MONTENEGRO

Highlights

- **Economic growth in 2014 was disappointing.** A rebound on the back of strong foreign direct investment (FDI) inflows and progress on a major highway project is expected in 2015.
- **Construction of a section of a motorway from the capital to the north east of the country has begun.** The Chinese construction company CRBC will be in charge of construction of the 44-km long priority section (about one-third of the total motorway), while 85 per cent of financing will be covered by a 20-year loan from China EximBank.
- **Steady progress is being made on EU accession negotiations.** Montenegro has now opened more than half of the EU *acquis* chapters, and two chapters are provisionally closed.

Key priorities for 2016

- **Public finances need to be managed carefully.** The new highway project has added significantly to the public debt burden, notwithstanding the favourable interest rate and lengthy repayment period, and carries significant currency risk. Prudent management of spending will be vital to maintaining macroeconomic stability.
- **Further business environment reforms are needed.** Although Montenegro has been successful in attracting FDI, investor surveys point to dissatisfaction with areas such as the rule of law and property development, as well as tax policy stability and flexibility. Addressing rule-of-law issues will also be needed for further EU approximation.
- **Privatisation impetus needs to be restored.** Progress over the past year has been minimal, and a new effort is needed to bring assets to sale and attract further investment into key sectors such as energy and tourism.

Main macroeconomic indicators %

	2011	2012	2013	2014	2015 proj.
GDP growth	3.2	-2.5	3.3	1.8	3.0
Inflation (average)	3.5	4.1	2.2	-0.5	1.7
Government balance/GDP	-5.9	-6.8	-6.5	-3.0	-10.0
Current account balance/GDP	-17.7	-18.7	-14.6	-15.3	-17.0
Net FDI/GDP [neg. sign = inflows]	-12.0	-14.7	-9.7	-10.3	-11.4
External debt/GDP	117.6	126.6	128.7	132.9	n.a.
Gross reserves/GDP	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	57.9	57.4	57.0	55.7	n.a.

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Macroeconomic performance

Growth in 2014 was disappointing. Economic activity in 2014 was weakest in the second quarter, reflecting a reduction in the output of major utilities (relative to the same quarter in 2013). Growth in the third quarter (which accounts for about one-third of annual GDP and is highly dependent on tourism) was subdued, possibly as a result of difficulties in flood-hit Serbia and Bosnia and Herzegovina, and sanctions-hit Russia, which are major tourism markets for Montenegro. Overall, growth last year was 1.8 per cent. However, economic activity has picked up in the first half of 2015 with industrial production having risen by 6.7 per cent year-on-year. Tourism is also performing strongly: the number of tourists visiting Montenegro for the first six months of 2015 was 13.8 per cent above the same period of 2014.

The current account deficit continued to decline. This was due largely to a rise in revenue from tourism and remittances. Despite this, the current account remains one of the highest in the region at close to 15 per cent of GDP in 2014. However, as the country enters a new investment cycle, with several major projects in tourism, energy and infrastructure in the pipeline, the declining current account trend is likely to reverse.

Public debt is increasing. As of December 2014, public debt amounted to just below 60 per cent of GDP. The risk from activation of further state loan guarantees, equivalent to 9.4 per cent of GDP, remains. In line with the latest negative developments (public debt has increased by 20 percentage points since 2010), parliament has endorsed a new law on fiscal responsibility which regulates budget execution and the issuance of state guarantees, and sets a 3 per cent/GDP limit for the budget deficit and 60 per cent/GDP for public debt. This is an important step in improving the standards of public finance management in Montenegro. However, the law allows higher deficits (and debt) in case of financing for projects of "national interest". In December 2014 the parliament voted for the highway project to be treated as such. Nonetheless, the authorities have made significant progress in consolidating Montenegro's public finances in recent years. Fiscal tightening has been achieved by a combination of fiscal measures such as a VAT increase from 17 per cent to 19 per cent (although new exemptions have been introduced), an income tax increase for above-average earnings from 9 per cent to 13 per cent, and a freeze of public employees' wages and pensions, as well as improvements in revenue collection and containment of expenditures which are not designated for capital projects.

