



CENTRAL BANK OF
MONTENEGRO

**ECONOMIC POLICY RECOMMENDATIONS TO THE
GOVERNMENT OF MONTENEGRO FOR THE YEAR
2021**

Podgorica, December 2020

INTRODUCTORY REMARKS

For many years now, the Central Bank has been communicating economic policy recommendations to the Government of Montenegro, in accordance with the Central Bank of Montenegro Law. The year 2021 will be an extraordinary year with many challenges due to the strong impact of the COVID-19 pandemic and a large number of health, social, and economic measures adopted to preserve the health and social and economic status of the population and the economy. This time, the Central Bank has committed to providing recommendations that are crucial in the pandemic crisis, as well as measures whose implementation should not be delayed due to potential long-term negative effects. All recommendations we have communicated in previous years that have not been implemented remain valid, but we recommend for the priority to be given to those that will mitigate the consequences of the COVID-19 pandemic.

The coronavirus pandemic has seriously shaken Montenegro's economy and further deepened existing vulnerabilities. The virus is here and it will stay here despite the vaccine development. Montenegro is in the group of countries most severely affected by the pandemic, primarily due to the low degree of diversification of activities and a high degree of dependence on tourism, as well as the fact that economic growth relies but little on innovative and creative industries. All existing risks are magnified, with a growing tendency. The pandemic has largely affected the country's GDP, which is expected to significantly drop by some 17%¹ this year, a significant rise in unemployment, a decline in activity in most sectors, the closure of a number of companies, increased costs, and difficult functioning of the health system.

The crisis has hit the hardest the public finances that had already been burdened with numerous vulnerabilities from the previous period. On one hand, the crisis resulted in a significant decline in public revenues, as a result of the tax base shrinking due to the reduced level of activity, while on the other hand it brought about increase in public expenditures due to the increased interventions. As a result, public debt has additionally increased and this growth will reach over 90% of GDP at the end of the year. For these reasons, Montenegro has entered a public debt crisis, the worst since the 1993 hyperinflation. Therefore, the fiscal policy in 2021 should be focused on selected priorities for dealing with the impact of the pandemic, while the continuation of strategic investments should be exclusively through international grant programs or contracting soft loans from international institutions.

The banking system has maintained stability and made a significant contribution to preserving the real economy. Through intensive communication with banks and international financial institutions, the CBCG has carried out significant activities that have preserved liquidity in the system. The implementation of the mandatory moratorium on the repayment of credit liabilities during March, April and May was enough to affect an increase in liquidity of private individuals and legal entities of over 150 million euros. In addition, reducing the reserve requirement rate by two percentage points has increased liquidity of the banking sector by 70 million euros, which resulted in an increase in their credit potential. During the first nine months of 2020, banks provided adequate support to the system and approved 33,154 new loans for 29,784 clients, in the total amount of 620.2 million euros. Also, in order to mitigate the negative impact of the crisis, clients continued to use the offered moratorium, which resulted in additional 131 million euros in this category as at the end of September.

¹ Given the high degree of uncertainty, unavailability of a large number of data, as well as the absence of previous similar experiences, this projection should be accepted very conditionally.

Also, the Central Bank decisions relaxed loan restructuring requirements, allowing the treatment of these loans as newly approved loans. By the end of September, 134 million euros in loans were restructured. Regardless of the good liquidity of the banking sector, the CBCG provided a repo credit line from the Bank for International Settlements (BIS) in the amount of 100 million euros, and another one from the European Central Bank (ECB) in the amount of 250 million euros. These funds would be used to support banks` liquidity in the event of unforeseen emergencies. Moreover, in order to strengthen solvency and liquidity, temporary measures introduced the prohibition of dividend payment to shareholders, while the fee charged to banks for using required reserves for liquidity purposes is reduced by 50%. In addition, new measures have been initiated to allow individuals to approve a moratorium if their employment has been terminated as a result of the negative impact of the pandemic and/or they are allowed to change the repayment plan by extending the loan repayment period if their salary has been reduced by no less than 10%.

