

1. RECENT ECONOMIC DEVELOPMENTS

A. BACKGROUND

1.1 **Serbia and Montenegro (SAM) is a union of two loosely affiliated republics,¹ the Republic of Serbia and the Republic of Montenegro.** Twelve years after the breakup of the Socialist Federal Republic of Yugoslavia in 1991, the Constitutional Charter of Serbia and Montenegro was enacted in February 2003 by the Parliament of Serbia, the Parliament of Montenegro and the Parliament of the Federal Republic of Yugoslavia to give birth to “Serbia and Montenegro,” a country that has come to replace the former Federal Republic of Yugoslavia.

1.2 **Montenegro is by far the smaller of the two republics in the State Union of Serbia and Montenegro.** Geographically, it is a small, mountainous, and picturesque area of about 13,214 square kilometers, located in the Western Balkans region of Southeast Europe, with about 293 kilometers of coastline on the Adriatic. According to the November 2003 population census issued by its Bureau of Statistics, Montenegro is approximately one-sixth the geographical size of Serbia, with 620,145 inhabitants (less than one-tenth of Serbia's population). Its economic base consists of significant deposits of natural resources (bauxite), aluminum, a great potential for tourism development, some tracts of arable land, and a pool of relatively skilled labor.

1.3 **Although much remains unclear about the political future of Montenegro,² EU accession remains an overarching strategic goal.** Following the “Belgrade Agreement” of 2002, Montenegro and Serbia agreed on the so-called “Action Plan for Harmonization of Economic Systems of Member States of the State Union of Serbia and Montenegro for the purpose of Preventing and Removing Obstacles to Free Movement of People, Goods, Services and Capital” (“Action Plan”), whose purpose was to bring the two economic systems together so that they could move jointly toward EU accession. In practice, however, the harmonization of tariffs and trade policy proved difficult, with the result that in October 2004 the EU proposed a “two-track” approach to EU accession. The twin-track approach allows the EU to deal with Serbia and Montenegro separately on issues relating to trade, customs and economic and sectoral policies, while seeking to reach an agreement with the union on international political obligations and human rights. Given its small domestic market, Montenegro’s EU (and WTO) accession³ and further regional integration will be fundamental to its growth and prosperity (see Box 1.1.). Maintaining its competitiveness in these markets, too, will be critical.

¹ In 2002, Montenegro signed the Accord on principles in relations between Serbia and Montenegro (“Belgrade Agreement”) with Serbia and the EU, which established a new State Union of Serbia and Montenegro. As presently constituted, the Union has limited responsibilities in the area of foreign affairs, defense, human rights, intellectual property rights, standardization and technical regulations, metrology and statistics. All other areas are at responsibility of the member states.

² The final shape of the Union with Serbia is unclear. Three years after the establishment of the State Union, the member states have the right to hold a referendum on withdrawal from the State Union.

³ The European Union (EU) published its feasibility study for the initiation of negotiations on Stabilization and Association Agreement (SAA) in May 2005. In October 2005, Serbia and Montenegro officially started the negotiations with the EU on the SAA.

Box 1.1. Montenegro: Why Regional Integration and EU Accession?

Market integration within the framework of the EU and WTO accessions is vital for a small economy like Montenegro's for several reasons.

First, in view of its small size, it is fundamental to increase specialization and efficiency in the production of goods and services. If Montenegro remained a closed economy, its economy would be forced to produce a larger range of products, under less than efficient conditions. The lack of specialization reduces efficiency and income. On the other hand, trade in goods would allow a small country like Montenegro to specialize in a smaller range of goods and services following its natural resource base, and importing other goods from the rest of the world. It would also enlarge the set of opportunities a consumer has well beyond Montenegro's own production possibilities. Trade in goods and services, however, depends on transportation costs, tariff and quantity restrictions and "behind the border barriers." That is why the issues of tax harmonization and the removal of barriers to the free trade of goods and services in the context of EU accession are important for Montenegro.

Second, regional integration and EU accession are also essential to reduce the cost of doing business and for risk diversification. The establishment of idiosyncratic institutions by small states like Montenegro may imply a higher per capita cost of providing public goods and higher costs of doing business. Indeed, empirical evidence shows that small states have higher costs of producing public goods (Alesina and Wacziarg, 1998). Furthermore, small size implies difficulties in diversifying risk within borders. For example, a bank forced to hold onto portfolio mortgages generated within the small Montenegrin market may face a larger risk than if it had access to a larger market.

Finally, regional integration and EU accession can help reduce the high income volatility that small states like Montenegro often experience. Empirical evidence suggests that there is a negative correlation between population size and the standard deviation of per capita income (Easterly and Kraay, 1999). This is not surprising since, with a given level of shock, the impact on consumption will be more rapidly felt in a small state. Regional integration may make it possible to smooth income and consumption arising from such shocks. Conversely, regulations imposing restrictions on the flow of capital and labor may prolong the cost of adjustment to shocks. Where feasible, trade in institutions, such as when a country adopts an institution of another country relinquishing its national institution or independent policy (e.g., the euro as a currency, a defense agreement which puts a small state under the umbrella of a larger regional power), may also help reduce costs, ensure stability and reduce risks.

Source: Based on Favaro (2003).

B. THE ECONOMIC REFORMS TO DATE⁴

1.4 **Montenegro, like all other regional states, inherited a legacy of four decades of inefficient economic management and institutional policies that stifled growth and private initiatives.** For nearly a decade following the breakup of the former Federal Republic of Yugoslavia, regional conflicts and international isolation crippled the economy and delayed the start of the transition to a market economy. Since 1997, however, Montenegro, with the support of the international community,⁵ has been engaged in a long series of reforms designed to move its economy from a socialist to a modern market-based economy. In 2003, the Government of the Republic of Montenegro formally adopted its Economic Reform Agenda (ERA) covering the period 2003-2007, and a Poverty Reduction Strategy (PRSP) aimed at reducing poverty. The ERA established a broad strategic vision of a liberalized, market-based economy, on which subsequent economic reforms have been based.⁶ The ERA has recently been updated to guide economic reform program for the period 2005-2007.

⁴ See Annex 1 for a chronology of main events in Montenegro, including dates of some key policy reforms.

⁵ Main donors in Montenegro include USAID, EAR, World Bank, UNDP.

⁶ See Republic of Montenegro Economic Reform Agenda, 2003. The main goals of the ERA are the establishment of an open economy based on the private sector, the creation of a favorable business environment attractive for

1.5 **Montenegro's economic reform program since 1997 has rested on two broad pillars:** macroeconomic stabilization, and market-oriented structural reforms, including extensive price and trade liberalization, privatization, public administration reform, financial sector reform, and reforms aimed at improving the business climate and the labor market.

Macroeconomic Stabilization

1.6 ***Currency reforms.*** **A cornerstone of the Montenegrin stabilization program was the adoption of first the DM and then the euro as the legal tender in the Republic.** In November 1999, the Montenegrin Government declared the Deutsche Mark (DM) an official parallel currency to the Yugoslav dinar. One year later, in November 2000, the Central Bank of Montenegro (CBM) declared the DM the sole legal tender in the Republic. On January 1, 2002, the euro replaced the DM as Montenegro's official currency.

1.7 **Both economic and political factors underpinned Montenegro's adoption of the DM, and subsequently the euro, as the official currency** (Bogetic, 2002). The economic rationale had to do mainly with the monetary policy of the federal government, which resulted in two devastating hyperinflations in 1990 and 1992-93. The political reasons largely reflected Montenegro's growing estrangement from Milosevic's policies of the late 1990s, and the consequent decision by the Montenegrin authorities to take control of some state functions that were previously in the federal domain (e.g., customs, foreign representation). While the currency reforms—in particular euroization—laid some solid foundations for stability and economic recovery, it has also reduced policy flexibility (see Box 2.2). Inflation (CPI) fell from 67 percent in 1999 to 24 percent in 2000, and has continued in a gradually declining trend. Since 2002, inflation in Montenegro has been held to single digits.

