DOCUMENT OF THE EUROPEAN BANK
FOR RECONSTRUCTION AND DEVELOPMENT

STRATEGY FOR MONTENEGRO

As approved by the Board of Directors on 18 September 2007

I. EXECUTIVE SUMMARY

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

The country became independent on 3 June 2006, following the holding of a referendum on independence, an option envisaged by the Constitutional Charter of the State Union of Serbia and Montenegro, created in 2002 with the active involvement of the European Union. The EU Foreign Ministers on 12 June 2006 recognised the referendum result and announced that EU members would individually recognise Montenegro and establish diplomatic relations with it. Serbia recognised Montenegro as an independent state on 15 June 2006. The resolution of pending issues with Serbia has been proceeding smoothly, including succession and division of assets, as well as issues concerning citizenship rights and social security.

Montenegro was admitted to the OSCE on 21 June 2006 and became a member of the UN on 28 June 2006. It joined the EBRD on 6 September 2006, and the IMF and World Bank in January 2007. The new state has already a relatively open trade regime and the talks on WTO membership are progressing well. On 11 May 2007 Montenegro was admitted to the Council of Europe.

Recent economic developments have been favourable. The last two years have seen a combination of strong GDP growth – more than 6 per cent in 2006 – low inflation and a significant inflow of foreign direct investment (more than US$ 1 billion over the two years combined). Fiscal performance has also improved and the country's level of external debt is moderate. The unilateral adoption of the DM in 2000 (and subsequently the euro in 2002) as sole legal tender has contributed to economic stability and there are no realistic prospects of the country introducing an independent currency. Montenegro has also made important advances in some dimensions of transition, notably in the areas of price and trade liberalisation, privatisation and banking sector reform.

During its first year as an independent country, Montenegro has proved to be a politically stable and economically viable state, which has the potential to grow rapidly over the medium term. The country has had some success already in creating a favorable business climate and in attracting reputable foreign investors, who can play a crucial role in signalling to others that Montenegro is an attractive investment destination. At the same time, many problems and weaknesses common to the region, not least the limited capacity of public administration, are present in Montenegro. The main transition challenges ahead are in the areas of institutional reform, especially in the areas of corporate governance and competition, infrastructure and non-bank financial institutions. A number of key assets remain to be privatised, and energy sector reform is a particularly vital challenge facing the country.

To date, the Bank's activities in Montenegro have been rather limited, reflecting the small size of the country. The Bank's portfolio has somewhat increased in the previous Strategy period, reaching €36.2 million by end-2006. Operating assets were €20.8 million as of end-2006 and there are no impaired assets. Infrastructure projects dominate the portfolio. The Bank's commitments in this sector comprise two rehabilitation transport projects: one for the Montenegro Airports (signed in 2003 and largely disbursed) and the other for the roads (signed in 2005 and partially disbursed).

Investments in financial institutions are at €6 million and include loans or equity investments in NLB Montenegrobanka, including a merger between Euromarket Bank and NLB Montenegrobanka, as well as strong support for micro-enterprises. Several transactions in the financial sector supported local banks through mortgage financing, TFP, and SME financing under the Western Balkans Framework SME credit line. The SME sector has also received support from Turnaround Management (TAM) and Business Advisory Services (BAS). In the corporate sector, the EBRD invested in a greenfield technical gas facility (DIF) and provided a pre-privatisation loan for KAP, an aluminium combine to finance the investment advisor. Both of these transactions have been completed.

The Bank is shifting its focus to the private sector and the pipeline looks quite promising in that respect. The Bank's priorities over the strategy period will be:

Private Corporate Sector: Montenegro's tourism and property sector is an area where the Bank can play an important role by providing both funding and political comfort to foreign investors. There is significant demand for good office, retail, hotel and housing (permanent and holiday home) space. Taking into account the natural beauty of the country the Bank will actively support the chosen strategy of low density, higher-end tourism property development including ensuring positive backward linkages these developments will create and the need for a balanced and environmentally friendly sustainable development. The Bank also aims to increase its operations with local private corporate clients and promote their investments in new technology and environmental improvements. The privatisation process and post-privatisation restructuring will be supported. In addition, the Bank will continue to support MSMEs through existing and new financial instruments like the EBRD-Italy Western Balkan Local Enterprise Facility (WBLEF) and the MSME Finance Framework for Western Balkans and Croatia (MSMEWBF) to local banks and specialised microfinance institutions.

Infrastructure: The Bank will, in cooperation with the European Investment Bank (EIB), the World Bank and the EU, continue lending for key infrastructure projects where clear transition impact can be achieved and with an emphasis on involvement of a private sponsor wherever possible. Priority will be given to projects with a material impact on tourism and/or a strong regional dimension. The Bank will support corporate restructuring in the electricity, gas and oil, roads and railway sectors, and will attempt to advance commercial financing to municipalities. Future sovereign projects will be limited by the tight fiscal space. This will require a selective approach and the need to phase infrastructure projects over several years to make them viable from a sovereign borrowing point of view.

Financial Sector: The Bank will focus on the following areas: (i) Cooperation with strong local or foreign banks looking for opportunities to increase market share by assisting in further consolidation; and (ii) Continued support to commercial banks and micro-lending institutions, especially in the field of MSME and mortgage lending through existing product and through WBLEF and MSMEWBF.

TC and Official co-financing

TC and official co-financing will remain crucial for project preparation and institution building, particularly promoting smaller scale local enterprises and for public sector operations. The Bank will continue its close co-operation with the EU/EAR and bilateral donor institutions, and will coordinate its activities closely with other IFIs, including the IMF, World Bank and EIB.

LIST OF ABBREVIATIONS

BAS	Business Advisory Services
DIF	Direct Investment Facility
EIB	European Investment Bank
EC	European Commission
EU	European Union
FDI	Foreign Direct Investment
GTZ	Gesellschaft fuer Technische Zusammenarbeit
IFC	International Finance Corporation
IFI	International Financial Institution
IMF	International Monetary Fund
KfW	Kreditanstalt fuer Wiederaufbau
MEI	Municipal and Environmental Infrastructure
MSME	Micro, Small and Medium-sized Enterprise
SME	Small and Medium-sized Enterprise
TAM	TurnAround Management
TFP	Trade Facilitation Programme
UNDP	United Nations Development Programme
USAID	United States Agency for International Development
WB	World Bank
WBLEF	Western Balkan Local Enterprise Facility

1. THE BANK'S PORTFOLIO

1.1 OVERVIEW OF BANK ACTIVITIES TO DATE

As of end-May 2007, the Bank achieved a net cumulative business volume of €43 million. In 2006 there was one regional commitment allocated to Montenegro. The portfolio amounts to €37.7 million (7 projects and 2 TFP lines), of which €20.8 million (55%) are operating assets. There are no impaired assets. Although the infrastructure projects currently dominate the portfolio due to their relative size, the Bank is shifting its focus to the private sector and the pipeline looks quite promising in that respect.

1.2 IMPLEMENTATION OF THE PREVIOUS COUNTRY STRATEGY

The last country strategy (i.e. the joint strategy with Serbia), approved in November 2004, outlined the following strategic priorities and transition goals for the Bank in Montenegro:

- **Corporate Sector:** the emphasis would be on privatisation and post-privatisation company restructuring, capital investments in new technology, and environmental improvements, primarily with local investors. Projects in the property and tourism sectors would be emphasised. The Bank would continue to support SMEs through existing financial instruments to local banks and selective DIF investments.
- **Financial Sector**: Privatisation, financial and operational restructuring of state banks, and cooperation with strong local or foreign banks and micro-lending institutions looking for opportunities to increase market share by assisting in further consolidation.
- **Energy and other Infrastructure:** Priority would be given to infrastructure projects that have a strong regional dimension, and the Bank would work in close cooperation with other major IFIs and donors.

The Bank achieved some of its objectives during the last strategy period. Three operations (one new operation – Road Rehabilitation Project, one follow up - Alter Modus under the US/ EBRD SME Framework and one operation under the TFP) were signed. In addition, substantial effort was made to implement projects signed in previous strategy periods, with important transition impact in some cases (as described below). However, up to now, the Bank's activities have been limited by the small market and weak institutional capacity.

1.3 TRANSITION IMPACT OF THE BANK'S PORTFOLIO AND LESSONS LEARNED

- ***Corporate Sector:*** In the corporate sector, the Bank invested in Progas – a greenfield technical gas facility – through the Direct Investment Facility Programme (DIF). The Bank also provided a pre-privatisation loan for the aluminium combine, KAP, to finance the investment advisor. Both of these transactions have been completed successfully. However, the limited scope of these projects meant that they had very little effect on corporate governance or on the broader regulatory environment, which remains beset by problems. While the Progas project helped stir some competition in the sector, its business practices and of its competition remained largely unchecked, hampering proper development of the sector. Overall, a *negligible* transition impact has been achieved in the Corporate Sector.

- ***Financial sector:*** Investments to financial institutions are at €6 million and include loans or equity investments in NLB Montenegrobanka, including a merger between Euromarket Bank and NLB Montenegrobanka. Several transactions in the financial sector supported local banks through mortgage financing, TFP, and SME financing under the Western Balkans Framework SME credit line. The SME sector has also received strong support from TAM/ BAS. The Bank has been very active in advancing transition in the financial sector, especially the part dedicated to MSMEs. For example, the Bank supported Opportunity Bank A.D. Podgorica, a specialized microfinance bank. Opportunity Bank has had an excellent performance during the past years and has managed to progress from a non-profit microfinance organization to one of the most profitable banks in the country in just four years. Opportunity Bank fully prepaid the EBRD's loan in early 2007, thanks to its success in attracting deposits and ability to finance portfolio growth with its own funds. In December 2005, the Bank provided a second loan to Alter Modus, an MFI that offers small credits to micro-businesses that never before had access to the formal financial sector. The Bank's on-lending funds were accompanied by an institution-building TC component. Following the Bank's involvement, Alter Modus has been very successful in securing commercial funding from a number of sources. The Bank's support for Alter Modus is provided under the US/EBRD SME Financing Facility to support the growth of MSEs in a number of transition countries. Overall, a *good* transition impact has been achieved in the Financial Sector.

