CENTRAL BANK OF MONTENEGRO

RESEARCH, STATISTICS AND IT DEPARTMENT

Working paper 14

SUSTAINABILITY ANALYSIS OF MONTENEGRO`S CURRENT ACCOUNT DEFICIT

Nikola Fabris, PhD, Chief Economist
Boris Kilibarda, Director of Directorate for Balance of Payments and Real Sector

Podgorica, 2008

PUBLISHED BY: *Central Bank of Montenegro*
Bulevar Svetog Petra Cetinjskog 6
81000 Podgorica
Telephone: +382 20 665 331
Fax: +382 20 665 336

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

PREPARED BY: *Nikola Fabris, PhD*
Boris Kilibarda

The views expressed in this paper are those of the authors and do not necessarily reflect the views and policies of the Central Bank of Montenegero

TRANSLATED BY: *Translation Services Division*

DESIGNED BY: *Andrijana Vujović*

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ABBREVIATIONS

GDP	Gross domestic product
CBM	Central Bank of Montenegro
MNE	Montenegro
EBRD	European Bank for reconstruction and development
MFI	Micro-credit financial institutions
IMF	International Monetary Fund
MONSTAT	Statistical Office of Montenegro
MWh	Megawatt hours
USA	United States of America
SFRY	Socialist Federal Republic of Yugoslavia
S&P	Standard and Poor`s
WTTC	World Travel and Tourism Council

INTRODUCTION

The main characteristics of Montenegro's economy in the last few years have been the economy opening, liberalisation of foreign trade flows, an accelerated economic growth, low inflation rates, fiscal surplus, record FDI inflow, ongoing decline in unemployment, reduced foreign debt and a high current account deficit or, more precisely, a strong increase in the visible trade deficit, are. On one side, the economy was also characterised by numerous positive movements (unemployment decline, price stability, etc.) which speak in favour of reaching the internal balance, whereas on the other side, the balance of payments imbalance raises the issue of the external balance and the very sustainability of the current account deficit.

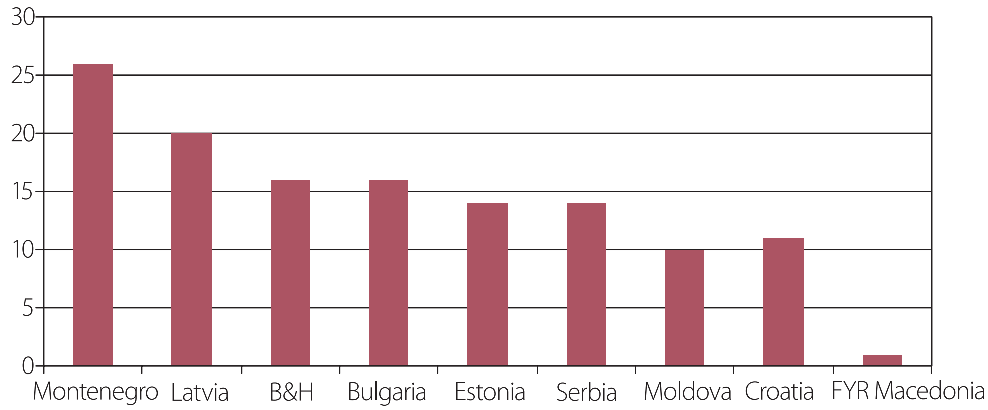
The current account balance shows a country's inflows and outflows arising from trade in goods, services, income and current transfers between residents and non-residents, i.e., on the occurrence of obligations to and claims on abroad arising from the aforesaid transactions.

The current account balance does not represent an economic policy variable such as, for example, money in circulation, but it is one of economic policy objectives like the inflation rate or a GDP level. Movements in the current account represent important sources of information for economic policy creators and they are also the reflection of monetary policy.

Montenegro's current account deficit is the highest in Europe (Graph 1). According to the IMF, the current account deficit could be considered a balanced response of a system to a large inflow of foreign private capital and a high credit growth rate.

This working paper analyzes movements of Montenegro's balance of payments in the last few years through analyzing its structure (with a special emphasis on the current account, that is, the structure of visible trade), determinants that affect the current account trends and the methods of current account financing. The analysis will try to provide some forecasts and answers regarding a long-term sustainability of such trends and macroeconomic sustainability as well, and it will propose measures for reducing the deficit.

Graph 1 – Current account deficit in % of GDP in the period 2005 – 2007



Source: Transition report 2007

1. BALANCE OF PAYMENTS

The balance of payments is a statistical report that systematically compiles economic transactions of a country with the rest of the world during a specific time period. This is a report applying the double-entry bookkeeping principle: every transaction is recorded twice – as a credit in one account and as a debit in other account, i.e. the sum of all credit and debit entries must equal zero. Thus, for example, the value of exported goods is recorded both in the current account (under goods) and the financial account as it affects deposits with banks (Table 1).

Table 1 – Example of double-entry bookkeeping

Country A (exporter)		Country B (importer)	
Export	Credit (+)	Import	Debit (-)
Increase in banking deposits	Debit (-)	Decrease in banking deposits	Credit (+)

Standard components of the balance of payments comprise the two main accounts:

- Current account and
- Capital-financial account.

All transactions (except those under financial items) referring to economic values and taking place between resident and non-resident entities are covered in the current account. These are transactions of business entities that create value and enter the gross domestic product calculation as such. Unlike them, transactions recorded in the capital-financial account represent transfers of a part of the already created income in the form of savings from one country to another. Current transactions increase the volume of the world income, whereas capital-financial transactions only record the redistribution of a part of this income. All transactions in goods, services, factor income and unilateral transfers are recorded as current transactions.

Since this involves a large number of transactions that cannot be covered in full (omitted), or even if they can be covered there is always the possibility that certain transactions will be inadequately valued (errors)[1], the balance of payments has the position "net errors and omissions" which serves for the balancing of credit and debit sides.

The position "net errors and omissions" shows that some transactions have not been covered or have been inadequately valued. It does not directly show where the discrepancies have occurred (in practise, it is usually in the balance of financial transactions). In addition, the value of this position cannot be treated as the indicator of a country's balance of transactions with abroad, as it is often the case. Moreover, a low value of net errors and omissions does not necessarily mean that the balance of payments statistics is good, but it can also be a product of balancing omissions when recording transactions on both sides (credit and debit).

As this is the system of double-entry bookkeeping, the balance of payments is always balanced. We cannot talk about the balance of payments surplus or deficit, but only of a surplus or a deficit in one of its sub-accounts, e.g. the current account, trade, and the like.

1.1. The current account deficit and its sustainability

A current account deficit that has accumulated over the years requires continuous funding sources: through net FDI inflows, portfolio investments, credit transactions or through reducing a country's foreign exchange reserves.

The point of foreign capital inflows is not only to cover the current account deficit, but to create a good environment for production investments and an increase in domestic savings and investments.

Foreign borrowing has its limitations, that is, the accumulation of a net foreign debt entails the obligation of its servicing. That is why the question that has been reiterated is whether the current account deficit could be sustained and how it will be financed in the conditions of reduced inflows of foreign direct investments.

[1] *E.g. customs declaration indicates one amount, but the other amount inflow to a bank account, or errors due to differences in the time of entry.*

However, the main question is what does the term `sustainability` actually imply? The opinion of many economists and economic policy creators regarding a country's external imbalance has changed significantly over the last decades. Today there is no common, generally accepted stance on the current account level that could be considered unsustainable or about the actual effects of a high current account deficit on other macroeconomic indicators. For many years, the IMF`s and other international financial institutions` standpoint on the current account level that is considered unsustainable is that which exceeds 5% of GDP. However, there are examples of many countries that have succeeded in sustaining and financing the current account deficit higher than the aforesaid threshold for many years and then turning it into a surplus; however, there are also many countries that ran a low current account deficit but could not avoid the balance of payments crisis (Mexico, Chile). All this has led to the abandoning of such a strictly established criterion.

Table 2 – Current account deficit as a percentage of GDP

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Armenia	-46.3	-6.0	3.8	-17.0	-18.2	-18.7	-22.1	-16.6	-14.6	-9.5	-6.2	-6.8	-4.5	-3.9	-1.4	-4.0	-4.2
Australia	-3.5	-3.1	-4.8	-5.2	-3.7	-2.9	-4.8	-5.3	-3.8	-2.0	-3.8	-5.4	-6.0	-5.8	-5.5	-5.7	-5.6
Azerbaijan	-16.6	-12.2	-5.5	-13.2	-25.9	-23.1	-31.9	-13.1	-3.5	-0.9	-12.3	-27.8	-29.8	1.3	15.7	31.4	39.9
Bulgaria	-4.4	-24.7	-0.4	-0.2	0.2	4.1	-0.5	-5.0	-5.6	-5.6	-2.4	-5.5	-6.6	-12.0	-15.8	-20.3	-19.0
Estonia	n/a	1.2	-6.8	-4.2	-8.6	-11.4	-8.7	-4.4	-5.4	-5.2	-10.6	-11.3	-12.3	-10.0	-15.5	-16.9	-15.9
Georgia	n/a	n/a	-33.8	-18.3	-12.6	-12.8	-12.8	-10.0	-7.9	-6.4	-8.4	-9.3	-12.2	-9.8	-13.8	-15.7	-15.2
Kazakhstan	-51.6	-8.6	-7.8	-1.3	-3.6	-3.5	-5.5	-0.2	3.0	-5.4	-4.2	-0.9	0.8	-1.8	-2.2	-2.2	-1.1
Malaysia	-3.7	-4.6	-7.6	-9.7	-4.4	-5.9	13.2	15.9	9.4	8.3	8.4	12.7	12.6	15.3	17.2	14.4	13.3
Maldives	-6.9	-16.7	-3.1	-4.6	-1.7	-6.2	-4.1	-13.4	-8.2	-9.4	-5.6	-4.6	-16.5	-35.8	-40.7	-40.5	-36.6
Malta	n/a	n/a	n/a	-11.9	-12.6	-6.7	-6.5	-3.7	-12.5	-3.8	2.7	-2.8	-6.3	-8.0	-6.1	-9.4	-8.2
Portugal	-0.2	0.3	-2.3	-0.1	-3.5	-5.8	-7.1	-8.5	-10.2	-9.9	-8.1	-6.1	-7.7	-9.7	-9.4	-9.2	-9.2
Romania	-7.8	-4.7	-1.7	-4.5	-6.7	-5.4	-7.1	-4.1	-3.7	-5.5	-3.3	-5.8	-8.4	-8.7	-10.3	-13.8	-13.2
Serbia	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	-1.7	-2.4	-7.9	-7.0	-11.7	-8.5	-11.5	-14.7	-15.0
Slovakia	n/a	-6.3	4.3	1.9	-9.8	-9.1	-9.5	-4.8	-3.3	-8.3	-8.0	-6.0	-7.8	-8.6	-8.3	-5.3	-4.5
Spain	-3.5	-1.1	-1.3	-0.3	-0.2	-0.1	-1.2	-2.9	-4.0	-3.9	-3.3	-3.5	-5.3	-7.4	-8.6	-9.8	-10.2
Turkey	0.1	-3.1	3.1	-0.3	-1.2	-1.1	1.0	-0.7	-5.0	2.4	-0.8	-3.3	-5.2	-6.2	-7.9	-7.5	-7.0
Ukraine	-3.0	-2.9	-3.2	-3.1	-2.7	-2.7	-3.1	5.3	4.7	3.7	7.5	5.8	10.6	2.9	-1.5	-3.5	-6.2
USA	-0.8	-1.3	-1.7	-1.5	-1.6	-1.7	-2.4	-3.2	-4.3	-3.8	-4.4	-4.8	-5.5	-6.1	-6.2	-5.7	-5.5

