CENTRAL BANK OF MONTENEGRO

RESEARCH AND STATISTICS DEPARTMENT

INFLATION REPORT

Podgorica, August 2005

PUBLISHED BY: *Central Bank of Montenegro*
Bulevar Svetog Petra Cetinjskog 6
81000 Podgorica
Telephone: +381 81 665 331
Fax: +381 81 665 336

WEBSITE: *http://www.cb-cg.org*

PREPARED BY: *Research and Statistics Department*
Nikola Fabris, PhD, Chief Economist
Danijela Vukajlović Grba, assistant director
Vesna Saveljić, chief of Real Sector Developments Analysis and Research Division
Milica Vlahović, chief of Monetary Research and Statistics Division
Svetlana Cerović, chief of Fiscal Analysis Division
Boris Kilibarda, chief of Balance of Payments Division

TRANSLATED BY: *Lidija Ćirović Popadić*

DESIGNED BY: *Andrijana Vujović*

Users of this publication are requested to make reference to the source of information whenever they use data from the Report.

CONTENTS

1. INTRODUCTION 5

2. INFLATION INDICATORS 6

3. INFLATION FORECASTS 12

4. INFLATION DETERMINANTS 14

4.1 Demand 14

4.1.1. Movement of Salaries and Other Available Demand Determinants 14

4.1.2. Budget Analysis 17

4.1.3. External Demand and Current Account 18

4.2. Supply And Production 20

4.3. Stock Exchange Indices 22

4.4. Money Supply 23

5. MONETARY POLICY 26

6. INFLATION FORECAST BY THE END OF 2005 27

1. INTRODUCTION

The Central Bank of Montenegro has decided to start with a new publication, the Inflation Report, to be prepared on a quarterly basis, and published on its website www.cb-cg.org. It is a publication that is published by many central banks in the world, especially in those countries that follow an inflation targeting policy.

The policy followed in Montenegro is a lot similar to inflation targeting, but due to the limited monetary policy instruments at its disposal it cannot be entirely treated as such. Therefore, the aim of this publication is to indicate inflation expectations, all the elements of demand and supply, and to present to the public the Central Bank`s estimate of the inflation rate.

Box 1 Inflation Targeting

New Zealand was the first to implement the inflation targeting concept in the mid-80`s of the previous century, and since then this monetary policy concept has been adopted very quickly by other countries as well. The point of inflation targeting is for the central bank or the government to announce the targeted inflation rate in a form of a common rate or a zone. The central bank then tries to keep inflation within the announced target by using its instruments. Some countries impose sanctions against the makers of monetary policy if the targeted inflation rate is not achieved, and in other cases these are corrective measures.

One of the most famous examples of inflation targeting is the United Kingdom. Here the government announces the targeted inflation, and the Bank of England tries to maintain it within the planned framework. A communication campaign is simultaneously led by both the Government and the Bank of England. If the target is exceeded by more than 1%, the Governor of the Bank of England then writes an open letter to the Government informing it about the reasons for not meeting the target, and about the corrective measures the Bank plans to implement.

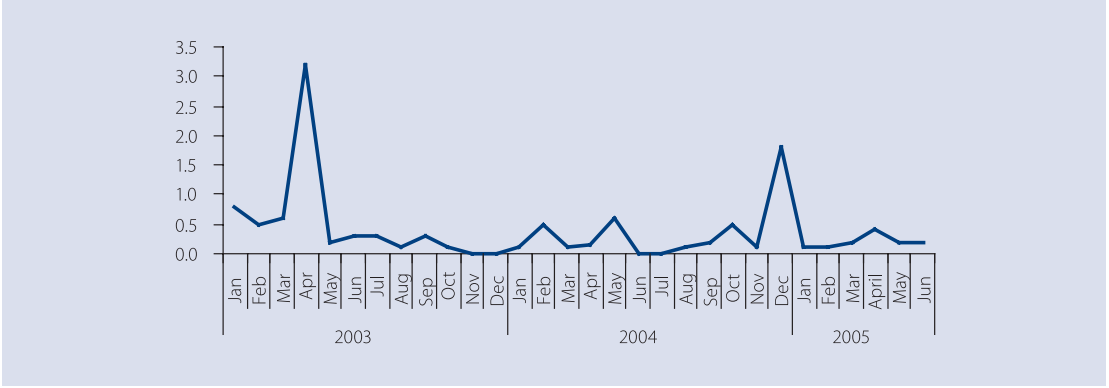
Although this kind of report significantly differs from country to country, it more often than not includes some standard components. Unfortunately, Montenegrin statistics are still in their infancy and cannot provide any significant information for this kind of reporting, especially about personal consumption, investment consumption, some supply aspects, updated quarterly data on GDP movements, and so on. However, in spite of being deprived of this important information, we believe that this report will prove useful.

2. INFLATION INDICATORS

During the first six months of 2005, retail prices in Montenegro grew moderately, 0.2% on average. Only in April prices rose above the average, 0.4%, and in other months they grew at the average rate (March, May, and June), or below (January and February). These movements resulted in a 1.2% inflation measured by the retail price index in June, in relation to end-2004.

The prices of goods increased by 1.2%, mainly due to the prices of agricultural products and beverages that grew by 7.5% and 6.4%, respectively. The increase in the former was evident in March (1.1%, which can be attributed to the bad weather that resulted in lower supply), and May and June (4.2% and 1.9%, respectively, which is usual for this time of year due to seasonal products and the price calculation methodology applied by Monstat). The existing Law on Excise Duties ("Official Gazette of RoM", no. 65/01 and 12/02) foresees the gradual adjustment of excise duties in Montenegro to the minimum amount existing in the European Union. Thus, pursuant to this law, higher excise duties on the production of alcoholic beverages became effective as of 1 January 2005. The excise duty on beer increased from EUR 1.55 per alcohol volume per hectolitre to EUR 1.90, and that on the manufacturing of brandy increased from EUR 100 to EUR 550 per hectolitre of pure alcohol. These increases were the main reasons for the increase in the retail prices of beverages and their contribution to total inflation of 28%. The prices of industrial food products increased by 0.33% due to the higher prices of fresh meat by 1.7% that contributed 11% to total inflation.

Graph 1
Retail prices, monthly increase



Source: Monstat

Table 1
Contribution of certain groups (goods and services) to total inflation

	Total	Weight	Contribution
		10000	100%
1	GOODS	8108	83,76%
11	Agricultural products	514	31,73%
12	Manufactured products	7594	52,09%
121	Manufactured food products	3246	8,85%
122	Beverages	526	27,78%
123	Tobacco	514	0%
124	Manufactured non-food products	3308	15,04%
12473	Liquid fuels and lubricants	141	12,03%
2	SERVICES	1892	16,57%
21	Handicraft	131	7,55%
22	Public utility services	248	0,06%
23	Financial and other services	316	9,61%
24	Education	114	0,73%
25	Social security	65	0%
26	Transportation and PTT services	1018	-0,08%

Source: Monstat and calculations by the CBM

The highest pressure on the increase in the prices of industrial non-food products were from the prices of liquid fuels and lubricants that rose by 10.3%. Higher prices were of liquid fuels were a consequence of the continued accelerated growth in the prices of crude oil in the world market. To wit, very cold weather in the first quarter of the current year in the USA and most of Europe, as well as the continued economic growth of China, and the improved economic performance of Japan generated higher demand for crude oil which OPEC, in spite of increased production, could not meet in full. The situation deteriorated even more in the second quarter because of some speculative forecasts that the prices of oil could double due to a potential lower supply in the summer months and the beginning of the holiday season in the USA. Thus, the price of the OPEC reference basket in June 2005 was 36% higher in comparison with the average from 2004.

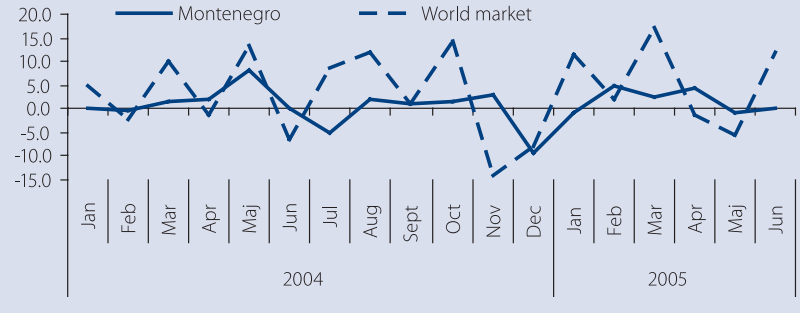
Table 2
Average monthly prices of crude oil of the OPEC reference basket and selected crude oil (USD/barrel)

Description/ Period	2004	2005					
	XII	I	II	III	IV	V	VI
OPEC	35,70	40,24	41,68	49,07	49,63	46,96	52,04
Brent	39,43	44,01	44,87	52,60	51,87	48,90	54,73
WTI	43,12	46,64	47,69	54,09	53,09	50,25	56,60

Source: Monthly oil market reports, OPEC

Although the prices in Montenegro followed the prices movements in the world market, the fluctuations were somewhat milder.