- ***Infrastructure:*** The Bank's commitments in the infrastructure sector comprise two rehabilitation transport projects: one for the Montenegro Airports (signed in 2003 and largely disbursed) and the other for the roads (signed in 2005 and partially disbursed). The airport project was aimed at commercialising a newly established state-owned airport company through implementation of a fully commercially based tariffs, improved corporate governance and business practices, as well as compliance with international standards of safety and security coupled with an increased level of services and comfort provided to customers. Through the implementation of the project tariffs have been established on fully commercial basis, business planning and IFRS audited financial statements have been introduced and total airport management system has been implemented. In regards to the road project during Q2/ 2007 a contract for rehabilitation of the road and stabilization of slopes on M-2 Road Mioska to Kolasin (km 1029 to km 1041), part A2 of the Loan Agreement was signed between the Traffic Directorate and the Constructor. A completion of works is expected to improve safety and quality of the road, characterized by the highest number of traffic stoppage and accidents. Overall, a *moderate* transition impact has been achieved in the Infrastructure Sector.

- ***TAM*** has been operating in Montenegro since 2002 and has supported 54 projects, utilizing €2.45 million in funding from various bilateral donors and the European Agency for Reconstruction (EAR). BAS has been operating in Montenegro since 2003 and has funded 125 projects, utilizing over €1.85 million from the EAR. Under new EAR funding, BAS will start 65 projects during 2007-2008.

1.4 PORTFOLIO RATIO

Based on the current portfolio of €37.7 million, the private/public portfolio ratio stands at 33/67. In terms of number of projects, private sector transactions are expected to dominate the project pipeline in the forthcoming strategy period. However, considering the smaller size of such private sector projects (particularly under the WBLEF), achieving the target of 60/40 private/public sector portfolio in 2007-2009 will be difficult. The average risk rating of the portfolio stands at 6.18 compared to 5.47 for the Bank, while the private sector risk rating is at 5.64. The portfolio should be closely monitored to avoid the possible delay of project implementation of public sector projects by state-owned enterprises.

2. OPERATIONAL ENVIRONMENT

2.1 THE GENERAL REFORM ENVIRONMENT

2.1.1 Political Developments

Montenegro became an independent state on 3 June 2006, following the holding of a referendum on independence. On an 86 per cent voter turnout, 55.5 per cent voted for independence, 0.5 percentage points above the threshold foreseen by the referendum legislation. The EU Foreign Ministers on 12 June recognised the referendum result and announced that EU members would individually recognise Montenegro and establish diplomatic relations with it. Serbia recognised Montenegro as an independent state on 15 June 2006.

The independence achieved in 2006 is a culmination of long-term aspirations. Montenegro boasted some traditions of statehood from the late Middle Ages, and was an internationally recognized country from 1878 until 1918, before becoming a part of former Yugoslavia, in its various incarnations, for most of the 20th century. The success of the pro-independence movement in recent Montenegrin history is closely associated with the former President and Prime Minister of Montenegro Milo Djukanovic, currently the leader of the ruling Democratic Party of Socialists, who started to distance Montenegro from the Milosevic regime in the mid-1990s. What was initially perceived by many as a conflict between conservatives and reformers in the leadership of the then ruling Socialist Party led by Milosevic, soon became a clash of opposite views regarding the future of the state. Djukanovic and his associates projected a pro-reform, pro-Western course, which soon became intertwined with the above-mentioned pro-independence aspirations always present in Montenegrin society. Under Djukanovic's leadership, Montenegro made its way to independence gradually and peacefully.

Despite various warnings offered in abundance by observers in the past – Milosevic's imminent invasion, the country falling apart because of the independence referendum initiative, civil war after independence and so on – Montenegro has survived all manner of threats and appears to be currently quite stable politically. To be sure, it is still divided into two large camps, both along ideological and ethnic lines. Ethnic Serbs, who, according to the latest census, make 30 per cent of the population, voted overwhelmingly against independence and are the principal opposition to the current government. However, the level of tension in Montenegro is considerably lower than could be expected. The parliamentary opposition is fragmented and the 'old' opponents of Djukanovic have been disoriented ever since they lost the independence referendum. It may take time for a possible 'third force' to emerge, and meanwhile, the ruling coalition can enjoy a majority until the next elections, which are not due until 2010.

Parliamentary and local elections were held in Montenegro on 10 September 2006, in the wake of independence euphoria. The Democratic Party of Socialists (DPS) led by the then Prime Minister Milo Djukanovic won the elections, and ensured, in a coalition with a smaller Social Democratic Party (SDP), 41 seats in an 81-seat Parliament. Djukanovic has since stepped down from the highest state positions, after ten years of unrivaled power, setting a unique example for the region, and was replaced by former Justice Minister Zeljko Sturanovic, who has formed another pro-market and pro-business coalition government.

One of the most important issues for Montenegro is the adoption of a new Constitution, preparations for which commenced immediately after the independence. The first phase of the deliberations on substance, which ended on 5 May 2007 and which included the first reading in Parliament and subsequent public debate, revealed that the most contentious issues pertain to national symbols (including the national anthem and the name for the official language of the country), as well as some issues related to local self-government (see minority issues in the *Annex 2*).

During its first year as an independent country, Montenegro has proved to be a politically stable and economically viable state, which has the potential to grow rapidly over the medium term. The country has had some success already in creating a favorable business climate and in attracting reputable foreign investors, who can play a crucial role in signalling to others that Montenegro is an attractive investment destination. At the same time, many problems and weaknesses common to the region, not least the limited capacity of public administration, are present in Montenegro as well.

2.1.2 Legal reform[1]

The Republic of Montenegro has made wholesale changes to its legal system in recent years, with the aim of attracting foreign investment and harmonising its legal system with EU norms. The most important legislative acts adopted in recent years include laws governing securities and capital markets, business activities and corporate governance, concessions, insolvency, and secured transactions. Another example of legislative acts designed to support the business environment reform is the Law on Protection of Competition adopted in 2005, whose provisions on restrictive agreements, abuse of dominance and merger control are generally compatible with the EU standard competition practices.

Despite significant progress towards the establishment of a free market-oriented economy and stable democratic institutions, the government of Montenegro is still facing numerous challenges on its path. The Montenegrin government needs to focus on improving its administrative capacity to be able to implement and enforce its newly adopted legislation aiming at such key areas as capital markets, free movement of goods, competition, and public procurement. Special efforts are required in the areas of justice, freedom, security and eradication of corruption and organised crime, which are still prevalent in the country. To achieve that goal, Montenegro will have to significantly upgrade its weak judicial system to make it fully independent from the government.

2.1.3 Environment

In 1991, Montenegro's National Assembly declared the country to be an 'ecological State', committing to protect environment to the highest level. The Ministry of Environmental Protection and Physical Planning prepared and the Montenegro Parliament adopted a series of environmental laws, regulations and ordinances from 1991.

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[1] For the EBRD assessment of legal transition in Montenegro, please refer to *Annex 2.*

In 2000, Montenegro published its first national environmental report, the State of Environment. It outlines the state of the environment in general terms, as specific data are not available due to a poor and unorganised monitoring system. In 2001, the Government adopted the Development Directions for Montenegro, which provided a long-term strategic direction, including environmental, economic and social orientation.

In the period from 2000-2006, the Montenegro Government has adopted the main legal framework which includes environmental protection, strategic environmental impact assessment, impact assessment and waste management laws.

In 2006, the Government completed a final draft of the Montenegro National Sustainable Strategy which was based on the concept of sustainable development, identification of environmental problems, natural resources management, and economic and social development. It includes the following main objectives:

1. Enhance economic development and growth and reduce uneven regional development;
2. Reduce poverty; provide equality in accessing public services and resouces;
3. Ensure efficient control, reduce environmental pollution and enforce sustainable management of natural resources;
4. Improve environmental management system and public participation; mobilize all the actors and promote capacity building at all the levels;
5. Protect and conserve cultural diversity and identity.

Based on the Strategy, National Action Plan was prepared in 2006. It sets out national priorities, time table for their implementation and the responsible implementation agencies. The following objectives are identified:

- Enhance development of services (tourism, maritime, etc.);
- Development of eco-tourism, food production and forestry;
- Improvement of infrastructure: transport, water supply, energy as prerequisite for successful development;
- Full integration of environmental protection during development of infrastructure projects; reduction of pollution caused by transport;
- Development of tourist projects which will integrate sustainability criteria;
- Efficient use of electric power;
- Improvement of industrial efficiency to reduce environmental pollution;
- Enhance research, development and innovation;
- Enhance national protective areas;
- Development of legal framework for biodiversity protection, enhance capacity building and development of efficient monitoring system;
- Provide sufficient quantity and required quality of drinking water;
- Improve integral management of catchment area;
- Improve air quality in urban areas;
- Improve soil/land management to reduce its degradation;
- Ensure sustainable management of forestry;
- Development of the integrated institutional management of environment based on the EU legislation.