Source: World Economics Outlook Database for October 2007, IMF

Table 2 indicates that, for example the USA, Spain, Turkey, Estonia, Romania, Bulgaria, etc. have run the current account deficit above 5% of GDP for many years now. However, this could hardly lead to the conclusion that some of them are on the verge of an economic crisis. The advocates of the thesis that "the balance of payments crisis is largely a politically charged phrase" point exactly to the countries such as the USA, Spain, Slovakia, etc. They claim that a country can run the current account deficit for years, yet the economy will not suffer if the deficit is used for private financing of investments. On the other hand, the budgetary deficit can cause default in foreign obligations, that is, actually induce the balance of payments crisis. Some analysts illustrate the example of Russia in 1998, when the Russian Government did not have funds to repay the foreign debt. However, the opinion that the current account deficit is not important if it is a result of the private sector deficit (Lawson doctrine)[2] was discredited by the Asian financial crisis which occurred during 1997 and 1998. The crisis occurred due to a large external exposure of the private sector regardless of the balanced budget.

If we begin with the fact that each deficit has to be financed, that is, should have the sources of financing, then it could be said that the current account deficit is sustainable to the degree and within time limits the creditors consider sustainable. As such, the term "sustainability" incorporates expectations related to future movements which will influence the current account (the country's future economic policy, behaviour of the private sector and other factors which, directly or indirectly, affect international relations). Therefore, the current account deficit is sustainable if the continuation of the country's current economic policy and/or the behaviour of the private sector and possible external shocks will not call for the introduction of significant changes in the economic policy nor induce the balance of payment crisis. As long as financial markets have confidence that the debtor country will duly service its obligations, the debtor crisis will not occur.

Therefore, it could be stated that there is no unique criterion for the assessment of the current account deficit sustainability which could be applied to all countries. When performing an assessment one should take into consideration specific characteristics of each country and other macroeconomic indicators (inflation rate, GDP growth rate etc.), monitor the current account trends, the structure of imported goods (consumer goods or investment goods), the capital-financial account situation (foreign direct and portfolio investments, loans and their maturity structure and purpose).

As for Montenegro, the current account deficit /GDP growth ratio can be taken as the criterion for the sustainability of the current account deficit. If the deficit increase is higher than GDP growth over long-term, then the current account deficit will be unsustainable. This indicator should not be observed in short-term, because a short-term deficit can indicate that it has been financed by investment which will influence GDP growth in the forthcoming period.

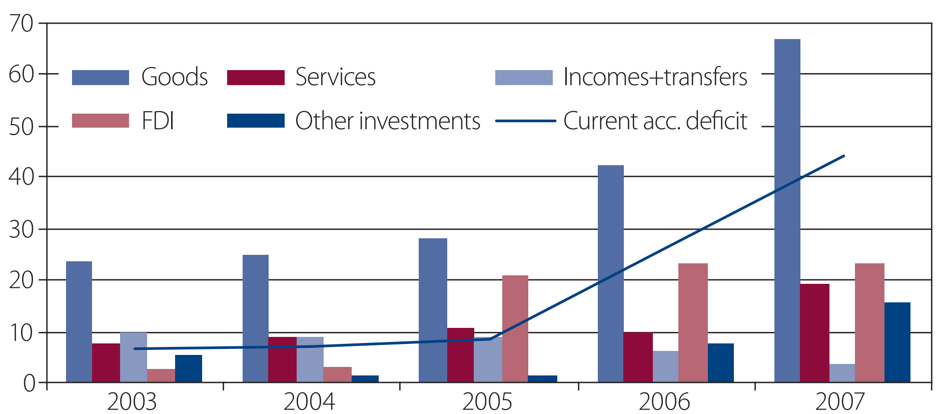
[2] According to the Lawson doctrine, named after Nigel Lawson, as long as the current account balance reflects the private sector savnigs-investment decisions, there are no disturbances and expectations are rational, then there is no reason for a government to intervene.

2. MONTENEGRO`S BALANCE OF PAYMENTS

2.1. Introduction

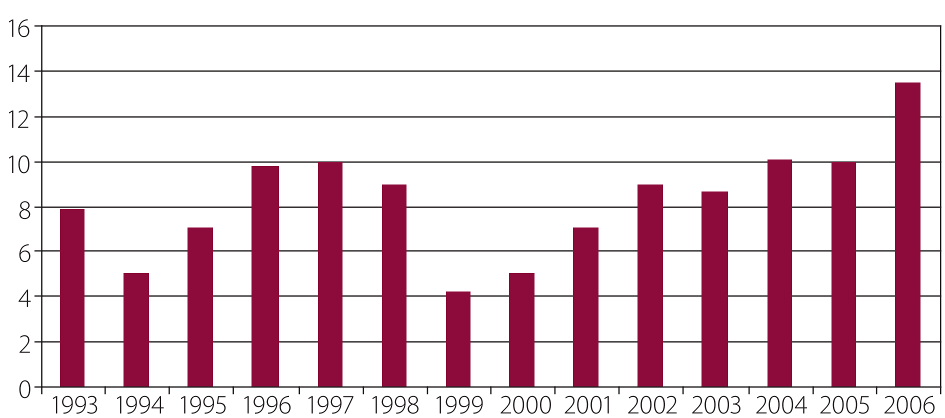
The opening of the economy, macroeconomic stability, stabilization of the political situation, the banking sector recovery that resulted in the arrival of strong banks, increase in salaries and banking loans, creation of business-friendly environment for foreign investors and large FDI inflows, a higher credit rating of the country, and growth in construction investments are some of the factors which directly influenced an increase in domestic demand and the import of goods which resulted in the high current account deficit.

Graph 2 – Balance of payments components in Montenegro, as the percentage of GDP



Source: CBM

Graph 3 – Average current account deficit in South East European countries



Source: EBRD

The high current account deficit and the large FDI inflow are the characteristics of almost all Central and East European countries. In this way, countries finance their development.

Further on the paper discusses external and internal factors which influenced the balance of payments movements in Montenegro, as well as the structural analysis of movements on individual balance of payments accounts and sub-accounts, and the structural analysis of the current account deficit financing.

2.2. Methodological explanations

The CBM produces the balance of payments statistics according to the IMF methodology (Balance of Payments Manual, fifth edition, 1993), which implies the ongoing improvements in terms of coverage, inclusion of new transactions, new data sources and evaluation.

The analysis of the balance of payments in Montenegro covers the 2003 – 2007 period, with a special overview of 2006 and 2007 when the current account deficit was extremely high.

The external trade with the most significant trade partner, Serbia, could not be monitored through customs declarations in the period before 2003. At that time, the sources of data were domestic banks, that is, reports on foreign payment operations. This and the methodological inconsistency made the analysis of the import of goods structure impossible.

In addition, we should mention that data on the external trade in 2003 were processed by two institutions: the Federal Statistical Office (from January to April) and the CBM[3] (from April to the year-end), which allows different use of the processing methods. Besides, during the existence of the State Union of Serbia and Montenegro, most of the goods which traversed the Montenegrin-Serbian border were neither recorded by the customs, nor it was possible to do the assessments of these goods. It should be mentioned that, at the time, there was a possibility for the residents of Serbia to legally drive motor vehicles with Montenegrin license plates (with the verified authorization), which could not be recorded as the Montenegrin exports although it practically represented the export. Since 2005, MONSTAT has been in charge for the processing of the external statistics.

Taking into account the aforesaid, this analysis puts the emphasis on the period 2005 – 2007 when the unique methodology for the customs declarations processing began.

[3] The need for data processing in Belgrade ceased to exist with the establishment of the Montenegrin Customs Administration. The CBM was the only institution in Montenegro able to process customs declarations at the time.

2.3. Current account

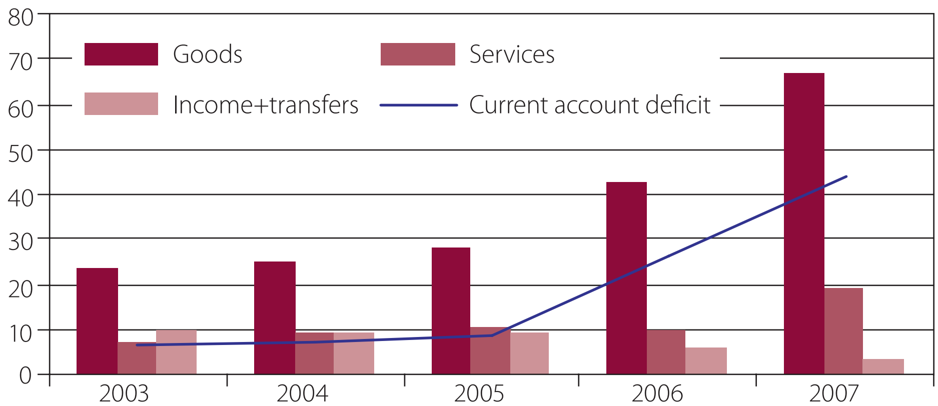
In the period 2003-2005 the current account deficit ranged between 6.8 and 8.5% of GDP, but in the last two years (2006 and 2007) there was a sudden increase in the deficit (Table 3, Graph 4)

The main characteristics of the Montenegrin economy in the observed period were an increase in households' purchasing power, accelerated growth in household and corporate loans, more expressed interest of foreign investors in the Montenegrin economy and other country's resources, two-digit growth rates in tourism revenues, high growth of activity in construction, as well as transition from the budget deficit to the budget surplus. All these trends reflected on the current account. The Montenegrin economy could not meet growing demand for goods arising from the increased purchasing power and greater investments. This induced exceptionally high growth in visible imports which was followed by much lesser visible exports. There was an expansion in tourism revenues on the services sub-account, which is the direct consequence of a large FDI influx, then increased revenues from transport, as well as other services (intellectual, project and the like). Acceleration of investment work, Montenegro tourism promotion, investments in infrastructure through the purchase of different software, resulted in an increase of expenditures on services, especially in construction industry (building construction and civil engineering construction). With regard to factor income and current transfers, there was an increase in revenues from compensations to employees abroad, as well as growth in outflow of funds arising from interests on borrowed funds and from residents` transfers abroad. Inflow of various types of assistance decreased as the economy strengthened.