Graph 2
Oil prices (monthly increase)

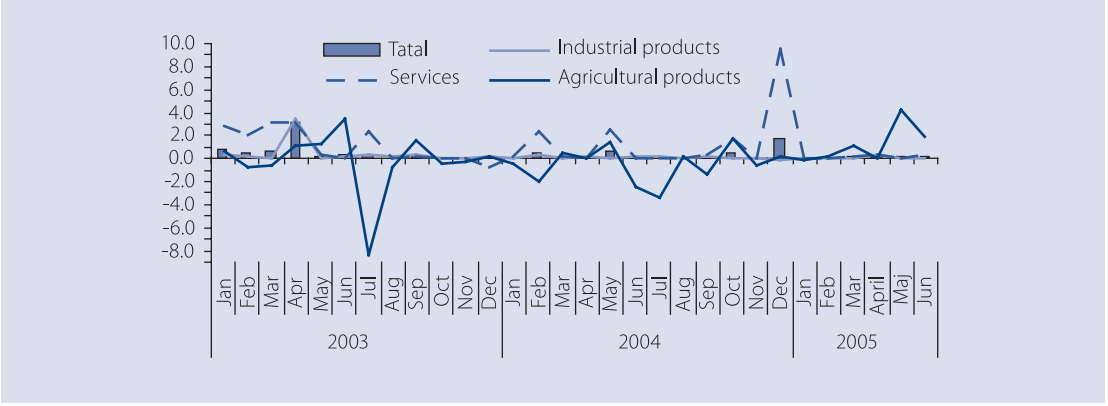


Sources: Monstat and Monthly oil market reports, OPEC

The prices of services in the first half of the year rose by 1.1%, contributing 17% to total inflation. The increases in the prices of obligatory vehicle insurance of 1.3% in March and 2.5% in June had the greatest effect on the prices of services. Also, the prices of handicraft services that rose by 7% contributed 7.5% to total inflation.

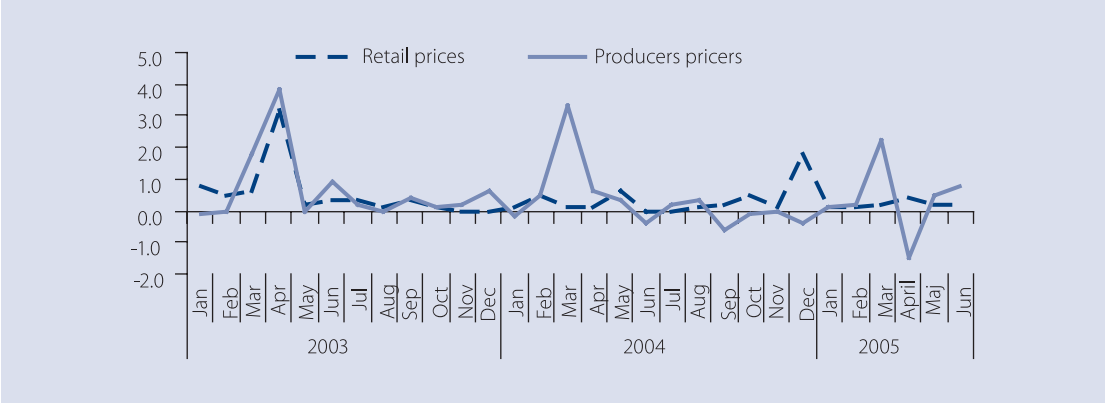
Producers` prices of manufactured products continued their strong growth this year, growing much faster than retail prices. This was due to the continued increase in the price of aluminium in the world markets, and the aforementioned implementation of new excise duties on the production of alcoholic beverages. These changes only partly affected retail prices because the prices of intermediate goods are not included in the basket for the calculation of retail prices.

Graph 3
Retail prices, monthly increase



Source: Monstat

Graph 4
Retail prices and Producers` prices of manufactured products (monthly increase)



Source: Monstat

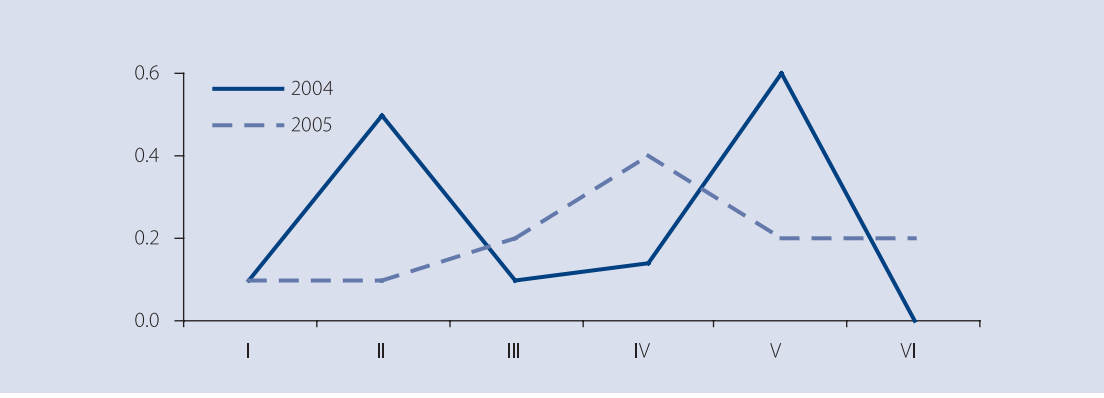
Retail prices in the six-month period of both 2005 and 2004 grew at the average monthly rate of 0.2%, but their movement this year shows smaller oscillations. The prices of goods grew at the same pace, and the prices of services grew much slower this year.

If we look at the movement of inflation in Montenegro from 2000 onwards, we notice that it has declined gradually. The exception was the year 2001 when the inflation rate amounted to 28% due to the transition from a state controlled to a market oriented economy which implied the liberalisation of the state controlled prices and their free market determination. Double-digit inflation in 2000 and 2001 was due to a loan granted to the Montenegrin Government by ZOP[1] (some EUR 40 million), and a large inflow of humanitarian aid the main portion of which was used for consumption. The establishment of the Central Bank of Montenegro as an independent institution in March 2001 abolished the possibility of financing the Government, which remarkably undermined the pressure on inflation. The introduction of the euro as the legal tender in 2002 instigated a one-off inflationary shock in April that year when DEM was officially replaced by EUR. Retailers took advantage of the conversion to increase their prices, and not just to translate them from DEM to EUR. After this shock, the annual inflation was 9.4%, which was the first time in 26 years that a one-digit annual inflation was achieved.

Structural reforms in the Montenegrin economy continued in 2003, which was characterized by the introduction of VAT and a new inflationary shock (3.2% in April). However, increases in the prices of goods and services due to VAT were even higher because of the increase in the state controlled prices of electricity of 23%. In spite of these two strong impacts, inflation remained at 6.7%. The main culprit for the 4.3% inflation in 2004 was the prices of non-tradable services (obligatory vehicle insurance, TV subscription fee, and telephone charges). The annual inflation rate in June 2005 (measured by the retail price index in June 2005 in relation to June 2004) amounted to 3.8%. However, its further decline is expected by the end of the year because of the still low comparative base. To wit, the highest price growth was recorded in December 2004 because of the increase in the prices of telephone charges, which will increase the comparative base and, at the same time, a lower inflation indicator, but not until December 2005.

The comparison of inflation in some Southeast European countries, new members of the European Union, and the USA shows that inflation in Montenegro was at their average. It was lower than in Bulgaria, Romania, and Serbia, but it was the same as in Hungary, a new EU member country.