Despite all taken measures, it is reasonable to expect a certain growth in non-performing loans in the coming period as a result of difficulties faced by the real economy. However, it is not expected that financial stability will be jeopardized since the banking system is liquid and solvent.

As for positive indicators, we can mention an increase in the net inflow of foreign direct investments which will be very significant in the recovery period. It is also expected that the current account deficit will be lower compared to the previous year, but this is not a result of improved competitiveness but a reduced level of activity and total demand. Inflation is also low, but low inflation accompanies a recessionary environment.

As for 2021, the uncertainty remains high, first of all because nobody knows how long the pandemic will last, but apparently it will last for sure during the first half of the next year, and probably longer. Nevertheless, it is reasonable to expect that GDP growth will be achieved next year. Estimates² indicate that it could range from 5% to 6.9%. However, it should be noted that this growth will primarily be the result of the low base from 2020 and that the level of GDP at the end of 2021 will still be significantly lower than in 2019. This means that all challenges we face this year will remain in the next year, but the situation may be more difficult due to depleted or spent reserves with economic entities, as well as due to reduced possibility of budget support.

2

Institution	2021 GDP projection
International Monetary Fund (as of 13 October)	5.5%
World Bank (as of 7 October)	6.9% (4.8% medium-growth scenario)
Vienna Institute (as of 6 May)	5%
European Commission (from the meeting held on 13 October, unpublished)	6.6% (4.4% last published in May)

1. RECOMMENDATIONS CONCERNING FISCAL POLICY

When it comes to fiscal policy, the key recommendation is to urgently prepare a fiscal consolidation program. Empirical experience suggests that successful programs of fiscal consolidation that were predominantly based on increase in public revenues have been successful only in the case when there was a low share of taxes in GDP and some room for their increase, which is not the case in Montenegro. Given the lessons learned from successful examples of fiscal consolidation, the program should primarily focus on the expenditure side. Of course, this does not mean that the revenue side of the budget should be ignored, but its improvement should not be made with tax increases but with better collection and reduction of tax arrears.

With a view to continuing the budget consolidation process and reaching fiscal stability, the following is necessary:

- In order to reinforce long-term sustainability of public finances during the pandemic, develop a new Fiscal Strategy as soon as possible, in accordance with the Law on Budget and Fiscal Responsibility, which will be the umbrella document for creating fiscal policy guidelines for the coming period;
- The new Plan of measures for deficit resolution and public debt reduction for the next period will put special emphasis on measures related to cutting expenditures with a high share in total costs (gross earnings, unproductive spending, and the like) and collection of tax arrears. Also, measures from the previous period should be considered if they contribute to reducing fiscal risks;
- Create and implement a medium-term fiscal framework in order to improve cost efficiency, with more binding medium-term expenditure limits (introduce spending limits), including a general expenditure ceiling and the obligation to reconcile and justify any changes in expenditures;
- Accelerate activities on the establishment of the Fiscal Council as an independent body for fiscal supervision;
- Urgently provide funds for the repayment of the Eurobond issue due in March 2021 so that any potential default would not lead to a public finance crisis with decades of negative consequences for Montenegro. In this regard, examine the possibilities of the market coverage given the dilemma of whether a new successful Eurobonds issue is possible due to the uncertainty of how the financial markets will perceive Montenegro's risk profile;
- Consider potential entry into an arrangement with the IMF should all other modalities of providing funds fail, in order to increase credibility, ensure funding and expert advice to implement fiscal consolidation;
- Launch an initiative with creditors to restructure parts of the public debt, as the mechanisms (besides refinancing) to ensure its long-term sustainability in the context of the expected duration of the COVID-19 pandemic, limited economic growth, reduced budget revenues, and anticipated difficult borrowing conditions on the international market;
- Create fiscal rules that will avoid procyclicality and ensure consistency in implementation and/or revise the existing fiscal rules in place;
- In order to preserve fiscal sustainability, refrain from further planning and creating new large capital expenditures in the budget for the purpose of funding public investments

until the risk to sustainability of the public debt has been diminished and the situation with public finances has significantly improved. Also, in order to continue the construction of the remaining highway sections, consider all funding models without burdening the public debt. To that end, launch a regional initiative towards the EU for the infrastructure in Southeast Europe (SEE) to be built mostly as an EU donation in order to encourage regional development and convergence towards the EU;

