partner banks for on-lending to residential energy efficiency and renewable energy projects in the Western Balkans. At the same time the Bank will explore public and private channels for addressing energy efficiency in public buildings and infrastructure.
- The Bank will support resource efficiency projects in municipal district heating networks with a particular focus on the utilisation of biomass.

Policy Dialogue

- The Bank will continue providing support for the transposition of EU directives related to energy efficiency, particularly to unlock investments in the buildings sector.
- The Bank will continue supporting institutional capacity building further, implementation of investor-friendly laws and regulations and development of the national RES plan in line with EU RES Directives.
- The Bank will support authorities in Montenegro to update the support scheme for renewables so that it is in line with current EU practices – in particular, greater competition in determining and awarding support to projects and greater integration into electricity markets.
- The Bank will engage in regular dialogue with the authorities to ensure that its operations in the hospitality and tourism sector are sustainable, resource efficient, climate resilient, environmentally responsible and consistent with the country's long-term tourism strategy, leveraging EU IPA II funds for environment and climate action and transport (envisaging 80 per cent of the allocated funds in this sector to be climate change relevant).

Priority 3: Continue to foster transition to a *Green* economy, including sustainable tourism.

	CHALLENGES	OBJECTIVES	ACTIVITIES	TRACKING INDICATORS
3.1	Montenegro's energy and resource intensity remains high and there are significant challenges in the municipal infrastructure, the state of which is also often an obstacle for sustainable tourism development.	**Support implementation of the institutional framework, finance programmes and investments that promote energy and resource efficiency, with a particular focus on the tourism sector**	▪ Finance GET investments, directly or indirectly via financial intermediaries. ▪ Investments supporting municipal water, waste and materials efficiency, particularly in the tourist areas. ▪ Direct funding for investments in the tourism sector, primarily focused on modernisation of the existing assets and sustainable tourism. ▪ Policy dialogue with the authorities to ensure that the hospitality and tourism sector are sustainable, environmentally responsible and consistent with the country's long-term tourism strategy.	▪ CO_2 emissions reduction associated with Bank operations, in tCO_2e/yr (*Baseline – 0)* ▪ Number/volume of disbursed loans through partner financial institutions under energy/resource efficiency frameworks (e.g. GEFF) (*Baseline – Established at projects approval)*
3.2	Implementation of the improvements in legal framework for supporting sustainable energy projects with new generating capacities remains challenging due to limited administrative capacity.	**Diversify Montenegro's energy mix by increasing share of renewable resources, provided there is political will.**	▪ Financing RES investments through Direct Financing Facility (DFF) or dedicated credit lines with local financial institutions and support strengthening and expansion of the grid, combined with smart grid tools (especially in the touristic areas) to accommodate additional RES investments, while continuing to support, on a selective basis, implementation and update of the policy and regulatory framework for renewable energy.	▪ Installed renewable energy capacity with Bank support (in MW) (*Baseline – 0)*
	Impact indicator: Δ Montenegro Energy Intensity *(Baseline: 0.11 TPES/GDP PPP (toe/thousand 2010 USD)*. Source: IEA 2014			

3.3 Potential Risks to Country Strategy implementation

The proposed strategy for Montenegro is ambitious as it matches the Government of Montenegro's own very ambitious reform programme with the overall risk to the Country Strategy implementation rated as high. The prospects of an incremental operational response in infrastructure, private sector lending and privatisations are dependent on reforms and progress in the project implementation capacity of the administration, the government's privatisation programme of remaining SOEs, utilisation of the fiscal headroom and the resolution of the NPL problem.

The Bank's ability to deliver on its strategy in Montenegro will be influenced by a number of factors outside the Bank's control, including availability of grant funding and donor resources. Where feasible, the Bank will work to address and mitigate these risks through proactive and sustained engagement with clients, the authorities and other stakeholders.

- **The limited sovereign fiscal headroom linked to the country's ability to return to a sustainable macro-fiscal path is the main risk to delivery under the proposed strategy**. Public debt is high at 65 per cent of the estimated 2016 GDP, which is above the median for similarly rated countries. The proposed priorities are likely to increase exposure to the sovereign, particularly the focus on cross-border transport, for which projects often have sovereign guarantees. Furthermore, fiscal prudence would require difficult political decisions, including reversal of recent policy measures. Should this risk materialise, the results under the 2nd and partly 3rd strategic priority will be reassessed at the time of the Country Strategy Delivery Reviews and the programme would be scaled down and readjusted through reallocation of some resources towards investment operations supporting the country in strengthening its resilience to shocks and advance towards a private-sector driven, inclusive growth model under Priority 1. It has been stipulated with the European Commission that the Government of Montenegro will issue sovereign guarantees only for infrastructure projects, as well as for loan facilities identified to contribute to economic development of the country, such as projects where the assessment is that there is no risk for the guarantees to be called.

- **Political and governance risks are substantial**. The government often changes priorities for the Bank's engagement. The Bank's engagement will remain flexible and with regards to governance, the ongoing EU accession agenda features it prominently under IPA II with incentives embedded in the accession process, notwithstanding changes at the political level.

- **Excessive number of banks for a very small economy, depressed credit demand, significant NPLs and low profitability hamper growth prospects for the banking system**. Risks are mainly related to financial stability as growing risks in domestic banks and weaknesses in bank regulation and oversight pose fiscal and financial stability risks that could potentially reverse the economic recovery. Also, the bulk of NPLs are backed by real estate collateral, which, given the depressed state of the real estate market combined with the inability or unwillingness of some banks to absorb losses, prevents a speedy and successful resolution. Also, financial sector regulation is disjointed, a macroprudential framework is missing, and there are significant gaps in the application of prudential regulations. Euroisation of the economy limits the central bank's ability to act as a lender of last resort.

- **The universe of bankable projects in Montenegro is small.** The country is over-banked and high leverage remains an enduring legacy of the 2008 banking crisis. Growth in the size of the tourism industry could increase macroeconomic volatility, with the economy becoming more sensitive to the health of neighbouring economies.

- **Insufficiently developed infrastructure** leaves Montenegro relatively isolated from its neighbours. While this provides some degree of protection from new entrants, it constraints successful corporates from expanding beyond the borders. The Bank will promote regional integration and connectivity as key priorities in the new strategy period.

- **Institutional capacity risk is substantial**, reflecting uneven implementation capacity which indicates that project preparation and implementation could take longer than expected. The Bank will continue to offer hands-on preparation and implementation support.