Table 3 – Montenegro's current account, in EUR thousand

	2003	2004	2005	2006	2007
CURRENT ACCOUNT (1+2+3+4)	-102.056	-119.642	-154.045	-531.207	-1.007.640
1. GOODS	**-359.330**	**-416.436**	**-513.653**	**-849.325**	**-1.524.176**
1.1.Export	270.574	452.148	460.648	648.327	627.717
1.2. Import	629.904	868.584	974.301	1.497.651	2.151.893
2. SERVICES	**111.663**	**148.176**	**195.540**	**197.099**	**440.133**
2.1. Revenues	191.325	249.529	329.765	418.036	674.056
2.2. Expenses	79.662	101.353	134.225	220.937	233.923
3. INCOMES	**87.926**	**86.242**	**17.512**	**30.800**	**17.010**
3.1. Revenues	113.753	135.455	62.291	65.334	89.420
3.2. Expenses	25.827	49.213	44.779	34.534	72.410
4. CURRENT TRANSFERS	**57.685**	**62.376**	**146.556**	**90.220**	**59.394**
4.1. Transfers in Montenegro	66.809	73.493	163.455	108.555	100.775
4.2. Transfers from Montenegro	9.124	11.117	16.899	18.336	41.381

Graph 4 – Current account sub-accounts, as percentage of GDP



The current account balance of Montenegro is traditionally negative. It was mentioned in some previous analyses that in some time periods Montenegro ran the current account surpluses. However, that was the time when Montenegro was in the federation with other former Yugoslav republics and when imports/exports among the republics represented the internal trade and thus not treated as the balance of payment transactions[4].

Preliminary data show that the current account deficit in 2007 amounted to EUR 1,007.6 million or 44.2% of GDP. Compared to 2006, this was an 89.7% growth, that is, an increase of 17.7 percentage points if measured by the share in GDP. In 2006, the current account deficit was 244.8% higher than in 2005, that is, 18 percentage points as a share in GDP.

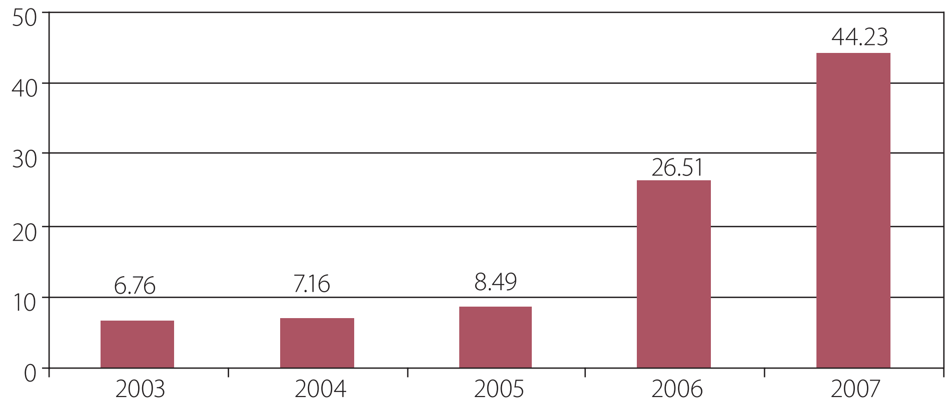
There is a great difference between Montenegro's spending (investments) and that what it is able to produce. The mismatch between savings and investments is always shown in the visible trade deficit and services with abroad. It is almost always covered by inflows of capital from abroad which, as a rule, increases indebtedness.

As shown in Graph 5, the current account deficit increase was particularly obvious in 2006 and 2007. Due to the increase in deficit on sub-account of goods in 2005 and 2006, the current account deficit rose 6.5 times.

Influence of some individual accounts on Montenegro's current account balance is analyzed and discussed in more details in the following chapters.

[4] *Today, about a half of Montenegro's total imports is from the former SFRY republics.*

Graph 5 – Montenegro's current account deficit as percentage of GDP

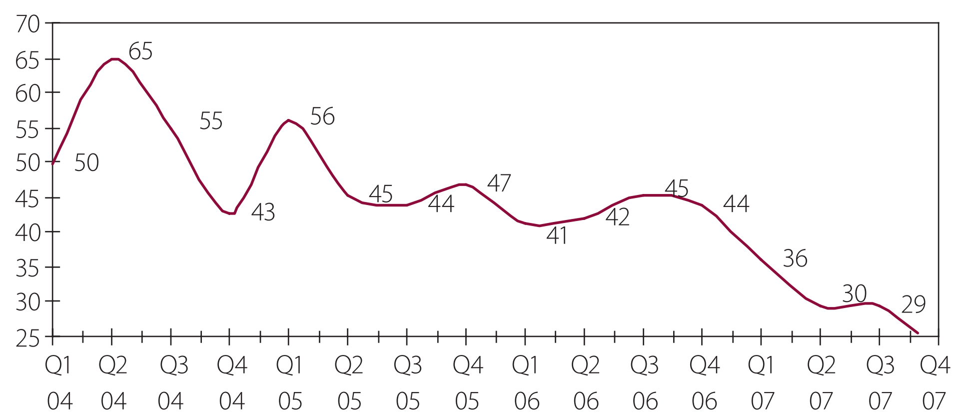


Source: CBM

2.3.1. Sub-account of goods

Total volume of visible trade with abroad has been growing over the years. The year-on-year increase in 2007 amounted to 29.5%. However, due to significantly larger imports than exports, the export/import coverage continuously declined, amounting to 29.2% in 2007, which is 14 percentage points less than in 2006 (Graph 6).

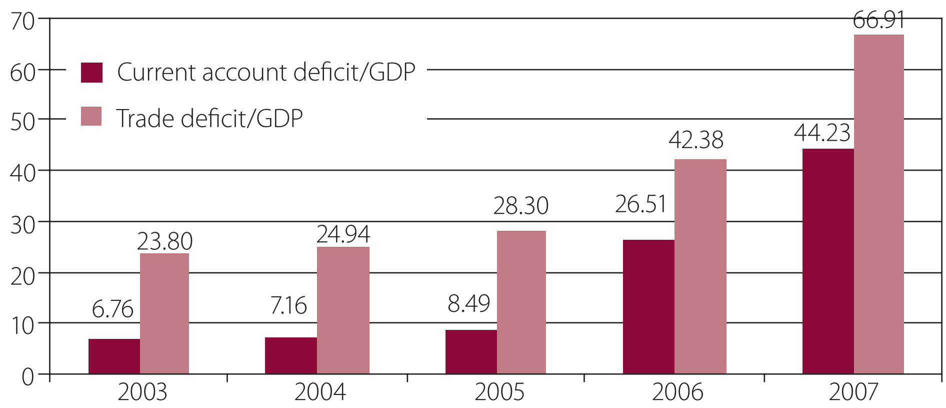
Graph 6 - Coverage of visible imports by exports, 2004 – 2007



Source: CBM

Strong growth in trade deficit, as the main generator of the current account deficit increase (Graph 7), was not covered by surpluses on other current account subaccounts.

Graph 7 – Current account and trade account deficit, as GDP percentage, 2003–2007

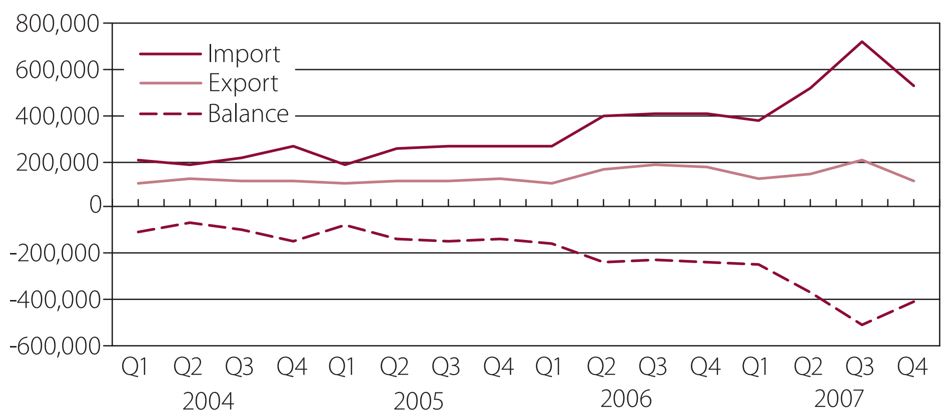


Source: CBM

The coverage of foreign trade deficit by surpluses on other sub-accounts amounted to 33.9% in 2007, which is 3.6 percentage points less than in 2006.

In the last few years, Montenegro recorded an upsurge in visible imports (especially during 2006 and 2007) with significantly lower exports, and even its fall in 2007 (Graph 8).

Graph 8 – Foreign trade of Montenegro, 2004 – 2007, EUR 000



Source: CBM and MONSTAT

The ongoing trend of large visible imports as of 2006 has been mainly influenced by large FDI and credit inflow, that is, an increase in demand for investments and consumption goods, record prices of oil derivatives, deterioration in the USD/EUR exchange rate, as well as increases in prices of some other imported products (wheat and other).

A portion of funds for visible imports come from FDI (which does not cause an increase in country's indebtedness). However, a significant part comes from borrowing, both local and foreign. If capital, borrowed from abroad, has good return in the form of larger output of goods and services, then the economy should not have problems with debt repayment in the future. However, if investments are not good, the indebtedness will not be good as well. However, this is difficult to predict in advance.

Since it is obvious that the main reason for Montenegro's balance of payments imbalance is large visible imports, as the main generator of the current account deficit, we give a brief analysis of the structure of visible imports.

2.3.1.1. Analysis of visible imports

The purpose of the analysis is to conclude whether imported goods are used for investment purposes or this is just the import of consumer goods. Data processing neither according to economic purpose of products for 2006 and 2007[5] nor by International classification of by broad economic categories[6] is available, so that visible imports analysis is based on only one form available- HS Codes, that is, the presentation of goods according to the harmonized system, signs used during filling in the customs declarations.

Harmonized System Codes (HS Code) includes:

- 21sections - marked by Roman numerals from I to XXI
- 99 chapters - marked by Arabic numerals from 1 to 97
- 1244 headings - marked by four-digit Arabic numerals
- 5244 sub-headings - marked by six-digit Arabic numerals

During the last three years, three chapters of products have accounted for the one third of Montenegrin imports, while seven chapters of products have made up one half of total imports (Table 4).