- Improve fiscal management and capital investment management through the strengthening of supervision of capital expenditures, especially investment plans (cost-benefit analyses), all with the aim of more efficient use of budget funds;
- Implement a restrictive policy of issuing new guarantees, and every newly issued guarantee should be secured with proper collateral;
- Considering a high degree of uncertainty, establish a significant amount of fiscal reserve in case of materialization of certain risks that would result in additional expenditures (calling of guarantees, deterioration of the economic situation, and the like);
- Improve the process of budget planning and execution and the assessment of outstanding liabilities in order to prevent their build-up, and especially ensure more efficient planning, budget implementation and the harmonization of operations of all spending units with the regulations governing budget operations in Montenegro in all material aspects, in accordance with recommendations of the State Audit Institution (SAI);
- Improve cash planning on quarterly and annual bases, as well as necessary monthly cash buffers. In order to improve transparency and reduce their price, create a preliminary annual calendar for the Treasury bill issues. Reduce the amount of outstanding liabilities at the local level, including local businesses;
- Consider the development of a new economic aid package by taking into account the needs of the real economy on one hand, and actual possibilities on the other. In addition, given the difficult measures under the fiscal consolidation program, a social support package should be established for the most vulnerable categories;
- Create a detailed database in the Ministry of Finance of all state-owned companies and implement the OECD principles of corporate governance in these companies and enhance their financial supervision;
- Ensure financial sustainability of the pension system by implementing rigorous measures to control the payment of pension and disability contributions, especially for outstanding liabilities;
- Implement a reform in order to optimize the public administration. Create a new medium-term strategy and optimization plan which will contain specific measures to be voiced in an Action Plan which will be implemented efficiently and without delay. In addition to employee optimization, the reform should include other key elements such as: human resources planning, increasing efficiency and productivity, severance pays, transition of employees to the private sector, data integration³, cooperation at all management levels, in accordance with international experiences;

³ A comprehensive approach to employee-level data requires the merging of payroll and employee databases and the expansion of coverage to include more employees. Combining the database on employees and payrolls with stricter audits would help identify ghost workers.

2. RECOMMENDATIONS CONCERNING REAL SECTOR

The economy of Montenegro is characterized by a high share of micro-, small and medium-sized businesses and it is still in the phase of growth and development towards stronger and more productive capacities. Encouraging economic activity and improving current productivity are the key elements of economic policy in creating new value, reducing the burden of existing debts, increasing the system liquidity, and unleashing growth potential.

2.1. Tourism

Tourism industry is one of the priority sectors for the development of Montenegro and one of the key generators of growth and employment, given its connection with many other sectors. On the other hand, tourism is one of the sectors hardest hit by the pandemic. In this regard, it is necessary to implement structural reforms that will enable sustainable climate-friendly tourism, but one also more resilient to external shocks. The key measures to be considered are as follows:

- With the aim of promoting Montenegro as a year-round tourist destination, with the help of innovative technology, create software solutions for visitors and brochures for virtual reality travels, in accordance with the Smart Specialisation Strategy of Montenegro 2019-2024.
- Divert the promotional campaign towards the promotion of outdoor activities, especially in the event of a continued COVID-19 pandemic;
- In order to recover the tourism industry, restore the confidence of passengers by implementing new health protocols, in cooperation with caterers and tour operators, that will ensure safe travel and minimize travel restrictions;
- Align the recovery of the sector with environmental objectives, in particular by addressing municipal and plastic waste, the development of low-carbon tourism, and the devastation of green areas and national parks;
- Encourage access to international funds such as the Global Environment Facility (GEF) and the Green Climate Fund (GCF), as well as green and *greenfield* investments. Also, explore possibilities of a public-private partnership model in this area;
- Improve the development of rural tourism with better management of the EU financial support funds (IPA and IPARD), as well as with further implementation of incentive programs for the construction of new hotel facilities in the north of Montenegro (economic citizenship program);
- Develop tourism-related sectors to reduce import dependence (food industry, agriculture, business services, construction, transport infrastructure) and identify potential synergies to make more efficient use of funds.