- **Environmental and social risks are substantial**. The country is vulnerable to natural disasters and climate change-related risks. Should a serious a serious event occurs during the strategy implementation, it could derail the achievement of intended development results particularly under Priority 3 where focus is on the development of sustainable tourism. These risks will be mitigated by supporting more effective industrial waste disposal, addressing climate change challenges as part of integrated water resources management and climate change adaptation in national planning, with a view to support investments that enhance and preserve the country's national resources.

3.4 Environmental and Social Implications of Bank Proposed Activities

Montenegro's environmental and social legislative framework reflects the main elements of the EU's approach to project appraisal and management. It includes laws on Strategic Environmental Assessment, Environmental Impact Assessment, Integrated Pollution Prevention and Control and requirements for information disclosure and public consultation. This sets out a sound framework for structuring the Bank's projects to comply with its Environmental and Social Policy and Performance Requirements. The Bank will work with clients to assess each project's environmental and social risks and opportunities, and will assist them in implementing the Performance Requirements, including good international practice and relevant EU standards. During the construction and operating phases EBRD will monitor projects against agreed commitments and standards, and the nature and frequency of monitoring will be determined by the environmental and social risks associated with the investment.

Much of Montenegro's economic development will depend on its ability to develop its natural and cultural resources in an environmentally and socially sustainable way. The country has several internationally recognised biodiversity sites including the Bay of Kotor, Lake Skadar and the Lovcen National Park. There are also three UNESCO World Heritage sites in the country, including Durmitor, Old town of Kotor and the Tara River Canyon. Projects in the tourism sector should be designed and implemented in a way that protects, and where possible enhances, these natural and cultural resources. EBRD will support initiatives to promote sustainable tourism. Infrastructure that supports the development of the tourism sector, including transport, roads and wastewater treatment should also be designed and constructed to meet best practice environmental and social standards, including worker and public health and safety.

Investments in the energy efficiency and renewable energy sectors have the potential to significantly reduce Montenegro's carbon intensity. For renewable energy projects, and particularly hydropower plants and wind turbines, siting decisions should take account of biodiversity and habitat considerations, including avoiding or minimising impacts on existing and proposed protected areas and bird migratory routes. When assessing renewable energy projects, the Bank will place specific emphasis on ensuring that any potential direct, indirect and cumulative impact on the environment and biodiversity is appropriately assessed and mitigated. This will also apply to electricity transmission projects. Additionally for transmission projects, EBRD environmental due diligence will include an assessment of the carbon intensity of the generating source. Finally, renewable energy and electricity transmission projects often involve land acquisition and where this is the case, EBRD requirements for resettlement and livelihood restoration will apply. Montenegro is a member of the ILO and has ratified 68 ILO conventions. However, there are a number of gaps around forced and child labour, discrimination and work accommodation.

3.5 EBRD's co-operation with IFIs and international organisations

Donor and IFIs coordination in Montenegro is under the guidance of the Ministry of Foreign Affairs, with the EU Delegation also organising regular donor meetings and EBRD being the most active IFI in the country. Overall development partners' coordination has traditionally been led, in an informal way, by the Ministry of Foreign Affairs. The Ministry is currently in the process of defining the basis for the establishment of an institutional and strategic framework for the management of humanitarian and development aid, based on existing best practices and available knowledge.

Due to a small size of the international community, the absence of a formal setting has not been a major impediment. Coordination among development partners has been mostly informal, yet regular; at sector or sub-sector level the interaction has mainly been bilateral, i.e. between agencies collaborating in their respective sectors of engagement. There is, however, a strong interest in stepping up multilateral coordination, not least for presenting a joint position to the Government on strategic policy matters. The World Bank is aiming to initiate monthly updates among the partners and consult the Ministry of Finance and the Ministry of Foreign Affairs on ways to help facilitate joint coordination sessions with the Government.

In this spirit, the Bank will continue the following:

- The Bank will continue to seek the opportunities for cooperation with **EIB** in co-financing reconstruction of the main roads and railways in Montenegro. In relation to the EU funded programmes, the Bank will provide further support to projects that are delegated through **WBIF**, with a particular focus on the energy and transport sector. In the previous strategy period, the EBRD supported several feasibility studies through WBIF with the aim to promote regional interconnection and development of infrastructure such as Montenegro Gas Development Master Plan and expansion of the country and regional power transmission network. In the area of SME development and finance, activities will be coordinated with the efforts of the WB Enterprise Development and Innovation Facility (EDIF).

- The EBRD will continue to complement efforts of the **World Bank** and **IFC** with joint policy dialogue initiatives that promote stability of the financial sector. The World Bank approved its new country framework for Montenegro covering the period 2016-2020 and is currently working on energy efficiency in public buildings in Montenegro, industrial waste management and clean-up, support of higher education (HERIC), and agriculture institutional development and strengthening (MIDAS). The World Bank proposed Country Partnership Framework for 2016-2020 will be focused on: 1) Enhancing resilience to shocks, with the objectives on i) improving efficiency of public finances, ii) increasing oversight and efficiency of the financial sector and iii) enhancing environmental sustainability and 2) enabling inclusive access to economic opportunities and jobs, with the objectives on i) increasing alignment between skills and labour market demand, ii) strengthening incentives for work, iii) enhancing private investments and job creation in key sectors.

- Kreditanstalt für Wiederaufbau **(KfW)** is present in the country and they are mainly engaged in energy efficiency projects and water and waste water treatment. The Bank will continue cooperation with KfW on implementation of the existing flagship projects in the energy sector such as development of the Lastva-Pljevlja high-voltage transmission line, Krnovo windfarm project and additional integration of the regional electricity markets through CAO. Over the strategy period, there may be potential for co-financing with KfW in the energy and wastewater treatment projects.

- The EBRD will continue its successful joint work with the Food and Agriculture Organization of the United Nations **(FAO)** in the agribusiness sector in Montenegro and the Western Balkans. The partnership with FAO is supporting EBRD efforts in upgrading food safety and quality standards and improving linkages along the agribusiness value chain, through bringing together producers, processors, retailers, associations and the government. Joint efforts going forward will continue supporting quality-oriented production, sufficient supply and better organisation of producers – including through public-private dialogue and technical cooperation – to bring the Montenegrin agribusiness sector in line with EU requirements and support access to new markets, including for SMEs.

ANNEX 1 – POLITICAL ASSESSMENT

Montenegro is committed to and applying the principles of multiparty democracy, pluralism and market economics in accordance with the conditions specified in Article 1 of the Agreement Establishing the Bank.