5 Intermediate goods, investment and consumer goods

6 Classification by Broad Economic Categories – BEC

Table 4 – Most important chapters of HS Code products that Montenegro imported during 2005 – 2007, EUR million

Customs tariff	Product	2005	2006	2007	Percentage share		
					2005	2006	2007
27	Mineral fuels, mineral oils and products of their distillation; bitumen material; mineral waxes	139,1	238,7	247,0	14,28	16,10	11,57
87	Vehicles, except for railway and tram vehicles and their parts	84,2	130,9	242,7	8,64	8,83	11,37
84	Reactor, boilers, machine and mechanics equipment and their components	64,1	126,2	191,6	6,58	8,51	8,98
85	Electrics machine and equipment and theirs components; machine for tone recording and reproducing, TV apparatus for recording and reproduction of picture and tone	66,4	104,4	188,4	6,82	7,04	8,83
73	Iron and steel products	27,7	46,4	82,4	2,85	3,13	3,86
94	Furniture, linen, mattress, mattress transporters, pillows and related products, lamps and other fluorescent items, etc.	26,8	46,2	75,2	2,75	3,12	3,52
72	Iron and steel	34,0	43,4	69,7	3,49	2,93	3,26
39	Plastic masses and related products	23,2	35,8	62,6	2,38	2,41	2,94
99	Not classified	58,2	86,2	60,7	5,98	5,82	2,84
22	Beverages, alcohol and vinegar	30,2	35,7	57,5	3,10	2,41	2,69
30	Pharmaceutical products	31,6	42,7	48,6	3,25	2,88	2,28
69	Ceramic products	15,7	27,5	47,8	1,61	1,86	2,24

Note: The group of products with a share in total 2007 imports higher than 2% is presented here. The Group 99 includes various products which the customs office classifies under the same code with a view to simplifying the customs clearance procedure, but this does not provide either an insight in the goods structure nor can they be analyzed.

Articles of Chapter 27

Articles of the Chapter 27 – "Mineral fuels, oils, waxes and bituminous substances" are incorporated in the group of articles for which there is the greatest demand by the Montenegrin economy. This refers to the import of oil, oil derivatives and electricity. A part of these articles is afterwards exported to other destinations.

Table 5 – Import and export of articles of the chapter 27, EUR million

Articles of the chapter 27	2005	2006	2007
Import	139.1	238.7	247.0
Export	10.0	48.3	40.4
Rest	129.1	190.4	206.6

Source: MONSTAT and CBM

If we extend the analysis to cover the headings, it can be noticed that about 60% of total import of articles of the Chapter 27 in 2007 refer to the heading 2710 - ,"Petroleum oils, oils obtained from bituminous minerals, preparations thereof" and 28% refers to electricity. (Table 6)

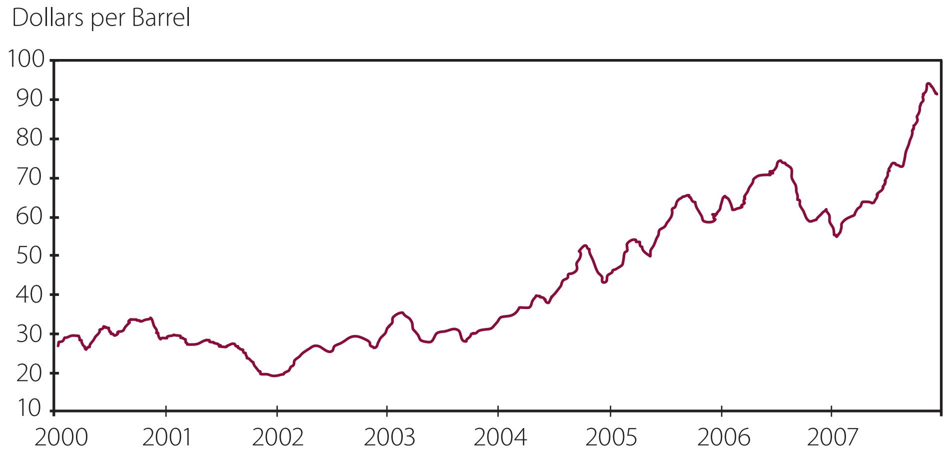
Table 6 - Import structure of articles of Chapter 27, EUR million

Name	2005	2006	2007	% 2007
Mineral oils derived from oil and mineral oils derived from bituminous minerals, apart from row oils	87,4	152,8	147,2	59.6
Electricity	43,6	54,2	68,1	27.6
Oil coke, oil bitumen an other rests of oil or oil derived from bituminous minerals:	1,4	17,7	14,8	6.0
Total import of the chapter 27	139,1	238,7	247,0	

Source: MONSTAT

The year-on-year increase in import of these articles in 2007 was primarily influenced by an increase in electricity import. Observed by value, the import of oil and oil derivatives remained the same as in 2006, although oil prices on the world market constantly increased (Graph 9). The aforementioned facts could imply that the import in 2007 declined in relation to 2006. However, it should be taken into account that ongoing oil price rises on the world market motivates export companies to create supplies. This indicates that a part of oil imported in 2006 was used in 2007. In addition, it should be mentioned that data for 2007 are still preliminary. It would be interesting to analyze the quantities of oil imported in both years, but such data is difficult to obtain.

Graph 9 - Oil prices in the period 2000 – 2007



Source: www. Economagic.com

The year 2006 was the year of large investments[7] in infrastructure, which in turn resulted in larger spending of construction material and also an increase in the utilization of machinery[8], growth in international air transport, the number of foreign tourists, the opening of new hotels and other tourism capacities and a growth in vehicles import (both new and used vehicles). This trend continued in 2007 as well, having a direct impact on oil and oil derivatives import.

In addition, the data indicate the growth of coke import in 2006, which is raw material used in production of anodes during the process of aluminium production.

An uptrend in electricity import continued over 2006 and 2007. In 2006, the import of MWh increased by 10.4% in comparison with 2005, while the year-on-year import increase in 2007 amounted to 22.6%. The reasons for the increased electricity import are very similar to those which influenced the increase in oil import. Production growth in Aluminium Plant Podgorica (KAP) entailed an increase in electricity consumption and import as well. Electricity consumption increased due to the construction of new hotels and an increase in tourist arrivals. In addition, cheap electricity in comparison to other alternative fuels during the winter period and declining prices of air conditioners are some of the reasons for the increase in electricity consumption, that is, import. One of the important reasons for this is also a decline in the production of electricity in relation to the previous year.

Starting from the assumed further growth in oil and electricity prices on the world market and plans for the construction of infrastructure and investments to be made in Montenegrin tourism industry, it could be expected that the import of this group of articles will remain stable, somewhere at the level recorded during 2006 and 2007.

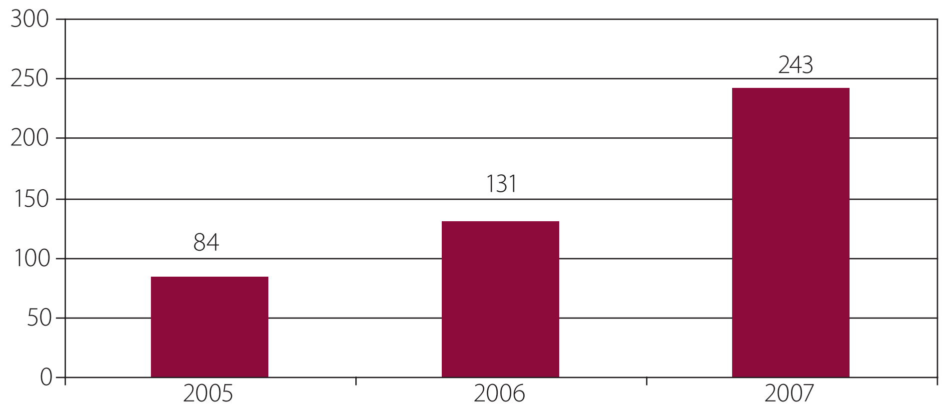
[7] *Construction of tunnels, roads, reconstruction of airports*
[8] *See: Vehicle import analysis*

Articles of Chapter 87

In recent years, articles of the Chapter 87 - „Vehicles, other than railway or tramway rolling stock and parts thereof", the second largest chapter of articles, has been the most interesting one for analysts and broader public.

The import of these articles in 2006 and in 2007 was 50% (or three times) higher than in 2005. The officially registered export of motor vehicles in all three years was lower than EUR 4.5 million.

Graph 10 - Import of articles of Chapter 87, 2005 – 2007, EUR million



Source Monstat

Articles of the heading 8703 – "Motor cars & vehicles for transporting persons" accounted for the largest share (62%) in total imports in 2007, followed by articles of the heading 8704 – "Motor vehicles for transport of goods" with a 15.6%, share and 8705 – "Special purpose motor vehicles nesoi", with a 6% share (Table 7).

Table 7 – Import structure of articles of Chapter 87, 2005 – 2007, EUR million

Heading	Name	2005	2006	2007	% in 2007
8703	motor vehicles & vehicles for transporting persons	62.7	95.6	150.9	62.15
8704	motor vehicles for transport of goods	8.3	14.2	37.9	15.63
8705	special purpose motor vehicles (crane vehicles, fire vehicles, vehicles with concrete mixer, vehicles for cleaning roads, etc)	2.7	4.6	14.3	5.91
8702	motor vehicles for transport of 10 or more passengers	2.8	3.8	10.2	4.20
8701	tractors (other than works trucks) of heading 8709	1.4	2.6	9.1	3.75
8708	parts & accessories for motor vehicles	3.4	5.3	8.6	3.56
8716	trailers etc, other vehicles, not mech propelled	1.1	2.2	5.4	2.23
8711	motorcycles (including mopeds) & cycles with auxiliary motor	1.2	1.6	5.0	2.05
8712	bicycles & other cycles (inc delivery tricycle)	0.3	0.5	0.6	0.26
8715	baby carriages (including strollers) and parts thereof	0.2	0.3	0.3	0.13
8714	parts & access for vehicles of headings 8711 - 8713	0.1	0.1	0.1	0.06
8709	works trucks, self-prop, no lift, stat tractors	0.0	0.1	0.1	0.04
8707	bodies (including cabs), for specific motor vehicles	0.0	0.1	0.1	0.03
8713	invalid carriages	0.0	0.0	0.0	0.01
8706	chassis with engine for motor vehicles	0.0	0.0	0.0	0.00
	Total	84.2	130.9	242.7	

Source: Monstat

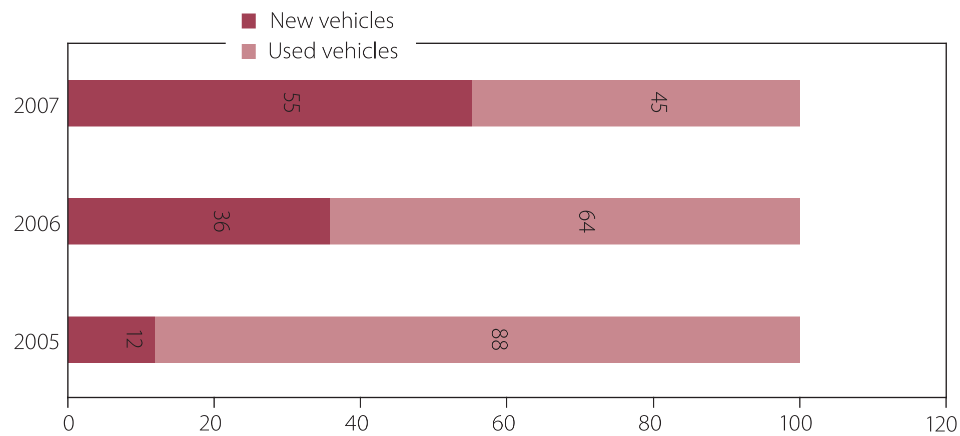
An increase in households' purchasing power, the expansion of consumer loans, the possibility of an unlimited import of used vehicles[9], and accelerated development of the financial leasing market[10] viewed in a growing number of leasing institutions and banks offering financial leasing services, directly influenced the increase in motor vehicles import. The purchase of motor vehicles is the main subject of leasing.

