Montenegro

Highlights

- **Economic recovery continues.** A strong performance by the tourism sector was the driving force behind 13.0 per cent gross domestic product (GDP) growth in 2021. Robust household consumption growth continued into 2022, supported by a minimum wage hike, but rising imports are stifling the growth rate.
- **The government introduced tax measures to improve living standards and decrease informality.** In addition to an 80 per cent minimum wage hike, the authorities introduced progressive taxation and reduced the sizeable labour tax wedge.
- **Reforms in the energy sector have continued.** The Montenegrin power exchange company is making progress on establishing a day-ahead electricity market with two regional power exchanges, while the state-owned power utility has joined the day-ahead power market of the Serbian power exchange.

Key priorities for 2023

- **There needs to be continuity of economic policy and implementation despite political change.** Public institutions should be strengthened to mitigate the potentially harmful effects of frequent political changes on policymaking and reform progress.
- **The pathway to decarbonisation should be developed.** The National Energy and Climate Plan (NECP) should be finalised, setting out plans for ending coal-powered generation, while a modern regulatory framework that creates incentives for private investment in renewable generation should be developed.
- **Public-sector reform should be stepped up.** Key measures that should be prioritised include adopting the draft Public Administration Reform Strategy, formulating a state ownership policy and centralising oversight of state-owned enterprises (SOEs), and improving fiscal impact analyses of proposed social measures and public investment plans.

TABLE Main macroeconomic indicators %

	2018	2019	2020	2021	2022 proj.
GDP growth	5.1	4.1	-15.3	13.0	3.7
Inflation (average)	2.6	0.4	-0.3	2.4	12.8
Government balance/GDP	-6.2	-1.8	-10.9	-1.7	-5.0
Current account balance/GDP	-17.0	-14.3	-26.0	-9.2	-13.8
Net FDI/GDP [neg. sign = inflows]	-6.9	-6.2	-11.2	-11.7	-11.1
External debt/GDP	163.7	167.4	221.6	191.5	n.a.
Gross reserves/GDP	22.3	27.6	41.5	35.3	n.a.
Credit to private sector/GDP	49.6	49.0	60.0	52.3	n.a.

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Macroeconomic developments and policy response

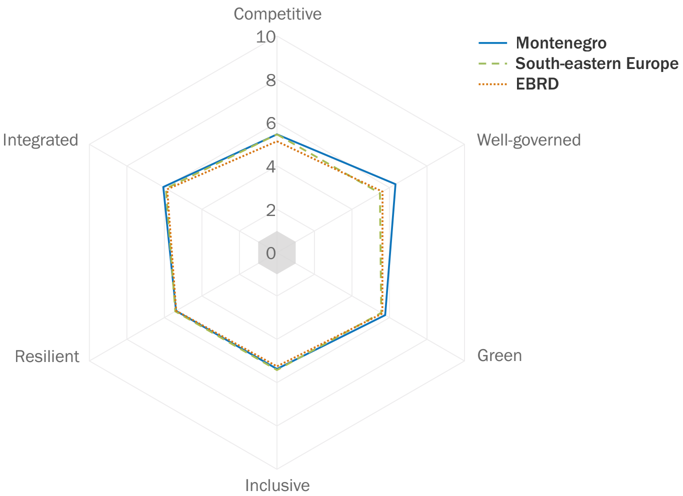
Economic recovery continues. Output grew by a strong 13.0 per cent in 2021 on the back of a successful summer tourism season, following a deep pandemic-induced recession in 2020. The expansion continued in 2022 with the economy growing by 7.1 per cent and 12.7 per cent year on year in the first two quarters of the year, respectively, as household consumption remained elevated but imports surged, leading to negative net exports. Household demand was supported by an 80 per cent minimum wage hike in January 2022 and the abolition of mandatory health contributions, driving a 33 per cent nominal increase in the average net wage in the first eight months of the year, albeit more muted in real terms due to high inflation. Retail trade led growth on the production side as foreign tourist arrivals were up by 59 per cent year on year by the end of August, although still below record 2019 levels. Investment remained weak amid a strong contraction in construction activity, as work on the Bar-Boljare highway, the country's largest infrastructure project, nears first-phase completion and political turmoil acts as a drag on new projects.

Inflation has risen sharply and the current account deficit has widened. The rate of inflation accelerated to 16 per cent year on year in September 2022, driven by rising prices for food and energy imports and exacerbated by wage growth. In the first half of the year, the current account deficit widened by 31 per cent annually, mainly because of higher prices for fossil-fuel imports, primarily petroleum. The country managed to satisfy power demand from local production in the 2021-22 winter, as the state-owned aluminium smelter, a significant electricity consumer, was closed temporarily. Meanwhile, foreign direct investment (FDI) increased by 80 per cent on the year in the first half of 2022 as investment in real estate more than doubled, with the largest portion of FDI coming from Russia.