The legislative framework for a pluralistic parliamentary democracy is in place. The separation of powers and checks and balances in the political system, guarantees for fundamental rights, and the protection of minorities and for a meaningful role of civil society, are largely in line with international and European standards, as assessed by the Council of Europe. Elections are generally conducted in a manner deemed by the OSCE and the Council of Europe to be free and in line with international standards.

In the period since the adoption of the previous Country Strategy, Montenegro has made further progress in democratic reform, to a great extent geared towards integration into the EU. Progress in particular has been made in the areas considered to be the key weaknesses in the Western Balkans countries, including the rule of law, especially as regards improving the legislative framework. However, Montenegro still needs to build a solid track record of tangible results in the fight against corruption and organised crime.

The progress in democratic reforms achieved by the Montenegrin authorities has been reflected in its accelerated approximation with the EU. Since the adoption of the previous Strategy, Montenegro has opened a number of EU accession negotiations chapters, including critical chapters related to the rule of law. According to the conclusions of the latest Progress Report by the European Commission (EC) on Montenegro, published on 9 November 2016, Montenegro is "moderately prepared" in many *acquis* areas and overall for taking on the obligations of EU membership, although strengthening of the administrative capacity for ensuring the application of the *acquis* remains a challenge.[10]

Free Elections and Representative Government

Free, fair and competitive elections

The post-independence Constitution established a unicameral parliament of 81 deputies, who are elected for four-year terms in a single nationwide constituency under a proportional, closed-list system. Four general elections have been conducted since the proclamation of independence in 2006. Elections are generally highly competitive, starting with the inclusive and transparent candidate registration that offers a diverse choice to the electorate. The candidates are able to campaign freely. The Central Election Commission is an independent permanent body, appointed by the parliament, and operates in a transparent manner. The Electoral Code provides for both domestic and international election observation at all levels of election administration.

The existing legal framework, which benefited from a series of reforms, enables an adequate basis for the conduct of democratic elections. The Constitution and the Law on the Election of Councillors and Representatives (electoral law) are the primary pieces of legislation that regulate elections. The initial electoral law from 1998 was amended several times, based on

[10] European Commission, communication from the Commission to the European Parliament and the Council, Montenegro 2015 Progress Report, 9 November 2016.

the recommendations by the OSCE Office for Democratic Institutions and Human Rights (OSCE/ODIHR) and the Council of Europe, designed, among other things, to harmonise the electoral law with the new Constitution. The changes in the electoral legislation, adopted in 2014, included those introducing new rules on the electronic identification of voters and the financing of political parties and election campaigns.

Considerable efforts were made to further improve electoral framework ahead of the last general elections, which took place in October 2016, in order to ensure level playing field in the elections and strengthen public trust in the process, since both were concern in the past. The new legislation addressed most of the OSCE/ODIHR and Council of Europe recommendations, although not all, which led to the OSCE/ODIHR's conclusion that the electoral legislation, while significantly improved, remains "neither coherent nor comprehensive".[11]

The last general elections, which took place on 16 October 2016, were assessed by the OSCE/ODIHR as having been conducted in a competitive environment, with fundamental freedoms generally respected. The Election Day proceeded orderly, with only a few isolated cases of tension. Authorities announced the detention of 20 persons suspected of planning terrorist attacks on election day. Investigation into this incident is ongoing. The opposition parties and civil society representatives maintained that the ruling party enjoyed such institutional advantage after 25 years in power that even the innovative establishment of a temporary Government of Electoral Trust, which included representatives of the opposition, ahead of the elections, did not change the situation. Nevertheless, the preliminary report of the international Election Observation Mission did not contain accusations, present in OSCE/ODIHR reports on some previous elections in Montenegro, of "blurring of the line between state and the ruling party" and abuse of public funds for political purposes. The final report by the OSCE/ODIHR, published in January 2017, noted that pervasiveness of allegations of a "correlation between employment in public service and affiliation with the ruling party", irrespective of the veracity, "likely diminished public confidence in the fairness of the overall electoral process".[12]

Separation of powers and effective checks and balances

The constitutional and legislative framework for a parliamentary democracy – underpinned by the separation of powers and checks and balances in the political system, an independent legislature and well-established procedures of legislative oversight in prescribed domains of decision-making – is in place in Montenegro and largely in line with international and European standards, as assessed by the Council of Europe. The scope of powers of the legislature to hold the government to account and to exercise parliamentary oversight is largely in line with international standards. All public bodies respect the recommendations by the Ombudsman Office.

Overall the functioning of the parliament is satisfactory and further progress has been made in its legislative and oversight role since the adoption of the previous Strategy. In 2014, the parliament adopted its Code of Ethics, which establishes rules of conduct and promotes transparency. Overall, the Montenegrin parliament is displaying a high level of transparency.

[11] OSCE/ODIHR, PACE: International Election Observation mission – Montenegro, parliamentary elections, 16 October 2016 – Statement of preliminary findings and conclusions, 17 October 2016.
[12] OSCE/ODIHR: Election Observation mission – Montenegro, parliamentary elections, 16 October 2016 – Final Report, 25 January 2017.

At the request of CSOs it started publishing the voting record of individual MPs on its website.

The government's rules of procedure require the government to submit its work programme to the parliament as well as to conduct mandatory impact assessments for draft legislation. Measures to increase the accountability of the government were also undertaken at the local level, through the new law on the territorial organisation of Montenegro and amendments to the law on local self-government.

Effective power to govern of elected officials

Montenegro has established institutional, legal, and financial arrangements for elected officials to exercise effective power to govern, and they are not constrained by any non-democratic veto powers or other undue influences. As in many other transition countries, there has long been a close relationship between business and political elites. However, this does not compromise the powers of elected officials to govern the country.

Civil Society, Media and Participation

Scale and independence of civil society

There is a satisfactory legal framework for civil society organisations. In the past, the number of SCOs exceeded 5,000. Since the adoption of the Law on Non-Governmental Organisations, compelling CSOs to amend their statutes in line with European standards and to re-register accordingly, the number of registered CSOs has consequently decreased.

The new Council for the development of non-governmental organisations has been operational since 2014. Its main tasks include monitoring the government's strategy for developing CSOs. Civil society representatives have been especially actively involved in the work on the EU-related agenda, particularly as regards the implementation of the action plan for the rule of law chapters of the EU accession negotiations.

The right to form trade unions is enshrined in law and labour and trade union rights are generally respected in practice. However, the capacity of the Social Council remains limited and certain amendments are required to the Labour Law to bring it in line with the EU *acquis*.