The analysis pays special attention to the structure of imported motor vehicles. During 2005, almost 90% of the imported motor vehicles were used motor vehicles, in 2006 their share declined by 64% and in 2007 this structure changed in favour of new motor vehicles (55%). The analysis shows that the share of motor vehicles using diesel fuel in the total imported motor vehicles in

[9] *Restrictions were introduced in mid-2007.*
[10] *Law on Financial Leasing enacted in December 2005*

2005 was 54%, 58% in 2006 and 67.5% in (Graph 11). The prohibition of import of motor vehicles older than six years influenced these flows although to a small extent because dealers of used motor vehicles had previously made solid stocks.

Graph11 – Import of motor vehicles, 2005 – 2007



Source: Monstat

Many legal entities and private individuals used the opportunity of lease purchase of motor vehicles. Taking into account that the first are the most frequent users of financial leasing services, it can be concluded that a substantial portion of lease financing is intended for commercial activities. A large number of new taxi service associations are evident[11] and more and more legal entities have been using financial leasing for the purchase of new vehicles, that is, for the replacement of old vehicles stock.

The analysis of imported motor vehicles according to their purpose (for commercial purposes or representing investments in non-profitable goods) shows that a substantial portion of motor vehicles are used for commercial purposes.

The expansion of investments, especially in construction, directly influenced a strong growth in the import of vehicles for transport of goods, resulting in 6.5 times more vehicles imported in both 2006 and 2007 than in 2005. In addition, increased investments affected an increase of import of the so-called special purpose motor vehicles – various vehicles for constructions, machinery, vehicles with concrete mixer, road cleaning vehicles and the like. The import of these vehicles in 2006 and 2007 was seven times higher than in 2005. Consequently, the import of parts thereof increased as well, being four times higher in 2006 and 2007 than in 2005.

[11] The official evidence does not exist, but it is supposed that approximately 3,000 motor cars in Montenegro are used for by taxi service associations and many of them use new motor vehicles.

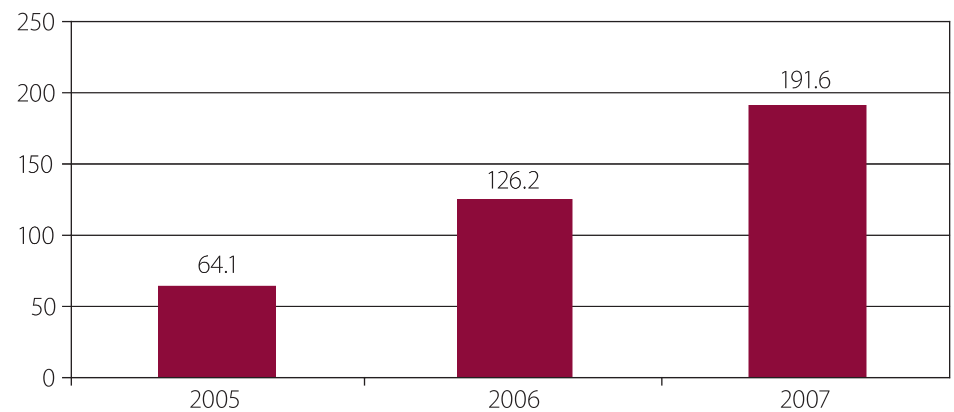
Besides the aforementioned, the import of the vehicles for transport of 10 or more passengers significantly increased (being 5 times higher in 2006 and 2007 than in 2005), as well as the import of tractors, road haulage vehicles, semitrailers and trailers (8 times higher).

The purpose of such a detailed analysis is to get an overview of the import of these products through the prospective return on invested funds. It should be mentioned that there is a great possibility that a part of the vehicles registered as import are treated as directs investments in the form of goods. For a lot of construction companies, which were established as a type of foreign direct investments, it is cost-efficient to import their own construction machinery from abroad. Until recently, the Customs Administration was not able to register foreign direct investments in goods.

Articles of Chapter 84

Articles of the Chapter 84 – "Nuclear reactors, boilers, machinery and mechanical appliances and parts thereof" are the third most imported items in 2006 and 2007, being almost 5 times higher than in 2005 (Graph 12).

Graph 12 – Import of articles of Chapter 84, 2005 – 2007, EUR million



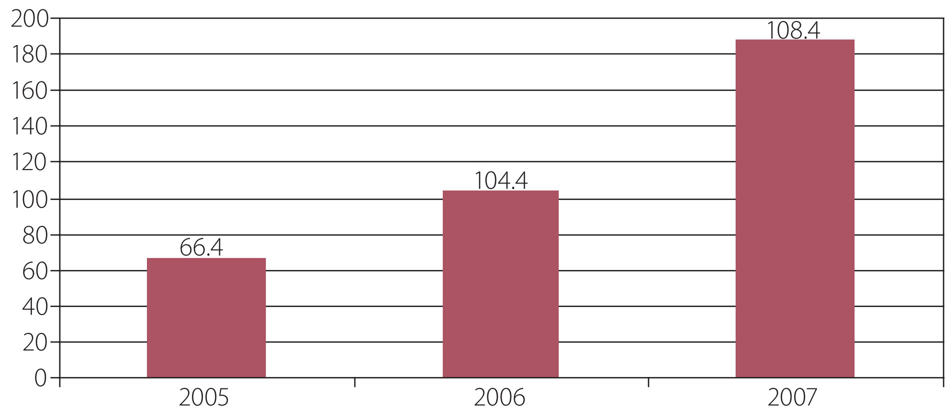
Source: Monstat

Articles of this chapter are mainly automatic data processing machines, construction machines (self-propelled bulldozers, graders, scrapers and spare parts), machines for various material processing, printing machines, various air conditioning devices and refrigerators and freezers. Most of these products are used for commercial purposes. An (8 times) increase in import of articles under the heading 8429 - "Self-propelled bulldozers, graders, scrapers etc" in 2006 and 2007 in relation to 2005, can be mentioned as the fact that speaks in favour of investments made in construction. The construction of new and the reconstruction of old tourist facilities influence an increase in import of air conditioning devices which are not produced in the country. This also refers to the various kinds of refrigerators, freezers and show-cases used in meet industry, which is also in expansion in Montenegro.

Articles of Chapter 85

"Electrical machinery and equipment and parts, telecommunications equipment, sound recorders, television recorders" is the title for the group of articles under the Chapter 85 of the Harmonization System Codes.

Graph 13 - Import of articles of Chapter 85, 2005 – 2007, EUR million



Source: Monstat

One quarter of import of this group make up articles under "Telephones, trans apparatus for radiotelephony or other cordless networks etc." The commencement of operations of a new mobile operator in 2007, the strengthening of competition in that area, more gratis telephone offers to regular and new customers influenced the import of base stations and their parts and the supporting equipment, necessary for offering this kind of services.

In 2007, the value of import of these goods amounted to EUR 47.4 million, while in the previous two years it was significantly lower: EUR 5.4 million in 2006 and EUR 2.8 million in 2005. It is assumed that the majority of the imported goods (especially base stations for the new mobile operator) represent foreign direct investments in the form of goods. This means that Montenegrin residents do not pay tax on this part of the import, but it is paid by a direct investor.

The rest of the import mainly refers to the conductor devices, optical cables, trans apparatus for radiotelephony, electric transformers, electrical apparatus for switching, relays, fuses, transformers, electricity distribution devices and the like, that is, goods related to the commercial activities.

Articles of Chapter 94

Most of the imported goods refer to wooden furniture for living, dining and bedrooms (25%), then kitchen furniture, furniture for shops and offices, mattresses and the like. It is assumed that a part of these products is used for equipping new hotels, offices and the like, that is used for the business purposes. In addition, the possibility of obtaining the commodity loans and deferred payment of goods have facilitated the purchase of these articles by private individuals, so their increased import has been evident in recent years.

Articles of Chapters 25, 44, 68, 69, 70, 72, 73, 76

The import of these groups of products, which accounted for more than 15% of the 2007 imports, is primarily due to new construction activities and activities in iron processing industry (Table 8).

Table 8 – Import of articles of Chapters 25,44,68,69,70,72,73,76, 2005 – 2007, EUR million

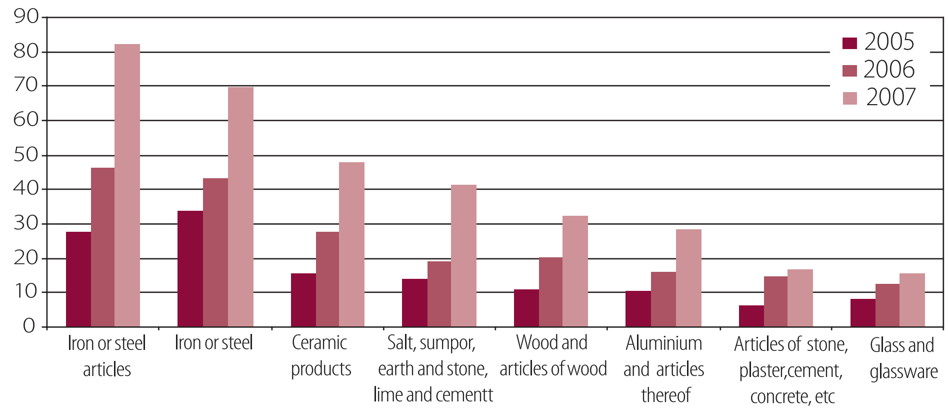
chapter	Name	2005.	2006.	2007.
73	Articles of iron or steel	27.7	46.4	82.4
72	Iron and steel	34.0	43.4	69.7
69	Ceramic products	15.7	27.5	47.8
25	Salt; sulphur; earth and stone, lime and cement	13.9	19,0	41.1
44	Wood and articles of wood; wood charcoal	10.7	20.1	32.3
76	Aluminium and articles thereof	10.6	15.9	28.6
68	Articles of stone, plaster, cement, asbestos, mica or similar materials	6.2	14.8	16.7
70	Glass and glassware	8.0	12.5	15.5

Source: Monstat

The import of ”ferrous waist and scrap” amounted to EUR 27.4 million in 2007, which is 97% more than in 2006. In 2007, the import of hot-rolled wire, iron bars and profiles, various rolled iron articles increased by 50% in comparison with 2005 and 2006. The import of various constructions, such as bridges, towers, roofs, roof frames, doors and windows, iron and steel plates and the like, was 30% higher in 2007 than total import of these articles in both 2005 and 2006. The import of the so-called “fabrics”, among which the most frequently imported are armature wires, was 80% higher in 2007 than in the previous two years.