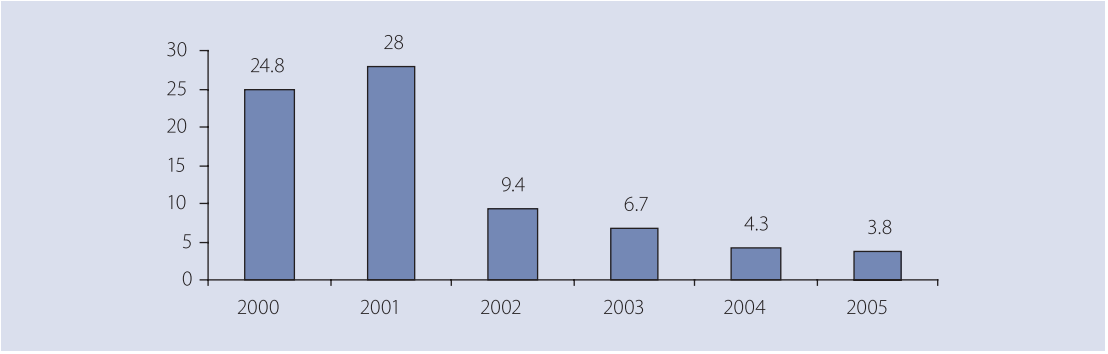
Graph 5
Retail prices, monthly increase



Source: Monstat

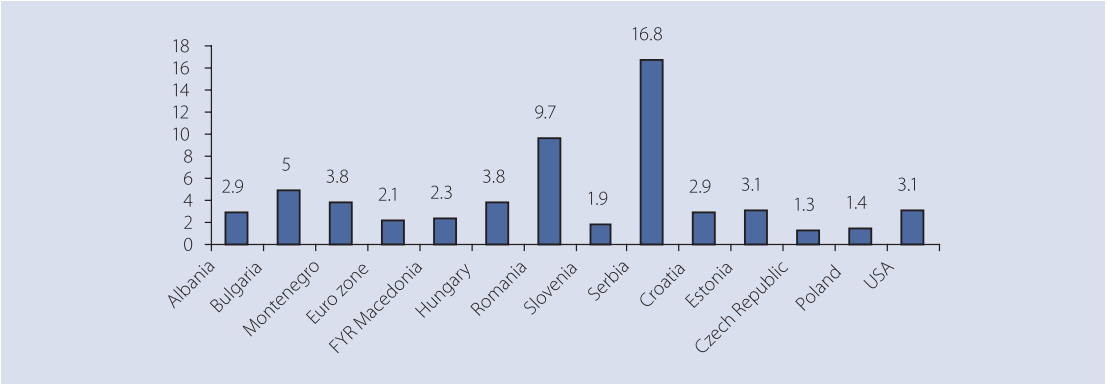
[1] *The former Clearing and Payments Bureau*

Graph 6
Inflation in Montenegro (annual increase)

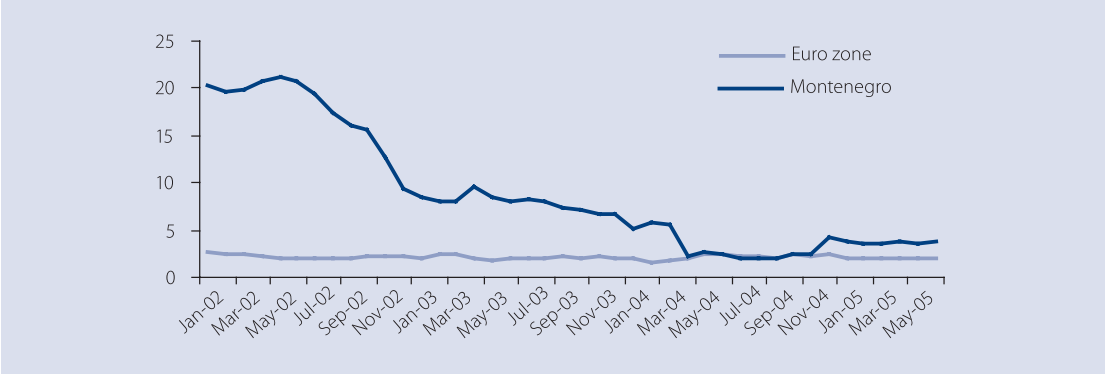


Source: Monstat

Graph 7
Inflation in selected countries in 2005 (in %, June 2005/June 2004)



Graph 8
Inflation in Montenegro and the Euro zone since the introduction of EUR (annual change)



Source: Monstat and the European Central Bank

The comparison between the planned and achieved rates of inflation and GDP shows that the projected values were achieved, and they were frequently overachieved. This speaks in favour of following a responsible economic policy, and that it is reasonable to expect the achievement of the planned values for this year.

Table 3
Achieved and projected inflation and GDP

	Inflation		GDP (EUR million)	
	Projected	Achieved	Projected	Achieved
2002		9,4%		1.301,50
2003	8%	6,7%	1.375	1.433,0
2004	4,5%	4,3%	1.475	1.535,0
2005	3%		1.642,5	

3. INFLATION FORECASTS

The method normally employed to prepare inflation forecasts of this sort is through a banking system survey. In many countries this takes the form of a random sample. For Montenegrin report, however, the survey is fully comprehensive, including all banks.

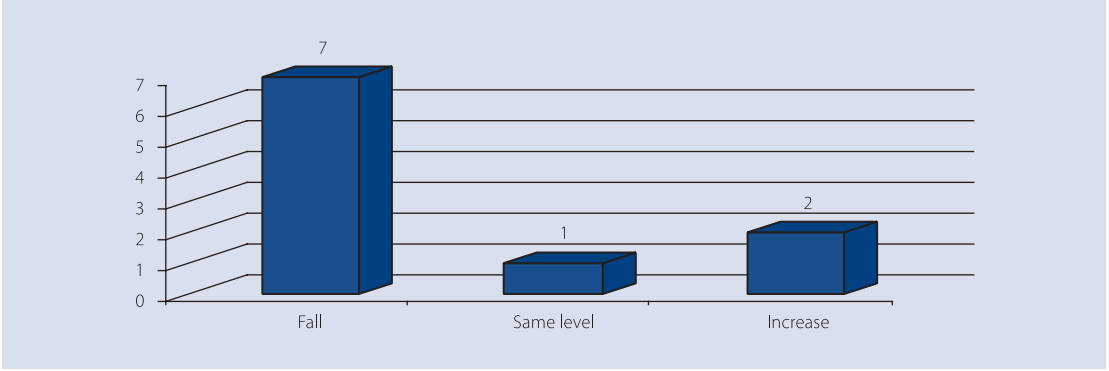
There are several reasons why banks are considered to be useful indicators of inflationary expectations. Firstly, their business moves can have an effect on both an increase and a decrease in inflation. Thus, an appropriate estimate of the inflation rate has a great effect on a bank`s business success, i.e. in a case of overestimating or underestimating this rate, a bank could face losses. Also, it should be taken into account that banks, as a rule, have a very qualified staff able to consider all determinants of inflation and use them in preparing a valid estimate.

A definite conclusion arising from our survey is that inflation forecasts are low. Seven banks expect the inflation rate to be lower than in 2004, one bank believes that it will be the same, and only two banks anticipate an increase in inflation (Graph 9).

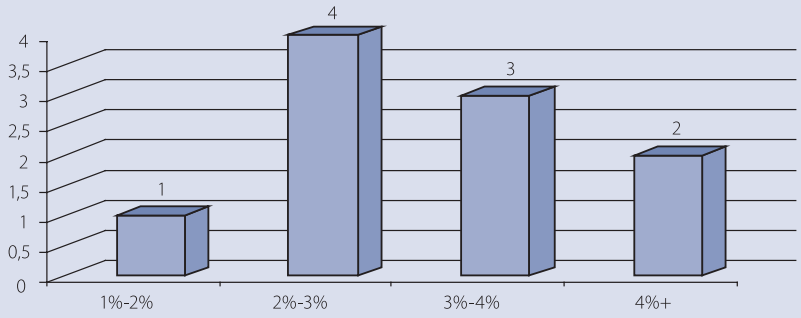
As for its level in this year, most banks (4) expect that the inflation rate will range between 2% and 3%, three banks predict that it will be over 4%, two banks its varying between 2% and 3%, and one bank expects it to be between 1% and 2%. (Graph 10)

No bank anticipates an increase in either real or nominal interest rates. Nine banks envisage a fall in real interest rates, and one that they will remain at the same level. Similar assumptions are made with regard to nominal interest rates – 8 banks expect their decline, and two believe that they will not change. (Graph 11)