Independence and pluralism of media operating without censorship

The legal framework for pluralistic media that operate without censorship is largely in place and in line with international standards. The media environment is highly politicised and the journalists, although jointly represented in the media trade union, are divided. There are currently several public television broadcasters (one of them, the nationwide Radio and Television Montenegro, operates three channels) and a number of private television broadcasters. There is also an active printed media sector, although the rates of circulation are limited. In the last few years, several outlets have been closed due to poor financial performance, and many journalists lost their jobs.

Although the transparency of media ownership has improved in recent years with the requirement that all companies operating in Montenegro register ownership with the commercial court, civil society representatives have expressed concerns regarding lack of transparency and discrimination in advertising. They are also concerned about frequent smear campaigns by tabloids targeting prominent civil society activists.

There have been reports of intimidation and violence against journalists over recent years. An ad-hoc commission was set up by the government in 2013 in order to monitor investigations of the cases of attacks against journalists. In 2014, it issued a number of recommendations, not all of which have been implemented.

Recent years witnessed explosive growth in internet usage and the percentage of the population with internet access grew from 28.9 per cent in 2006 to 61 per cent in 2014. Social media is playing an increasingly important role and about 51.4 per cent of Montenegrins are active Facebook users.[13] During the latest elections, SCOs accused authorities of suspending the internet services of Viber and WhatsApp on election day.

Multiple channels of civic and political participation

Multiple channels of civic and political participation are in place. The parliament, in particular, has taken a number of measures in the last years to improve interaction with civil society and the general public. There are certain rules and procedures regarding public consultations, but they are not always enforced.

Freedom to form political parties and existence of organised opposition

The freedom to form political parties is both guaranteed by the Constitution and implemented in practice, highlighted by the existence of a significant opposition able to campaign freely and oppose government initiatives. 17 parties participated in the last elections, and nine political parties are currently represented in the parliament.

Rule of Law and Access to Justice

Supremacy of the law

Necessary legislative and institutional safeguards for the supremacy of the law are in place. The right to a fair trial and freedom from arbitrary arrest and detention are enshrined in the Montenegrin Constitution and criminal code. Montenegro continued to make progress in comprehensive reforms of the judiciary and in aligning it with European standards. In accordance with the new approach by the EC to the accession negotiations, Montenegro's accession negotiations have started with the most difficult chapters – related to the rule of law – in order to provide sufficient time for the country to address all shortcomings.

Independence of the judiciary

The independence and impartiality of the judiciary is guaranteed by the Constitution and key safeguards are in place to ensure its impartiality. This includes the role of the Judicial and Prosecutorial Councils, whose legal framework has recently been amended and is broadly in line with European standards. The constitutional amendments, adopted in 2013, further strengthened independence of the judiciary by reducing political influence on the appointment

[13] Internet World Stats: http://www.internetworldstats.com/europa2.htm#md and World Bank: http://data.worldbank.org/indicator/IT.NET.USER.P2?page=1

of high-level judicial officials. The latest progress reports on Montenegro by the EC noted good progress in strengthening the legislative framework to increase the independence and professionalism of the judiciary.

Government and citizens equally subject to the law

The track record in preventing and combating abuse of authority has improved. A number of verdicts have been issued against individuals for abuse of office. Amendments to the Law on Free Access to Public Information were enacted by the parliament in 2012. Recently adopted legislation on conflicts of interest and public procurement started to be implemented. The accountability of the judiciary has also increased, due to a number of measures implemented in the recent years, including provisions for public accessibility of all decisions by the Administrative Court, the Appellate Court and other courts, as well as the appointment of Commissions for monitoring compliance with the Codes of Ethics of judges and prosecutors. In 2015, new systems of disciplinary accountability were introduced for judges and prosecutors.

Effective policies and institutions to prevent corruption

According to the 2016 Transparency International Corruption Perception Index (CPI), Montenegro had a score of 45, which places it 64th out of 176 countries. This is a slight improvement from previous years, and the best position among Western Balkans countries.[14]

According to the EC, over the past years, Montenegro has achieved progress in strengthening the institutional and legislative framework for the fight against corruption. Montenegro is a party to the main international instruments against corruption, including the UN convention against corruption. In 2014, the parliament adopted a compressive package of modern legislation, including the bill paving the way for an independent Anti-Corruption Agency, which started its work in 2016. The ongoing negotiations on chapter 23 of the EU accession negotiations include the work on the special action plan that outlines further necessary reforms on the prevention and combating corruption. Its implementation is being monitored by a special inter-institutional working group, which includes representative of the civil society.

An assessment on Montenegro's compliance with international anti-corruption standards was recently made by the Council of Europe's Group of States against Corruption (GRECO). In its January 2015 report, GRECO congratulated Montenegro for its sustained efforts to meet the recommendations of the Third Evaluation Report, having implemented satisfactorily or dealt with in a satisfactory manner twelve of the fourteen recommendations.[15] According to the Evaluation Report of the Fourth Evaluation Round, Montenegro has taken constructive steps in recent years upgrading its legislation to meet the EU accession and Council of Europe requirements; however corruption remains an important concern. The next GRECO evaluation round is due in October 2017.

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[14] Transparency International, Corruption Perceptions Index (2016).

[15] Council of Europe, Group of States against Corruption (GRECO), Third Evaluation Round, Second Compliance Report on Montenegro, 19 January 2015, p. 7.

Civil and Political Rights

Freedom of speech, information, religion, conscience, movement, association, assembly and private property

The Constitution and relevant laws prohibit discrimination on grounds of sex, race, language, religion, national or social origin, property or social status. The Constitution guarantees the basic freedoms and rights of citizens recognised in international law, including the freedom of speech, information, religion and conscience, movement, association and assembly, and private property.