The Bank's approach to supporting environmental improvement within Montenegro is two-fold: firstly to ensure, through support of specific environmental projects where key environmental concerns are addressed. For example, the Bank is currently considering financing a part of the Montenegro Regional Water Supply project which will ensure safe and sufficient drinking water supply to the towns Sv. Stefan, Budva, Tivat and possibly Herceg Novi. The other component of this water supply system is considered for financing by IBRD.

Secondly, all EBRD operations in Montenegro are subject to the Bank's Environmental Policy and incorporate, where appropriate, Environmental Action Plans into the legal documentation in order to address issues raised during environmental due diligence. For example, the Bank is financing regional road reconstruction project and it is in the process of considering a loan to Montenegro Railway Company for improvement of its infrastructure. The Bank is also supporting the country's sustainable tourism through its involvement in the tourism sector.

2.2 PROGRESS IN TRANSITION AND THE ECONOMY'S RESPONSE

2.2.1 Macroeconomic Conditions for Bank Operations

Montenegro's economy has much potential. GDP per capita is comparable to the regional average at around €3,000 but the economy is growing quickly and FDI is arriving at unprecedented levels. Montenegro still has a few important industries, notably in the metals processing sector, but the economy is increasingly dominated by the services sector which accounts for more than half of GDP. Industrial production is about 20 per cent of GDP, the majority of which is accounted for by the giant aluminium conglomerate, KAP. Exports of aluminium and aluminium products accounted for 41.8 per cent of total exports in 2006, down from 49 per cent in 2004 but still highly significant. KAP was privatised in mid-2005 to a subsidiary of the Russian firm, Rusal, and, according to preliminary figures, made a profit in 2006.

The sector with most long-term potential for Montenegro is tourism. Total revenues from tourism in 2006 are estimated at €308 million, more than triple the level from four years' previously and representing about 15 per cent of GDP. The tourist-friendly attributes are obvious – spectacular scenery, sunshine, warm sea and, at least for the time being, a touch of exoticism. The country is also enjoying spillovers from the rapid growth of tourism in recent years in neighbouring Croatia. But the quality of tourism-related infrastructure has a long way to go before it is up to western European levels, highlighting the need for further investments in this sector. Most tourism at present is from countries such as Serbia, Bosnia and Herzegovina, Albania and Russia.

In recent years, Montenegro's economy has enjoyed moderate and stable growth. Economic performance has improved steadily over this period, and real GDP growth in 2006 was more than 6 per cent, according to official estimates. Most of this growth appears to be driven by services, especially related to tourism, while the demand side has been fuelled last year by a dramatic increase in domestic credit in the economy, by well over 100 per cent. However, there are signs that the growth is not being evenly spread. Poverty is a serious problem in parts of the country and unemployment remains high, though on a downward trend. In addition, growth is concentrated in a relatively small number of sectors, exposing the economy to risks if these sectors were to suffer adverse shocks.

Monetary policy is relatively straightforward in Montenegro. The country has no currency of its own, having unilaterally adopted the DM in 1999 as a parallel currency to the Yugoslav dinar and then as the sole legal currency in 2000 (and subsequently the Euro in 2002). The policy has been successful at delivering low inflation, which has been at low single-digit levels for several years, and there are no plans to introduce a domestic currency. Reserve requirements for banks were lowered in April 2006, with the standard rate for short-term deposits falling from 23 to 19 per cent.

The conduct of fiscal policy has improved significantly in recent years. While total government revenue has remained steady at around 40 per cent of GDP, government expenditure was reduced gradually to about 42 per cent of GDP in 2005, resulting in a fiscal deficit for that year (after grants) of 1.6 per cent of GDP. During 2006, strong revenue collection (especially from VAT) has put the fiscal accounts in surplus of 4.4% of GDP for the year, and a further surplus is expected in 2007.

According to central bank data, the current account recorded a deficit of 8.6 per cent of GDP in 2005. Estimates for 2006 suggest a sharp increase in the deficit to around 30 per cent of GDP. This seemingly dramatic widening of external imbalances should be seen in the context not only of high energy prices but also of the extraordinary influx of FDI in recent years. In 2005 it was €375 million, or nearly 20 per cent of GDP, and it rose further in 2006 to about €500 million, on the back of further privatisations and investments in the banking sector and strong greenfield investment in tourism. Looking ahead, the size of the current account deficit is likely to remain very high in the short-term but decline gradually thereafter. Montenegro has a relatively liberal trade regime and exports and services (mostly related to tourism) are forecast to rise sharply over the medium-term.

Montenegro's level of external debt is moderate at about 38 per cent of GDP, of which less than one-quarter is private. The debt service profile is relatively favourable – most of the debt is on a long-term basis from IFIs and bilaterals. Estimates from the central bank show that servicing of the foreign public debt was €26 million in 2006, rising to a mere €32 million by 2010. Montenegro has not attempted to tap capital markets and is unlikely to do so in the near future. As a result, the risk of serious difficulties in debt servicing over the short-term appears to be small. However, the overall debt of the government is difficult to measure because of uncertainty surrounding restitution claims.

2.2.2 Transition successes and challenges

Montenegro began the path to a market economy in the late-1990s, when the republic began to distance itself from Serbia. So far, transition-related reforms have advanced well in several areas – notably price and trade liberalisation, privatisation and banking sector reform – but only limited progress has occurred when it comes to deeper institutional reforms. The latter may reflect the weak administrative capacity in the country. Also, much of the attention of politicians in recent years has been focused on the referendum issue. Now that this is resolved, and with a stable, reform-minded government in place (see above) and an SAA with the EU already initialled and close to signing, there are reasons to expect the reform process to be accelerated in the coming years. The main challenges include: completing privatization of large enterprises and ensuring effective standards of corporate governance; rehabilitating and promoting a commercial approach in infrastructure services; enhancing competition and removing obstacles to doing business; and developing further the provision of financial products.

In terms of business environment, the country has liberal, business-friendly laws on the books, although there are some impediments. The corporate tax rate, at 9 per cent, is among the lowest in Europe, and the introduction of a flat income tax was introduced in

January 2007. In principle, new businesses can be registered in four days at a nominal cost of €1. However, the procedures for obtaining the necessary licences and other permits are sometimes cumbersome and provide scope for petty corruption.

Privatisation is well advanced in Montenegro, most recently focusing on the sale of the remaining large companies in state hands. A voucher scheme for small enterprises was completed in 2002. However, many of these vouchers ended up in investment funds, some of which have so far shown little interest in genuine restructuring, so further work needs to be done to ensure improvements in corporate governance of these companies. In July 2006 a tender was launched to find a new buyer for the Niksic steel mill (which had been effectively renationalised by the government earlier in the year). Four companies made bids for the 67 per cent on offer, and the company was taken over in January 2007 by Resource Capital & Management.

A new competition law, generally in line with European standards, was adopted in 2005, and preparations for a draft competition strategy are in hand. In March 2006, the government agreed to set up an independent competition authority. However, to date the application of the new law has been limited. The competition authority is not yet in place and more progress is needed to implement this decision and to ensure effective implementation of the new law.

Infrastructure reform varies widely across sectors. Privatisation of the telecommunications sector is complete and the government recently awarded a new licence in the mobile sector to Telekom Srbija. Power sector privatisation is still at an early stage, with preparations under way to implement a pre-privatisation agreement associated with the unbundling of the state-owned power company, Elektroprivreda Crne Gore. A proposed privatisation of the thermal power plant in Pljevlja is currently [June 2007] on hold, reflecting disagreement within the ruling coalition. Montenegro has considerable, but relatively undeveloped, hydroelectric potential, and two new hydropower plants are under reconstruction. Infrastructure reforms in the road and railway sectors have also advanced slowly.

The performance and supervision of the banking sector have improved significantly in recent years. As of end-2006, there were 11 banks operating in Montenegro (plus one in liquidation and one in bankruptcy). All banks have been transferred to private hands and only five per cent of bank capital still belongs to state-owned companies. Confidence in the banking sector has been enhanced by the establishment of a Deposit Protection Fund in January 2006. The Fund protects depositors (up to €5,000) in the event of a bank failure or bankruptcy. Although confidence has been largely restored to the financial sector, much more needs to be done to strengthen intermediation. Consolidation is ongoing and privatisation nearly finished with seven out of ten banks foreign-owned, and three majority-owned by local private investors with some minority state ownership. Further consolidation would be beneficial for the sector. One of the priorities is to improve banking skills and longer-term funding, which will lead to an increase in the loan portfolio. Although improvements have occurred, access to finance remains limited. Emphasis should also be put on developing the non-banking financial system which is still in its early stages.

2.3 ACCESS TO CAPITAL AND INVESTMENT REQUIREMENTS

The state has limited access to capital markets, and most of the foreign debt consists of long-term debt from bilateral governments and multilateral organizations. The country's rating from Standard and Poor's was upgraded in March 2007 from BB to BB+ for long-term currency. At the company level, access to credit has increased significantly in recent years, in line with the improved banking sector. However, SMEs in particular still find it difficult to access loans on favourable terms. Non-bank sources of finance are limited – the country has two stock exchanges but they play a small role as a source of equity finance (see *Annex 3* for more details).

3. STRATEGIC ORIENTATIONS

3.1 BANK'S PRIORITIES FOR THE STRATEGY PERIOD

The Bank will support the efforts of the Government to continue the implementation of the reform agenda and improve the country's business environment in order to enhance the development of the local private sector and attract further inflows of FDI, while continuing to modernise key infrastructure on a sustainable basis. The Bank's operational priorities will continue to support the development of the private sector, especially in projects linked to the country's important tourism sector. In this respect, further strengthening of the financial sector and the rehabilitation of the country's transport (railway, road networks, ports and airports), energy (especially transmission), municipal infrastructure (in particular for water supply and waste water treatment) are paramount. Furthermore, consolidation in the financial sector and introduction of new products will be a priority over the next strategy period.