The import of articles of the Chapter 69 – “Ceramic products” was almost double the import in the previous year. The import of cement, lime and plaster in 2007 was 25% higher than in both 2005 and 2006. Very popular aluminium joinery and a growing number of companies in Montenegro dealing with the production of this kind of joinery, resulted in an increase of import of finished and semi-finished aluminium products (various profiles, plates, tapes). A similar situation is with the Chapters 68 and 70.

Graph no. 14 – Import of the articles of the chapters 25, 44, 68, 69, 70, 72, 73, 76



Source: CBM

* * * * *

The brief analysis presented above covers articles of chapters which made up 70% of the imported goods in 2007. At the same time, the import of those articles accounted for a 70% increase of import in 2007 in comparison with 2006, or 73% when compared to 2005.

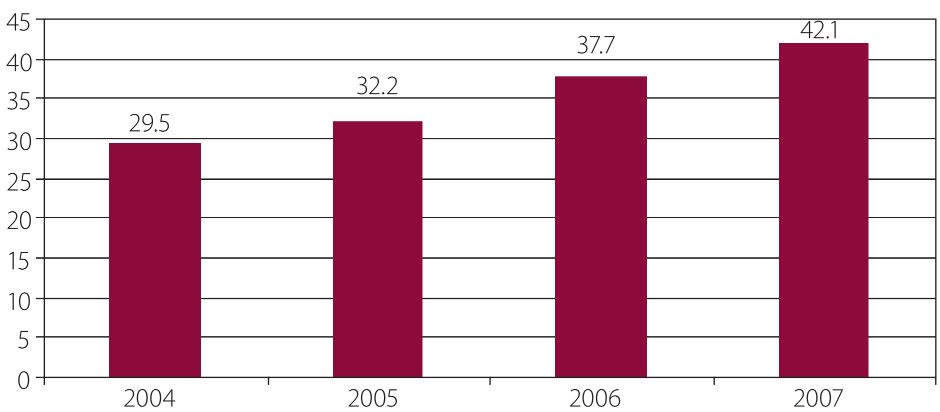
Considering the analysis extent, it could be concluded that one of the main reasons for the import growth is a strong investment cycle in construction.

The issues which should be analyzed in more detail are: the purpose of buildings under construction (private facilities, hotels, weekend cottages) and for which industry (tourism or other), that is, whether the construction is for business purposes or other. The construction of new hotel capacities and the reconstruction of the existing ones is evident, as well as the construction of roads, housing and weekend cottages. The majority of the constructed buildings and infrastructure is due to extremely positive movements in the Montenegrin tourism industry, as well as global trends in this area (WTTC anticipates that a direct share of travels, that is, tourism, in global GDP will amount to 3.6% in 2007, while the employment in the aforesaid fields amounted to 8.3% of total employment). It is estimated that this is a highly profitable field and that return on investments will exceed total costs by far.

2.3.2. Services account

The services account consists of three main sub-accounts: transport, travels-tourism and other. The volume of services trade has grown at an accelerated pace over the years (Graph 15).

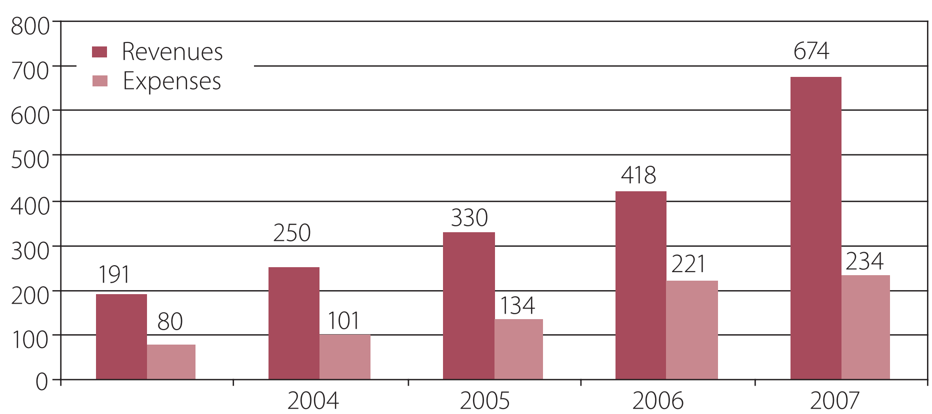
Graph 15 – Growth rate of services exchange, 2003 – 2007



Source: CBM

The balance of services is traditionally in surplus (Graph 16) and has played a very important role in financing the visible trade deficit.

Graph 16 – Revenues and expenses of services trade, 2003 – 2007, EUR million



Source: CBM

Revenues from services have been increasing over the last couple of years at high rates which ranged between 27% and 61%. In 2007, most revenue came from travels – EUR 459.5 million or 68% of total revenues, then transport - EUR 72 million (11% of total revenues) and other services – EUR 142.6 million (21% of total revenues). If we compare Montenegro's revenues from travels, that is, tourism and total export of goods and export of aluminium and aluminium products in 2007, the result is 63% higher revenues from tourism, that is, 73% of the total value of exported goods (Graph 17). Large investments in tourism have already resulted in better quality of tourism offer and, consequently, an increase in the number of foreign tourist, tourist overnights and spending.

Graph 17 – Revenues from travels, total export and aluminium export, EUR million

Source: CBM and Monstat

In the last four years, WTTC has reported that Montenegro is one of the three fastest growing tourist economies in the world.

As for other services, the larges revenues came from construction and various business, professional, technical, trade and communication services. Service expenditures side recorded significant increases in 2006 and 2007 in comparison to 2005. This can be explained by employment of non-residents in construction industry, this including the development of projects, consultancy, bookkeeping, and the hiring of non-residents to perform construction work. One of the reasons is also the engagement of foreign transport companies for the import of construction material. In addition, in order to gain access to foreign markets, there were a lot of activities on the promotion of domestic products and services through the participation at international fairs and different kinds of advertising.

2.3.3. Income and current transfers

The income and current transfers accounts are the accounts in which Montenegro has been traditionally running surpluses. The income account covers revenues and expenditures arising from ownership of the production factors. This part of the current account incorporates compensations paid to employees (salaries and wages), revenues from and expenditures on interests, investments, that is, dividends. Current transfers are unilateral transactions, that is, the delivery of goods or remittances without the obligation to provide any compensations.

The main characteristics of these two parts of the current account over the last three years have been the following: growing inflow of funds arising from compensations paid to employees (our employees abroad), a decline in inflow of foreign assistance and other means of transfers, growth in interest expenses, and outflow of funds arising from direct investment revenues. The strengthening of the economy, accelerated economic growth, an increase in purchasing power of households are logical reasons for the reduced need for foreign assistance. On the other hand, an increase in foreign borrowing influences a higher outflow of funds arising from interest expenses. In the past few years, these expenses have been growing. A substantial outflow of interest on borrowed funds was recorded in 2007, amounting to EUR 55 million or 85.3% more than in 2006. In 2006, this outflow amounted to EUR 29.7 million or 20.4% more than in 2005.

2.4. Capital-financial account or how the current account deficit is financed

The capital-financial account consists of the two main components – the capital account and the financial transactions account, which are in accordance with the same accounts existing in the System of national accounts (SNA).

The main capital account components are capital transfers and purchase/sale of non-productive, non-financial assets. Capital transfers consist of transfers related to the transfer of an ownership of fixed assets; financial asset transfers related to or conditioned by fixed assets purchase or sale; or cancellation of debt by mutual agreement between the debtor and the creditor.

All financial account categories are classified according to the investment type or functional division (direct investments, portfolio investments, other investments, reserve assets).

If the capital-financial account balance is positive, then it shows us the current account deficit financing structure[12] as per types of investments, institutional sectors, instruments, maturity, etc. In case of a negative balance of the capital-financial account, then it shows the use of surplus of

[12] *For example, a decrease in funds in foreign exchange accounts, inflow from foreign direct and portfolio investments, foreign borrowing*

funds arising from the current account surplus[13] with respect to types of investments, institutional sectors, instruments, maturity and the like.

Montenegro's capital-financial account in the period 2003-2007 is shown in Table 9.

Table 9 - Montenegro's capital-financial account,2003-2007, EUR thousand

	2003	2004	2005	2006	2007
CAPITAL AND FINANCIAL ACCOUNT	16,626	58,858	191,589	537,593	1,164,837
1. CAPITAL ACCOUNT				-14,028	-1,435
2. FINANCIAL ACCOUNT (1+2+3+4+5)	16,626	58,858	191,589	551,621	1,166,271
1. Net direct investments	38,725	50,567	380,921	466,701	524,876
2. Net portfolio investments	942	5,524	4,815	-4,444	-4,888
3. Other investments-net	-82,157	-19,446	-20,390	153,398	358,108
4. Change in net foreign assets, number of items	54,517	31,820	-60,900	73,015	438,976
5. Change in CBM reserves	4,599	-9,607	-112,857	-137,048	-150,800
C. NET ERRORS AND OMMISSIONS (A+B)	-85,430	-60,784	37,543	6,387	157,197

Source: CBM

The main financial account categories to be analyzed in this part with a view to presenting the way of the current account deficit financing are direct investments and other investments accounts. Portfolio investments will not be analyzed due to their insignificant effects.

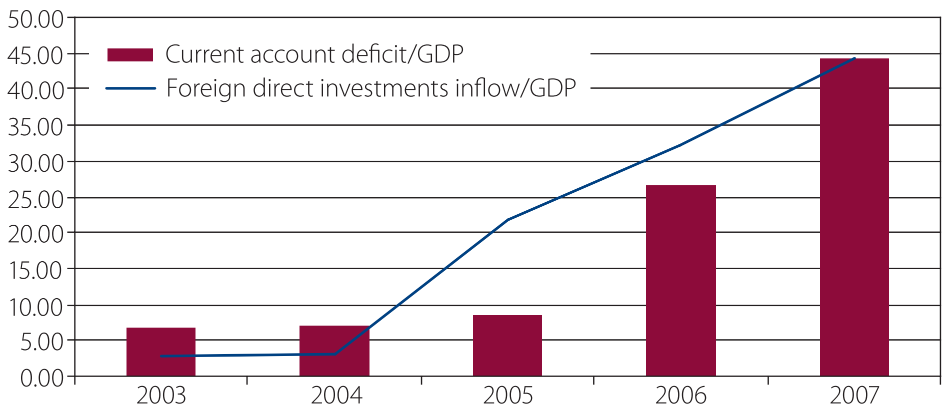
2.4.1. Foreign direct and other investments

Direct investing is the category of international investing presenting the efforts of a resident body in an economy to obtain direct interests in an undertaking which is a resident of another economy. The lasting interest implies the existence of a long-term relationship between the direct investor and the company, as well as a significant degree of the investor's influence on the company's management. Direct investing is not only the initial transaction, through which the relationship between the investor and the company is built, but all subsequent mutual transactions and transactions with the associates and subsidiaries. According to the IMF definition, foreign direct investment is when non-resident has 10% or more of ownership share in some resident company. This threshold was arbitrarily specified in order to facilitate the statistical tracking of these movements. According to their maturity, foreign direct investments are classified as long-term, which means that a possibility of a sudden outflow of capital on this basis is minimized.