Montenegro is a signatory to major international human rights instruments. Montenegro ratified the Convention on Reduction of Statelessness in 2013. By the end of 2015 the total number of pending applications submitted to the European Court of Human Rights (ECHR) from Montenegro stood at 180.[16]

The latest assessment of the track record of Montenegro in the area of human rights in the framework of the United Nations Universal Periodic Review (UPR) was conducted in 2013. The top three recommendations related to rights of the child (27 per cent of recommendations); minorities (15 per cent); and women's rights (13 per cent). Montenegro accepted 96 per cent of a total of 127 recommendations made through the review process.[17]

According to the report of the Working Group on the UPR, Montenegro "achieved significant progress since its previous report in 2008, inter alia, in the following areas: independence of the judiciary; decriminalization of insult and defamation; fight against corruption and organized crime; improvement of the prison system; legal reforms related to anti-discrimination, domestic violence, trafficking in human beings, strengthening of capacities of the Ombudsman; setting up the Council for anti-discrimination, Council for persons with disabilities and Council for rights of the child; advancement of tolerance towards differences, in particular in relation to the LGBT population; social inclusion of the Roma and Egyptian community."[18]

As regards property rights, progress has been made in returning property confiscated under the communist regime. However, the process of restitution is being hampered by the lack of administrative capacity leaving a large number of restitution claims unresolved, while displaced persons living in the country still face discrimination over access to land.[19]

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[16] European Court of Human Rights, Press Country Profile, Montenegro: http://www.echr.coe.int/Documents/CP_Montenegro_ENG.pdf
[17] United Nations, Universal Periodic Review (UPR), Montenegro, and UPR Info Statistics http://www.upr-info.org/database/statistics/index_sur.php?fk_sur=116&cycle=2
[18] United Nations General Assembly, Report of the Working Group on the Universal Periodic Review, Montenegro, 21 March 2013, p. 3.
[19] European Commission, communication from the Commission to the European Parliament and the Council, Montenegro 2015 Progress Report, 10 November 2015, p. 59.

Political inclusiveness for women, ethnic and other minorities

The legislative framework for the protection of ethnic minorities is broadly in place, and the Law on Minority Rights is being implemented. The country has a complex ethnic composition. According to the 2011 census, only 45 per cent of the population identify themselves as Montenegrins. Ethnic Serbs represent 28.73 per cent of the population; Bosniaks 8.65 per cent; Albanians 4.91 per cent. Roma represent 1 per cent of the population, and there are also Egyptians and Ashkali (the members of these three communities are often grouped together as RAE, because they face similar problems). Inter-ethnic relations in the country are generally good, and often compare positively with the situation among the regional neighbours. RAE remains the most vulnerable minority and discrimination against it persists in access to employment, social, and healthcare.

The key legislative elements for promoting and enforcing gender equality are in place, although the implementation is often hindered by the scarcity of resources. Recent amendments to the electoral law introduced a gender quota in candidate lists, which led to an increase in the number of women among candidates contesting elections (32 per cent of candidates in the last general elections were women, as compared to 15 per cent during the first post-independence elections), as well in the share of women among MPs (25 per cent in the current parliament). In everyday life, besides under-representation in the labour market and pay gaps, the main issue of concern is domestic violence. The government has adopted a special strategy for the implementation of the law on protection from family violence.

Freedom from harassment, intimidation and torture

Constitutional guarantees against harassment, intimidation, and torture are in place and are largely upheld in practice. A delegation of the Council of Europe's Committee for the Prevention of Torture and Inhuman or Degrading Treatment or Punishment (CPT) last visited Montenegro in 2013. In the report, published in 2014, the CPT states that significant legislative changes, since its previous visit in 2008, had been made, however it recommended improving the conditions of detention, as well as combating the overcrowding in prisons.[20]

[20] Council of Europe, European Committee for the Prevention of Torture and Inhuman Degrading Treatment or Punishment, Report to the Government of Montenegro, 22 May 2014.

ANNEX 2 – SELECTED ECONOMIC INDICATORS

*Montenegro uses Euro as its legal tender

	2010	2011	2012	2013	2014	2015 *estimate*
Output and expenditure			*(Percentage change in real terms)*			
GDP	2.5	3.2	-2.7	3.5	1.8	3.4
Private consumption	n/a	0.5	-3.9	1.6	2.9	0.7
Public consumption	n/a	-0.3	3.0	1.3	1.4	2.9
Gross fixed capital formation	n/a	-7.2	-2.4	10.7	-2.5	10.5
Exports of goods and services	n/a	14.6	-0.3	-1.3	-0.7	10.2
Imports of goods and services	n/a	0.3	0.6	-3.1	1.6	7.9
Labour Market			*(Percentage change)*			
Gross average monthly earnings (annual average)	11.0	1.0	0.8	-0.2	-0.3	0.3
Real LCU wage growth	10.3	-2.1	-2.8	-2.4	-1.0	-1.3
			(In per cent of labour force)			
Unemployment rate	19.7	19.7	20.0	19.5	18.0	17.5
Prices			*(Percentage change)*			
Consumer prices (annual average)	0.7	3.1	3.6	2.2	-0.7	1.6
Consumer prices (end-year)	0.7	2.8	5.1	0.3	-0.3	1.4
Fiscal Indicators			*(In per cent of GDP)*			
General government balance	-4.9	-6.7	-5.8	-6.3	-2.6	-7.4
General government revenues	41.8	38.5	39.9	41.3	43.5	40.6
General government expenditure	46.6	45.3	45.7	47.6	46.1	48.0
General government debt	40.7	45.6	53.4	55.2	59.9	66.5
Monetary and financial sectors			*(Percentage change)*			
Broad money (M2, end-year) *	n/a	n/a	n/a	n/a	n/a	n/a
Credit to the private sector (end-year)	-7.7	-13.2	-3.5	5.0	-1.5	2.9
			(In per cent of total loans)			
Non-performing loans ratio (end-year)	21.0	15.5	17.6	18.4	16.8	12.5
Interest and exchange rates			*(In per cent per annum)*			
Policy rate *	n/a	n/a	n/a	n/a	n/a	n/a
Deposit rate	3.7	3.1	3.3	2.9	2.1	1.5
Lending rate	9.5	9.7	9.6	9.4	9.4	8.9
			(EUR per US dollar)			
Exchange rate (end-year)	0.75	0.77	0.76	0.73	0.82	0.92
Exchange rate (annual average)	0.76	0.72	0.78	0.75	0.75	0.90
External sector			*(In per cent of GDP)*			
Current account	-22.7	-17.6	-18.5	-14.5	-15.2	-13.3
Balance of goods and services	-25.6	-22.0	-24.5	-20.1	-19.8	-17.9
Trade balance of goods	-40.5	-40.0	-43.7	-39.5	-39.8	-40.2
Merchandise exports	11.4	14.6	12.3	11.8	10.3	9.0
Merchandise imports	-52.0	-54.6	-56.0	-51.3	-50.1	-49.2
Trade balance of services	14.9	18.0	19.2	19.4	20.0	22.3
Foreign direct investment, net	17.7	11.9	14.5	9.6	10.2	15.7
External debt stock	141.6	145.0	155.9	151.5	154.8	152.1
Public external debt	29.1	32.6	40.7	40.2	45.2	57.3
Private external debt	112.5	112.4	115.2	111.3	109.6	94.8
Gross international reserves *	n/a	n/a	n/a	n/a	n/a	n/a
Memorandum items			*(Denominations as indicated)*			
Population (end-year, million)	0.6	0.6	0.6	0.6	0.6	0.6
GDP (in billions of EUR)	3.1	3.3	3.2	3.4	3.5	3.6
GDP per capita (in EUR)	5,045	5,265	5,126	5,413	5,561	5,848
Share of industry in GVA (in per cent)	14.6	12.1	12.2	14.3	13.5	n/a
Share of agriculture in GVA (in per cent)	9.2	9.6	8.9	9.8	10.0	n/a