1.8 ***Fiscal reforms.*** **Fiscal reform in Montenegro started in 2001.** Many laws were adopted with a view to establishing a more transparent and efficient collection of budget revenues. A new value added tax replaced a previous sales tax system in 2003; the Treasury of the Republic of Montenegro was established; fiscal cash registers were introduced and tax identification numbers applied; and most recently, the monopoly of the domestic payment services (the former payment bureau, called ZOP) was abolished, allowing commercial banks to initiate and settle inter-bank payments without the mandatory intermediation of any institution or agency. The establishment and enforcement of the *Law on Public Procurement* has raised the level of transparency as well as the efficiency of public expenditure control. Revenues, which were previously distributed through extra budgetary funds and other institutions, have been centralized within the Budget of the Republic. The introduction of a medium-term expenditure framework has been initiated, and programmatic budgeting is being developed on a pilot basis in two institutions: the Ministry of Transport and Navigation and the Institution for the Execution of Penalties (penitentiary). The internal audit was established in 2004 within the Ministry of Finance, and the Supreme Financial Institution for Auditing was established in April 2004.

1.9 **The Government has, however, made progress in containing fiscal deficits.** Supported by the IMF programs in Serbia and Montenegro,⁷ Montenegro's consolidated budget deficit was cut from about

foreign investors, accession to the EU and the WTO, and the reform and development of various sectoral policies. The Economic Reform Program deals with Business Environment and Trade, Fiscal Reform, Financial System, Privatization, Reform of the Pension System, Sectoral Policies (Tourism, Energy, Agriculture), Public Administrative Reform, Judicial Reform, Civil Society, Information Society, Macro-Economy and Statistics, and Management of the Reform.

⁷ The macroeconomic policies of SAM were supported by three successive IMF programs. The first program, the Emergency Post-Conflict Facility, was approved in December 2000 and was followed by a Stand-by Arrangement

8 percent of republican GDP in 2000 to about 3 percent in 2004. Chapter 3 of this report will examine whether this fiscal deficit is sustainable, and where the Government might tighten and/or reallocate expenditures to support the goal of macroeconomic stability and faster growth.

Box 1.2. The Costs and Benefits of Euroization

Euroization has several benefits. First, it eliminates the risk of a nominal devaluation of the country's exchange rate. This can in turn help avoid a sudden stop in capital flows motivated by fear of devaluation; and lower the cost of borrowing from international market, through reduced country risk. As such, it can contribute to building a stronger financial system, and facilitate financial integration. Second, euroization can help rein in inflation. The reason is simple. Under euroization there is no domestic monetary authority that could expand the quantity of money. Third, euroization also makes commercial integration with the rest of the world easier because it eliminates the transaction costs associated with currency exchange. Finally, euroization can have a disciplining effect on fiscal policy, although it does not prevent fiscal indiscipline. While the Central Bank cannot monetize fiscal deficits under euroization, the authorities can still engage in fiscal profligacy through excessive borrowing to finance large fiscal deficits.

On the other hand, euroization has several costs. Among these are: (a) the sacrifice of an independent monetary policy; (b) the loss of the lender of last resort; (c) the sacrifice of the inflation tax; and (d) the loss of seigniorage. An independent monetary policy is clearly lost under euroization. For example, if the authorities believed that some insulation of the domestic financial system is needed for the purposes of, say, improving its stability, through the imposition of capital controls, they would find such measures difficult to accomplish, because it would always be possible for private agents to convert their assets to euro cash. Second, the lack of a lender of last resort puts even greater importance on the need to have a strong banking sector supervision and management of liquidity in the financial system. Third, euroization limits policy flexibility, and puts the full burden of adjustment to shocks on prices, fiscal policy, and most importantly structural reforms including labor market reforms.

Structural Reforms

1.10 Parallel with stabilization policies, the Republic of Montenegro also implemented a program of structural reforms, including price and trade liberalization, privatization, public administration reform, financial sector reform, and labor market and business environment reforms.⁸

1.11 **Price liberalization. Beginning in 1998, the Government of Montenegro launched a concerted reform effort to liberalize prices and foreign trade.** Most price categories were liberalized by the early 2000s except for some public utilities such as electricity. Even in electricity, continued price adjustments since 2001 have further reduced the need for electricity subsidies, although full cost recovery prices are not yet in place. Overall, Montenegro's pricing policy is based on market principles, and price liberalization is almost complete. Only a small number of products are currently subject to administrative price control, including medicines for human consumption, oil and derivative products, and postal services, while local authorities may control the prices of certain utility services

1.12 **Foreign trade liberalization. In June 2000, Montenegro significantly liberalized its foreign trade regime.** The Government adopted a temporary regulation taking over the jurisdiction of customs from the federal authorities, pending the preparation of the new Customs Code. According to the Temporary Act on Custom Tariffs, only Montenegrin laws and institutions regulate all international

of SDR 200 million approved in June 2001. A three year Extended Arrangement (EA) of SDR 650 million was approved in May 2002 and spans the period through end-December 2005.

⁸ For a more detailed description of the structural reforms agenda after 2003, see the Government's Economic Reform Agenda of 2003. The Government is currently revising and updating its Economic Reform Agenda for 2005-2007.

transactions. All customs rates, previously determined by the federal legislation, are now set by Montenegro's authorities. The trade reform has significantly simplified Montenegro's trade regime by substantially reducing and simplifying licenses, quotas and tariff rates and structure. According to the new Law on Customs (January 30, 2002), imports face six tariff rates; 0, 1, 3, 5, 10, and 15 percent. The average duty is a low 3.5 percent. Most notably, the tariff structure contains no high, very protective peaks. More than 95 percent of imports are no longer subject to quota or license requirements. Manufacturers importing equipment, materials and components face reduced but constrained tariff rates and difficulties with customs procedures. Firms with export opportunities which are entitled to obtain rebates on import tariffs paid for materials or components used in their production do not often receive these rebates, as there is no effective duty drawback system. In the context of its participation in the SEE Stability Pact, Montenegro as a member of the state union along with other signatories has established a network of 28 bilateral free trade agreements (FTAs) in the region and all the 28 agreements are being implemented.

Box 1.3. Montenegro's History of Privatization

State-owned companies in Montenegro were transformed, under the *Law on Ownership and Management Transformation* (RM OG No. 2/92, 27/94, 23/96), in the early 1990s. Under that Law, employees were granted 10 percent of shares free of charge and up to 30 percent more, to be paid in installments with a discount based on the working period that had been spent in a company. The remaining 60 percent or more of the shares were transferred to three state-owned funds: the Development Fund (60 percent), the Pension Fund (30 percent) and the Employment Fund (10 percent). Approximately 350 companies were involved in this process. Subsequently, 117 of these companies were sold through different methods of sales including direct sales of majority or minority stakes and auction sales.

The Privatization Council was established in 1998 to manage the privatization process. Based on proposals made by the Privatization Council, the Government has since issued an annual privatization plan and conducted privatizations of state-owned enterprises in accordance with the annual plans. The plans contain the number of shares in each company to be privatized or given back to former owners of industries nationalized after World War II.

The Government earnestly embarked on the privatization process with the launching of the mass voucher privatization (MVP) of 2002. Through this process, more than 400,000 citizens of Montenegro acquired vouchers for free and exchanged them for shares of companies or investment units of privatization investment funds. About 66.47 percent of voucher points were invested in privatization funds and 29.05 percent directly in the companies. More than 200 companies, covering about one-fourth of the socially owned companies, were privatized through the MVP process. Today, shares of companies and investment units are traded on the two stock exchanges, NEX Montenegro and the Montenegro Stock Exchange. Yet the trade in shares is slow, so that new majority owners are not found quickly.