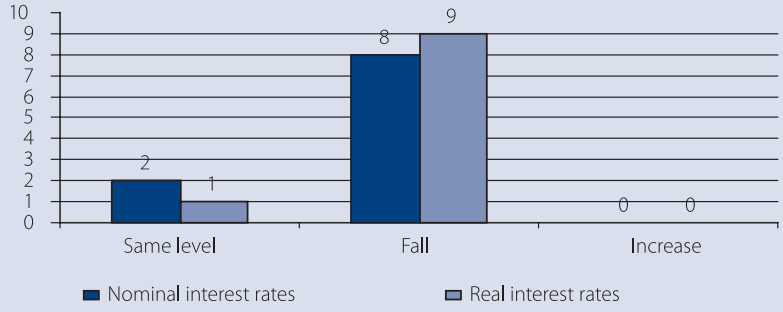
Graph 9:
Inflation forecasts



Graph 10
Expected inflation



Graph 11
Interest rates expectations



4. INFLATION DETERMINANTS

4.1 Demand

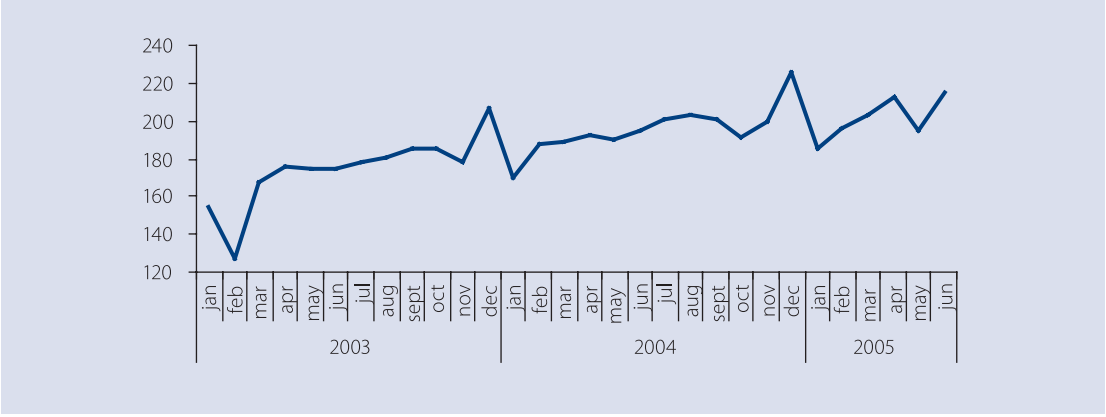
4.1.1. Movement of Salaries and Other Available Demand Determinants

The average salary in June amounted to EUR 329,56, and the average salary without taxes and contributions was EUR 214,70. Compared to the previous month, it grew by 10.3%. Higher salaries than the Republic average were recorded in eight of fifteen sectors (mining and quarrying; production of electricity, gas and the water supply; transportation, warehousing and communications; financial intermediation; property transactions; state administration and social security; education; health care and social work). The lowest salary was in the sector wholesale and retail trade.

Monstat data shows that average salaries in the Republic were on a slight uptrend in the previous two years. Thus, the growth recorded in 2004, in relation to 2003, amounted to 12.3%, and an increase in the average salary without taxes and contributions in the first half of 2004 was EUR 200,96, being 7.4% higher than in the same period the year before.

If we take into account the cost of living, i.e. the movement of salaries in real amounts, the increase in salaries without taxes and contributions salaries would be 5.7%.

Graph 12
Average salaries without taxes and contributions



Source: Monstat

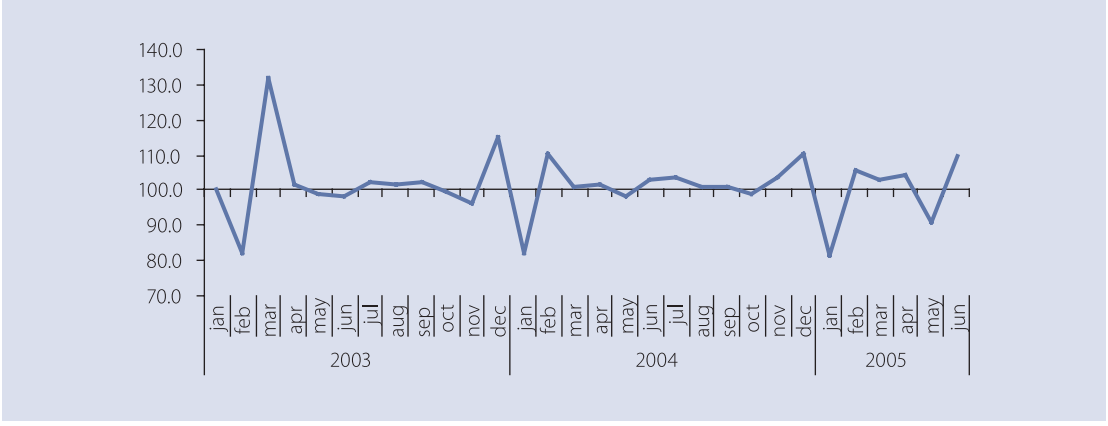
Private citizens used bank loans as alternative financing sources, which have recorded a continuous increase in the last two years, and have significantly affected the increase in demand.

Private citizens owed banks EUR 87.4 million worth of loans at end-June, which represents an annual increase rate of 34%. In spite of the continuous growth and high annual rates of increase, the growth in loans granted to private citizens was lower than in the same six-month period of 2004, the monthly average increase in 2005 and 2004 being 3% and 5%, respectively.

Until the beginning of 2005, citizens mainly used short-term loans which enabled them to meet their everyday needs, after which the structure changed in favour of long-term loans. Also, crediting through credit cards has been on an increase, allowing citizens to be in the red. This form of financing citizens use with a view compensating for an insufficient salary to meet their current needs.

In spite of the increase in loans granted, deposits by private citizens have grown continuously, being above the level of loans granted since October 2004. Graph 16 shows the connection between loans to, de-

Graph 13
Real salaries (monthly increase)

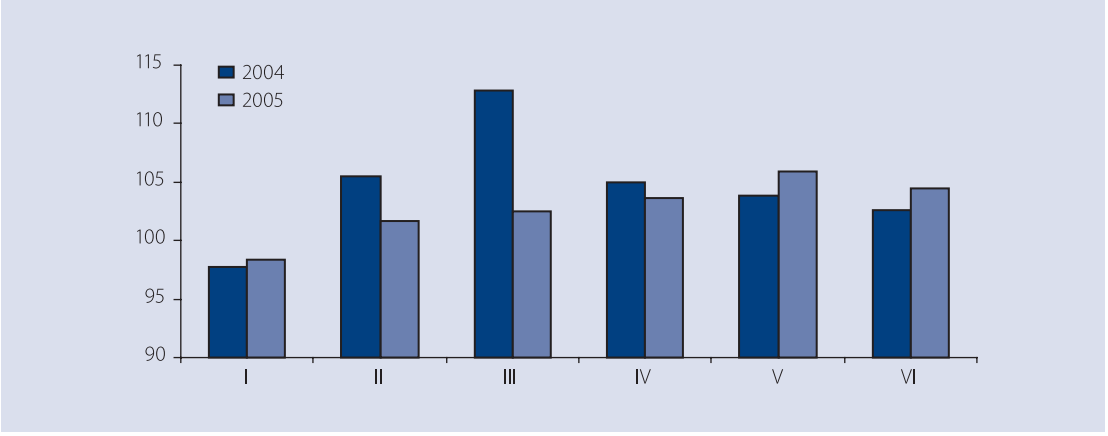


Graph 14
Loans granted to private citizens, EUR thousand

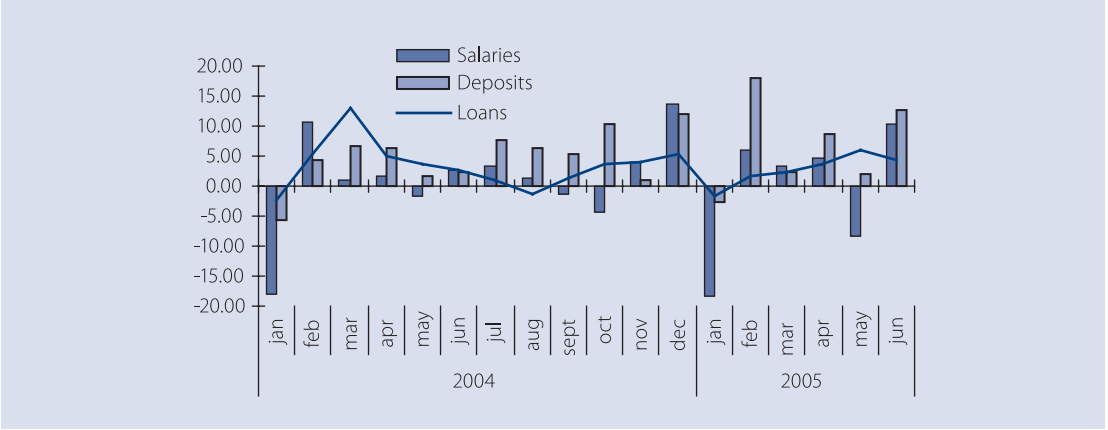
posits, and salaries by private citizens. Thus, salaries and deposits show positive interdependence – an increase in salaries leads to an increase in deposits. On the other hand, there is a negative correlation between there aforesaid categories and loans, i.e. loans increase in months when salaries and deposits record low or negative rates of increase.

