**Document of**
**The World Bank**

Report No. 66151-ME

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROGRAM DOCUMENT FOR A

PROPOSED POLICY BASED GUARANTEE

IN THE AMOUNT OF EUR60 MILLION
(US$79.2 MILLION EQUIVALENT)

TO

MONTENEGRO

FOR A

FINANCIAL SECTOR POLICY BASED GUARANTEE

May 31, 2012

Private and Financial Sectors Development Unit (ECSPF)
South East Europe Country Unit (ECCU4)
Europe and Central Asia (ECA)

**MONTENEGRO – GOVERNMENT FISCAL YEAR**
January 1 – December 31

**CURRENCY EQUIVALENTS**
(Exchange Rate Effective as of April 30, 2012)

| Currency Unit | EUR |
|---|---|
| US$1.00 | €0.76 |

Weights and Measures
Metric System

## ABBREVIATION AND ACRONYMS

| | | | |
|---|---|---|---|
| CAMELS | Capital Adequacy, Asset Quality, Management, Earnings and Liquidity and Sensitivity to market risk | IFC | International Finance Corporation |
| CAR | Capital Adequacy Ratio | IFI | International Financial Institutions |
| CBCG | Central Bank of Montenegro | IFRS | International Financial Reporting Standards |
| CPS | Country Partnership Strategy | IIA | Institute of Internal Auditors |
| DPF | Deposit Protection Fund | IMF | International Monetary Fund |
| DPL | Development Policy Loan | KAP | Kombinat Aluminijuma Podgorica |
| EBRD | European Bank for Reconstruction and Development | KfW | Kreditanstalt für Wiederaufbau / German Development Bank |
| EC | European Commission | LTD | Loan-to-deposit ratio |
| ECA | Europe and Central Asia | MoF | Ministry of Finance |
| EIB | European Investment Bank | MPBS | Measures for Protection of the Banking System |
| EPCG | Elektroprivreda Crne Gore AD | NPL | Nonperforming Loan |
| EU | European Union | PEFA | Public Expenditure and Financial Accountability Assessment |
| FDI | Foreign Direct Investment | PFM | Public Financial Management |
| FIRST | Financial Sector Reform and Strengthening Initiative | ROA | Return on Assets |
| FMS/MOP | Family Material Support | ROE | Return on Equity |
| FSAP | Financial Sector Assessment Program | ROSC | Report on The Observance of Standards and Codes |
| FSC | Financial Stability Council | SAC | Structural Adjustment Credit |
| FSDPL | Financial Sector Development Policy Loan | SAI | State Audit Institution |
| FSL | Financial Stability Law | SAP | Supervisory Action Plan |
| FSPBG | Financial Sector Policy Based Guarantee | SEE | South Eastern Europe |
| FX | Foreign Exchange | SMEs | Small and medium enterprises |
| GDP | Gross Domestic Product | TA | Technical Assistance |
| GoM | Government of Montenegro | WB | World Bank |
| IBRD | International Bank for Reconstruction and Development | WTO | World Trade Organization |

| | |
|---|---|
| Vice President: | Philippe Le Houérou |
| Country Director: | Jane Armitage |
| Sector Director: | Gerardo Corrochano |
| Sector Manager: | Lalit Raina |
| Task Team Leader: | Martin Melecky |

**MONTENEGRO**

**FINANCIAL SECTOR POLICY BASED GUARANTEE**

**TABLE OF CONTENTS**



The Policy Based Guarantee is prepared by a Bank team consisting of Martin Melecky (Task Team Leader, ECSF1), Leyla Castillo (ECSF1), Andrew Lovegrove, and Djurdjica Ognjenovic (ECSPF expert consultants), Zeljko Bogetic, Sanja Madzarevic-Sujster and Danijela Vukajlovic-Grba (ECSP2), Gianfranco Bertozzi (BDM), Julie Rieger (LEGEM), Neil Pravin Ashar (LEGCF), Kenneth Simler (ECSP3), and Aleksandar Crnomarkovic (ECSO3).