Overall, Montenegro has to date privatized more than 60 percent of the former socially owned capital. In addition, about 80 percent of the capital in another 179 firms has been privatized, as has 70 percent of the capital in 27 companies. However, in some of the largest companies there is still a little private capital, but the Government plans to relinquish majority shares in these companies through international tender in the near future (2005).

1.13 *Privatization.* **Montenegro's privatization program dates back to the early 1990s** when some state-owned companies were transformed, under the *Law on Ownership and Management Transformation*, to employee ownership (see Box 1.3). However, the privatization program was launched with renewed vigor in the late 1990s with the establishment in 1998 of the Privatization Council (to oversee the tenders and auctions in large enterprises) and the launching of the mass voucher privatization (MVP) for small stakes in selected enterprises in 2002. In the MVP program, completed in 2002, vouchers were distributed to all citizens, and widespread share ownership was established for more than 200 socially owned companies, comprising about 25 percent of the state-owned companies in Montenegro (see Box 1.3).

1.14 **Montenegro has recently accelerated its privatization plans and expects to wrap up the privatization of its biggest companies in 2005.**⁹ In mid-2004 the largest steel producer Niksicka Steelworks was privatized. In 2005, the local telecommunication monopoly, Telekom Montenegro, and the largest aluminum producer, Kombinat Aluminum Podgorica (KAP), contributing about half of the nation's merchandise export, were sold. An international financial advisor for the privatization of Podgorička Banka, the largest state-owned bank, was selected in February. The authorities have prepared a time-bound strategy for the privatization of majority and minority-owned equity stakes in the remaining state-owned banks. Besides, hotels and other minor assets have been privatized. Another 120 small and medium-size companies are expected to be offered for sale on the stock market.

1.15 *Public administration reform.* **Montenegro adopted its public administration reform program in June 2003.** Soon after the adoption of the program, the Government made some effort to reduce employment in the public sector, mainly in the police and education sectors (some police officers were laid off in August 2003). In March 2003, the Government adopted an employment and wage policy action plan, which foresaw a reduction of redundant public employees—especially in the education sector--by 3,000, as well as a larger differentiation of salaries to increase the incentives for qualified staff in public administration. In 2003-2004, the Ministry of Education and Science conducted a rationalization of the education system, which reduced the number of employees by 728 workers. In 2004, the Ombudsman Office was established and staffed. New procedural legislation (administrative litigation) and the Code of Conduct for civil servants were prepared, and regulations governing the status of civil servants were developed, with the aim of introducing professionalism and more transparency through obligatory public competition for all posts apart from ministerial posts and a very limited number of personal advisers. Most recently, a separate organizational unit for human resources management has been established, and a new salary law introduced to decompress the salary system and create a transparent reward system for civil servants (although it remains unimplemented to date). The Ministry of Justice has led the introduction of many of these reforms, and today an adequate legal and regulatory framework exists in Montenegro for public administration reform, but the more difficult phase of institutional building is yet to be fully implemented.

1.16 *Financial sector reform.* **In the financial sector several reforms were carried out.** The institutional framework for banking supervision has been strengthened over the past years with the introduction of new regulations on licensing, minimal capital requirement, asset classification and provisioning and large exposures. The finalizing of the privatization in July 2003 of the Montenegro Banka, formerly the largest bank in the Republic, contributed to banking sector stability. Since the sale of Montenegro Banka and the closure of some smaller banks, all banks operating in Montenegro are now considered to be liquid and to be in compliance with capital requirements. In 2003 the Ministry of Finance revoked all licenses given to offshore banks registered in Montenegro. An anti-money laundering law was adopted in 2004, and Montenegro became the member of the Egmont Group in Washington on June 29, 2005. The importance of membership is manifold, both for Montenegro and for the Administration for Money Laundering Prevention, and includes exchange of confidential information on money laundering. In January 2005, the Montenegrin Central Bank completed the transfer of the inter-bank payment system (known also as ZOP) from the Central Bank to the jurisdiction of commercial banks, a move which is expected to help consolidate financial transactions at commercial banks and reduce the banks' high transactions fees. The privatization of the last bank with majority public ownership, Podgoricka Banka, is currently under way.

⁹ Further details are contained in the Government's document: "Montenegro Privatization Plan for 2005".

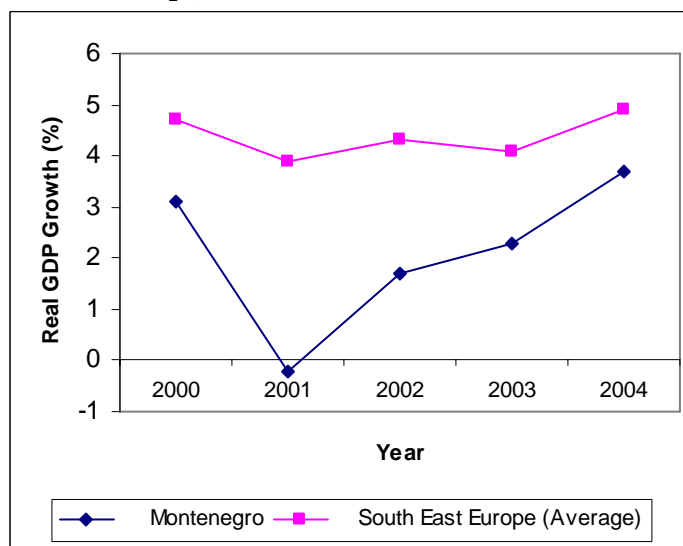
1.17 *Business environment reform.* Finally, several reforms aimed at improving the business climate and labor market flexibility were initiated in recent years (see Chapter 4). The Government enacted new enterprise, bankruptcy, and secured transaction laws to create a more favorable business environment. A new energy law was enacted, which provides a basis for the development of a regulatory framework, together with energy industry restructuring and liberalization. A new labor law, aimed at increasing labor market flexibility, was enacted in 2003.

1.18 In summary, Montenegro has made significant progress in terms of both macroeconomic and structural reforms. With the implementation of currency and fiscal policy reforms, it has succeeded to rein in inflation and bring about macroeconomic stability. In parallel to the stabilization policies, it has also implemented a number of structural reforms, including price and trade liberalization, privatization, public administration reform, financial sector reform, and labor market and business environment reforms. Yet, despite the progress, many structural reforms remain to be carried out. The Government's recently updated Economic Reform Program for 2005-2007 provides a framework for what economic reforms remain to be done over the coming years.

C. THE RESULTS SO FAR: MACROECONOMIC AND POVERTY OUTCOMES

1.19 Despite serious data constraints in Montenegro, available evidence suggests that the macroeconomic and structural reforms pursued since the late 1990s have supported four years of modest economic recovery and transition. Pervasive data problems exist in Montenegro, which highly constrain the ability to make evidence-based analysis and derive conclusions (see Box 1.4). Basic national accounts statistics are either too old (the latest official GDP figure available from MONSTAT, the Republican statistical office, is for 2002), or unreliable, apart from setting aside issues of whether their compilation meets internationally accepted methodology. Economic data on output are highly unreliable, as they include only statistics based on the large socially owned and state-owned companies, thus excluding an emerging private sector whose share in total output may be steadily growing. The quality of employment and unemployment data are questionable, as are the imports, exports and the balance of payments data. The analysis and conclusions below, while subject to the above caveat, are based on the best evidence and information that could be assembled for the Montenegrin economy.

Figure 1.1. Montenegro's Growth Compared to South Eastern Europe, 2000-2004



Source: MONSTAT.

Growth and Employment

1.20 With the reforms of the late 1990s and early 2000s, real output growth has shown modest recovery. With the advent of reforms, it was expected that the Montenegrin economy would grow rapidly. The actual results, however, show that growth is still sluggish.: average annual real GDP growth over

2000-2004 was only **about 2** percent, significantly below the regional average growth rate (Figure 1.1). Moreover, the recorded growth of output remains below its potential, as Montenegro's GDP remains far behind its pre-transition levels.