A pick-up in growth is expected in 2015. As an oil importer, Montenegro can expect a modest gain from the dramatic reduction in the oil price. If combined with strong FDI inflows and progress on the major highway project, growth this year could be around 3 per cent. The tourism sector, a major source of economic activity for the country, has been doing very well. However, the sector's infrastructure remains an obstacle and thus has an even higher impact on the economy. In addition, fiscal risks remain significant and, as a small and open economy, Montenegro is highly vulnerable to external shocks. Diversification of the economy remains a challenge for building sustainable growth in the medium term, but the visible progress in the EU approximation process should help to attract further FDI and ultimately boost the country's growth prospects. Future growth should be mainly underpinned by tourism, energy and infrastructure investments.

Major structural reform developments

Montenegro has advanced further in EU approximation. As of July 2015, Montenegro had opened 20 negotiating chapters (out of 35), and had provisionally closed two: science and research; and education and culture. Chapters opened in the past year are mostly economics related, and include: financial services, taxation, financial and budgetary provisions, customs union, statistics, consumer and health protection, trans-European networks and external relations. Montenegro has been allocated up to €270.5 million under the EU's new Instrument for Pre-Accession Assistance (IPA II) in 2014-2020. The assistance will support reforms in preparation for EU membership, socio-economic and regional development, social policies and rural development, as well as competitiveness.

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Progress on improving the business environment has been mixed. Over the years, Montenegro has established a track record of business-friendly legislation and openness to foreign investors, with the country regularly topping the regional list of countries in terms of FDI per capita. The country ranks 46th out of 189 countries on the World Bank's ease of doing business score. At the same time, the latest Foreign Investor Council White Book points to areas such as the rule of law and property development as problematic areas in the past year.

Little progress has occurred recently on privatisation. The 2015 Privatisation Plan, announced in February, envisaged the continuation of privatisation and publication of tenders in areas such as tourism, manufacturing and the nation's airline company, Montenegro Airlines. However, there has been little progress in selling off these assets since the plan was announced. A tender for the Igalo Health Institute was completed in April 2015 and the results of the tender were adopted by the Privatization Council on 20 August 2015.

Plans for construction of a new unit at the thermal power plant have advanced. In 2013 a tender was opened for the construction of a second 220-300 MW unit at Montenegro's only thermal power plant, TE Pljevlja. Following a competitive bidding process, Montenegro's electricity producer (EPCG) is to start talks with the Czech company Skoda Praha for the construction of a 250 MW thermal power unit. Skoda Praha has offered to build the unit for €338.5 million. Doubling the current capacity of the country's sole thermal power plant is important, as the submarine power link between Italy and Montenegro (connecting the Western Balkans with the EU market) is scheduled for operation in 2018.

Construction of a section of a major motorway has been launched. The Chinese construction company CRBC is in charge of the construction of the 44-km long priority section (about one-third of the total motorway), worth €809 million. Under the Law on Major Highway, a mechanism is to be put in place to allow for this major infrastructural project to be exempt from taxes and custom fees, while at least 30 per cent of the work should be assigned to local companies. The project will be financed by a 20-year loan (of €689 million) from China's EximBank, which will have a six-year grace period and a 2 per cent interest rate, while the Montenegrin government provides the remaining €121 million. The Chinese loan is denominated in US dollars and therefore carries significant currency risk.

The banking system's health is gradually improving, but non-performing loans (NPLs) remain high. At the end of 2014 a total of 12 banks were active in the country. Since then, two new banks have opened: the Ukrainian-owned "Zapad" (West) bank was granted a licence in January 2015, while Turkey's state-owned bank Ziraat Bank received its licence in April 2015. In addition one more bank is due to obtain a licence from the central bank. Credit to the real economy turned positive again in May 2015 and the overall health of the banking sector appears to be improving gradually. Nevertheless, NPLs, at 17 per cent of total loans, continue to be a substantial drag on asset returns and lending. The "Podgorica approach" under which banks and companies engage in voluntary restructuring and out-of-court work-outs, is being implemented slowly. The law on restructuring of NPLs has been adopted by the parliament, but it remains to be seen whether its implementation will be effective. In addition, a new factoring law has been drafted and may be in place by the end of 2015 or early 2016.