## GUARANTEE AND PROGRAM SUMMARY

## MONTENEGRO

## FINANCIAL SECTOR POLICY BASED GUARANTEE

| | |
|---|---|
| Borrower | Montenegro |
| Implementing Agency | The Ministry of Finance (MoF) of Montenegro will be responsible for overall implementation of the proposed operation. The Central Bank of Montenegro (CBCG) is closely involved in the work on most prior actions. |
| Financing Data | <u>IBRD Policy-Based Guarantee</u><br>The guarantee will cover EUR60 million (equivalent to US$79.2 million using the April 30th exchange rate and the WB rounding rule) of the EUR [100] million principal of a commercial loan to Montenegro with [five to seven]-year maturity. Repayments will be amortizing, with the final EUR60 million payable at scheduled maturity. |
| Operation Type | Policy Based Guarantee |
| Main Policy Areas | The proposed guarantee supports a comprehensive program of measures to strengthen the banking sector, with a view to addressing vulnerabilities of the Montenegrin banking sector and increase the resilience of the sector to possible future shocks. The proposed specific reforms to strengthen the banking sector are in the following areas: (i) systemic risk monitoring and the crisis management framework; (ii) banking sector vulnerabilities; (iii) restructuring of Prva Banka; (iv) the depositor protection scheme; and (v) the regulatory framework for banks. These reforms are an integral part of Montenegro's EU accession strategy insofar as they aim to bring the supervisory and regulatory framework for the banking sector closer to EU best practices. |
| Key Outcome Indicators | The expected outcomes of this operation are: (i) enhanced macroprudential oversight and the legal authority of the CBCG and MoF to rapidly and transparently resolve any future crisis situations, (ii) enhanced stability and soundness of the banking system; (iii) Prva Banka operating under sound and safe financial conditions and a market-based financing structure; (iv) confidence in the banking sector is restored and total bank deposits steadily increasing to their pre-crisis levels; and (v) supervision of the banking system is conducted consistent with Basel Core Principles and based on best practice international accounting standards and |

| | |
|---|---|
| | regulatory reporting.<br>The expected results indicators are:<br>• Enhanced macroprudential oversight and crisis management framework in line with international good practice as appraised by next Financial Stability Assessment Program (FSAP) update (baseline: 2007 FSAP appraisal; next FSAP update expected in 2013-2014);<br>• Improved quality of banks' loan portfolios (baseline: system's non-performing loan (NPL) ratio at 19.7 percent by September 2011; target: NPLs below 12 percent by end-2012);<br>• Well-capitalized banks (target: average CAR of banking system to remain above 15 percent);<br>• Prva Banka has a market based financing structure, and operates in sound and safe financial condition while meeting all prudential norms (baseline: EUR18.2 million of Government deposits by end-December 2011; target: EUR0 by end-June 2012);<br>• Increased confidence in the banking sector leading to positive annual growth in bank deposits over 2012-2013 to gradually reach the pre-crisis (September 2008) level of deposits (the total decline in deposits from September 2008 to March 2011 reached -19.3 percent);<br>• Effective supervision of banking system consistent with Basel Core Principles (no materially non-compliant ratings on BCP assessment in next FSAP update);<br>• All banks produce financial statements based on international accounting standards (IFRS) as of 2014;<br>• Adequate liquidity in the banking sector (target: liquidity ratio in compliance with the CBCG norms). |
| Program Development Objective(s) and Contribution to CAS | The overarching objective of the operation is to strengthen the banking sector, which is a critical pre-condition for sustainable economic recovery and balanced private sector-led growth.<br>The reform program supported by this operation falls under Pillar I of the Country Partnership Strategy (CPS), namely, to support EU integration through strengthening institutions and competitiveness in line with EU accession requirements. The proposed operation contributes to this strategic priority by supporting reforms in the legal, regulatory, and supervisory framework for the banking sector that are in line with international good practices and EU standards. |