1.21 **On the demand side, the recorded growth came mainly from high domestic consumption (both private and public) during 2000-2002.** The latest period for which demand composition is available is 2000-2002. According to these data, both private and public consumption grew. While investment declined in real terms by 16 percent in 2002, it is estimated to have recovered in 2003 and 2004. Even so, Montenegro's investment, at around 20 percent of GDP, remains below the levels characteristic of leading transition countries.

Box 1.4. Montenegro –Key Statistical Issues

Montenegro's statistical system is weak, basic macroeconomic data are not available at all or are not timely, and their compilation does not fully comply with international standards.

Real Sector. Real sector statistics are compiled and published by MONSTAT, the statistical agency of Montenegro. MONSTAT has recently produced estimates of GDP by activity and by expenditure for 2000-2002. However, no official GDP estimates are available for 2003 and 2004, and no quarterly data are available. Generally, the methodology follows the *System of National Accounts (1993 SNA)*, but there are problems with the scope of the accounts and the basis for recording that are not broadly consistent with the international standards. Overall, the data quality is poor, and the data sources are in need of improvement. The statistical techniques used for the national accounts compilation also need further improvement. There is a master plan for the improvement of statistics, developed with the assistance of EUROSTAT, which has been approved by the Government but not fully implemented. Further, the restructuring and staffing plan for MONSTAT, although under preparation for some time, is yet to be approved and implemented.

Balance of Payments. Balance of payments statistics are currently compiled by the Central Bank of Montenegro (CBM). The principal sources of data are customs data on merchandise trade as processed by the Central Bank and information on foreign exchange transactions provided by banks and exchange bureaus. An IMF balance of payments technical assistance mission to the CBM in June/July 2004 provided recommendations to improve international trade statistics, external debt. Imports and exports are not accurately captured, especially with Serbia.

Government Finance. Fiscal statistics for Montenegro are compiled by the Montenegro Ministry of Finance. The principal data sources are the Republican Treasury and the budget execution reports of the spending ministries and the first level budget units. Montenegro now reports the Republican budget implementation data on a monthly basis. Fiscal data for the central government of Montenegro are based on the new GFS classification. Data for the Social Security Funds, reported directly by the funds, are compiled with significant delays and not on a GFS basis. A new chart of accounts was introduced in Montenegro in 2001, but it still needs to be fully implemented by local governments. Local governments are not yet integrated into the consolidated general government revenues and expenditures.

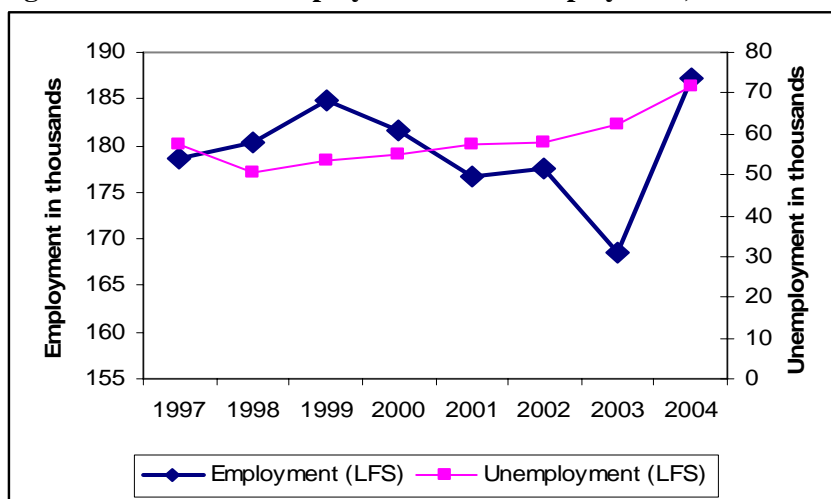
Monetary Accounts. Monetary and financial statistics are compiled by the CBM, broadly following the methodology set forth in the *Monetary and Financial Statistics Manual*. Estimates of cash in circulation are not regularly available. The Republic of Montenegro introduced new charts of accounts for the CBM (January 2004) and for the commercial banks (December 2003). The CBM is now compiling monetary statistics from data collected based on the new charts of accounts. The monetary and financial statistics mission of the IMF (2004) made recommendations to the CBM for improving (i) the classification of financial instruments, including loan-loss provisions and depreciation, (ii) the mapping between the charts of accounts of the CBM and other depository corporations with the respective sectoral balance sheets. While many of these recommendations have been implemented, there is still room for further improvement.

Source: Bank Staff assessment; IMF Statistical Note on Serbia and Montenegro.

1.22 **On the supply side, industry and agriculture contributed most to the growth of GDP during 2000-2002, but data are not available for later years.** Services, manufacturing, and agriculture are the most important economic sectors, with shares in GDP of about 60 percent, 25 percent and 13 percent, respectively. Within services, tourism plays an important role. Within manufacturing, the metal industry (which includes the most important factory, KAP) plays a dominant role. KAP is not only the single most important exporter, accounting for more than 40 percent of total merchandise exports, but it also has about 3,000 employees and contributes significantly to value-added in the economy. According to the available data, since 2003 the main sources of growth in Montenegro appear to have been industrial production and tourism, with annual increases of about 6 percent and 10 percent, respectively. (see Box 1.5 for possible drivers of growth).

1.23 **The limited output recovery was not accompanied by employment growth** (see Figure 1.2). Like many other transition countries, Montenegro has faced “jobless growth” (or even “job loss growth”). Recorded employment has on average declined over the last 15 years. Labor Force Surveys for Montenegro show that the numbers of the employed in companies (so called “wage-earners”) declined by about 7 percent over 1998-2004. The 2004 Labor Force Survey shows that employment recovery has continued.

Figure 1.2. Trends in Employment and Unemployment, 2000-2003



Source: MONSTAT, Labor Force Survey (various years).

1.24 **Yet, average monthly net wages doubled**

over the last 4 years, from EUR 96.3 in 2000 to EUR 195.9 in 2004. Only in 2004, real wages in Montenegro went up by 9.11 per cent. This has led to a wage growth far in excess of productivity, thereby seriously endangering Montenegro’s competitiveness (see competitiveness section below).

1.25 **Unemployment persists as a structural problem in Montenegro.** It is exceptionally high, and long-term unemployment is widely prevalent. According to the 2004 labor force survey data (October), there were 71,800 unemployed at age of 15 and over, with the unemployment rate of 27.7 percent. In April 2005, the Employment Agency had 58,000 registered unemployed on the roster, a 23.5 percent decline compared to 2004, mainly because of the legalization of existing informal sector jobs. Long-term unemployment is widely prevalent. More than one-fifth of the registered unemployed are on the roster for more than eight years. The skills and work habits of many of the long-term unemployed have eroded and to a large extent the reintegration of this group into the labor market is complicated, at least without an upgrade of their human capital. Long-term unemployment constitutes an additional burden on the social funds and on the families of the affected. The persistence of high unemployment and growing under-employment even after more than a decade of economic growth suggests that the new private sector, comprised of small firms, has not yet developed the critical mass to generate enough jobs to offset the job losses in the old public sector. Facilitating the entry of new firms and the growth of small enterprises is necessary for faster job creation, the reduction of unemployment, and economic growth (see Chapter 4).

Box 1.5. Drivers of Growth in Montenegro

Sectorally, the services sector—in particular tourism—holds the greatest potential for growth. The manufacturing sector and the metal industry, in particular the most important aluminum company KAP, play an important role in the Montenegrin economy. KAP is currently the single most important exporter, accounting for more than 40 percent of total merchandise exports. It also contributes significantly to value-added and employment in the economy, although its contribution to the future growth of the economy will depend on the amount of investment, technology, and innovation that will be brought in by the new owner of KAP (i.e., Rusal). To a lesser extent, forestry (in particular wood processing) and agriculture also contribute to the growth of the economy.