3.2 SECTORAL CHALLENGES AND BANK OBJECTIVES

3.2.1 Corporate Sector

The Bank will target its support towards smaller-scale local regional export-oriented companies showing good corporate governance. This support will be through loans, guarantees or equity investments, including through the WBLEF. Assistance to local enterprises will be provided through the TAM/BAS programmes. The Bank will support strategic foreign investors.

<u>Property and Tourism</u>: Tourism is at the heart of Montenegro's strategy for future economic growth. A number of international companies are contemplating major tourism-related investments in the country. However, progress is inhibited by the lack of adequate infrastructure, the non-availability of long term financing and a lingering perception of country risk. The Bank will continue to support both local and international investors for investment in the tourist sector. The aim of the country to develop low-density, higher end tourism will be supported. In all projects, the Bank will ensure that these investments have positive backward linkages to related sectors in the economy.

Montenegro has also a need for modern commercial real estate space. The potential for growth of the property sector is strong, in line with the growing economy and increased demand from regional and international companies for institutional quality commercial space. Experienced real estate developers and investors are currently considering several commercial projects in Podgorica and progressively in the main regional cities, in a wide range of asset types including office, hotel, retail, industrial and housing (permanent and holiday home). Availability of real estate long-term financing is still limited, but is following the same positive pattern, due both to the involvement of experienced real estate players on the market and to the positive outlook of the property sector's fundamentals. The Bank will support well-conceived and viable projects in these sectors.

3.2.2 Financial Sector

The Bank will focus on:

- providing banks with funding and institutional support to assist the banks develop new products (including TFP and co-financing), grow their business on a sustainable basis, and improve corporate governance. The Bank will extend its mortgage finance programme to selected banks in Montenegro, and will continue to assist micro-enterprises through existing projects.
- continuation of existing micro and SME financing, including through the implementation of the EU/EBRD Western Balkans SME framework. The Bank will also continue to provide MSME facilities in Montenegro under the existing range of products, supporting existing partner banks and microfinance institutions as well as introducing new banks and NBMFIs and finance loans to banks under the WBLEF and MSMEWBF**.**
- The Montenegrin banking sector is still fragmented and there is room for further bank consolidation. In this context, the Bank may support selected merger and acquisition opportunities among local private banks.

The non-banking financial institution sector is seriously underdeveloped and it is possible that, towards the end of the strategy period, the Bank will be able to identify better performing leasing companies for support or develop leasing operations within the existing banks.

3.2.3 Infrastructure

Montenegro has major infrastructure needs but limited scope for new sovereign borrowing. Although the country has substantial funds available for public investment from previous privatisations, the Bank can play an important role in selected high-priority projects to provide not only capital but also technical expertise to ensure maximum transition impact. Accordingly, the Bank will participate in the upgrading of infrastructure in Montenegro in a phased manner and in close cooperation with other IFIs and donors, such as the European Investment Bank (EIB), the World Bank (WB) and the EU. In addition, there may be selective opportunities to finance transport or energy infrastructure on a non-sovereign basis, especially if related to development of strategic sectors such as tourism.

The Bank will focus on (i) supporting privatisation and commercialisation of public utilities, also through the implementation of the pre-privatisation agreement for the newly un-bundled electricity distribution and generation companies, (ii) energy projects that fit the regional energy market development such as regional electricity and gas interconnections, (iii) promoting regional transport networks, including the restructuring of the road maintenance sector, and (iv) supporting the new fiscal decentralisation process, including through possible municipal-guaranteed water and waste water sector investments.

<u>Transport Sector</u>: The Bank's transition objectives in the transport sector will be to support:

- the preparation and implementation of sector reform, in particular preparation of the reform of the maritime sector, the implementation of the railway sector reform programme and measures to improve the efficiency of the road sector;

- institutional strengthening of key transport sector operators in the country to enable efficient implementation of reforms and increased commercialisation of their operations;
- encouragement of private sector participation in transport sector operations when these result from the on-going sector reform programme (e.g. port concessions).

The Bank's transport sector activities will focus primarily on the following operational priorities:

- emergency support for the railway infrastructure within the context of the on-going sector reform, with potential involvement in private sector freight operations in the medium-term. In this respect projects such as rail market opening under the EC initiated South East Europe Core Regional Transport Network (SEECRN) and activities in line with the Rolling Multi-Annual Plan will be considered.
- support for rehabilitation and upgrading of the road network in conjunction with the reform of the sector financing, further development of the SEECRN and a strategy for PPPs in this sub-sector.
- consideration of a non-sovereign project to support necessary investments in air sector; and
- support for the envisaged privatisation of the operations at the Port of Bar as well as the port infrastructure.

MEI

Montenegro has large needs in all sectors of municipal infrastructure as a basic pre-condition for tourism development. This include water supply, waste water and solid waste projects, especially for those coastal cities which are going to be involved in larger scale tourism projects. Tariff collection rates are often low and the legislative framework needs to be improved, especially to allow the easier arrangement of multi – municipality projects. Solid waste and waste water treatment represent a serious issue especially in view of the government plan to promote Montenegro as eco-friendly and environmentally sound country.

The Bank is processing a large water supply project, in co-operation with other IFIs and donors, and is liaising closely with other IFIs on how to carry forward waste water and solid waste projects.

The key limiting factor for municipal projects is Montenegro limited fiscal space while most of these projects would require a sovereign guarantee to be financially viable, especially in view of affordability considerations. Another key issue is the willingness of local authorities to work together on a multi-municipal basis and discuss their financial and operational practices in an open and transparent manner.

Power and Energy[2]:

The Bank's energy operations over the strategy period will focus on:

- *Sector restructuring and rehabilitation:* The 2003 Energy law is the main legislative basis for the current and planned reforms in the energy sector, and its aims are consistent with EU energy directives. The existing monopoly EPCG has been unbundled into separate generation, transmission, distribution and supply businesses. The Regulatory Agency is responsible for issuing the relevant licences,

[2] Please refer to the *Annex 4* on the current situation regarding electricity in Montenegro.

regulating tariffs for monopoly activities, and monitoring the operation of the energy market to ensure it is functioning correctly. The Bank will keep an active policy dialogue on further reform and will consider investments that will reduce high distribution losses, improve interconnections with neighbouring systems, and rehabilitate or built new generating capacities.

- *Privatisation:* The tender for privatisation of the only thermal power plant (in Pljevlja) has resulted in a preferred bidder (En+ of Russia), but progress on privatisation is currently suspended (see above). The Bank will continue monitoring progress and, if the process resumes, will consider taking an equity stake alongside the winning bidder, or providing debt finance aimed at rehabilitating the power plant and/or its associated coal mine. Where possible, the Bank will endeavour to channel long term finance to private public partnership schemes, subject to open and transparent tender procedures. The Bank will continue its policy dialogue on the privatisation of utilities and will make itself available to support viable privatisation schemes in other generators, as well as the distribution system. In other private sector projects, the Bank will support viable PPPs and/or BOO/BOOT concessions for the construction of new generation capacity (e.g. hydropower plants) in Montenegro if such projects meet the Bank's concessions policy requirements and environmental standards.

- *Environmental, renewable energy, and energy efficiency projects:* It is the government's stated priority (as well as constitutional obligation) to focus on environmentally-friendly development. The energy efficiency and renewable sector is at a very early stage of development. Security of supply, appropriate tariff structure, full commercialisation and adequate regulation appear necessary preconditions for the sector to operate. The Bank will maintain a policy dialogue aimed at improving the regulatory environment in order to allow for the possibility for commercially viable investments in renewables and energy efficiency.

- *Affordability:* Electricity tariffs are a sensitive and contentious issue in Montenegro. Households are used to cheap electricity and in the past the government has deliberately used EPCG to implement its social protection policies by providing cheap electricity to all households. As well as depriving EPCG of the necessary income, this policy has also led to the inefficient and wasteful use of electricity (e.g. for heating purposes). The market reforms that the government is committed to imply tariff increases to market levels. However, the expected benefits to the sector, as well as higher energy efficiency levels, will arise only if the Regulator is able to implement a transparent tariff-setting mechanism. The Bank will emphasise the need for social protection measures that are targeted at the most vulnerable consumers.

- *Energy Community of South Eastern Europe:* The Bank has been closely cooperating with various institutions participating in the EU-led process to create the Energy Community of Southeast Europe (ECSEE). These institutions include the EIB, USAID, CIDA, the Cooperazione Italiana and KfW. In order to support this process the Bank will consider transmission grid investments aimed at building a new (or enhancing existing) interconnections with neighbouring transmission systems.

4. OTHER IFIS AND MULTILATERAL DONORS

TC and official co-financing will remain crucial for project preparation and institution building, particularly promoting smaller scale local enterprises and for public sector operations. The Bank will continue its close co-operation with the EU/EAR and bi-lateral donor institutions. From January 2008, the EAR will no longer be active. The Agency will be replaced by EU-IPA.

In addition, the Western Balkans Multi-Donor Fund set up in 2006 will enable the Bank to use donor funds in the region including Montenegro to identify and prepare key projects that are vital to economic growth and regional cooperation to narrow the transition gap that has emerged between the Western Balkans and neighbouring countries.

The activities of the main IFIs and bilateral donors in Montenegro can be summarised as follows:

IMF: Montenegro became a member of the IMF in January 2007. Previously, the State Union of Serbia and Montenegro successfully concluded its Extended Arrangement with the IMF in February 2006.