| | |
|---|---|
| Risks and Risk Mitigation | The proposed Financial Sector Policy-Based Guarantee (FSPBG) is a high risk operation. The key risks are as follows:<br><br>1. ***Economic risk*** is substantial, given Montenegro's small size and external vulnerability and, importantly, a highly uncertain and volatile external environment. Both external and public debt levels remain elevated, and the heavy dependence on external financing has made the economy vulnerable. Growth recovery coupled with the ongoing fiscal consolidation efforts moderated the imbalances. However, another global turmoil may reverse these trends. This could jeopardize the achievement of planned medium-term macroeconomic and social outcomes. The ongoing deleveraging of the financial sector makes growth vulnerable to a slowdown in capital inflows. Finally, given the small size of the country, even a small shock may have a sizeable impact on the economy. The Government's substantial fiscal consolidation, building of fiscal reserves, and deepening structural reforms as well as the mobilized financing for its 2012 program provide important mitigation framework. Given the quarterly profile of the Government's financing needs, which are concentrated in the first half of 2012, the timing of the proposed FSPBG in the first half of 2012 is important as it will help mitigate the external risks and financing pressures.<br><br>2. The ***risk of financial instability*** is high given the banking sector risk exposures and the possibility of adverse external shocks. Deposits have still not recovered to pre-crisis levels and are being significantly reallocated across banks. Nonperforming loans in the system have peaked in August 2011 and then declined as banks sold their bad loans to asset management companies. However, stock of bad debt in the real economy remains a challenge. Several systemically important banks remain fragile. Of special concern is Prva Banka, which remains vulnerable and lacks the support from a strong foreign parent bank or strategic investor. At the same time, this bank has been reduced in size in an orderly fashion from the third largest to a medium-size bank in the system. This risk is directly mitigated by the policy reforms supported by the operation including strengthening systemic risk monitoring and the crisis management framework; continued efforts to bring problem banks to sound financial conditions under appropriate supervisory arrangements; completing the restructuring of Prva Banka; further strengthening the deposit insurance scheme; and aligning the regulatory framework in the banking sector with EU best practice.<br><br>3. ***Governance risk.*** Montenegro has a solid track record of institutional, structural and social reforms and key indicators show |

| | |
|---|---|
| | gradual improvements in recent years. Nevertheless, a slowdown in the progress on governance improvements could undermine Montenegro's path toward EU accession and thus threaten its efforts to achieve long term macroeconomic and financial sector stability. The EU and domestic observers have raised concerns in the past about the lack of transparency, judiciary, and possible influence exercised by organized crime. With encouragement from the EU and other international observers (including the Bank), the Montenegrin authorities have been making a concerted effort to strengthen government effectiveness in these areas and correct this perception. Specifically, the legislative changes and more robust monitoring, and inspection and supervision efforts supported by this operation are expected to strengthen the regulator's standing and improve governance standards in the financial sector.<br><br>4. ***Implementation risk.*** Implementation of the program is dependent on consistent collaboration amongst authorities, especially between the MoF and the CBCG. These two economic agencies have strong economic teams and routinely communicate, discuss, and coordinate fiscal and financial sector policies. With the new legislative framework now in place, the CBCG will need to use its improved mandate to enforce prudential norms, encourage higher capital and liquidity buffers, and take appropriate supervisory measures for banks of special concern. To mitigate implementation risks, the Bank has promoted an inclusive, consultative approach in designing the program. Through a series of technical consultations involving both the CBCG and MoF, the team has sought to foster a mutual understanding and agreement on the content of the reforms. Judging by the recent progress with the reform program, it appears that regulator's actions are fully coordinated with, and supported by the Government, without jeopardizing the CBCG's operational independence. There is also a risk that the implementation of politically sensitive and technically complex reforms in the financial sector may stall or even backtrack following the approval of this FSPBG. To mitigate this risk, the prior actions for the proposed operation entail tangible steps that would be hard to reverse. Finally, adding to the implementation risk, Montenegro is vulnerable to natural (e.g., earthquakes, floods) and climatic risks as evidenced by the ongoing, extraordinarily cold winter, which resulted in the state of emergency in February 2012, which could affect economic activity and spending priorities. |
| Operation ID | P130157 |

**INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT PROGRAM DOCUMENT FOR A PROPOSED FINANCIAL SECTOR POLICY BASED GUARANTEE**

# I. INTRODUCTION

1. **This document describes a proposed EUR60 million (US$79.2 million equivalent) Financial Sector Policy Based Guarantee (FSPBG) to Montenegro in support of a comprehensive banking sector reform program.** The objective of the operation is to support the authorities' efforts to strengthen the banking system and increase its resilience to possible future shocks by continuing to undertake sectoral policy reforms and system restructuring. The specific objectives of the Government's reform program are to: (i) strengthen systemic risk monitoring and the crisis management framework, (ii) address banking sector vulnerabilities, (iii) complete the restructuring of Prva Banka, (iv) enhance depositors' confidence, and (v) further improve the regulatory framework for the banking system. The program supported by the FSPBG has been implemented primarily by the Ministry of Finance (MoF) and the Central Bank of Montenegro (CBCG).

2. **The objectives of the FSPBG are consistent with the key priorities laid out in the current Country Partnership Strategy (CPS).** The FY11-FY14 CPS for Montenegro, endorsed by the Board in January 2011, envisages a series of two programmatic financial sector development policy loans (DPLs). The first operation was approved in September 2011, and the second DPL has been converted into a stand-alone financial sector PBG. The proposed FSPBG falls under the first of the two main CPS priority areas, as one of its key outcomes is expected to be "a stronger banking system governed by a modern regulatory framework and central institutions, which is more resilient to future shocks."

3. **The FSPBG is proposed considering the country's strong track record in institutional, structural, and social policy reforms, an adequate track record on macroeconomic management, and a satisfactory external financing plan.** Since independence in 2006, Montenegro has implemented a range of institutional and structural reforms required of an aspiring European Union (EU) member country. Recognizing the important progress with structural reforms so far, Montenegro became a candidate country and on October 12, 2011, the European Commission (EC) recommended the opening of formal membership negotiations for Montenegro. Further, Montenegro was granted membership in the World Trade Organization (WTO) in December 2011 and in May 2012, it became 154$^{th}$ member of WTO, and the country is expected to open the first chapters in membership negotiations with the EU in June 2012. During the 2007-2008 period, the Government and the Central Bank implemented macroprudential policy measures to limit the credit boom and Montenegro ran fiscal surpluses and repaid some expensive debt. But, in the presence of increasing government

revenues, it also raised previously compressed capital expenditures on basic infrastructure and allowed some increases in public consumption, which added to overheating pressures. Given Montenegro's full euroization and thus the absence of a monetary policy instrument, the country was unable to fully contain the impact of large inflows and build-up of risk exposure during the 2007-2008 global boom. In response to the global crisis, since 2009, the Government has been pursuing a program of fiscal consolidation and financial sector reforms. Facing the spillovers of the global financial crisis, the authorities responded with extraordinary measures and managed to contain the financial turmoil in the banking sector, including stabilization of the systemically important Prva Banka that had a central role in the excessive credit growth during the pre-crisis period. This Government's program merited the first Bank-supported Financial Sector Development Policy Loan (FSDPL1) that was approved in September 2011 and successfully disbursed in February 2012.