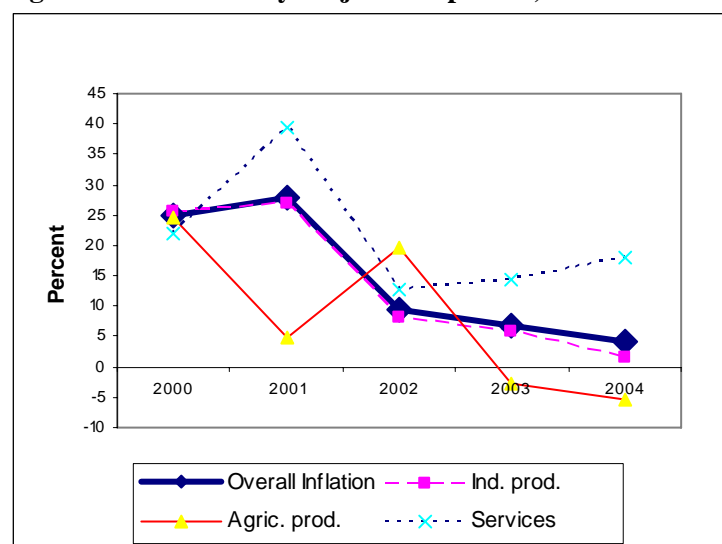
Geographically, Montenegro is characterized by huge differences (in terms of population density, and level of development) between its northern, central and southern parts. The northern region, primarily a mountainous region, is the least developed region and depends mostly on industry and small agriculture. The central region, including Podgorica, is more developed, and industry and services, and to a lesser extent agriculture, constitute the basis of its economic activity. In the southern region—i.e., the coastal area—services, tourism and transport provide the basis of the economy. These regional differences would need to be taken into consideration in designing a regional approach to development. The northern region has a good potential for landscape-based tourism, as it has many hills, mountains, rivers, canyons and lakes. To a lesser extent, it has the potential for timber industry, small scale agriculture and food processing. Tourism development in this area would be of great importance to the Republic to overcome the problem of the high seasonality of coastal tourism and the related economic activities. The central region has considerable potential for the further development of services (transport, tourism, financial services) and some agriculture and food processing. The southern part, besides tourism, could benefit from further increases of transport services (shipping, ports, land transport, etc.). There is also the possibility for the recovery of fruit production.

Inflation

1.26 **Montenegro's adoption of the DM and then the euro as the sole legal tender helped rein in inflation.** With currency reforms, inflation dropped from 24.8 percent at the end of 2000 to 4.3 percent at the end of 2004. By the main components of the CPI, the prices of services grew much more than the other components (Figure 1.3). On the other hand, the prices of agricultural products have decelerated since 2004.

1.27 **With the adoption of the euro as the official currency (“euroization”), the role of monetary policy has been severely curtailed.** The Central Bank of Montenegro (CBM) can no longer engage in any active monetary policy. Its role has been limited mainly to the supervision of banks and the privatization of the remaining state banks. The latest estimate available of the currency in circulation as of January 2003, shows the amount of euro 250

Figure 1.3. Inflation by Major Component, 2000-2004



Source: Central Bank of Montenegro.

million.

Competitiveness

1.28 **The evidence suggests that over the last four years Montenegro has become less competitive.**

¹⁰To be sure, competitiveness is shaped by a number of factors, including: factor endowments; the country's infrastructure and support systems such as transport, energy, and communications as well as research and development; government policies and the regulatory environment; enterprise structure, strategy, and competition; demand conditions; and exogenous events. While these are ex ante determinants of competitiveness, ex post competitiveness can be measured in a variety of ways.

1.29 **One of the most useful indicators of international competitiveness is movements in the real exchange rate based on unit labor costs.** With the adoption of the euro as the official currency, Montenegro has by definition fixed its nominal exchange rate to the euro zone. Yet its real exchange rate—adjusted for differences in Montenegro's rate of inflation for the euro zone or its trading partners more generally—may have moved significantly. Montenegro's main exports are aluminum and tourism, and its main trading partners are the euro zone countries and Montenegro's main exports are aluminum and tourism, and its main trading partners are the euro zone countries and the United States. Its main imports are oil and oil derivatives, fuel, pharmaceutical products and electricity. For exports, the biggest trade partners of Montenegro, besides Serbia and Kosovo, are mainly EU countries (Italy, Greece, Cyprus, Hungary) and Switzerland. For imports, its biggest trade partners are countries in transition—Serbia, Croatia, Bosnia and Herzegovina—followed by European countries—Greece, Italy, Germany, Slovenia and Great Britain. Given that Montenegro's larger share of exports go to the EU countries and regional states, movements in the real exchange rate against the euro zone may be a reasonable index of Montenegro's competitiveness.

Table 1.1. Montenegro's Unit Labor Costs, 2000-2004

	2000	2001	2002	2003	2004
Nominal GDP, million euros	1022.2	1244.8	1301.5	1433.0*	1535.0*
GDP deflator	23.1	22	2.8	8	3.1
Annual real GDP growth rate	3.1	-0.2	1.7	2.3	3.7
Real GDP in 2000 prices, million euros	1022.2	1020.2	1037.5	1061.4	1100.7
Employment (official data), in thousands	140.8	141.1	140.1	142.7	143.5
Average monthly gross wage (official data), euros	150.9	176.2	251.3	271	302.6
Total wage fund, million euros	206.1	241.3	342.9	363.9	398.3
Labor compensation, million euros**	300	342	478	507	539
Unit labor costs***	0.293	0.335	0.461	0.478	0.491
Unit labor costs index 2000=100	100	114.3	157.3	163.1	167.6

* Estimated.

** Includes wages and salaries in cash and wages and salaries in kind as well as employers' social contributions.

*** Calculated as the ratio of compensation per employee to real GDP per employee.

Source: MONSTAT and World Bank staff calculations.

1.30 Table 1.1 shows the evolution of Montenegro's unit labor costs for the period 2000-2004. The rise in the ratio of Montenegro's unit labor costs relative to those of the euro zone or of the United States

¹⁰ It is important to note that Montenegro embarked on price liberalization, currency reforms, and trade reforms during 2000-2002. The implementation of these reforms could in part explain the surge in wages and unit labor costs experienced during this period. The choice of 2000 as the base year for measuring trends in competitiveness is thus not ideal, as it could give a more alarming loss of competitiveness than is the actual case. Yet, data availability constrains the use of any longer period.

weighted by the nominal exchange rate suggests that Montenegro has become less competitive over time. The fall in this ratio indicates improved competitiveness. These indices are given in Table 1.2.