Policy responses to rising prices were introduced with a delay due to political changes. In May 2022 the new government temporarily abolished value added tax (VAT) on cooking oil and flour and halved excise duty on fuel. In June 2022 retail profit margins on basic foodstuffs (cooking oil, flour, sugar and salt) were capped, VAT on bread was abolished and excise duties on single-use plastic were removed, to the benefit of domestic food producers. The government capped the rising price of wood pellets in July, and in September took steps to limit their export.

The short-term growth outlook is uncertain. We forecast GDP growth of 3.7 per cent in 2022 and 4.0 per cent in 2023. The economic impact of the war on Ukraine is reflected in continually elevated inflation, which is set to dampen demand. At the same time, stronger than expected private consumption and robust performance of the hospitality sector tilt the short-term outlook towards the upside. Political instability – with two governments being voted out in no-confidence ballots in parliament in the space of a few months – is creating uncertainty about the implementation of reforms needed to improve medium-term growth prospects.

CHART Assessment of transition qualities (1-10)



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Structural reform developments

The authorities are focused on closing European Union (EU) accession negotiating chapters. Having opened all negotiating chapters of the EU accession negotiating framework, the *acquis communautaire*, the focus has now shifted to closing chapters. Only three chapters have been provisionally closed since the opening of accession negotiations in June 2012 and there has been no progress in this regard over the past year. According to the European Council and European Commission, further progress in negotiations will depend on Montenegro meeting the interim benchmarks set in the rule-of-law chapters (23 and 24) of the *acquis.*

Important tax and wage changes have been adopted. In December 2021 key components of a previous government's Europe Now programme were included alongside the state budget for 2022 in a bid to reduce the sizeable labour tax wedge and reduce informality. Changes from the start of 2022 included an 80 per cent hike in the minimum wage to €450, the introduction of progressive personal and corporate taxation, the introduction of a non-taxable salary base and the abolition of obligatory healthcare contributions. These reforms were designed to attract new investment and lead to the formalisation of employment, but are likely to lead to lower net tax revenues, partially as all proposed revenue-reducing measures were adopted, including additional last-minute ones, while also not including all proposed revenue-enhancing measures. A budget rebalance was adopted in September 2022.

The first section of the country's biggest infrastructure project has been completed. The planned 170-kilometre Bar-Boljare highway is set to eventually connect the Montenegrin coast with the Serbian border. Highway construction started in 2015, led by the China Road and Bridge Corporation and supported by financing from China ExIm Bank. The first section, opened in July 2022, is 41 kilometres long and, due to the difficult terrain, the most expensive section.

The government has adopted an economic recovery platform for 2022-26. The platform, adopted by the then government in March 2022, aims to provide a detailed picture of the Montenegrin economy and presents a vision for medium-term development that should serve as a basis for further strategic documents. The six key objectives of implementation are: macroeconomic stability, stabilisation of demographic challenges, economic diversification, better implementation of infrastructure projects, innovation, digitalisation and the green economy, and good governance. The effectiveness of the platform remains to be seen in light of political changes since adoption.

Regulatory requirements for banks have been strengthened. The new Law on Credit Institutions, the Law on Resolution of Credit Institutions and an accompanying set of by-laws came into effect at the start of 2022, aligning regulation and supervision with Basel III standards (with a transition period) and the EU's regulatory framework. The Law on Credit Institutions strengthens the capital requirements of banks, introduces mandatory board supervision, tightens norms for the identification and classification of non-performing loans and sets criteria for determining the systemic importance of banks, while the latter introduces the resolution fund, minimum requirements for eligible liabilities (MREL) and a bail-in tool.

The Strategy for the Development of Women's Entrepreneurship was adopted in October 2021. The Strategy and accompanying action plan run from 2021 to 2024 and set out four strategic priorities: enhancing the business environment for women in business, access to finance, access to knowledge and skills, and promotion and networking.

A day-ahead power market is in the works as the energy regulator strengthens supervision. The Montenegrin power exchange company, BELEN, signed a service agreement in October 2021 with the European Power Exchange (EPEX SPOT) and the Slovenian SouthPool Energy Exchange (BSP) to establish a day-ahead electricity market in Montenegro. According to the Energy Community Secretariat, the agreement is a key step in improving competition and liquidity in the power market. In June 2022, the state-owned power utility, EPCG, joined the day-ahead power market of the Serbian power exchange, SEEPEX, primarily selling output from the Piva hydropower plant. In January 2022 legislation on the supervision of wholesale electricity and gas markets entered into force, empowering the national energy regulator to monitor markets and investigate abuse, thus helping to ensure fair energy prices.

Montenegro Works, the SOE management company, was liquidated in July 2022, less than a year after its founding. The company was established in August 2021, tasked with overseeing and analysing the financial performance of SOEs.