2.2. Agriculture, forestry and fishery

Agriculture represents a significant yet untapped potential of the country. Its further development would enable growth of production, increase of employment, reduction of the current account deficit, but also diversification of the economy which would reduce the high degree of vulnerability of the Montenegrin economy. It is particularly important to carry out a planned agricultural development on all fertile territories as that would activate the potentials

to a greater extent and result in shrinking regional differences and slowing population migrations. Also, it is necessary to pay attention to the development of forestry and fishery, especially in the context of small and medium-sized business development. To strengthen these sectors, the following is proposed:

- Ensure an adequate level of subsidies to make our farmers competitive, especially having in mind that agriculture is the only export sector that is allowed to be subsidised, according to the rules of the World Trade Organization;
- Promote an increase of arable land and the consolidation of segmented agricultural plots;
- Encourage the interest of young people in education in the field of forestry through scholarships, having in mind the educational and age structure of the existing staff, that is, the lack of forestry engineers in the labour market;
- Increase activities on combating pollution and degradation of fishing (and other) areas caused by wastewater discharge by encouraging economic entities to invest in the construction of industrial wastewater treatment plants through international support programs, in order to protect fish stock and sustainable use of fish resources.

2.3. Energy

The energy sector has a big growth potential, an important development role in the economy, and it significantly contributes to increasing the overall competitiveness of the economy. In order to further strengthen this sector, the following is proposed:

- In line with the highest environmental standards, continue valorising the production of energy from renewable sources and develop hybrid energy systems;
- Continue improving electric power infrastructure given the relatively big losses in energy transmission;
- Promote energy efficiency in industry as well as in construction, tourism, households, and all business premises;
- Encourage testing and investment in smart grids and smart facilities (houses, buildings, facilities for public institutions, hotels, and the like).

2.4. Manufacturing industry

The current crisis has shown the importance of diversifying the production structure. In previous decades, Montenegro lost a large number of industries and/or companies predominantly from the manufacturing sector. It is clear that the renewal of the majority of these companies is not possible given the lack of domestic accumulation for such an endeavour, as well as the lack of interest of foreign partners to develop large industrial enterprises in countries with small domestic markets. This certainly does not mean that Montenegro should give up the development of industry, but it is necessary to adopt a strategy of reindustrialization that would give a realistic overview of industries that could develop (such as the food industry) as well as modalities to support their development. Import substitution and domestic demand open the possibility for the development of certain branches of manufacturing industry in Montenegro. Other measures proposed to strengthen this sector are as follows:

- Promote the importance of waste management and recycling in manufacturing industry, as well as recycling of industrial waste in order to create new values in the field of waste processing whilst preserving the environment;
- Encourage investments in the modernisation of manufacturing industry in order to increase competitiveness through the implementation of new technologies, innovations and investments in research and development, as well as through connecting economic entities in this field with scientific research institutions and creating regional and domestic clusters;
- Consider launching new plants for the production of construction machinery and equipment needed for the functioning of construction and reducing the high import dependence of this sector;
- Encourage the production of higher-processing products (for example, aluminium products) as this provides higher added value and export revenues.