Table 1.2. Montenegro's Competitiveness, 2000-2004¹¹

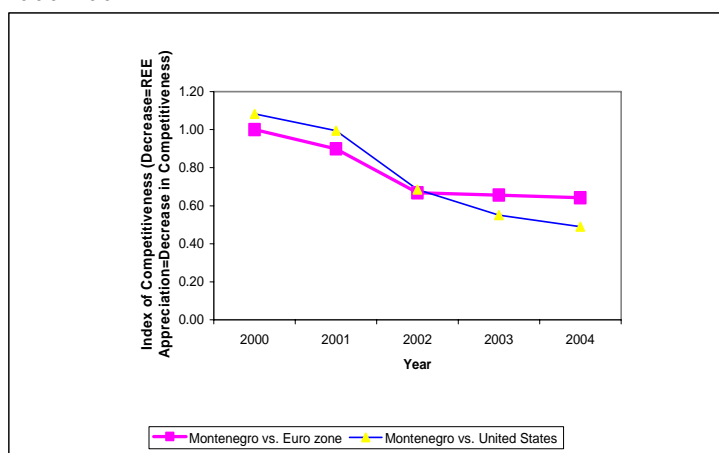
	2000	2001	2002	2003	2004
Nominal Exchange Rate (euro/ 1US\$)	1.0832	1.1171	1.0578	0.8838	0.8040
Unit Labor Cost Index (2000=100)					
Montenegro	100.0	114.3	157.3	163.1	167.6
Euro zone	100.0	102.8	105.0	107.1	107.6
United States	100.0	101.8	101.9	101.6	102.1
Index of Competitiveness					
Euro zone vs. United States	1.08	1.11	1.03	0.84	0.76
Montenegro vs. euro zone	1.00	0.90	0.67	0.66	0.64
Montenegro vs. United States	1.08	1.00	0.69	0.55	0.49

Note: Annual nominal exchange rate data between the US\$ and the euro are obtained from the Federal Reserve Statistics (Statistical Releases for January 3, 2005 and January 5, 2004). EU inflation (harmonized index of consumer prices, HICP) data are obtained from the European Central Bank ("Statistics Pocket Book, May 2004"). EU unit labor cost data are obtained from Eurostat ("Statistical Annex of European Economy").

Source: US unit labor cost and inflation data are from the US Bureau of Labor Statistics (www.bls.gov).

1.31 Calculations show that Montenegro's unit labor costs have risen much faster than those of the EU zone, thereby eroding its competitiveness (Figure 1.4). Total labor compensations have increased rapidly and are far ahead of labor productivity--by 12.3 percent only in 2004-- thus reducing the competitiveness of the Montenegrin economy. In addition, the presence of a relatively rigid labor regulation, which imposes additional costs, has contributed to the rapid increases in unit labor costs and appreciation of the real exchange rate against the euro zone. Montenegro's competitiveness has declined by an even greater magnitude against the U.S. economy, although USA is a minor trading partner of Montenegro, contributing only about 1 percent of the total foreign exchange earnings of the latter.

Figure 1.4. Trends in Montenegro's Competitiveness, 2000-2004



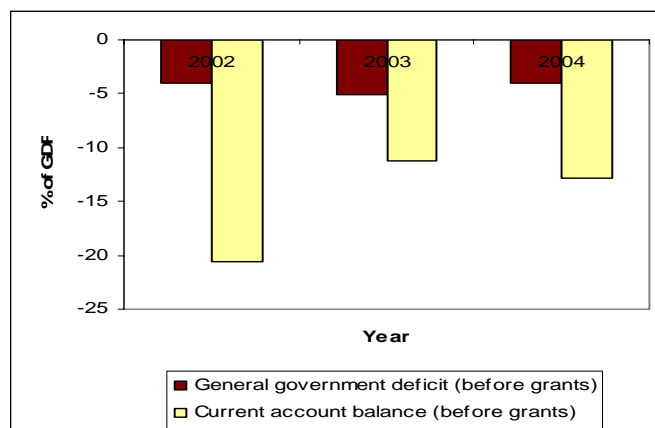
Source: Bank Staff calculations.

¹¹ Nominal exchange rate weighted by unit labor cost index. EU zone refers to the narrow definition, composed of 15 EU countries. All unit labor costs in the table refer to nominal unit labor costs, defined as the ratio of total labor compensation per employee to real GDP per employee. The decrease in the index of competitiveness means appreciation of the real exchange rate, and therefore a decline in competitiveness. To generate comparative trends, it is assumed that Montenegro adopted the euro since 2000 (although the actual adoption of euro came in 2002 and Montenegro was using the Deutsche Mark between 2000 and 2002).

Internal and External Balance

1.32 **One of the macroeconomic challenges facing Montenegro is that of maintaining sustainable internal and external balances.** Both the general government deficit and the current account deficit have remained high and unsustainable (at 4 percent and 12.8 percent in 2004, respectively) (Figure 1.5). Internally, loose fiscal policy characterized the early years of transition. Fiscal deficits before grants remained high at between 5 percent of GDP in 2001 and 3 percent in 2004. The high deficit was financed primarily through the huge inflow of foreign grants and concessional borrowing and through the domestic Treasury Bills market.¹² Expenditures on wages and social transfers not only constitute a significant proportion of public spending but are also much above average for the region. At the same time, the share of capital expenditures in total expenditures remained low. Also, arrears were accumulated in the central government accounts as well as in the social funds. Thus may be a need not only to reduce the overall public spending but also to shift public expenditure from current to capital expenditure (see Chapter 3).

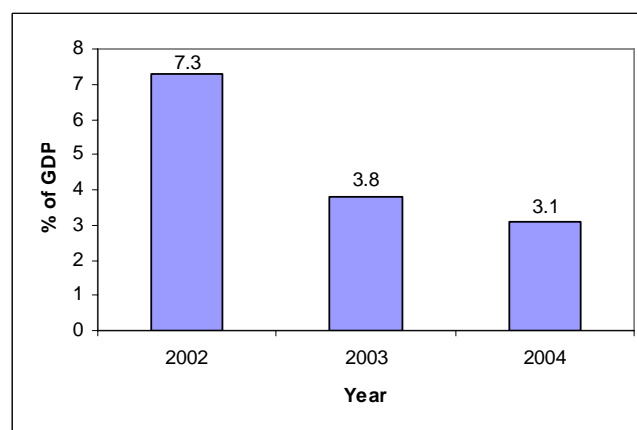
Figure 1.5. Fiscal and Current Account Deficits, 2002-2004



Source: Central Bank of Montenegro; IMF.

1.33 **Externally, the recorded current account deficit before grants¹³ has declined (from about 20 percent of GDP in 2002 to 12.8 percent in 2004), but it remains large.** Montenegro's merchandise exports are not diversified and remain largely dominated by the export of aluminum, which accounts for almost 50 percent of merchandise exports. Merchandise exports remained stable at about 25 percent of GDP in 2002 and 2004, while imports were reduced from about 57 percent of GDP in 2002 to about 53 percent in 2004. Recorded private remittances have almost doubled, from about 5 percent to about 9.5 percent, while net non-factor service receipts, which include mainly tourism receipts, have grown slightly.¹⁴ This resulted in a current account deficit before grants of 12.8 percent of GDP in 2004.

Figure 1.6. Official Grants to Montenegro, 2002-2004



Source: Central Bank of Montenegro.

1.34 **The financing of the high current account deficit has been made possible in part by the exceptionally high grants Montenegro received during the period.** Such grants, however, have

¹² Privatization revenues as source of financing deficit were low except in 2002.

¹³ Montenegro's Balance of Payments data prior to 2002 are unreliable. For 2002-04, imports are probably overestimated since a significant proportion is actually "exported" onwards to Serbia. Also some of the financing items in the capital account, such as the FDI data, may not be reliable.

¹⁴ Foreign trade statistics probably does not capture well the contributions of tourism to foreign exchange earnings.

progressively declined over time (from 7 percent of GDP in 2002 to about 3 percent in 2004) (see Figure 1.6), and are set to continue to decline further in the future.¹⁵ On the other hand, it is worrisome that foreign loans to Montenegro have been rising, from almost none in 2001 to about 7 percent of GDP in 2004. While it is not unusual for transition countries such as Montenegro to run a high current account deficit in view of low domestic savings and the current account deficit facilitating a capital replacement, there is a need to for Montenegro to adjust to a lower current account deficit especially in view of the declining grants and rising loans and debt service payments. Furthermore, in the case of Montenegro, the high current account deficit has led to a high private sector foreign borrowing to finance it. This puts an even greater importance for a strong Central Bank banking supervision and monitoring to ensure sustainable financial sector development.

1.35 With euroization, such adjustment to a lower current account deficit will necessitate either domestic demand restraint through a prudent fiscal policy and/or the expansion of exports. Fiscal policy is discussed in detail in Chapter 3; opportunities for export expansion through tourism development are discussed in Chapter 5.