Another source of financing citizens` expenditure is an inflow of foreign funds. The balance of payments statistics shows a substantial inflow of foreign funds to private citizens in the first half of 2005, 32% more than in the same period the year before. It includes payments to employees, pensions, remittances, and other transfers, all causing greater expenditure by private citizens.

Graph 15
Loans to private citizens, monthly index

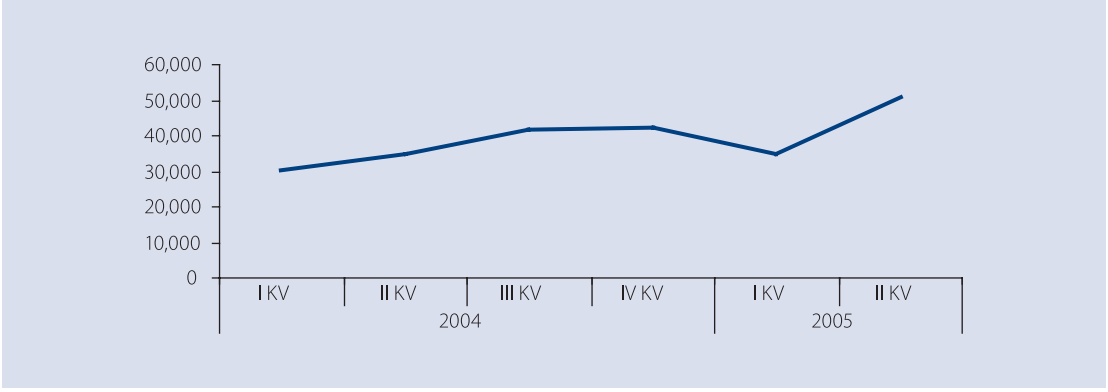


Graph 16
Salaries and deposits by, and loans to, private citizens; monthly increase



Source: Central Bank of Montenegro and Monstat

Graph 17
Inflow of foreign funds to private citizens



4.1.2. Budget Analysis

The budget of the Republic recorded a surplus of EUR 115.7 million in the first six months of 2005, which is the result of the continuous trend recorded in every month but February when a deficit of EUR 4.2 million was recorded[2]. The recorded surplus was primarily the result of the revenues from privatisation received in March, revenues from taxes, and a fall in certain expenditure. A continuous increase in Budget revenues has been recorded since April 2003 when VAT was introduced, and the reduction of corporation tax and personal income tax influenced positively this trend.

The budgetary deficit fell in 2004 from EUR 45.29 million to EUR 32.21 million, and its contribution to GDP declined from 3.29% to 2.18%. The plan for 2005 foresees a deficit increase to EUR 34.32 million, but also its smaller contribution to GDP of 2.17%. In spite of the substantial surplus in the reporting period, the plan is to use budgetary funds for some capital investments, and the repayment of outstanding short-term T-bills and bank loans.

Revenues from property sale increased (amounting to EUR 111 million), and those from taxes increased by 17.8% in relation to the same period a year ago. This was mainly due the revenues from VAT and excise duties which amounted to EUR 111.3 million, being 19.3% higher than in the comparative period. Revenues from VAT contributed 48% to total tax revenues. Within revenues from tax, a substantial increase was recorded in corporation tax (69.8%), amounting to EUR 11.9 million, and making up 69% of the planned amount for 2005. Revenues from personal income tax and tax on international trade and transactions also increased, 1.3% and 9.4%, respectively. On the other hand, revenues from property tax and capital transfer tax fell by 16.4%[3]. Other republic revenues amounted to EUR 9.3 million or 28.6% of the plan for 2005, being 20.7% lower than in the comparative period.

Budgetary expenditure in this period amounted to EUR 254.9 million or 51.8% of the plan for this year. The dominant contributor was regular budgetary expenditure (65.4%), followed by debt repayments (27.2%) which are 127.1% higher than in the comparative period, whereas 44.4% more was allocated for capital expenditure. Pursuant to the Law on Restitution of Deprived Property Rights and Reparation ("Official Gazette of RM", no, 21/04) the Government of Montenegro introduced a new category of budgetary expenditure in April 2005 – Reserve deposits for

[2] Observing the surplus/deficit as the difference between total revenues reduced for loans and borrowings and total expenditure reduced for loans and borrowings and principal repayment.

[3] Due to the levied value added tax on newly built property that was previously levied with capital transfer tax, and the implementation of tax relief for taxpayers in accordance with the Law on Property Tax ("Official Gazette of RM", no. 69/03) implemented as of January 2004.

restitution and reparation of land to the amount of EUR 11.1 million. A substantial increase in privatisation revenues enabled the commencement of payment of this expenditure. The Government allocated 18.5% less funds for borrowings and loans, which corresponds to the plan for the reduction of this expenditure. Subventions to public and other enterprises fell by 37.9%.

Total budgetary expenditure in the reporting period amounted to EUR 243.8 million (without expenditure for restitution), being 1.8% lower than planned. Regular budgetary expenditure recorded a fall of 33% in relation to the plan. In the structure of this expenditure, expenditure for gross salaries declined by 14.9%, other earnings and compensations by 24%, material and services by 26%, rental expenditure by 18.8%, and that for subventions by 18.3%. Additionally, expenditure for grants and social benefits fell by 29.8%, of which a noticeable fall was recorded in expenditure for budget transfers and grants to individuals of 58.7% and 37%, respectively. Capital expenditure fell by 46.4% and other expenditure by 34.2%. Expenditure for borrowings and loans (to public and other enterprises, financial institutions, and other borrowings and loans) was 52.8% lower. On the other hand, compared to the six-month plan for 2005, a remarkable increase was recorded in expenditure for debt repayments and interest, three times more and 4.2% more, respectively, which is positive taking into account its positive effects on the reduction of Montenegro`s public debt, through regular servicing of foreign debts and other loans. The recorded reduction in total budgetary expenditure points to the persistence in following the policy of rationalisation and budget consolidation.

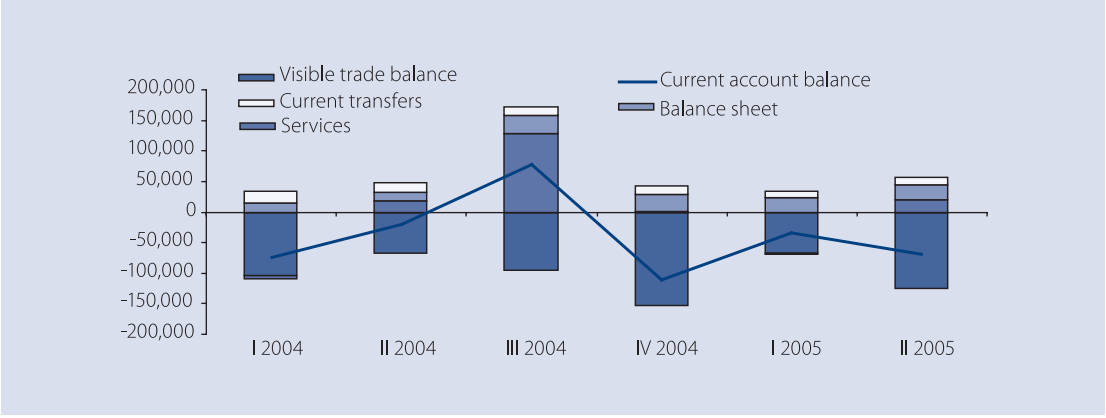
The expenditure dynamic in the forthcoming period is expected to be stable. It could only be hindered by the payment of outstanding liabilities for already issued short-term Treasury bills (EUR 24 million at end-June), in accordance with the IMF recommendations. In addition, it is possible that capital expenditure will increase if the planned road construction in the north of the Republic starts. The building of roads is the basis for the development of tourist and other potentials of this area. In any event, there is no fear that the Government will exceed the planned deficit for this year.