World Bank: Montenegro became a member of the World Bank Group in January 2007. The World Bank has been providing support to Montenegro since 2001. Active support from the World Bank is currently around US$ 30 million, while the IFC has a portfolio of private sector projects of around US$ 18 million. In June 2007, the World Bank approved a new four-year Country Partnership, which will help to develop capacity in the public administration, ensure the country moves on to a sustainable growth path and help the country on its path to the EU.

European Agency for Reconstruction: the EAR manages, on behalf of the European Commission, a cumulative portfolio of some €129 million in Montenegro. The country has received assistance from the European Union since 1998, principally under the Community Assistance for Reconstruction, Development and Stabilisation (CARDS) Programme which is part of the wider Stabilisation and Association Process – the EU's key strategy for the Western Balkans region. The emphasis of EU assistance has evolved from post-conflict reconstruction to helping Montenegro with reform in areas such as justice and home affairs, public administration and public finance, and economic development. Currently, programmes strengthen central and local administration, the police and the judiciary, public finances, the agricultural, transport and energy sectors, the environment and state utility providers. Projects also promote social development, with a special focus on minorities, women, refugees and the displaced, and the strengthening of civil society, including independent media. EC funds are helping the region establish the conditions for economic growth, with a particular emphasis on attracting investment, particularly from IFIs. To this end, the Agency collaborates closely with IFIs and has prepared strategic investment plans for environmental infrastructure works, which have been used as the basis for identifying ongoing loan programmes. To complement this investment, the Agency also supports the development of project implementation units in the transport and environment sectors.

European Investment Bank: In Montenegro the EIB is financing limited scale projects of small and medium enterprises and local infrastructure projects of local authorities. In addition, it is considering financing waste water and sanitation of the municipalities and along with the Bank it is considering financing of the rehabilitation of the railway infrastructure.

USA: USAID activities in Montenegro are built around three broad objectives: (1) Building a strong investment climate. USAID partners with Montenegrin government counterparts, non-governmental organizations and with other US Government departments to help deepen structural reforms and improve the legislative process; to provide support on implementation and enforcement of new legislation and to help improve governance, including the balance of and exercise of authority of key institutions and their responsiveness to the public. (2) Fuelling local economic growth. USAID programs support the local dynamic for private sector growth by helping improve the local environment that will enable businesses to grow and prosper; and strengthening the capacity of businesses to enter and participate in the market. (3) Strengthening democracy and economic security. USAID activities throughout Montenegro are working to strengthen civil society advocacy, enhance the capacity of the media to transmit crucial information to citizens, and also to strengthen the ability of democratic parties to represent constituent interests in political processes.

Italy: From 2004 to 2006 Italy has pledged more than €1.5 million in technical assistance for the environmental sector in Montenegro. Activities focused on sustainable development, legal advice on the ratification of Kyoto Protocol, energy sector development, energy efficiency, potential renewable sources, and management of water resources.

Germany: The German development agency KfW has handled the majority of German bilateral commitments for Montenegro. Recent assistance has focused on energy restructuring, credit lines through a local bank for energy efficiency, support to municipalities to help detect and reduce leakages in the water supply system, as well as to develop wastewater removal capacity.

ANNEXES

Annex 1	**Selected Economic Indicators**
Annex 2	**Political Assessment in the Context of Article 1 of the Agreement Establishing the Bank**
Annex 3	**Assessment of Legal Transition**
Annex 4	**Background on Montenegro's Electricity Sector**
Annex 5	**EBRD Technical Co-Operation Programs**

Annex 1: Selected Economic Indicators

Montenegro	2001	2002	2003	2004	2005	2006	2007
						Estimate	*Projection*
Output and expenditure			*(Percentage change in real terms)*				
GDP	-0.2	1.7	1.5	3.7	4.1	6.5	7.0
Industrial gross output	-2.0	0.7	2.2	13.8	-1.9	1.1	na
Agricultural gross output	na	na	na	na	na	na	na
Employment			*(Percentage change)*				
Labour force (end-year)	-1.3	-0.5	-2.7	-3.3	-4.8	0.0	na
Employment (end-year)	0.0	-0.7	2.1	0.0	0.7	10.4	na
			(In per cent of labour force)				
Unemployment (end-year)	36.5	36.7	33.5	31.3	27.3	19.7	na
Prices and wages			*(Percentage change)*				
Consumer prices (annual average)	22.6	18.2	6.7	2.2	2.6	3.0	2.6
Consumer prices (end-year)	26.6	9.3	6.0	1.6	2.5	2.8	2.5
Producer prices (annual average)	14.5	4.6	2.9	5.8	2.1	na	na
Gross average monthly earnings in economy (annual avg)	16.8	30.5	17.8	12.2	7.6	na	na
Government sector			*(In per cent of GDP)*				
General government balance	-4.0	-3.8	-4.9	-2.6	-1.7	3.6	3.0
General government expenditure	39.9	37.3	45.6	43.3	42.0	41.9	na
Monetary sector			*(Percentage change)*				
Broad money (M2, end-year)	na	na	na	16.3	49.6	87.4	na
Domestic credit (end-year)	na	na	na	42.4	10.6	135.9	na
			(In per cent of GDP)				
Broad money (M2, end-year)	na	na	33.1	34.9	48.8	83.5	na
Interest and exchange rates			*(In per cent per annum, end-year)*				
Discount rate	na	na	na	na	na	na	na
Money market rate	na	na	na	na	na	na	na
Deposit rate	na	na	na	na	na	na	na
Lending rate (long-term)	na	na	na	na	10.8	9.1	na
			(Euros per US dollar)				
Exchange rate (official, end-year)	1.1	1.0	0.8	0.7	0.8	0.8	na
Exchange rate (official, annual average)	1.1	1.1	0.9	0.8	0.8	0.8	na
External sector			*(In millions of US dollars)*				
Current account	-169	-158	-116	-149	-180	-657	-606
Trade balance	-436	-402	-405	-518	-640	-1,197	-1,289
Merchandise exports	211	305	306	561	549	603	711
Merchandise imports	647	707	711	1,079	1,189	1,800	2,000
Foreign direct investment, net	10	84	44	63	474	550	650
Gross reserves, excluding gold (end-year)	na	na	56	75	219	251	na
External debt stock	na	700	na	na	822	867	na
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	na	na	0.8	0.7	1.9	1.5	na
			(In per cent of exports of goods and services)				
Debt service	na	4.2	4.8	3.4	2.9	3.0	na
Memorandum items			*(Denominations as indicated)*				
Population (end-year, million)	0.7	0.7	0.7	0.7	0.7	0.7	na
GDP (in billions of euros)	1.24	1.30	1.39	1.54	1.64	1.80	1.97
GDP per capita (in US dollar)	1,688	1,857	2,381	2,889	3,147	3,426	na
Share of industry in GDP (in per cent)	na	na	na	na	na	na	na
Share of agriculture in GDP (in per cent)	na	na	na	na	na	na	na
Current account/GDP (in per cent)	-15.2	-12.9	-7.4	-7.8	-8.6	-29.1	-22.9
External debt - reserves (in US$ million)	na	na	na	na	603	615	na
External debt/GDP (in per cent)	na	57.1	na	na	39.6	38.3	na
External debt/exports of goods and services (in per cent)	na	148.6	na	na	86.7	80.2	na

Annex 2: Political Assessment in the Context of Article 1 of the Agreement Establishing the Bank

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 country became independent on 3 June 2006, following the holding of a referendum on independence, an option envisaged by the Constitutional Charter of the State Union of Serbia and Montenegro, created in 2002 with the active involvement of the European Union. The EU Foreign Ministers on 12 June 2006 recognised the referendum result and announced that EU members would individually recognise Montenegro and establish diplomatic relations with it. Serbia recognised Montenegro as an independent state on 15 June 2006. The resolution of pending issues with Serbia has been proceeding smoothly, including succession and division of assets, as well as issues concerning citizenship rights and social security.

The independence achieved in 2006 is a culmination of long-time aspirations. The pro-independence movement, which has centuries long tradition, in the last ten years has been closely associated with the former President and Prime Minister of Montenegro (currently the leader of the ruling Democratic Party of Socialists) Milo Djukanovic and his associates, who started to distance themselves from the Milosevic regime in the mid-1990s. What was initially perceived by many as a conflict between conservatives and reformers in the leadership of the then ruling Socialist Party led by Milosevic, soon became a clash of opposite views regarding the future of the state. Djukanovic and his associates projected a pro-reform, pro-Western course, which soon became intertwined with the above-mentioned pro-independence aspirations always present in Montenegrin society. Under Djukanovic's leadership, Montenegro made its way to independence gradually and peacefully.

During its first year as an independent country Montenegro has proved to be a politically stable and economically viable state, which has the potential to grow rapidly over the medium term. At the same time, many problems and weaknesses common to the region, not least the low capacity of public administration, are present in Montenegro as well. Among the main challenges ahead are in the area of institutional reform, as well as the adoption of the country's new Constitution (see Rule of Law).

<u>Elections</u>

Parliamentary and local elections were held in Montenegro on 10 September 2006, in the wake of Independence euphoria. According to the international Election Observation Mission led by OSCE Office for Democratic Institutions and Human Rights (ODIHR), they were held largely in line with international standards. However, a number of challenges were identified, related mainly to media behaviour. Voter turnout was relatively high at 71.37 per cent. The Parliament resulting from the parliamentary elections is considered a Constitutive Assembly. The opposition maintains that, once the country' s new Constitution is adopted, new parliamentary elections will have to be held, but this view is not appreciated by the ruling coalition.