1.36 Montenegro is expected to receive substantially higher than expected privatization revenue in 2005. The government currently expects proceeds of €165-180 million in 2005. For fiscal sustainability and macroeconomic stability, it will be extremely important that the receipts are used to reduce the domestic debt (i.e. retiring the debt to domestic banks and amortizing T-bills falling due in 2005) and build up reserves instead of increasing deficit spending. Additional public investment spending is best considered after a strong macroeconomic and fiscal performance has been established.

Debt Position

1.37 Montenegro began its transition as a moderately indebted republic. The restructuring of debt toward the Paris club and bilateral donors and IFIs in 2001 helped improve the external debt position of SAM. With most of the debts of SAM currently being allocated between Serbia and Montenegro, the external debt of Montenegro is becoming clearer. At the end of 2004, the total debt stood at 31.8 percent of GDP, down from 32.2 percent of GDP in 2003. (Table 1.3). Although there has been a rise in the absolute amount of borrowing since 2000, foreign borrowing as a ratio of GDP records relative actually slightly fell. With an expected debt write-off to Montenegro of some 26 million euros by the Paris Club creditors by end-2005, the debt position could further improve.

Table 1.3. Total Public Debt of Montenegro, 2002 – 2005 (% GDP)

	2002	2003	2004	2005*
Domestic debt	19.6	17.4	16.6	11.6
Foreign debt	68.7	32.2	31.8	30.9
Total public debt	88.3	49.6	48.4	42.5
Memo: GDP (million euros)	1,301	1,433	1,535	1,644

* Data for 2005 cover only through end-September 2005.

Source: Montenegrin Ministry of Finance.

1.38 The total public debt –inclusive both of foreign and domestic debt—stood at about 48 percent of GDP as of end-2004. Total public debt includes debt for the repayment of Frozen Foreign Currency Deposits (FFCDs) whose repayment deadline is 2017; debt toward commercial banks; T-bills

¹⁵ USAID, Montenegro's main donor, expects its assistance to Montenegro to be lower in the next five years compared to the past five years. The World Bank's Country Assistance Strategy for Serbia and Montenegro envisages about US\$ 50 million in program and project aid to Montenegro over the next three years.

debt and other debts on behalf of Government institutions or for which guarantees were issued; local governments' debt; budget liabilities or arrears; and foreign debt. Of this, domestic public debt accounted for about 20 percent at end-2004 (or under 10 percent of GDP) (see Table 1.4). Total outstanding FFCDs as at end-2004 stood at about 8 percent of GDP (123 million euros). Debt outstanding for issued treasury bills at end-2004 was about 2 percent of GDP (37.4 million euros), while as of end-Sept 2005 it was decreased to 12.5 million euros (less than 1 percent of GDP). Budget liabilities or arrears have been reduced from some 100 million euros in 2002 to 61.8 million euros by end-2004. The repayment plan suggests that the Government will need to allocate between 1.5 and 2 percent (21 and 33 million euros for debt service) each year over the next six years. Montenegro has shown a lot of progress in containing public debt in recent years, but further control through clearance of the Treasury bill debt and arrears, the buy back of FFCDs, and controlled external borrowing would be necessary to ensure debt sustainability and macroeconomic stability.

Table 1.4. Domestic Debt of Montenegro, 2002-2005 (in million euros)

	2002	2003	2004	2005*
Credits	18.2	19.5	8.9	1.45
T-bills	9.8	19.7	37.4	12.5
FFCDs	127	127	123	118
Budget Liabilities/ Arrears	100.6	83.5	61.8	35
Local Government Debt	0	0	23	23
Total Domestic Debt	255.6	249.7	254.1	154.95
Domestic Debt (% GDP)	19.65	17.42	16.55	11.6
Memo: GDP (in million euros)	1,301	1,433	1,535	1,644

* Data for 2005 cover only through end-September 2005.

Source: Montenegrin Ministry of Finance.

Poverty and Social Welfare

1.39 **With only limited economic recovery in Montenegro over the last four years, living standards remain low relative to historical standards.** With only a modest average GDP growth of about 2 percent per year over 2000-2004, and with jobless growth, unemployment has remained high. According to the official poverty line for 2003,¹⁶ about 12 percent of the citizens of Montenegro fell below the consumption poverty line. Consumption distribution is highly concentrated around the poverty line, and about 25 percent of the population has a consumption level that is less than 50 percent above the poverty line.¹⁷ This suggests that even small economic shocks can have potentially large effects on poverty. Conversely, a sustained economic growth is likely to result in a disproportional decline in poverty.

1.40 **There are significant differences in living standards among the different regions of Montenegro.** Generally, the poverty rate in the northern region is twice that in the central and southern regions (14.9 percent in the north versus 6.5 percent and 6.8 percent in the central and southern regions, respectively). Relative to the national average, a larger percentage of households in the north receives social assistance (4.9 percent versus 3.9 percent for the national average) and private transfers (23.3 percent versus 19.3 percent for the national average).

¹⁶ According to the Poverty Reduction Strategy Paper of the Government of Montenegro, the official poverty line for 2003 stood at 116.2 euros per person per month.

¹⁷ See World Bank, 2003, Serbia and Montenegro Public Expenditure and Institutional Review, Volume 3: Montenegro.

Table 1.5. Montenegro's Human Development Index, 2000-2003

	2000	2001	2002	2003
Life expectancy at birth (years)	73.4	73.4	73.0	73.1
Adult literacy rate (%)	94.9	94.9	94.9	94.9
Combined primary, secondary and tertiary gross enrollment ratio (%)	75.28	72.61	73.4	75.19
Overall human development index (HDI)	0.760	0.766	0.773	0.789

Source: ISSP and UNDP.

1.41 **In the broader dimensions of welfare, Montenegro has fared relatively well** (Table 1.4). Life expectancy, at 73 years, has remained stable over the last four years. The level of educational attainment is generally high. The adult literacy rate stands at about 95 percent, and only about 5 percent of the population aged 16-24 is not in school or does not attend secondary school (Serbia and Montenegro Poverty Assessment, 2003). According to the population census of 2003, the number of illiterate population in Montenegro is only about 2.5 percent. Combined primary, secondary and tertiary gross enrollment stands at about 75 percent and has not changed much over the last four years. An overall human development index (HDI), recently calculated for Montenegro by ISSP and the UNDP,¹⁸ shows that it has slowly improved. An international comparison of such indices shows that Montenegro falls in the middle group in the HDI (between 0.5 and 0.8), with a level of development similar to those in Bulgaria, Russia, Macedonia, Albania, Bosnia and Herzegovina and Romania.

D. THE CHALLENGES AHEAD: INCREASING GROWTH AND COMPETITIVENESS

1.42 **Montenegro's macroeconomic and structural reforms, pursued since the late 1990s, have yielded modest economic recovery and transition.** Real GDP grew by an average of about 2 percent per year over 2000-2004; inflation dropped from 24.8 percent at the end of 2000 to 4.3 percent at the end of 2004; Montenegro's consolidated budget deficit was reduced from about 8 percent of republican GDP in 2000 to about 3 percent in 2004; its current account deficit, although still high, is improving; and, its principal human welfare indicators such as poverty, life expectancy, and adult literacy have remained moderate and stable.

1.43 **Yet, Montenegro needs to move to a higher growth path if it is to achieve a higher standard of living for its citizens.** The Montenegrin economy grew by an average of only 1.8 percent per year between 2000 and 2004. With an average annual population growth rate of about 0.5 percent per year, the per capita income grew by only about 1.3 percent per year. As demonstrated earlier, the country's competitiveness, too, has declined over the last four years.