4.1.3. External Demand and Current Account

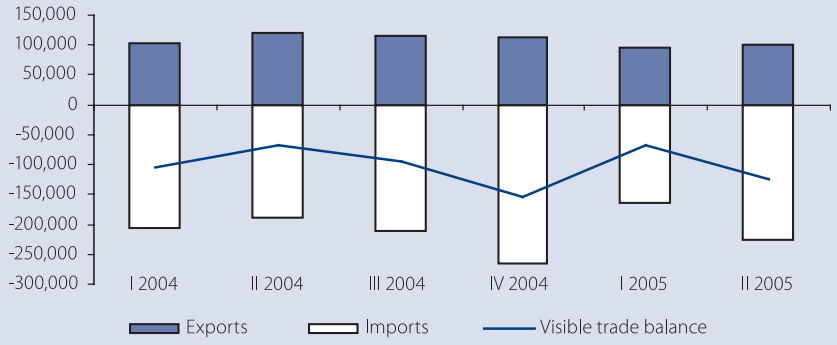
The current account recorded a deficit of EUR 103.4 million, which represents a deterioration of 10% in relation to the same six-month period the year before. The deficit in the current transactions account was entirely covered by foreign direct investments. The current account deficit was the result of the increase in the foreign trade deficit of 13% that was only partly covered by the surpluses achieved in the sub-balances of services, factor income, and transfers, 46.4%, whereas in the comparative period this coverage amounted to 44.9%. Total visible trade was EUR 585 million or 5% less.

As for services, revenues increased by 18.7%, mainly due to the revenues from transport and tourism. The balance of services was positive, being 37.8% higher than in 2004.

Graph 18
Current account – quarterly data, EUR thousand



Graph 19
External account balance, EUR thousand



A surplus increase of 60.6% was recorded in the sub-balance of factor income. The sub-balance of current transfers also recorded a surplus, but 29% lower than in the comparative period mainly due to a fall in foreign assistance and an increase in transfers from Montenegro to other countries.

Observed by quarters, the current account deficit in the second quarter of 2005 amounted to EUR 69 million, which is a 100% and no less than a 250% increase in relation to the previous quarter and the same quarter of 2004, respectively. The main reason for this was a greater fall in visible exports than the fall in visible imports, both substantially lower than the previous year.

The average quarterly foreign demand for domestic products amounted to EUR 97.9 million, in the comparative period it was EUR 111.7 million. On the other hand, the average domestic demand for foreign products amounted to EUR 194.4 million or EUR 3 million less. Compared to the previous quarter, imports in the second quarter of this year increased by 38% due to the increase in domestic demand in the periods before, and after, the tourist season.

The structure of imports also changed from the previous year. To wit, in the first half of 2005 falls were recorded in the imports of products from the group food and live animals, beverages and tobacco, chemical products, and products chiefly classified by the type of material, whereas the highest increase in imports was of miscellaneous finished products. The imports of products from the group food and live animals and products chiefly classified by the type of material fell by EUR 21.4 million and EUR 3.6 million, respectively. The imports of products from the group iron and steel rose by 28%.

The increased import of products from the group of various finished products of EUR 22 million is the result of statistical recording, i.e. the problem of non-updated nomenclature. The International Nomenclature HS-6 is updated every 5 years, which is not the case in Montenegro. That is why many products which actually belong to different sectors are treated as non-classified and recorded in the sector miscellaneous finished products, thus preventing the comparability of data with other countries, as well as periodical comparability.

The main sources of financing the current account deficit are foreign direct investments which in this period amounted to EUR 215 million. Most of this year`s investments were in services (81%), then in financial activities and property.

Table 4
Foreign direct investments, EUR thousand

Investment	I - VI 2005	%
In production	3,440	1,59
In services	175,068	81,36
In financial organisations	24,597	11,43
Sale of property	12,069	5,60
Total:	215,174	

4.2. Supply and Production

Data on the achieved gross domestic product are available only for the first quarter of this year. According to the estimates of the Secretariat for Development, GDP in the first quarter was EUR 340.1 million, which is a nominal increase of 5.5% in relation to the same period the year before. By applying the GDP deflator of 3.6%, we get a real growth estimate of 1.9%.

Table 5
GDP in the first quarter of 2005 (EUR million)

	2004	2005	Change in per cents	
			Nominal	Real
GDP	322.4	340.1	5.5%	1.9%

Source: Montenegrin Secretariat for Development

The Economic Policy for 2005 foresees GDP of EUR 1.642,5 million, which would represent a real growth of 5%.

The physical volume of **industrial production** in the reporting period fell by 1.8% in relation to the same period the year before. This fall was almost entirely due the lower production of electricity, gas and water supply of 16.3%.

The mining and quarrying sector recorded 10.5% higher production due to an increase in the production of metal ore and other mining and quarrying of 29.8% and 77.8%, respectively. Problems in the Pljevlja coal mine (the lack of funds for the repair of equipment, expropriation, investments, and daily liquidity maintenance) continued in the second trimester of the year which resulted in lower production of coal, lignite and peat of 19.2%.

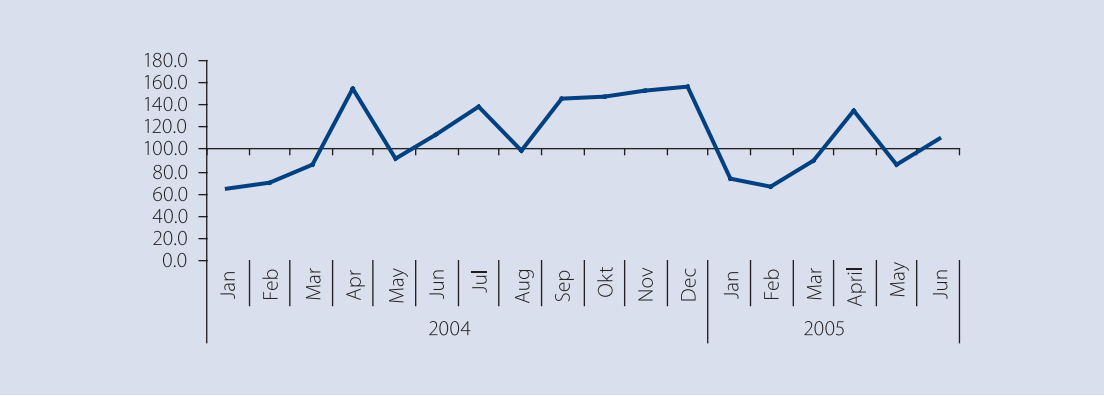
Reduced volume in the production of coal had an adverse effect on the production of electricity, gas and the water supply. To wit, after the regular annual repair of TE "Pljevlja" that took 56 days, the production of electricity stopped until the beginning of June due to insufficient amounts of coal. This thermo power plant was out of order for 88 days (almost three months), causing the lower production of electricity, gas and water supply of 16.3%.

Monstat data shows an increase in production in manufacturing industry of 4.2%. This increase was due to the greater production in six branches of the industry, whereas the other eleven branches lagged behind the average production achieved in the first half of 2004.

Industrial output in June 2005 was 3.2% lower than in the same month the year before, but it was 2.3% higher than in the previous month.

Monstat data shows that 178,000 **tourists** or 17.3% more than in the comparative period visited Montenegro in the reporting period. Increases were recorded in both domestic and foreign tourists. Domestic tourist arrivals grew by 7.3%, but what should be stressed is that foreign tourist arrivals increased this year, by 38%, which caused the structure of tourists to increase from 32% (in the first half of 2004) to 38%. A total of 898,000 tourist overnight stays was recorded in this period, which is an increase of 10% in relation to the comparative period. Domestic tourist overnight stays grew by 5.3%, and that of foreign tourists by 20.4%. The Economic Policy for 2005 foresees an increase in tourist overnight stays of 8%.

Graph 20
Industrial production, Ø 2000 = 100



Source: Monstat and calculations by the Central Bank of Montenegro

As for **forestry**, only 37,000 m^3 of wood products were produced in the first five months of the year, which is 33% less than in the comparative period. Bad weather conditions were the reason for the lower production causing no woodcutting in February and March. At the same time, 29,000 m^3 of wood products were sold in this period, which is a fall of 37%.

The activities in the **construction industry** in the first five months of 2005 showed positive movements and resulted in the value of registered construction work of EUR 21 million, being 20% higher than in the corresponding months in 2004, and effective hours increased by 6%.