<u>Rule of Law</u>

The Proclamation of Independence of Montenegro provided for a transitional implementation of the legislation of the former State Union, including its international obligations, until the adoption of relevant Montenegrin legislation. The country is gradually upgrading its capacity to perform new competences, notably in the areas of security, foreign affairs, visa, asylum and migration. Montenegro adopted a National Security Strategy, providing for the country to become part of regional and global security systems and for a professional Army with appropriate civilian control.

One of the most important issues for Montenegro is the adoption of a new Constitution, preparations for which commenced immediately after the independence. It has been developed in cooperation with the Venice Commission and is expected to be in line with European standards and practices, including guarantees for the independence of the judicial system and protection of minorities. The first phase of the deliberations on substance, which ended on 5 May 2007 and which included the first reading in the Parliament and subsequent public debate, revealed that the most contentious issues relate to national symbols (including national anthem and the name for the official language of the country), as well as local self-government (see below in the section devoted to minority rights).

The legal framework for the operation of the Montenegrin judiciary has gradually been put in place and is currently governed, pending the new Constitution, by the Montenegrin Constitution of 1992, which guarantees the independence of the Courts. The government has recognised the need to further reform and upgrade the judicial system in line with European standards, and has initiated a new Judicial Reform Strategy, which is due to address the efficiency of the judicial system, accessibility of the courts, education of judges and prosecutors and confidence in a judicial and legal system free from political interference.

Integrity issues

The Montenegrin government has made some progress in fighting against corruption. It adopted, in particular, an Action Plan and created a specialised unit within the Police. Key measures envisaged by this plan stem from important international documents, including GRECO, the PACO Impact project of the Council of Europe, as well as the European Partnership priorities. At the same time, progress in practical implementation on the ground is still slow and corruption continues to be a major issue. The overall legal and administrative framework for the management of public assets contains loopholes which allow corrupt activities to take place, including in privatisation, concessions, construction and spatial planning and public procurement. There is a lack of an appropriate legal framework to deal with the conflict of interests of officials. The capacity of the authorities to effectively monitor, prosecute and try corruption cases remains limited and so the total number of persons convicted also remains low. Overall, in spite of some progress, in particular in the area of the adoption of strategic documents and action plans, the situation concerning the fight against corruption on the ground needs further improvement.

Human Rights

The former Serbia and Montenegro State Union was a signatory to all major international human rights instruments, including the European Convention on Human Rights and Fundamental Freedoms. Pending the adoption of the new Constitution, Montenegro has developed a set of legal acts on the protection of human rights, which are based on the Chapter on Human and Minority Rights and Civil Freedoms of the Constitutional Charter of the former State Union of Serbia and Montenegro.

The constitutional guarantees of freedom of thought, conscience and religion are generally respected. There is a Commission for religious issues, operating under a

Minister without Portfolio. The government has not interfered in the continuing dispute between the Serbian Orthodox Church (SOC) and the Montenegrin Orthodox Church (MOC) on the canonical status of the latter, which remains unrecognized and largely isolated in the Orthodox World. The government has so far taken a firm approach regarding the protection of the property of the SOC, which the MOC seeks to overtake.

Montenegrin media has been assessed in the latest report by Freedom House as 'partially free' (separate from Serbia ranking is not available), but it continues to suffer from occasional political interference.

Montenegro has a satisfactory legal framework for civil society organisations. NGO representatives have been involved in the preparations of a platform for cooperation between the Government and civil society. Montenegrin NGOs are particularly active in the social field, including protection of vulnerable groups, and on election observation. They are also increasingly active in the area of European affairs.

The situation with human trafficking in Montenegro is comparable to that in other countries of the region. Montenegro is mainly a transit and destination country for women and girls trafficked for forced prostitution, and, to a lesser extent, also a source for human trafficking. The Government is making significant efforts to combat trafficking and forced prostitution (which are both sanctioned in the new criminal legislation as specific offences with stringent penalties), as well as to protect the victims. The special Action Plan for the protection of children has been adopted and covers the period up to 2010. The authorities are actively supporting activities aimed at the prevention of trafficking, including support for relevant NGOs and promoting various educational programmes. However, some problems still have to be addressed, including additional efforts to effectively prosecute traffickers and those who support them.

Minority rights

The new independent state inherited a highly heterogeneous ethnic composition. Montenegrins, according to the latest census, are 43% of the population. Ethnic Serbs are 30%, and, despite considerable linguistic, religious and cultural closeness, the relations between these two largest ethnic groups remain sensitive, particularly after the referendum, at which Serbs overwhelmingly voted against the independence of Montenegro. The largest other minorities are Bosniaks (7%) and Albanians (5%). Both of them are represented in the Parliament and in the government, and the relations with them are generally good, although there are certain disagreements with ethnic Albanian representatives regarding local self-government (the latter insist on enhanced competences in the areas where they are a majority, including establishing of separate municipalities instead of the current sub-municipalities).

The Framework Convention for the Protection of National Minorities and the European Charter of Local and Regional Languages were ratified by the former State Union of Serbia and Montenegro. In April 2006, a new Law on Minority Rights and Freedoms was adopted by the Parliament, which provided for a general framework for the protection of minorities and affirmed the multi-ethnic character of Montenegro, including non-discrimination of ethnic and other minorities, use of language, free association and participation of minorities in public and social life. It also envisages the establishment of minority National Councils, as well as a Republican Fund for Minorities. After the proclamation of independence, Montenegro is in the process of reviewing its legal obligations and defining the institutional and legal set-up for additional protection of minority rights.

External relations

As a newly independent state, Montenegro is keen to enlarge its participation in all relevant international organizations, and has so far been quite successful in this respect. Montenegro was admitted to the OSCE on 21 June 2006 and became a member of the UN on 28 June 2006. It joined the EBRD on 6 September 2006, and the IMF and World Bank in January 2007. The new state has already a relatively open trade regime and the talks on WTO membership are progressing well. On 11 May 2007 Montenegro was admitted to the Council of Europe.

The country leadership's clear foreign policy priority is integration into Euro-Atlantic institutions. However, the current level of popular support for NATO membership is significantly lower than that for EU membership. Nevertheless, Montenegro was invited in 2006 to join NATO's Partnership for Peace (PFP) Programme.

The process of EU approximation is developing well. Montenegro initialled a Stabilization and Association Agreement (SAA) with the EU on 16 March 2007 and its signing is foreseen in October 2007.

Montenegro's second foreign policy priority is regional cooperation, where it has participated constructively both on the multilateral level and in bilateral relations with regional neighbors. The progress in this area, which in and of itself brings numerous practical benefits, is an essential part of the process of moving towards the EU. Montenegro is an active participant in the Stability Pact and various regional initiatives. It signed the agreement establishing a regional free trade area within the framework of an enlarged and amended Central European Free Trade Agreement (CEFTA). It is a signatory to the Energy Community Treaty, and signed the European Common Aviation Area Agreement in June 2006. The country has gradually been establishing good neighbourly relations with all of the countries of the region. Progress achieved in negotiations with Serbia on pending issues resulting from the dissolution of the State Union is particularly significant. The Agreement between Serbia and Montenegro on membership into the International Financial Institutions and the distribution of financial assets and liabilities of 10 July 2006 paved the way for Montenegro's accession to those organisations. On Kosovo, Montenegro has traditionally pursued a constructive and pragmatic approach, even if its Kosovo policy is by nuance more cautious than that of some other immediate neighbours, which is understandable given the sensitivity of Podgorica's relations with Belgrade. Bilateral relations with its other immediate neighbours, Albania, BiH, and Croatia are very good, and there are practically no open issues.

There are no major problems in Montenegro's cooperation with the International Criminal Tribunal for the former Yugoslavia (ICTY).

Annex 3: Assessment of Legal Transition

The EBRD has developed and regularly updates a series of assessments of legal transition in its countries of operations, with a focus on selected areas relevant to investment activities: capital markets, company law and corporate governance, concessions, insolvency, secured transactions and telecommunications. The existing tools assess both the quality of the laws "on the books" (also referred to as "extensiveness") and the actual implementation of such laws (also referred to as "effectiveness"). All available results of these assessments can be found at www.ebrd.com/law. This annex presents a summary of the results for Montenegro accompanied by critical comments of the Bank's legal experts who have conducted the assessments.

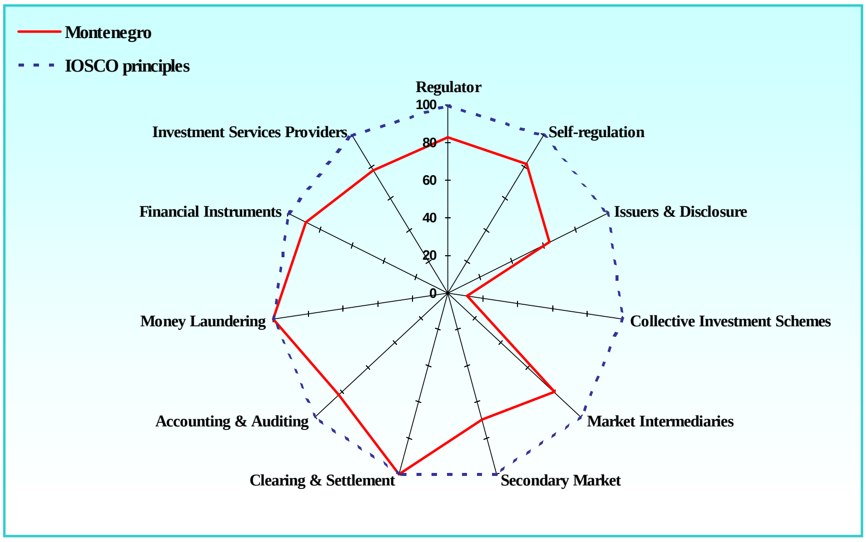
Capital Markets

The primary legislation governing the securities market in Montenegro is the Law on Securities, enacted in December 2000 as amended last in February 2006. The Law on Securities regulates the terms and conditions for issuance, public offering and trading of securities, the rights and obligations of participants in the securities market, and the organisation, scope and powers of the Securities Commission of the Republic of Montenegro.