1.44 **The key question, then, is why growth and competitiveness have been weak and what can the Government do to increase them?** According to a simple growth model¹⁹ in which low growth could be due to three principal factors—low social returns, low private appropriability, and the high cost of finance, or a combination of any of these—the low social returns could be due to lack of macroeconomic stability, or to lack of investment in complementary factors of production (human capital, technical know-how, infrastructure, or poor geography). Private appropriability could be reduced for a variety of reasons, including poor public administration, high regulation and poor property rights and contract enforcement, as well as the high costs of factor inputs.

¹⁸ The HDI has been calculated by the UNDP and ISSP, and takes into account average life expectancy, literacy rate, and GDP per capita based on purchasing power parity (as a proxy for the living standard).

¹⁹ See Rodrik, Hausmann and Velasco (2004). This model has recently been used as a framework to look into country-specific constraints to growth in a select set of client countries of the World Bank.

1.45 **Although Montenegro has shown considerable progress in attaining macroeconomic stability (inflation is single digit, and the twin deficits have been reduced), there are still concerns about its high fiscal and current account deficits.** Unless these deficits are addressed, they could pose a risk to continued macroeconomic stability and could also reduce social returns. Adjustment to a lower current account and to fiscal deficits is necessary, especially in view of declining foreign grants. On the other hand, there is no strong reason to believe that lack of growth has been due to insufficient investment in complementary factors of production (human capital, technical know-how, infrastructure, or poor geography). Montenegro enjoys a unique geographic location, being on the coast of the Adriatic Sea, with easy connections to the regional states as well as Western Europe. The labor force is relatively well educated, and there is a reasonable pool of skilled labor. Although investment in infrastructure (particularly in water supply and solid waste management in the coastal areas) may be critical for tourism development, the Republic enjoys a decent infrastructure.

1.46 **Private appropriability of returns to investment in Montenegro seems to be low for several reasons.** Although taxation is among the lowest in the region (especially after the recent tax reforms), the following factors also serve to reduce the private appropriability of the returns to private investment: (i) the high regulatory burden and poor public administration, as well as corruption and lack of transparency; (ii) poor property rights and contract enforcement; and (iii) labor-capital conflicts, including the high burden imposed on capital (employers) by the labor law and the collective bargaining agreements, and the labor unions in wage negotiations.

1.47 Montenegro's *high regulatory burden and poor public administration and institutional capacity* are manifested by the presence of a large informal sector on the one hand, and a high bureaucracy and a considerable presence of discretion and corruption in regulations and the enforcement of rules on the other. Its *poor property rights and contract enforcement* are manifested by the existence of an "implementation gap" for business-related laws such as mortgage law, restitution law, bankruptcy law, and company law, and by the lack of a speedy resolution of commercial disputes by courts. While significant progress has been made with regard to reforming and improving the legal and regulatory framework as it affects the private sector, there has been weak implementation of these laws. The lack of effective land registration and administration in the coastal areas is a clear example of poor property rights. The presence of *labor-capital conflicts* is evident in the still high costs imposed by the labor law and the new collective bargaining agreements, although the recent changes to the labor law were steps in the right direction (see Chapter 2).

1.48 **The cost of finance in Montenegro is high and the economy seems credit-constrained.** The nominal lending rates are very high, in the range of 15-20 percent. With inflation ranging between 3 and 7 percent in recent years, the real interest rate has ranged between 10 and 15 percent. The Republican Development Fund, and the Employment Fund of Montenegro lend funds to SMEs at subsidized interest rates (4-10 percent), but they are relatively marginal in terms of their share in private sector credit. Given Montenegro's limited opportunities in Greenfield investments, most investors would be hard pressed to find a project whose real rate of return would exceed 10-15 percent.

1.49 **Several factors may explain the high cost of finance in the economy.** Montenegro's national savings are low, but household savings with the banking sector have increased in recent years. Several other non-savings factors may be responsible for the high costs of finance and the poor financial intermediation. First, because of relatively high demands for credit by the public sector for deficit financing, the Treasury bills market actively competes for banking sector funds which could otherwise be directed to the private sector. The Treasury bills rate is high, between 8 and 12 percent.²⁰ The

²⁰ The Tbills rate has been significantly reduced in 2005—to less than 5%—as government cleared some of its domestic debt using the large privatization revenue.

Government's fiscal policy, in particular the control of domestic financing, is therefore one key factor in the poor financial sector intermediation and high real interest rates. Second, although Montenegro has made progress in recent years in terms of banking sector reforms, the banking sector is not competitive. Most of the banks are still either majority owned by the Government, or indirectly owned by the social funds (Pensions Fund, Health Fund). The banking services for the Government and for the main state-owned entities such as the KAP, EPCG are concentrated at a handful of banks. Therefore, the competition exists mainly in theory, rather than in practice. Finally, there is a high spread between the deposit and lending rates of commercial banks because of the high risks associated with collaterals, loan recovery and liquidity problems, the high administrative costs of commercial banks, and the very small size of the Montenegrin market.

1.50 The above cursory examination of Montenegro's economy would lead to five hypotheses on the binding constraints to growth in Montenegro:

- *Fiscal policy and the composition of expenditures:* Although significant progress has been made towards macroeconomic stability, the large current account deficit, coupled with euroization and falling aid flows (in particular grants), threatens macroeconomic stability and growth (i.e., low social returns). Furthermore, it is not clear whether the composition of fiscal expenditures is supportive of growth or whether there is a need for reallocation towards capital and infrastructure investments.
- *High regulatory burden and poor administrative and institutional capacity:* Despite reforms, corruption and inefficiency reduce investment and increase the informal economy (i.e., low private appropriability of social returns).
- *Poor property rights and contract enforcement* as manifested by the existence of an "implementation gap" for business-related laws such as mortgage law, restitution law, bankruptcy law, company law, and the lack of speedy resolution of commercial disputes by courts limit private investment and growth (i.e., low private appropriability).
- *The high cost of finance and poor financial intermediation,* as manifested by high real interest rates ranging between 10 and 15 percent and low credit to the private sector, has limited private investment and growth (i.e., low private appropriability).
- *Poor labor market conditions,* including the rapid real wage growth witnessed in recent years, and the high costs imposed by the labor law (despite recent improvements) and the new collective bargaining agreements, and the lack of labor market flexibility, have limited private investment and growth (i.e., low private appropriability)

1.51 How do these growth hypotheses relate to competitiveness? With a sound fiscal policy and continued macroeconomic stability, a further loss in competitiveness could be avoided by moderating wage increases in line with productivity growth. Furthermore, public expenditure reallocation towards infrastructure and capital investment could reduce the costs of doing business for the private sector by supplying public goods which are complementary to private investment. Poor administrative and institutional capacity increases the effective cost of doing business and may, by encouraging informal sector activities, undercut the competitiveness of firms in the formal economy. Conversely, cutting red tape for importers and exporters, and serving their needs through building strong institutions and a competent bureaucracy, can help promote the competitiveness of firms. Similarly, improving access to credit and reducing the cost of capital and labor would be important to increase the competitiveness of companies and businesses.

1.52 **The rest of this report examines these hypotheses with greater scrutiny of the Montenegrin data.** In Chapter 2 we take an in-depth look at Montenegro's labor market and its main characteristics, the extent to which the areas in which the labor law continues to be restrictive (despite recent improvements), and we examine whether the collective bargaining and social dialogue are supportive of growth and private sector employment creation. In Chapter 3 we examine Montenegro's fiscal policy, including whether the fiscal position is sustainable and whether the current level and structure of spending are supportive of growth, and what reallocation may be needed, if any, to support growth and competitiveness. In Chapter 4 we examine the extent to which poor administrative and institutional capacity, poor property rights and contract enforcement, and the high cost of capital and low financial intermediation are holding back growth and competitiveness in Montenegro. These are treated under the theme of constraints to private sector investment, growth and competitiveness. In Chapter 5 we use tourism as a case study to illustrate Montenegro's challenges of competitiveness and growth in practice.