ANNEX 3 – ASSESSMENT OF TRANSITION CHALLENGES

Market structure	Market institutions	Key challenges
CORPORATES		
Agribusiness		
Medium	Medium	• Improving land registry and cadastre to clarify land ownership and enhance tradability of land to allow for consolidation and collateralisation; • Improving the business environment to promote investments in agri-processing sectors to enhance their efficiency and competitiveness.
Manufacturing and Services		
Medium	Medium	• Further improving the business environment by reducing the barriers to enterprise entry, exit and growth, in order to facilitate the development of SMEs; • Enhancing business practices, transparency and corporate governance of local enterprises.
Real estate		
Medium	Medium	• Streamlining the real estate related bureaucracy, such as shortening the time to obtain a construction permit; • Further improving building standards, including energy efficiency and sustainability; • Increasing supply of modern commercial property, including higher quality tourism infrastructure.
ICT		
Small	Medium	• Further increasing competition in the fixed line segment; • Further developing the modern telecommunications infrastructure (broadband internet); • Further modernising the regulatory framework (aligning it with the EU 2009 regulatory framework).
ENERGY		
Natural Resources		
Small	Small	• Improving the legal framework for extractive industries; • Developing secondary legislation and setting up the necessary institutions to enforce the country's new energy regulation; • Enchancing the quality of transport infrastructure, the diversification of the value chain and the application of EHS&S standards in the mining sector; • Supporting the development of the regional and domestic gas market.
Power		
Large	Medium	• Completing the unbundling of the former vertically integrated undertaking; • Removing cross subsidies in regulated tariffs; • Improving effective independent regulation; • Modernisation of the transmission and distribution grid.

INFRASTRUCTURE		
Water and wastewater		
Large	Large	• Full corporatisation of water utilities; • Effective tariff reform based on transparent methodology and regulation; • Improved contractual arrangements in the water sector.
Urban Transport		
Small	Large	• Full corporatisation of urban transport companies; • Effective ticketing reforms based on transparent methodology and regulation; • Improved contractual arrangements for private and public operators in the urban transport sector.
Roads		
Medium	Large	• Introduction of competition in road maintenance; • Development of performance based maintenance contracts; • Development of PPP projects in line with international best practice.
Railways		
Medium	Medium	• Opening the freight segment to more competition; • Commercialisation of passenger business and establishing sustainable financial conditions; • Development of ancillary business and creation of new business opportunities; • Commercialisation of the infrastructure business and improvements in contractual arrangements.
FINANCIAL INSTITUTIONS		
Banking sector		
Medium	Medium	• Increasing bancarisation; • Improving bank's governance and risk management.
Insurance and other financial services		
Medium	Medium	• Increasing competition in the insurance market; • Further improving insurance legislation, with an aim to bring it to IAIS standards, and supervision; • Increasing insurance penetration.
Private equity		
Large	Large	• Improve corporate governance, transparency and business practices; • Develop a local institutional investor base.
Capital markets		
Large	Medium	• Further developing the money market; • Deepening the government bond markets; • Further developing the equity and debt market through regional partnership;

SME development		
Overall: Medium Subcomponents: - Non-bank Financing: Large - Legal Framework: Medium - Bank Financing: Medium - Business Standards and Skills: Medium - Business Environment: Medium		• Improve access to bank financing and increase ease of use of other sources of finance (e.g., leasing, factoring), including through legal reform; • Expand the accessibility and coverage of the credit information system; • Improve SMEs' financial management and business planning skills to increase their ability to present bankable projects.
SUSTAINABLE RESOURCE INITIATIVE		
Water efficiency		
Medium	Large	• Develop a water strategy and river basin plans; • Improve institutional coordination; • Reduce water loss; • Improve monitoring and enforcement of water use, discharge and tariffs.
Materials efficiency		
Medium	Medium	• Close dumpsites in favour of sanitary landfills; • Increase landfilling fees and enforcement; • Fully establish EPR schemes; • Adopt draft strategies and improve institutional capacities and coordination.
Sustainable energy		
Large	Medium	• Strengthen the institutional capacity for supporting sustainable energy; • Progress on the implementation of the legal framework for supporting sustainable energy; • Strengthen policy framework and institutional capacity for implementation of climate change initiatives.

ECONOMIC INCLUSION GAP RATINGS

ECONOMIC INCLUSION		
Inclusion gap dimension	**Inclusion gap**	**Key challenges**
Regions		
Institutions	Medium	▪ Addressing corruption in administrative, health and education systems at local municipal level in order to improve governance and satisfaction with locally provided public services.
Access to Services and Education	Medium	▪ Improving regional access to social infrastructure (such as local healthcare and education) in order to decrease regional inequalities in access to services.
Labour Markets	Large	▪ Improving regional integration and labour mobility through improved access to local jobs and training in sectors other than agriculture; ▪ Enhancing the engagement with local educational providers and facilitating a dialogue between public and private sector stakeholders to improve local skills matching.
Youth		
Youth Employment	Large	▪ Establishing work based learning opportunities (i.e. internships, apprenticeships, trainee programmes) through collaboration between the private sector and education providers to improve vocational education and technical training outcomes in line with employer requirements, with a particular focus on labour intensive sectors (including hospitality and tourism); ▪ Introducing skills standards and verification mechanisms that reflect employer requirements.
Quality of Education	Medium	▪ Improving teaching quality, especially in vocational education in order to respond the learning needs of the students as well as requirements of the employers.
Financial Inclusion	Medium	▪ Improving access to finance for young people and the availability of financial and business advisory services targeted at young entrepreneurs.