2.5. Information technologies

The current pandemic highlighted the importance of the digitalisation process of many economic activities. Information technologies represent significant untapped potential. In order to strengthen activities in this area, the following measures are proposed:

- Utilise the potential of science and technology parks (STPs) to adequately stimulate innovation and technology development through networking of the scientific and academic community with entrepreneurs. STPs should also be used as a platform to create high-tech companies;
- In accordance with the Smart Specialization Strategy of Montenegro 2019–2024, it is necessary to invest in education and training of the workforce as the key factor for the development of innovations and new technologies, but also the implementation of existing technological potentials;
- As much as possible, encourage the transition to e-administration;
- Encourage the development of software developers in order to create an IT services export sector.

3. RECOMMENDATIONS CONCERNING STATISTICS

The field of statistics is very important because the quality of formulated economic policy measures largely depends on correct and timely statistical data. Therefore, it is of great importance that further development of the statistical system is not suspended even during the pandemic. In order to achieve full harmonisation of official statistics with the acquis, the following is proposed:

- Continue activities on the introduction of the ESA2010 methodology in the system of official statistics, and particularly continue efforts to implement the methodology in public finance statistics;
- In line with international practice, designate a competent institution for the implementation of government finances statistics and excessive deficit procedures (EDP);
- In terms of implementation of the ESA2010 methodology in the statistical system of Montenegro, strengthen interinstitutional cooperation defined under the MoU on cooperation between institutions producing official statistics: Ministry of Finance, Statistical Office of Montenegro, and Central Bank of Montenegro, and consider the need to redefine the MoU;
- Strengthen staff capacities of the producers of official statistics, both through additional training of the existing staff and new employees specialized in the field of statistical production.

4. RECOMMENDATIONS CONCERNING OTHER AREAS OF IMPORTANCE FOR THE IMPLEMENTATION OF ECONOMIC POLICY

- Ensure the improvement of the legal framework for NPL resolution outside the Central Bank authority;
- Encourage foreign direct investments. Put special attention on investments in production of final products in order to reap benefits from the transfer of know-how, competitiveness, and changing growth models;
- Prepare a special program for the functioning of the economy in conditions of business uncertainty under the influence of the pandemic with as few restrictions for businesses as possible to the extent that public and individual health are not jeopardized (learn how to live with the coronavirus). The emphasis should not be on closing businesses but promoting safe business protocols subject to control and sanctioning of non-compliance;
- Encourage remote/working from home whenever work processes allow;
- Create a guarantee fund to support micro-, small and medium-sized enterprises and entrepreneurs;
- Provide strong support to micro-, small and medium-sized businesses, as well as female entrepreneurs, young entrepreneurs, and vulnerable groups;

- Intensify all EU accession activities that have been disrupted due to the pandemic;
- It is necessary to implement more efficient preparation of projects for the use of the EU funds and grants, especially when it comes to infrastructure projects, having in mind the limited possibilities of financing from domestic sources;
- Ratify the CEFTA Additional Protocol 6 on trade in services;
- Review the coverage of beneficiaries of social benefits in order to provide social protection to the most vulnerable population;
- Consider going back to the working week as this could increase employment and the tax base, and indirectly affect exports. At the same time, it is necessary to strengthen the control of observing the legal rights of employees;
- Ensure sustainable financing of the health system in order to strengthen the health sector both during the current pandemic and going forward. Improve the economic position of health care employees, and particularly consider the possibility of special financial incentives for deficient and overburdened medical staff in order to reduce staff outflow;
- Given the numerous structural imbalances in the Montenegrin economy, as well as the fact that it has been empirically proven that successful fiscal consolidation programs are a part of broader structural reforms, consider the possibility of creating a national structural reform committee;
- Involve private sector representatives in the preparation of the Regulatory Impact Assessment in order to obtain concrete analyses and assessment of impact on the improvement of the business environment;
- Improve the Central Registry of Commercial Entities (CRCE) by deleting all inactive companies in order to get a more realistic picture of the illiquidity situation. Also, increase the efficiency of the CRCE in terms of administrative procedures to meet deadlines when processing applications and verify the business sector in accordance with international classification standards;
- Tighten the penalty policy for companies – repeat offenders (especially for those in informal economy).