The Securities Commission of the Republic of Montenegro (SCM) is the market regulator in Montenegro. The SCM was founded in 2000 and took over the jurisdiction from the Yugoslav Federal Commission for Securities and Financial Markets, market regulator since 1989. The SCM has the authority to enact implementing provisions to the Law on Securities, to approve and supervise public offers of securities, to license and supervise securities markets participants, to authorize and regulate collective investment schemes, to regulate the manner and scope of the trading on the securities market and to regulate takeovers.

There are two stock exchanges in Montenegro. The Montenegro Stock Exchange (MSE) was established in June 1993 by four Montenegrin banks and the Montenegrin Agency for Economic Restructuring and Foreign Investments. The second stock exchange is the New Securities Exchange (NEX), established on 20 September 2001. According to the Securities Law, trading of securities can be performed only at the official stock exchanges; therefore no OTC market exists in Montenegro.

Quality of securities market legislation – Montenegro (2005)



Note: The extremity of each axis represents an ideal score, i.e., corresponding to the standards set forth in IOSCO's *Objectives and Principles for Securities Regulations*. The fuller the 'web', the closer the relevant securities market legislation of the country approximates these principles.

Source: EBRD Securities Market Legislation Assessment 2005

In 2005, the EBRD benchmarked the Montenegro securities markets legislation with the "Objectives and Principles of Securities Regulation" published by IOSCO. The results demonstrated that the national legislation is in "medium compliance" with international standards, with major deficiencies registered in the "Collective Investment Schemes" section. This reflects gaps in the legal framework as collective investment schemes are not regulated by law.

Corporate Governance

Corporate governance regulation in Montenegro is essentially contained in the "Business Organisation Law" enacted in February 2002. According to this law, commercial activities can be organised in Montenegro as individual entrepreneurships, joint stock companies ("JSC"), limited liability companies, general partnerships, limited partnerships and foreign company branches.

In July 2003 a corporate governance code was developed by the SCM with the assistance of the European Agency for Reconstruction. The code includes a list of best practices and general recommendations and aims at improving the corporate practices in place in Montenegro in line with international standards.

In 2005, the EBRD conducted a survey for testing the effectiveness of corporate governance (how the law works in practice). A case study dealing with related-party transactions was designed. The case study investigated i) the position of a minority shareholder seeking to access corporate information on a presumed related-party transaction was indeed entered into by the company and ii) how compensation could be obtained in case damage was suffered. Effectiveness of the system for both questions was assessed based on four principal variables: complexity, speed, enforceability and institutional environment.

The survey revealed that there are a limited number of avenues allowing a minority shareholder to request disclosure in Montenegro. Procedures are not considered particularly complex and an executive court order is usually obtainable in 5 months. Unfortunately, the low quality of company information generally available can undermine the effectiveness of the action. Moreover, judgements are usually difficult to enforce as there is no effective penalty for not obeying court decisions in enforcement proceeding and enforcement is usually obstructed by the defendant. When considering redress mechanisms, the situation appears somehow better, but enforcement difficulties and length of procedures – which might last over three years – contributes to weaken the effectiveness of the possible actions.

Related party transactions in Montenegro are not well defined and this negatively affects the outcome of our analysis. In general, the quality of company books, auditing, competence and experience of courts, prosecutors and market regulator need to be improved. Judicial proceedings are generally slow, providing the defendant with numerous possibilities for obstruction, without incurring procedural penalties. Citing case law by lawyers has only recently become a practice, since in the past the ordinary method was to refer only to laws and regulations. However its use is still limited due to the difficulties to find reliable case collections. Finally, corruption and partiality of judgements are still reported as problems.

Concessions

Concessions are regulated in Montenegro by the Law on Participation of Private Sector in Performing Public Services, dated 2002 (the "Law") which replaces a previous act, dating back to the 1990s, in an attempt to address numerous drawbacks. Such attempts have not however been entirely successful and a further reform is underway.

The Law governs a variety of PPP arrangements, including concessions, Build-Operate-Transfer (BOT), lease and management contracts, though often by way of reference to public procurement legislation (in particular, for lease and management contracts). Concessions application seems to be limited to natural resources, while BOT arrangements are applicable to other sectors such as transport, electricity and water. Overall, the Law is a fairly extensive piece of legislation regulating a number of important areas and generally providing a working base for PPP. Among well-drafted rules are sections governing dispute settlement which along with project agreement rules do provide for flexibility sought from modern laws.

However, there are some inconsistencies. The EBRD Concession Law Assessment project, that examined laws how they appear on the book throughout the EBRD's 27 countries of operations, demonstrated that the national legislation is in "medium compliance" with international standards. It revealed, in particular, the following areas that fall short of the good standards against which regimes were benchmarked. The Law does not clearly define its boundaries and lack coordination with sector specific legislation and the Public Procurement Law. Certain provisions are repetitive, others are conflicting. There are a numerous undefined terms used, a number of provisions are drafted without the due clarity (e.g. reference to "newest EU Rules"). An excessive number of public bodies involved, including the Privatisation Council, makes the overall process rather complex and lacking coordination, thus creating uncertainties. The selection procedure is also unclear in many respects (e.g. provisions regulating pre-qualification and request proposals procedures are not clearly distinguished) and seems difficult to implement. Provisions regulating the project agreement need to be improved as well (e.g. two articles in the Law regulate provisions to be included in such agreement) yet they do give guidance to main issues to be covered and remain flexible.

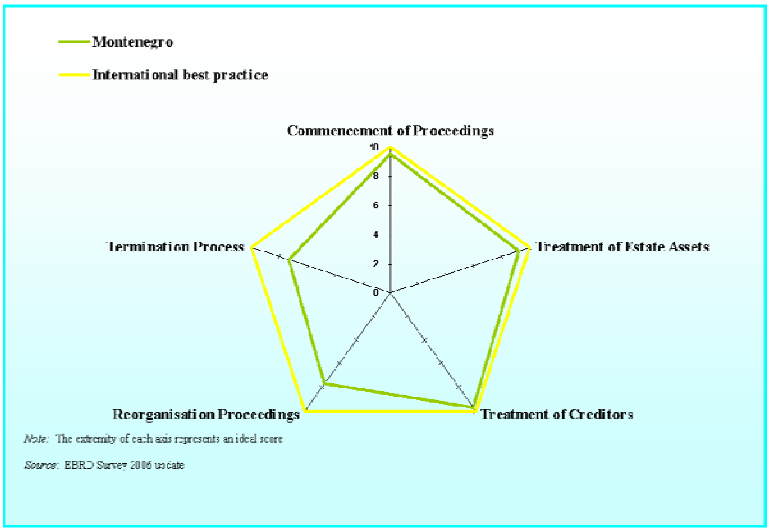
The 2006 EBRD Legal Indicator Survey, evaluating how laws work in practice, demonstrated that the concessions legal framework is overly detailed and complex, neither ensuring clarity and stability of rules nor providing for sufficient flexibility in their implementation.

Insolvency

Insolvency is governed by the Law on Business Organisations Insolvency (2002/ amended in 2007) (the "Law"). The Law is of very high quality and provides most of the tools essential for an efficient and effective insolvency system. In the 2006 EBRD Insolvency Sector Assessment, which examined the quality of insolvency laws against international standards, the Law was one of five which scored high compliance.

As demonstrated in the chart below, the Law is of a high quality throughout with no areas of significant weakness. It provides for a clear definition of the criteria which must be met to start a process; it sets out reasonably short deadlines and detailed provisions regarding the timing of the filing and hearing of applications; it provides for self-induced or creditor induced liquidations and re-organisations, administered by an insolvency administrator; and the Law provides for extensive recognition and cooperation in respect of cross-border insolvencies, adopting the UNCITRAL Model Law almost without change.

Quality of Insolvency Legislation – Montenegro (2006)



Note: The extremity of each axis represents an ideal score, i.e., corresponding to the international standards such as the World Bank's Principles and guidelines for Effective Insolvency and Creditor Rights Systems, the UNCITRAL Working Group on "Legislative Guidelines for Insolvency Law", and others. The fuller the 'web', the more closely insolvency laws of the country approximate these standards.

Source: EBRD Insolvency Sector Assessment 2006

The Law has many protections for creditors, including providing for "adequate protection". Where property of the estate is secured by a pledge, lien or security interest, and the creditor holding the pledge, lien or security interest is prevented from exercising its right to seize, possess or sell the property due to the operation of the moratorium under the law, the secured creditor is entitled to protection of the secured property in order to maintain its condition and value as it was at the time the moratorium came into being. The "adequate protection" can include cash payments, security over additional property, and repair, maintenance or insurance as required. Creditor rights are also protected in the detailed rules for the avoidance of certain transactions by the debtor and in the significant role that the law allows creditors to take in overseeing the insolvency process.

There is room for improvement in the law, however, with the reorganisation process being a prime example. While the reorganisation process is strong as a whole, it would benefit from provisions which limit the ability of connected parties to vote in respect of the approval of reorganisation plans; provision for the independent analysis of reorganisation plans to be available to creditors; provisions for the supervision of approved reorganisation plans; and provisions for the amendment of plans that are found to be incapable of completion as determined by the creditors.