Gender		
Health services	Medium	▪ Supporting better access to quality health services for women (particularly to improve contraceptive prevalence).
Labour Policy	Medium	▪ Easing legal restrictions on job types for women in order to expand the opportunities in the labour market for women; ▪ Equalizing retirement age for men and women in order to grant women equal opportunities for promotion and training.
Labour Practices	Large	▪ Improving policies and practices in relation to equal pay to reduce gender pay gap and encourage women's participation to the labour market; ▪ Ensuring compliance with ILO Discrimination and Equal Remuneration Conventions and enforcing the provisions of these conventions in order in order to remove barriers in front of women's economic participation.
Access to Finance	Medium	▪ Building the capacity of local banks to develop credit lines aimed at women-led SMEs, combining access to finance, training and business advisory services.

The EBRD Economic Inclusion gaps rate the institutions, markets and education systems across all EBRD's countries of operation in terms of their capacity to extend economic opportunity to individuals regardless of their gender, age or place of birth. These gaps measure *differences* in opportunities – between 15 to 24-year-olds and older workers, and between women and men – rather than opportunity *levels*. Gaps are reported in this Country Strategy where there exists an Inclusion Gap above Small. These gaps are consistent with the EBRD 2016 Inclusion Gap update.

ANNEX 4 – LEGAL TRANSITION

Introduction

This annex offers critical analysis on selected legal topics relevant to the Bank's investment strategy in Montenegro during the forthcoming period. It is based on the assessments of commercial laws conducted by EBRD Legal Transition Programme. For ease of reference, the analysis is presented along the main strategic orientations defined in this country strategy, in particular the actions proposed under 'Policy dialogue and TC'.

Priority 1: Enhance competitiveness of the private sector, by developing agribusiness value chains and backward linkages in the tourism sector.

Access to Finance

The Montenegro Law on Property Rights provides detailed, comprehensive and well developed framework for creating mortgage over immovable property. The law allows securing of conditional, future and revolving loans as long as the maximum amount of debt is registered. The mortgage secures the entire claim, interests and other ancillary claims and enforced collection costs. Enforcement of mortgage may be undertaken out of court or within regular court enforcement proceedings.

Provisions on taking pledge over movable assets and rights are regulated in the Law on Secured Transactions. According to the law, any movable property that may legally be transferred pursuant to the applicable law may serve as collateral. Future property can be collateralised as well, including uncut timber, unpicked crop and future livestock as well as inventory. The Law on Secured Transactions, together with the Law on Property Rights, provides several means of enforcing a secured pledge including: extrajudicial enforcement of the pledge, court-ordered enforcement and enforcement through Private Enforcement Officers.

The Law on Financial Leasing regulates the financial leasing transactions in the country but it does not regulate financial leasing companies. The Ministry of Finance, with EBRD's assistance, is planning to draft a new law on financial leasing. The regulatory aspects of financial leasing sector is a policy matter, yet to be decided upon, and to be implemented in a planned Law on Non-Banking Financial Institutions.

There is no special legislation of factoring apart from general provisions of the Obligations Law which provide the basis for assigning account receivables. Traditional or reverse factoring is almost inexistent in Montenegro and the provision of factoring services is not supervised by any authority in the financial market at the moment. The Montenegrin authorities, with EBRD's assistance, have prepared a draft law on factoring which is planned to be incorporated through two laws. Namely, factoring transactions are to be regulated by a factoring law, while the regulatory aspects are to be dealt with under the planned Law on Non-Banking Financial Institutions. The draft law introduces specific provisions on factoring e.g. factoring of future receivables, recourse and non-recourse factoring and at the same time introduces a light touch regulation of Non-banking Financial Institutions providing factoring services. Supporting development of factoring services by introducing specific legislation on factoring and improving leasing legislation might help to advance overall access to finance of

SMEs by increasing legal certainty of transactions and by giving credibility to this type of financial service through supervision and public oversight.

Finally, Montenegro has a developed and well-functioning credit bureau which automatically collects data from banks, leasing organizations, savings banks and insurance companies. There is a developed feedback system for reporting and dispute processing through which data subjects, who have objections are given the possibility to submit a dispute on data accuracy, at office of any user of the Credit Bureau of Montenegro services."

Insolvency

The Montenegrin Insolvency Law provides a gateway into insolvency proceedings to businesses which are over-indebted. Filing of an insolvency petition results in the opening of preliminary insolvency proceedings during which the court examines the case and decides whether the conditions for full insolvency proceedings are met. Full insolvency proceedings may lead either to: (i) bankruptcy, with the aim of settling the creditors' claims by selling the debtor's assets or the debtor as a legal entity; or (ii) reorganisation. In practice, however, reorganisation is not extensively used and most cases end up in liquidation.

The recently-adopted Law on Voluntary Restructuring of Debts introduced many incentives for out-of-court debt restructuring such as exemption of the creditor from the payment of value-added tax for the purchase of claims and/or debts and recognition of debt reduction granted under a restructuring agreement as a deductible loss to the creditor. Nevertheless, out-of-court debt restructurings especially through collective negotiations between banks are not frequently used in practice and the majority of the out-of-court restructurings are bilateral (one creditor/one debtor).

In 2014, EBRD published an Insolvency Officeholder Assessment which evaluates the insolvency office holder (IOH) profession's state of development and performance in 27 countries of operations. The IOH Assessment found that the Montenegrin IOH framework needs improvement in a number of key areas including work standards and ethics, and IOH regulation, supervision and discipline. Montenegro has recently introduced further improvements to its insolvency legislation, which have raised the overall standard of the legislation.

Concessions/Public Private Partnerships (PPP)

The legal and regulatory framework for concessions and PPP in Montenegro is being gradually aligned. The Concessions Law is quite comprehensive, providing a broad definition of concessions and incorporating a non-exhaustive list of sectors where concession arrangements may be applicable. The granting of concessions is generally organised through a competitive tender process with principles of transparency, non-discrimination and competitiveness clearly stipulated in the Concessions Law. An approval of the Government and/or Parliament is required for the exceptional cases of awarding a concession without a public tender process.

As far as the institutional framework is concerned, there is no dedicated PPP unit or agency in Montenegro, however the Commission for Concessions has a general supervisory function. According to the most recent EU reports, Montenegro needs to address remaining gaps and ensure full alignment with the 2014 EU directives on public procurement, including in particular the Directive on Concessions. A PPP law is currently being developed and it is expected to enhance project preparation and contract award procedures in accordance with best international standards and practice. The setting up of a specialised PPP Unit could also enhance the institutional framework and help PPP implementation in the country.