Monstat data on the volume of **transportation services** for the first five months point to a slowdown in overall transportation activities. Thus, 37% and 14% less passengers and goods, respectively, were transported in road transport. This slowdown was very obvious in the first quarter due to the poor road infrastructure, landslides and heavy snows that caused frequent traffic delays. The completion of the reconstruction of certain road sections of the Podgorica – Bijelo Polje main road, and the opening of the Sozina tunnel will improve the transportation activities in the forthcoming period. As for air traffic, 7% less passengers and 0.8% more goods were transported in the reporting period. The sources of data for both domestic and international traffic are the airports in Tivat and Podgorica. Bad weather and snows that caused the airports to be closed for traffic on a few occasions led to the lower turnover. Also, the strike in the Serbian airline company JAT led to the fewer number of transported passengers. However, taking into account the positive results being achieved in tourism, the higher number of domestic, and especially foreign, tourist arrivals, better results in this field are anticipated. Data on the transport of passengers and goods via railways shows a decline in the former of 15%, due to the extremely poor condition of transportation capacities and railway infrastructure, whereas the latter recorded a growth of 32%. The transport of goods in the marine transport reveals a fall of 33.7%. Total turnover in ports amounted to 730 thousand tonnes, representing a decrease of 18.6%, of which 415 thousand tonnes referred to exports, and 315 thousand tonnes to imports.

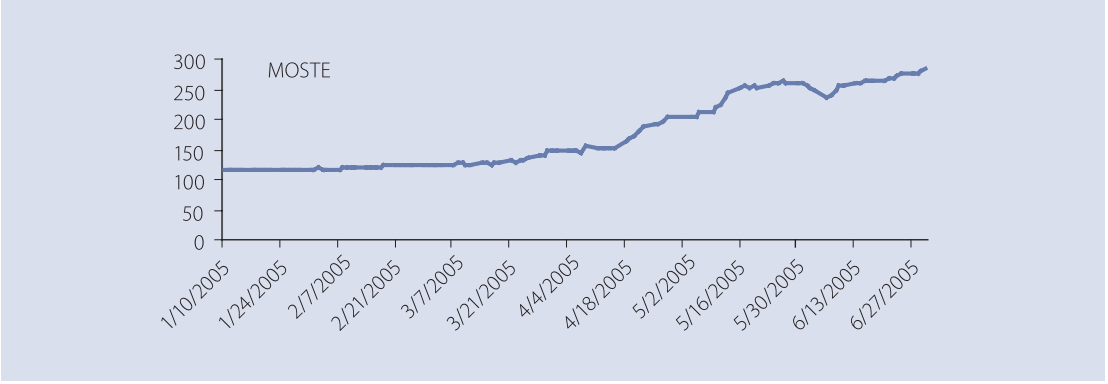
4.3. Stock Exchange Indices

The Montengroberza stock exchange index MOSTE grew from the beginning of the year by 167, 8958 points or 145,7621%.

The NEX 20 index recorded a growth of 2,289.15 points or 90.7453%. Its increase is an indicator of the effect of the capital inflow from the aforesaid privatisation of Telecom Montenegro on other shares in the market.

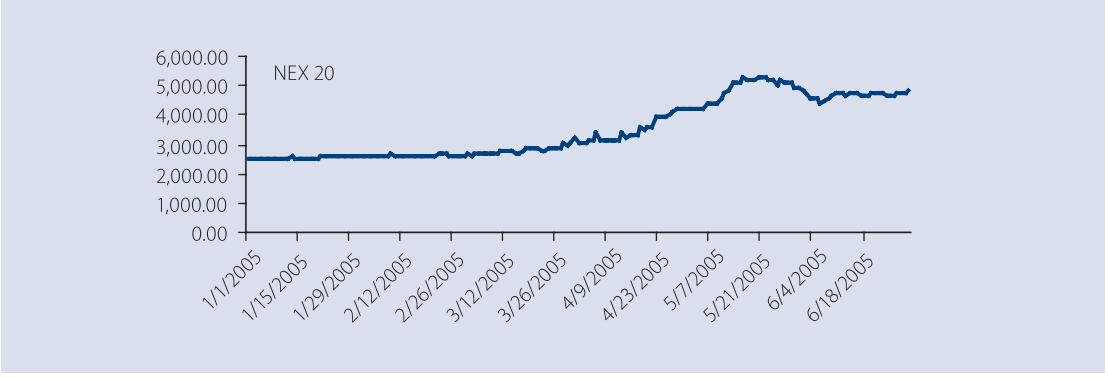
The NEX PIF index grew by 1,548.78 points or 96.58656%. The increase in this index was primarily affected by the takeover of one privatisation fund at end-May/beginning of June, and an attempted takeover of another investment fund.

Graph 21
Index MOSTE in the period January – June 2005



Source: Montenegroberza stock exchange

Graph 22.
Index NEX 20 in the period January – June 2005



Source: NEX Montenegro stock exchange

4.4. Money Supply

At the end of the reporting period, the money supply M21 reached its highest level ever, EUR 726 million.

During the first six months of 2005, the money supply grew more intensively than in the same period in previous years. The money supply M21 grew at the average rate of 5% in 2005, 1% in 2004, and less than 1% in 2003. The highest monthly increase of M21 was recorded at the end of the first quarter this year, 25%, due to a growth in term deposits after an inflow of funds from the privatisation of Telecom Montenegro to the Government`s account with the Central Bank of Montenegro.

At the end of the second quarter, the money supply M21 was 32.9% higher than at end-2004, and this increase in relation to the comparative period of that year was 46%. The annual growth in M21 in the first two quarters of the current year was more intensive than in the same quarters of the previous year. This was mainly due to the inflow of privatisation funds to the Government`s account with the CBM, but a higher annual increase was also recorded in the first two months of the year. The average annual increase in the reporting period is 33%, and the corresponding rate in 2004 amounted to 1%.

Similar movements also characterized other money supply aggregates.

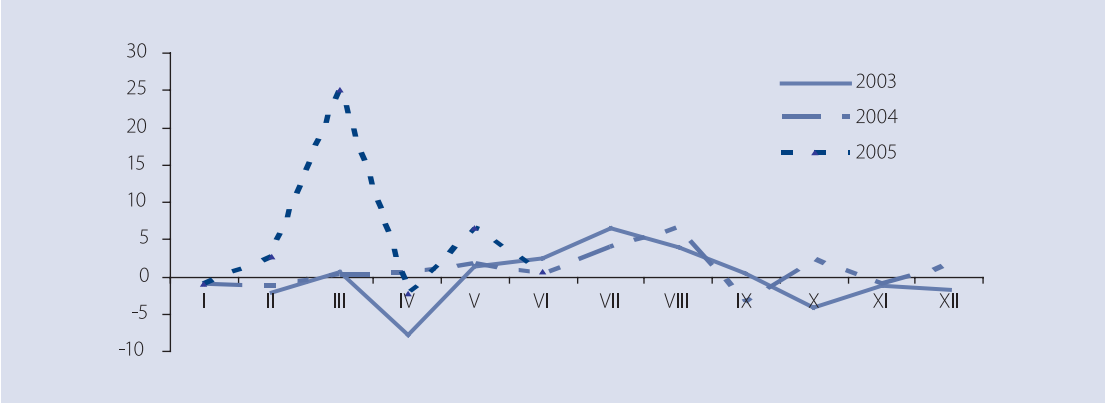
Table 6.
Money supply, end-months, EUR thousand

	2004		2005	
	VI	XII	III	VI
M0	**283.695**	**290.935**	**291.908**	**307.376**
Banks' deposits with CBM	33.695	40.935	41.908	57.376
Estimate of cash in circulation	250.000	250.000	250.000	250.000
M1	**393.308**	**430.657**	**450.494**	**490.980**
M0	283.695	290.935	291.908	307.376
Demand deposits in EUR	98.495	130.218	146.728	168.142
Demand deposits in other currencies	11.118	9.504	11.858	15.462
M11	**399.198**	**437.114**	**463.039**	**512.757**
M0	283.695	290.935	291.908	307.376
Demand deposits in EUR	103.921	136.302	159.130	188.970
Demand deposits in other currencies	11.582	9.877	12.001	16.411
M2	**485.328**	**535.548**	**564.394**	**622.851**
M1	393.308	430.657	450.494	490.980
Term deposits in EUR	85.872	98.128	107.183	125.682
Term deposits in other currencies	6.148	6.763	6.717	6.189
M21	**497.293**	**546.513**	**693.658**	**726.277**
M11	399.198	437.114	463.039	512.757
Term deposits in EUR	91.947	102.636	223.902	207.331
Term deposits in other currencies	6.148	6.763	6.717	6.189