Secured Transactions

Security over movable assets in Montenegro is governed by the Law on Secured Transactions for the Republic of Montenegro No. 38/02 (the "Law"), which is based on Article 9 of the US Uniform Commercial Code.

The Law's objective is to provide the exclusive means by which pledges (that is, security rights) over movable assets are created and become effective against third parties. As a result, the law applies to all transactions intended to create a pledge, regardless of their respective form.

The Law has been in force since January 1, 2003. The Pledge Registry, run by the Commercial Court in Podgorica, started operating in July 2003. The Registry is electronic and has its website at www.rzcg.cg.yu. Registration takes place either on-line for registered users, or by way of submitting an application form available on the registry's website, either personally or by fax. Only lawyers (members of the Montenegrin Bar Association) and commercial banks can be registered users. Searching however is available freely on the internet.

Generally, the law provides for a modern, flexible and transparent system and the register appears to function well – its use remains limited. The biggest uncertainty with the Law remains its enforcement, as it is still unclear whether the mechanisms provided in the law are able to operate as intended.

Telecommunications

The communications sector is currently regulated by the Agency for Telecommunications (Agentel) and governed by the Law on Telecommunications 2001. Agentel was established as an independent regulatory authority in 2001, one of the first in the region. In common with international best practice, its responsibilities include introducing competition, ensuring non-discriminatory access, settling disputes, issuing licences and regulating interconnection and tariffs. The law reflects most internationally accepted standards and a good level of harmonisation with relevant European Union (EU) norms.

Formal liberalisation of the market in 2004 and the incumbent operator, T-Crnogorski Telekom (T-CG) was privatised to Hungary's Matav (owned in turn by Deutsche Telekom) in 2005. The fixed sector is dominated by T-CG and maintains a teledensity of just over 30%. The mobile sector is currently shared between T-Mobile Montenegro (the mobile arm of T-CG) and ProMonte (a subsidiary of Norwegian Telenor) and reports a teledensity of in excess of 100%. A third mobile licence was recently awarded by Agentel to Mtel (a Telekom Srbija and Netherlands-based Ogalar consortium) following a February 2007 tender. Mtel reports July 2007 as a start-up date for operations.

Three fixed wireless licences were issued in March 2007 to the Telekom Srbija/Ogalar consortium; Internet provider Broadband Montenegro; and, T-Mobile Montenegro.

While Agentel appears to have put many of the necessary building blocks in place and work from a relatively advanced legislative basis and despite the formal liberalisation of the market in 2004, there is little or no meaningful competition in the fixed market, with T-CG retaining a near-monopoly. Restrictions on international access for operators other than T-CG also appear to remain in place, providing barriers to full competition. While the recently awarded third mobile and fixed wireless licences should spur competition, the authorities should ensure that all unjustified and unnecessary barriers to market entry are removed. While there are plans to revise the framework and update the current legislation to address these issues, it would appear that, though requiring update, the current legislative and regulatory base permits enough powers and authority for Agentel to implement a fully functioning competitive market place.

Going forward, the Government of Montenegro should provide Agentel all necessary support (policy and otherwise) to enable the fully implementation of EU best practice legal/regulatory framework and preparation of the necessary revisions to that framework. Agentel, for its part should move swiftly to fully implement an interconnection regime that will facilitate further competition and work to fully implement cost based tariffing at the earliest feasible point.

The EBRD Legal Transition Team is launching a programme of legal technical cooperation assistance with Agentel during the third quarter of 2007. This programme, to be funded through the EBRD West Balkans Fund, will provide Agentel with capacity building assistance and training and support with the implementation of EU consistent interconnection and tariffing frameworks.

Annex 4: Background on Montenegro's Electricity Sector

Electricity is the main energy source in Montenegro. It is the main source of space heating for households, and KAP, the largest industry in Montenegro accounts for almost 50% of total electricity consumption. Energy efficiency is fairly low compared to EU countries partially as a result of low tariffs and the use of inefficient appliances.

The Montenegrin electricity system is a small one, serving only 200,000 customers. Total electricity demand in Montenegro is about 3,800 GWh. Households account for 1,400 GWh, with the majority of households using electricity for heating. Montenegro is unable to satisfy all this demand from its own generation capacity, and has to import 33% if its total needs. These imports come from various neighbouring countries and are arranged on an annual contract basis.

Montenegro has two large hydropower stations, one large coal fired thermal power station and 7 small hydro power stations, with a total installed capacity of about 950 MW. TPP is designed to burn lignite coal from the nearby Pljevlja mine (RUP). Without considerable investment in emission control equipment TPP will fail to meet EU emission standards.

Total losses in the Montenegrin system are high compared to European standards. Distribution losses have remained at around 19% over the past ten years, estimated as being evenly divided between technical losses and electricity theft.

The Government will continue to be responsible for overall energy policy.

Montenegro's power plants and lines

Source: EiEE

Annex 5: EBRD Technical Co-Operation Programs

Montenegro – 2002/2007 (31-05-2007)
Overview of the EBRD TC Fund and Official Co-financing

- Aggregate TC Funds Commitment and Official co-financing signed projects;
- Future scenario.
- Detailed Breakdown of TC Projects
- Detailed Breakdown of Official Co-financing (signed) projects.

Aggregate TC Funds Commitment and Official co-financing signed projects;

- Since 2002, the Bank has been actively cooperating in the Country with multi and bilateral donors in the framework of both TC projects (for which the aggregate commitments value for the period 2001 – 05/2007 reached the value of € 5.9 million) and Official co-financing initiatives (€ 22.7 million is the total amount of contribution to 6 operations as per attached Table).
- TC Fund: Three donors (EAR, France and Italy) account for more than 80% of the total aggregate commitments and the ERA is, by far, the largest donor with €3.5 million. Four sectors benefited from the EBRD TC Fund. TAM/BAS Programme (€3.6 million), Transport (€1.1 million), Manufacturing (€ 0.65 million) and Finance/Banking (€ 0.3 million). In 2006, TC fund in the amount of €1.0 million have been committed to implement assignments in Montenegro and additional support has been provided for the TurnAround Management (TAM) and Business Advisory Services (BAS) Programmes.
- Official Co-financing: The EIB (€11.5) and the National Institutions (€9.1 million) have been the largest official co-financers and, with a total contribution of € 20.6 million, are covering more than the 90% of the total. Other co-financers have been "DEG" and the "US/EBRD SME Facility". In 2006 no official co-financing in Serbia has been signed. The large part of official co-financing (€11.5 million) has been provided in the form of IFI and/or parallel loans. The co-financing amount provided in Participation was €7.0 million) and €4.1 million was provided in equity. The co-financing has been used to implement project in two sectors: Transport (€20.6 million), and finance (€ 2.1 million).

TC Funds and Donors
Aggregate Commitments (2001-04/2007): €5.5 million

DONOR	€ Committed (€ '000)
EAR	3,490.6
France	796.6
Italy	425.7
Ireland	260.4
Greece	250.0
Spain	227.3
Japan	85.5
BRSF	27.0
TOTAL	**5,563.1**

Official Co-financing and Donors
Signed projects - Signing years: 2001-2006
€ 22.7 million

DONOR	€ Committed (€ million)
European Investment Bank	11.5
Montenegro	9.1
DEG (Germany)	1.5
USA	0.6
TOTAL	**22.7**

Future scenario: 2007

- Montenegro will remain among the priority countries for the donors' community.
- The EAR started the implementation of her exist strategy. There will not be a new budget allocation for 2007 and, by 2008, the Agency activities will come to an end.
- Montenegro is considered by the EU as a "Potential EU Candidate Country" and, as such, the Country will benefit from the newly established "EU-Instrument for Pre-Accession (IPA)"over the period 2007-2013. The EC has yet to finalise the details of the IPA programme, but has indicated that all previous financial instruments (including the co-funding ISPA instrument) will be merged into one and planning and budgeting will be on a multi-year basis. It is envisioned by the Commission that the recipient country will have the full management of the programmes, through a decentralised system. Over the period 2007-2010 the IPA assistance to Montenegro will mainly address "Transition assistance" and "Institutional building" with a "Cross Border Cooperation" component. The full implications for operational support of activities falling within EBRD's mandate have yet to be determined. It's unclear at which level the new instrument could ensure the utmost necessary grant support provided by the EAR over the previous years. The budget allocation should be in the region of €130 million over the programming period as follows[3] (in million €):

	2007	2008	2009	2010	TOTAL
Institutional Building, Transition Assistance	*27.5*	*28.1*	*28.6*	*29.2*	*113.4*
CBC	*3.9*	*4.5*	*4.7*	*4.8*	*17.9*
TOTAL	**31.4**	**32.6**	**33.3**	**34.0**	**131.3**

- The EBRD has recently established a new "Multi-donor Fund for the Western Balkans" which includes Montenegro. The Fund became operational in November 2006 with an initial allocation of € 10 million[4]. Since the beginning of its activities, the Fund has mobilised €104,000 to implement TMG

[3] Communication of the Commission on the IPA MIP 2008-2010

[4] To date, members of the multi donor Fund for W. Balkans are: Austria, Canada, Czech Republic, Finland, Ireland, Luxembourg, Norway, Poland, Slovak Republic, Slovenia, Spain, Sweden and United Kingdom.

assignments and it's expected that the Fund will become a key instrument for the preparation and implementation of projects in the Country.

- Montenegro is considered, like other W. Balkans Countries, as a priority Country for Italy. Among the new initiatives developed in 2006, Italian funds in the amount of €10 million have been allocated to implement the *"Italy-EBRD Western Balkans Local Enterprise Facility"*: it is a risk sharing and equity/quasi-equity facility supporting local enterprises in the region, inclusive Montenegro.