Priority 2: Improve connectivity and regional integration by expanding cross-border transport and energy links

Energy Sector

Despite initial delays with transposing the EU Third Energy Package, Montenegro adopted the new Energy Law in December 2015 and the Law on Cross Border Exchange of Electricity and Natural Gas in June 2016 thus fulfilling its transposition obligations. The new Energy Law promotes market integration and incorporates requirements on electricity system operators unbundling and a number of other safeguards aimed at improving the national energy framework. The Law on Cross Border Exchange of Electricity and Natural Gas defines the conditions for access to system of transmission of electricity and transport of gas and transparency of the electricity and natural gas market. This includes a procedure for certification of system operators, international cooperation, allocation of interconnectors capacity and transparency requirements. Following the adoption of the new energy laws, Montenegro should prioritise the finalisation and adoption of relevant secondary legislation and adequate implementation of the existing legal framework.

Montenegro’s electricity market was opened in 2009 to all eligible customers, with the exception of the market for households, which opened in 2015. The country is compliant with the EU rules as regards security of electricity supply and infrastructure investment. The country also has the necessary framework for the gas market structure. The Energy Regulatory Authority of Montenegro (RAE) is a non-profit organisation, legally and functionally independent from the state authorities and energy undertakings. RAE’s budget is adopted by the Parliament but it’s funded from licence fees, annual charges for use of licenses and other charges set by RAE.

Priority 3: Continue to foster transition to a green economy, including sustainable tourism

Energy Efficiency

While Montenegro energy efficiency (EE) regulatory framework was already quite well-developed with the Law on Energy Efficiency, the adoption of the new Law on Efficient Use of Energy further improved EE framework in the country. Specifically, the latter introduced clearer procedures for measuring and verifying energy savings, established a new register of large energy consumers, enhanced energy performance certification procedures, defined energy-related products and obligations for market players, set clearer procedures for inspection, etc.

The new Law on Efficient Use of Energy also allowed further development of secondary legislation in the field of EE. Following the provisions of the Law on Efficient Use of Energy, in December 2015 the Ministry of Economy prepared new and updated existing EE related rulebooks, such as Rulebook on methodology for determining annual consumption of primary energy, the content of the energy efficiency improvement plan and the report on implementation of the plan of big consumers; Rulebook on minimal energy efficiency requirements in buildings; Rulebook on certification of energy performance of buildings; Rulebook on performing energy audits of buildings, and others.

With regards to labelling, while the Law on Efficient Use of Energy transposed key requirements of Directive 2010/30/EU, the Rulebook on Labelling of Energy-Related Products is yet to be adopted.

Adoption of the remaining secondary legislation is a priority. The models for public private partnership in the field of EE, including energy service company enabling framework, should be developed further. The institutional set-up must be strengthened, either by increasing the capacity within the Ministry of Economy and local authorities or by establishing a specialised energy efficiency agency.

The authorities should focus on implementation of the Third Energy Package in practice, for which the adoption of comprehensive secondary legislation is necessary. Implementation of the existing provisions, such as enforcement of unbundling requirements and adequate implementation of the renewable energy support measures, is also critical. RAE needs to further strengthen its institutional capacity to effectively exercise the functions envisaged under the new energy legislation. The issue of renewable energy sources in the transport sector should also be addressed. In addition to the above, the regulatory and institutional framework promoting EE in public buildings through energy service companies and other forms of public-private partnership should be strengthened.

ANNEX 5 – EBRD AND THE DONOR COMMUNITY

Donor funded technical cooperation (TC) in Montenegro has allowed the Bank to undertake early diagnostic work, including the preparation of infrastructure investment opportunities, building capacities of prospective clients and sharing transition experience from policy makers and private sector stakeholders from EBRD Countries of Operations in Central and Eastern Europe. Further, TC funds have been provided to support the transfer of skills and the growth of local private MSMEs, including through local and international consultants under the Advice for Small Businesses, as well as to support regulatory reform efforts.

Bilateral donors have provided strong support particularly Italy, including the Central European Initiative, as well as the Czech Republic and the EBRD Shareholder Special Fund. Donor funds have contributed, amongst others, to the regional development of small hydropower projects, rehabilitating local roads, modernising Tivat airport and supporting energy security through the establishment of a coordinated auction office.

The focus of donor grants is expected to remain on developing core infrastructure, enhancing energy security and increasing the competitiveness of SMEs. To sustain these needs, the EBRD will rely on a number of donor funds administered by the Bank, in addition to resources made available by its shareholders:

- **Bilateral donors**: grant funds will be sought from bilateral donors who hold accounts administered by the EBRD, who have expressed interest in supporting activities in Montenegro.

- **EBRD Shareholder Special Fund (SSF)** endowed by the Bank's net income. The SSF is a complementary facility to donor resources and will provide TC and co-investment grants in areas where there is shortage or lack of support, however the area remains a priority for the Bank to advance transition.

- **The European Union:** Under IPA II (2014 – 2020) it is expected that the EU will continue to play a major role in supporting national and regional priorities which target the socio economic development and competitiveness of SMEs, environmental improvement, regional connectivity and progress towards EU accession.

  The Western Balkans Investment Framework is an important coordination platform of regional priority investments amongst the beneficiary governments of the Western Balkans. Financial support under the WBIF will grow and be increasingly used for co-financing projects, namely those which support connectivity in the energy and transport sectors between the countries of the region and between the region and the Member States of the European Union. Additionally, support is expected to scale up in the regional context through funds provided to a second phase of the Regional Energy Efficiency Programme for the Western Balkans (REEP Plus).

TC COMMITMENTS BY DONOR THROUGH EBRD, 2012-2016*

Donor	TC Commitments (€m)
EBRD Shareholder Special Fund	2.08
Italy	1.61
Czech Republic	1.11
Austria	0.49
Luxembourg	0.32
France	0.30
Norway	0.25
European Union	0.14
Total	6.30

TC COMMITMENTS BY COUNTRY STRATEGY THEME THROUGH EBRD, 2011-2016*

Country Strategy Theme	TC Commitments (€m)
Sustainable Infrastructure and Energy Security	2.29
Entrepreneurship and SMEs	1.37
Green Economy Transition	1.18
Private Sector Competitiveness	0.58
Good Governance	0.27
Innovation and knowledge economy	0.20
Strong Resilient and Effective Financial Sector Developed	0.19
Developed Local Currency and Capital Markets	0.14
Integration and Trade	0.08
Total	6.30

Note: 2012-2015 data is based on TC Commitments as at the end of March 2016 (the latest available date before the data migration in a new Donor Funds System. 2016 data is based on 2016 earmarks at the project level.