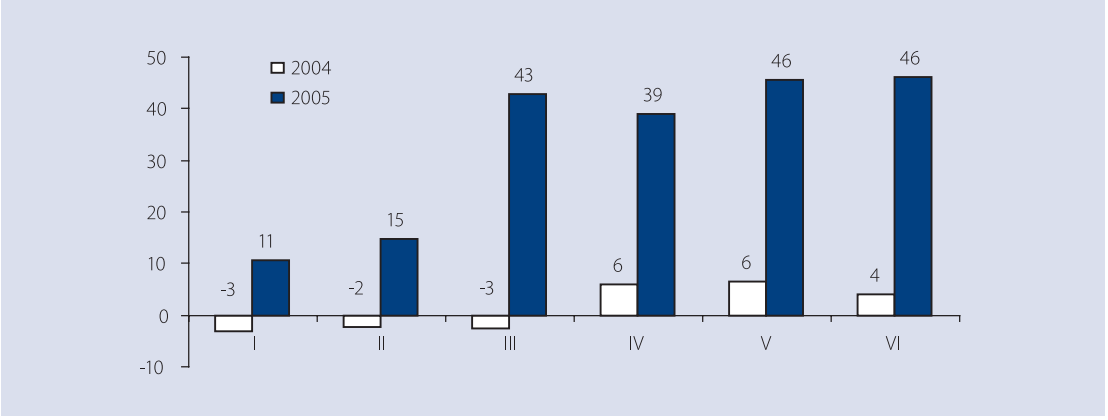
The largest portion of M21, 71%, referred to the money supply M11, that is, demand deposits, whereas term deposits made up 29% and their contribution to M21 improved in relation to end-2004 when it was 20%.

The money supply M11 amounted to EUR 512.7 million at end-June, which is 17% more than at end-2004, whereas term deposits were 95% higher, amounting to EUR 213.5 million.

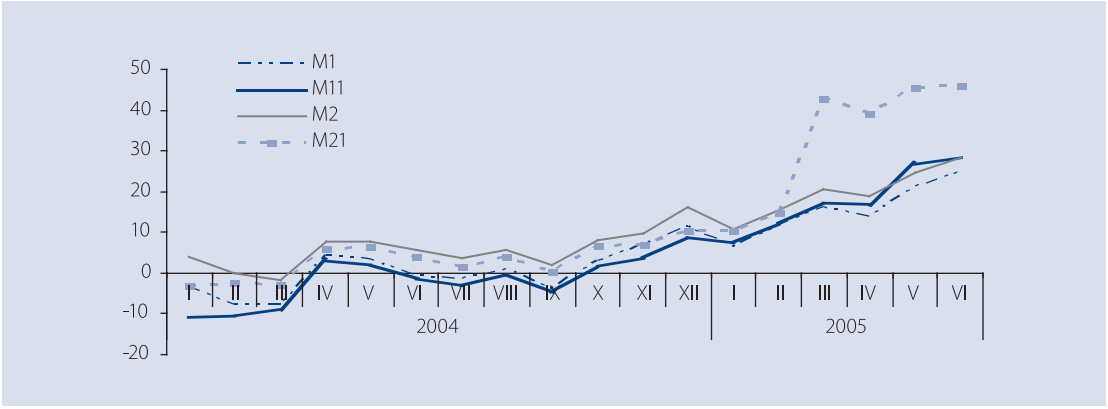
Graph 23
M21 monthly increase rates, in %



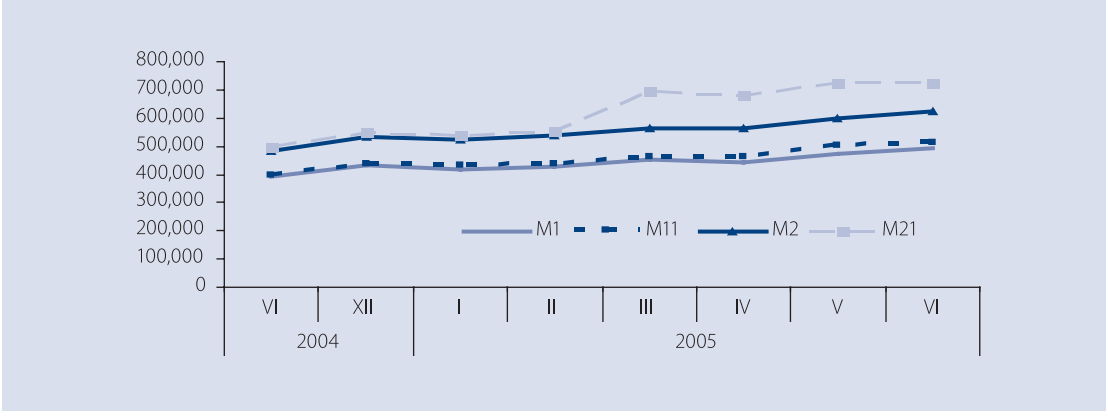
Graph 24.
M21 annual rates of increase, %



Graph 25.
Annual increase rates of monetary aggregates, %



Graph 26.
Money supply, EUR thousand



5. MONETARY POLICY

The Central Bank of Montenegro is responsible for monetary policy, the establishment and maintenance of a sound banking system and an efficient payment system in the Republic of Montenegro.

In the first half of 2005 there were no changes in the applying of reserve requirement instruments and conditions of the utilization of funds that the CBM grants to banks with a view to liquidity maintenance.

During this period, the CBM enacted the Regulation on Fees for the Services Provided by the Central Bank for Performing Payment Operations in the Country and Those for the Participation in RTGS and DNS ("Official Gazette of RoM", no. 39/05), prescribing lower charges by commercial banks for providing payment operation services for their clients, which represents a decrease of 60% in addition to the substantial lowering of charges to clients provided by the Central Bank of Montenegro with the introduction of the new payment system at the beginning of 2005.

In addition, the Regulatory Credit Bureau was established with a view to providing more precise risk assessments for banks, for both individual banks and for the banking system in general.

Old regulation		New regulation	
RTGS			
Payment order < 250 €, per order	0,08 €	Clearing, per order	1,50 €
Payment order ≥ 250 €, per order amount	0,06%		
Clearing of orders for public revenue payment < 250 €, per order	0,04 €	Clearing of orders for public revenue payments <1.000 €, per order	0,10 €
DNS			
Payment order in DNS<250, per order	0,04 €	Clearing, per order	0,10 €

6. INFLATION FORECAST BY THE END OF 2005

We will base the inflation forecast on the model of an expert assessment, and in future we hope to start econometric forecasting.

Consumer demand is definitely on the increase, higher than the increase in real salaries, the level of loans granted, or remittances from abroad. On the other hand, deposits by private citizens have an opposite trend. The level of economic performance is also gearing up, but is still much slower than demand. A high visible trade deficit also causes an increase in demand. However, in Montenegro, an increase in demand has a less powerful effect on inflation and a stronger influence on an increase in the current account deficit.

Inflation forecasts are relatively low, and in no case can they be an inflation generator. Also, the inflation rate in the first six months of the year was a mere 1.2%. It is expected that both nominal and effective interest rates will be on a downtrend in the forthcoming period. The increase in the money supply has no significant effect on inflation, which leads to the conclusion that the process of remonetization is still under way.

The fiscal deficit was brought down to an acceptable level, and fiscal policy does not exert any pressure on prices. A potential threat could be the withdrawal of a substantial amount of the privatisation revenues, held in international accounts, and their placement in the domestic market. However, no such announcements have yet been made.

A continuous growth in stock exchange trading, and an increase in exchange indicators points to the expectations of the financial market of sustained macroeconomic stability in the second half of the year.

Monetary policy instruments are rather limited, and in euroisation conditions there is no possibility of any money issue that would have a destabilising effect on inflation. The only change in monetary policy in this period was a decrease in commissions on cashless payments, which caused a fall in payment operation charges, and simultaneously a fall in inflation.

From all the aforesaid reasons we expect that the inflation rate in 2005 will range between 2.6% and 3.8%.

Table 7.
Inflation forecast

Optimistic forecast	Realistic forecast	Pessimistic forecast
2.6%	3.2%	3.8%

The assumptions that the aforementioned forecast is based on are as follows:

- There will be no increase in the prices of electricity this year,
- The increase in the prices of oil in the world markets will not exceed 10% by the end of the year, and
- There will be no abuse of monopoly, i.e. oligopoly position.

Any discrepancy in these indicators will require a forecast revision.

The achievement of the forecasted inflation would mean a continuation of a four-year downtrend, and a convergence to the inflation rate existing in the European Union, which represents a long-term objective of economic policy with regard to prices.