[13] *For example, an increase in funds on foreign exchange accounts, residents' investments abroad, foreign lending*

The annual amounts of foreign direct investments in Montenegro were relatively moderate by 2005, primarily due to the volatile macroeconomic and political situation. At end-2004, Standard&Poors' credit rating agency assigned credit rating to Montenegro (BB/stable/B) for the first time, which was one of the signals for foreign investors that Montenegro is a stable and promising economy, which is interesting for investments. The year-on-year FDI inflow in 2005 increased by 7.5 times and being even 9 times larger than in 2003. The uptrend in FDI inflow continued in 2006 and 2007 when EUR 644.3 million and EUR 1,007.7 million of gross FDI were received, respectively (Graph 18).

Graph 18 – Gross FDI inflow and the current account deficit, % of GDP



Source: CBM

Strong FDI inflow during 2005 induced a strong growth in imports in the second quarter of 2006, when it increased from EUR 230 million, as was the average from the previous nine quarters (as of 2004), to over EUR 400 million. As Montenegro's economy did not produce most of the material necessary for the investment process, foreign investors imported everything they needed: construction material, machinery and other equipment, raw material, furnishings and the like.

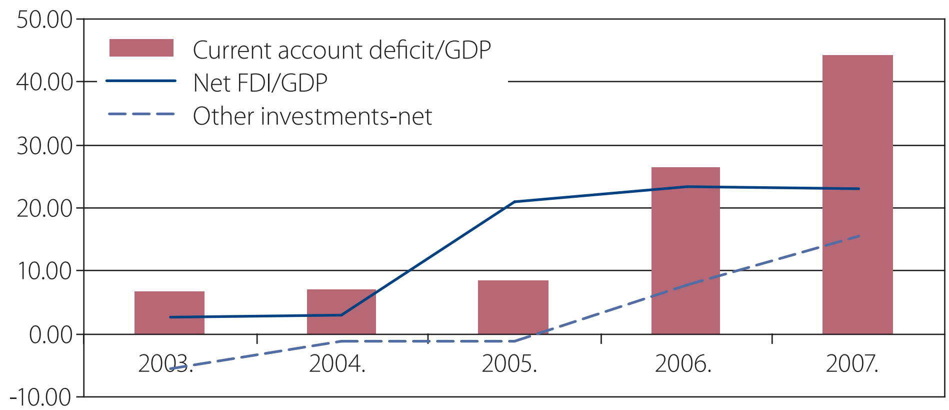
During 2005, net FDI investments completely covered the current account deficit, while in the following year this coverage was 88%.

The financing of the current account deficit from FDI inflow is good from the aspect of capital maturity (there is neither an increase in the external debt nor there is any tendency towards rapid capital withdrawal), but the problem is the structure of direct investments by activities. In 2005, 18% of total investments related to real estate investments, the same percentage referred to production activities, 51% referred to services, and 13% were investments in financial organizations. In the following year, the share of total investments in real estate rose up to 53%, and the rest was invested in companies and banks. In 2007, 51% were real estate investments, 37.5% was invested in banks and companies, and the remaining was in the form of intercompany debt (investments between associate companies).

The aforesaid leads to a conclusion that the existing FDI structure is not good. However, the secondary effects are positive and reflect in an increase in tourism revenues and declines in interest rates, unemployment, expenses for telecommunications etc. This means that FDI have had more influence on the invisible part of Montenegro's production.

Observing net FDI as a percentage of GDP, we can see that they were almost equal in 2006 and 2007. As the inflow of FDI funds started to increase so did their outflow. The purchase of land, real property construction and then its sale with the price difference, showed as a profitable business in our country. Many non-residents were in this business of buying real property and reselling it to other non-residents when the prices increased. In addition, residents started to directly invest abroad. However, this time the incentive for further export growth is foreign borrowing.

Graph 19 – Net FDI, Other investments and the current account deficit, % of GDP



Source: CBM

2.4.2. Foreign borrowing

We have already said that FDI are neither dangerous for the economic stability nor they increase the foreign debt. But, what is the situation with foreign borrowing?

It is obvious that high growth in borrowing directly influenced the further growth in visible imports, and subsequently led to deterioration in the current account deficit. A remarkably strong growth in foreign obligations arising from taken loans was recorded in 2006, when their year-on-year increase was almost 120%. The analysis of the structure of these loans[14], showed that about 47% of total inflow of funds in the form of loans to financial institutions (commercial banks, micro-

[14] Unfortunately, due to the non-existence of any regulation, and thus no obligation by a borrower to inform the CBM about the loan structure and other loan related information, there is no possibility for a more detailed analysis of these flows.

credit financial institutions, leasing companies), while some 36% referred to legal persons who took loans in order to perform construction works (construction of new hotels and reconstruction of the existing ones) and investments in real estate. Other loans related to other corporate entities. As for financial institutions, these were mostly borrowings between related entities (mother-daughter companies). With regard to loans taken for the purpose of building hotels, investments in other tourist objects and real estate (without going into details about the reasons for such a way of obtaining funds) it is very likely that most of these loans will be transformed into ownership investments. To wit, by treating a foreign investment as a loan, foreign investors may avoid the payment of a part of or the entire profit tax. So, this makes us think what are the actual foreign obligations arising from loans. In case that all loans presented in this way must be repaid, it should not be a problem with such growth rates in tourism. A similar situation regarding loans was in 2007.

As for the maturity structure of loans, 80% are long-term loans taken by financial institutions (banks, MFIs, financial leasing companies), while over 95% of short-term loans relates to a parent bank receivables from a daughter bank. It is also important to say that this is primarily the private sector indebtedness, so that private natural or legal persons are those who are responsible for them.

3. ANALYSIS OF «MONTENEGRO`S ECONOMY VULNERABILITY»

When foreign economic relations are in question, the Montenegrin economy is very vulnerable. Namely, the sale of aluminium and tourism revenues account for 73% of total export revenues. As a tradable product, aluminium is subject to price changes. On the other hand, potential restrictive factors for tourism development may be infrastructural problems and the emergence of some larger regional crisis. However, we should bear in mind that these two products imply significant imports, so that any decline in aluminium export or tourism activities would, in addition to significant reduction in exports revenues, entail a decrease in imports.

If we observe the structure of visible exports, the three most important export products - aluminium and related products, iron and steel, and mineral fuels and oils account for the two thirds of visible exports (67%). This shows a very poor exports diversification and structure since the three most important exports products, which account for the two thirds of total visible exports, are raw materials. On the other hand, the visible imports structure is much more diversified and the three most important imported products account for 31.9% of visible imports.

Observing the imports/exports geographic concentration, we can state that it is very unfavourable regarding imports. This means that our export is largely dependent on market trends. The three most important export markets (Serbia, Italy and Greece) account for 68% of total Montenegrin exports. This is much less regarding the import from these markets as they account for 43.16% of total imports.

4. MEASURES TO REDUCE THE CURRENT ACCOUNT DEFICIT

An additional concern is that exports has been declining (-4.5%), whereas growth in imports is exceptionally high (44%). The main causes for the current account deficit are the following:

- low imports, as a consequence of low competitiveness of local producers
- remarkably high growth rates in imports
- too high a level of aggregate demand
- large FDI inflow
- unfavourable global movements of prices of certain categories of products, primarily agricultural, food and energy products.

That is why the measures for the current account deficit reduction will be analyzed from the following four aspects.

1. **A low level of imports** is definitely the consequence of low competitiveness of local producers. However, we should bear in mind that the growing domestic demand, especially in tourism, resulted in that that a part of the products that were previously exported (primarily agricultural and food products) are now directed to meeting the increased local demand. With a view to increasing competitiveness of local producers, it is necessary to undertake the following measures:
   - Agriculture must not be left to free market conditions as it is subject to government support in both developed countries and transition economies. The WTO rules allow direct subsidizing of imports only in agriculture. If producers from competitive countries enjoy extensive government support, then any absence of such support brings local producers in an unfair position. In order to stimulate the export and reduce the import of agricultural products, it is necessary to provide larger budgetary funds to stimulate farmers producing organic food, promote agricultural production, ensure favourable loans and funds necessary the production process (machines, equipment, seeds, cattle etc.) through the Development Fund, redeem agricultural products and their surpluses (by allocating more budget funds for this purpose), ensure the food quality control system and encourage production of local brands, as well as consider possibilities for the implementation of stimulating measures for food industry, bearing in mind the branches in which Montenegro could have comparative advantages and

which would simultaneously provide incentives for the primary agricultural production development.

- Increase the state role with a view to facilitating the adoption of international quality standards by companies since the lack of such quality standards disables access to Western markets, and plan more budget funds for this purpose. A particular attention should be paid to obtaining the Halal certificate, bearing in mind the growing demand in countries requiring this certificate.
- Intensify activities on the promotion of Montenegrin economy on foreign markets, together with the allocation of significant government subsidies for these activities. Consider a possibility to increase funds for „grant schemes for reimbursement of costs“ (planned amount of EUR 200,000 in 2008)[15] to enable companies to participate in international economic fairs, prepare and printe promotion material and carry out market research studies. This type of subsidies is in accordance with the WTO rules. A more aggressive appearance of the Chamber of Commerce would also be useful, primarily in trade promotion, market research and providing information to companies about business opportunities abroad.
- Increase the level of informing companies about certificates, technical standards, rules of origin of goods and protection of producers on the EU market, bearing in mind the significance of this market[16] for Montenegro and its future integration processes.
- Harmonize certificate standards with EU regulations, that is, international institutions. Institutionally resolve the matter of issuing certificates to be accepted by the EU.
- Consider the possibility of establishing an institution for export insurance and crediting. In cooperation with the CBM, consider potential functions of this institution, supervision and other relevant issues.
- The concept of free zones in Montenegro is not used at all. The affirmation and promotion of this concept should be considered.
- Loans of the Development Fund should be primarily directed to exports programmes.
- Experiences of other countries showed that export cluster formation can contribute to increasing exports and improving export offer.
- The large budgetary surplus allows for considering in which areas the government can provide subsidies. Of course, the potential subsidies must be provided in accordance with the WTO rules. According to these rules, subsidies are allowed for exploration and development, coverage of ecological costs, costs of international promotion in fairs, agricultural production and other.
- Perform sector studies in order to identify the obstacles as well as potential measures for production and export increase in sectors in which Montenegro has or may have comparative advantages, primarily in the fields of agriculture, food industry, industry of alcoholic and soft beverages, wood processing, fishery and fish farming etc.
- Macroeconomic environment affects both local operations and export performance of a company. Although its improvement has been obvious over the years, much effort is

[15] State support program to small and medium enterprises for 2008, Government of Montenegro.
[16] In the previous year, Montenegro placed 59% of its exports to the EU market.

needed to improve it additionally. This implies activities on reducing the country risk, deregulation of operations, simplifying the export procedures, accelerating companies' privatization and restructuring, reducing administrative costs, increase efficiency in resolving commercial disputes, etc.

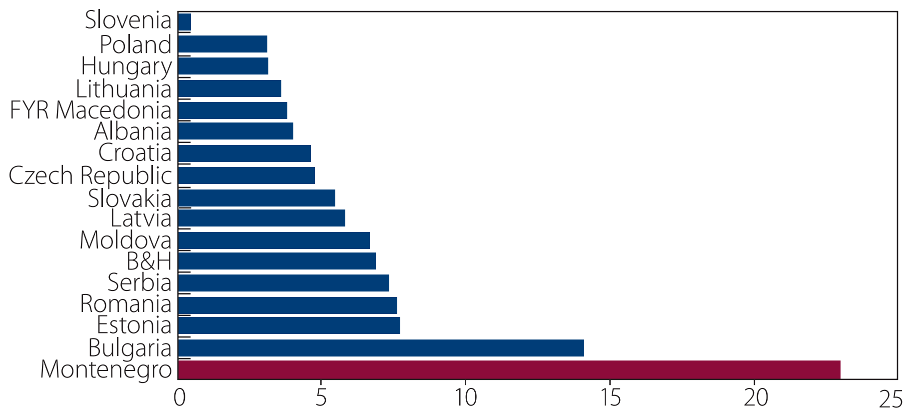
2. **A remarkably high growth in imports** is to mainly the consequence of accelerated economic development and large FDI inflows. This is supported by a large share of intermediate goods and equipment in total imports. With a view to reducing the current account deficit, it is very important to substitute imports by increasing local production. It is necessary to protect local producers through antidumping, compensatory customs duties, protection from excessive exports as well as enhancing control of attestation and meeting quality standards of imported goods, aiming at the prevention of unfair competition to local producers and protection of local production. This will partly reduce imports. Considering the large import of cars, we should think about amending the Decision on the requirements for import of used vehicles (Official Gazette of RM 44/07 and 46/07) so as to raise the limits with respect to the age of used cars. We should bear in mind that Montenegrin economy is highly import dependent, so that whenever we have a high GDP rate, as in 2007, we have large import of energy products and raw materials at the same time.

3. **A high level of aggregate demand** is the result of rapid increase in earnings, high growth rate of domestic loans, foreign indebtedness, as well as large revenues from real estate sale generated by a part of households. The aforementioned factors resulted in a significant growth in purchasing power of a part of households, which was primarily shown through the purchase of durable goods: household equipment and appliances, cars, etc. These products are not produced in Montenegro and they have to be imported. Taking into account that the expected revenues from real estate sale are expected to be much lower in 2008, it is reasonable to expect that a part of the aforesaid import will gradually decline. In addition, the CBM measures aimed at curbing credit growth will have positive effects on a decrease in imports. Considering a rapid growth of banks` foreign borrowing, a particular attention should be paid to this category of loans, and in case of further drastic expansion, measures for their restriction should be considered similarly to those undertaken in Croatia and Serbia[17]. A particular problem is that the existing legislation does not enable the CBM to either determine the exact amount of the private external debt or to perform a proper analysis of its structure. Therefore, it is very important this provision is included in the new Law on the Central Bank of Montenegro. The increase in earnings should be harmonized with GDP growth in the upcoming period.

4. According to the IMF assessment, Montenegro is undoubtedly the first among European economies in transition with regard to the average FDI inflow in the period 2005–2007.

[17] Large demand for the import of consumer goods is often financed from loans. Maturity mismatch between sources of funds and placement is often „ironed" by banks through foreign borrowing, mostly from parent banks. In this way import demand draws growth of foreign indebtedness of banks.

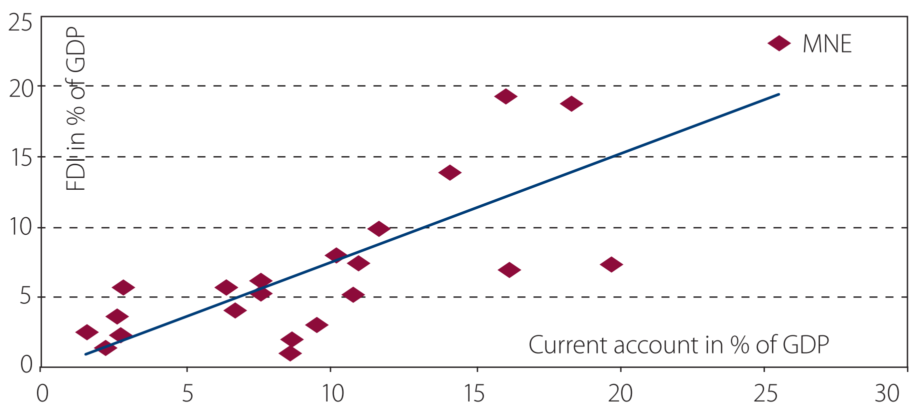
Graph 20 – FDI inflow as % of GDP, period 2005-2007



Source: IMF

Large FDI inflow influenced the growth in imports since foreign investors imported equipment, raw material, furnishings, construction material and the like in order to initiate the production process. This is the trend that is also present in other economies in transition, as shown in graph below.

Graph 21 – FDI and current account deficit, 2005-2007



Source: World Economic Outlook

Therefore, it is certain that a part of the current account deficit has self-correcting effects, that is, the cessation of FDI inflow will lead to a substantial reduction in imports. Each country has limited capabilities to absorb FDI inflow, but it is certain that they are still not used in Montenegro, meaning that Montenegro may count on large FDI inflows in the medium-term period of three to five years. Thus, it will not be possible to significantly reduce the current account deficit. On the other hand, initial investments in the construction of roads, power capacities or the implementation of some other large announced projects will certainly lead to growth in imports. This is the development component of the deficit, which bring positive effects in the long-term. In addition, as a result of large FDI inflow in the upcoming period, we should expect larger export revenues, which are now obvious in tourism. This means that corrective measures do not have to be undertaken when this development is in question. Of course, it would be of exceptional importance to influence the change of the FDI structure, that is, their redirection from real estate to other fields. A good promotion of Montenegro could play an important role in this, therefore, an increase of budget funds of the Montenegrin Investment Promotion Agency should be considered.

5. **High prices of agricultural, food and energy products** significantly affected the aggravation of the current account deficit. It is not possible to influence the prices of these products through any economic policy measures, but it is possible with regard to certain import components. Bearing in mind the exceptional advantages of Montenegro in the development of agricultural and food industries by the aforesaid measures (see point 1), it is necessary to stimulate larger production of these products in order to reduce their importing. Montenegro should also reduce the import of electricity and it could be achieved in many ways. Considering that the imbalance between local demand and production has existed for years, it is certain that the construction of new generation capacities is necessary in order to produce more power. Taking into account that the Government decided not to privatize the thermal power plant Pljevlja, as well as a drastic fall of production in this power facility recorded last year, the Government must provide funds for the required investments. It is necessary to increase the share of alternative energy sources (solar and wind energy, biomasses, atmospheric discharge, etc.); the issuing of building permits should be conditioned by the construction of energy efficient facilities and obligation to generate a part of energy by using alternative energy sources, for example by installing solar cells, introducing amendments to the existing legislation (the Law on Construction of Objects, the Law on Environmental Protection, the Energy Law). Taking into account the difference between the prices of construction and sale, this request would not be too much of a burden for construction companies. Implement the Energy Efficiency Strategy.

It is very important to continue with Montenegro's process of integration into the European Union and the World Trade Organization, which will eliminate a part of barriers to Montenegrin exporters. Bearing in mind the fact that the Montenegrin economy is highly opened, negative effects due to accessing these economies, as reflected in import growth, will be insignificant.

5. CONCLUDING CONSIDERATIONS

The characteristics of the Montenegrin balance of payments are the ongoing deepening of its imbalance, raw materials dominating the export, very poor export diversification, exceptionally high geographic concentration of exports, and rapid growth of imports with a simultaneously insignificant growth of exports. The main reasons that led to the current account deficit increase are the low competitiveness of local producers, large import of electricity, growth in global oil prices, large FDI inflow, excessive consumption, a high credit growth rate, etc.

In the eurosation conditions, the current account deficit entails less risk than in countries having their own currency, but the options for its elimination are narrowed in the absence of exchange rate policy. In a euroised and highly-opened economy with low transaction costs, local and foreign products become substitutes and households easily turn to imported products. The current account deficit can be considered as a balanced response of the system to a large foreign private capital inflow and a high credit growth rate. A significant part of the deficit will have self-correcting effect with a decline in capital inflow.

An increasing current account deficit is an indicator of growing imbalances: too large a capital inflow, overestimated value of property (securities and real estate), economy overheating, and aggravation of the corporate balance sheet positions (increase of indebtedness).

Borrowing in order to construct tourist facilities, infrastructure, raising the level of technical-technological equipping, that is, financing production investments, creates the prerequisites for the return of current borrowing with the future surpluses. Although the current account deficit is to a large extent the consequence of the accelerated growth, the reason for concern is the fact that it is less covered by FDI, while the private external debt increases. Net FDI inflow covered only 52% of the current account deficit in 2007, whereas in 2006 this coverage amounted to 88%.

The analysis of the most important Montenegrin balance of payment positions in the last few years showed that the high and long-term current account deficit cannot be externally financed indefinitely, but also that there are no unique criteria for assessing the current account deficit sustainability in practice. Taking into account large FDI inflows and investment cycle, it is not reasonable to expect any significant decrease of the current account deficit in the next few years. If the current account deficit maintains for a longer period of time and when FDI discontinue and loans mature, then the money supply will reduce and this could have a recession effect on the economy.

We should bear in mind that a remarkably large imports is also one of the important factors in fiscal surplus. However, after the completion of an investment boom, the current account deficit could be very dangerous, as it will lead to increased borrowing, the ultimate consequence will be the appearance of a twin deficit.

What is good and commendable is that the external public debt is relatively low, but it certainly does not mean that we can ignore an increase in external borrowing as it entails credit rating decline, which means that the banking system may at one pint estimate that a significant number of companies is overindebted and banks could refuse to grant loans to such companies due to possible default risk. This could result in the banking system having problems to choose quality companies and projects for financing, and it is known that the existence of free funds which cannot be placed may represent significant costs for the banking system.

We think that this is the right time to undertake measures that will lead to a gradual correction of Montenegro's current account deficit. In short-term, it is possible to provide financing of the existing current account deficit without jeopardizing the economic growth.