4. **Amidst the Eurozone turmoil and in volatile financial markets, the proposed FSPBG will enable Montenegro to raise the desired volume of funding under acceptable terms, and thus cover the financing gap for 2012:**[1]

- **The Guarantee approach is most beneficial for countries like Montenegro that find themselves with this level of impaired access to market funding, particularly during periods of market turbulence.** The PBG of EUR60 million will facilitate Government efforts to raise EUR80-100 million in funding that can help cover the financing gap. At the beginning of 2012, yields on Montenegro's outstanding bonds, which have three and four years remaining maturities, stood at about 10.5 percent. These have since fallen somewhat, to just under 9 percent, representing some marginal improvement in risk perception. Yet, these assets are infrequently exchanged, and caution should be taken in interpreting yields on illiquid bonds. Moreover, for a bond issue of the size and tenor of the proposed operation, the estimated cost to Montenegro would still be 9.5-10.0 percent in current markets, provided that the "risk on" phase currently underway continues. The Guarantee and the guaranteed debt's structure will provide the security required by lenders to extend credit to Montenegro in the desired volume and under acceptable terms, in still volatile markets. The overall transaction will concentrate the full guarantee coverage on a final balloon payment at maturity, and allow unsecured borrowed amounts to be amortized in preceding years.

- **The FSPBG will be used to leverage significant private sector resources, with only 60 percent of principal risk covered**, or roughly 50 percent of the cash flow risk for investors, in a transaction targeting EUR100 million. Hence, there is a significant "crowding-in" of the private sector envisaged, even more than observed in the Serbia and Macedonia transactions undertaken last year – where 85 percent and 65 percent, respectively, of cash flow risks were covered by the IBRD guarantee. A transaction targeting EUR80 million would have leverage similar to levels achieved in Macedonia's borrowing. Although Montenegro can obtain a competitively priced

[1] In line with the IBRD's policy on PBGs, the proposed operation: i) provides incremental market access; ii) leverages the Bank's capital better than a DPL; and iii) improves Montenegro's borrowing terms considerably.

loan (DPL) from the World Bank in the amount of US$20 million (approximately EUR15 million), unsecured market borrowing may not materialize under any acceptable terms in the current volatile market environment. Additionally, through a PBG, IBRD capital may be recycled much more quickly than would occur in the case of a DPL, with longer maturity. By tying up IBRD capital for only five years, resources are made available sooner for other development initiatives in Montenegro.

- **The FSPBG-supported bank loan would likely cost Montenegro around 5-6 percent, generating a savings of as much as 4 percent per annum over the life of the loan.** The IBRD Guarantee approach strikes the best balance between tradeoffs of tenor, size and participation by the private sector. For a bond issue of the size and tenor of the proposed operation, the estimated cost to Montenegro would be roughly 9.5-10.0 percent in current markets. Market soundings for the PBG-supported bank loan suggest that the cost to Montenegro, including the guarantee fee, would be in the order of 5-6 percent, a saving of roughly 4 percent per annum over the life of the loan. This operation compares favorably with the savings achieved in the Serbia and Macedonia operations, which were of the same magnitude, but had a higher percentage of their cash flows guaranteed. Although the pricing specifics for Montenegro have improved slightly in recent weeks, the future is still very uncertain and pursuing an unsecured transaction, such as a plain vanilla bond issue, would be not only costly but also risky from an execution perspective. This operation, therefore, supports refinancing risk management of the authorities, by providing access to source of financing that is to some extent insulated from market volatility.

## II. COUNTRY CONTEXT

### A. Pre-Crisis Developments and the Crisis Impact

5. **Montenegro's development over the past 10 years had three distinct phases**. The first phase was the period from the introduction of the euro in 2002 to independence in 2006, which was characterized by gradually improving macroeconomic environment, solid macroeconomic management and reforms. The second phase was the period of an unsustainable, short-lived boom in 2007 and 2008, which ended abruptly following the collapse of the Lehman brothers in September 2008. During this phase, the conduct of macroeconomic policy was mixed: macro-prudential policy measures could have been taken sooner and more aggressively to contain domestic credit boom and risk exposure. In addition, the Government should have contained demands for increases in public consumption to avoid adding to the overheating pressures being experienced by the Montenegrin economy. The failure to do so, together with the expansion of the public investment program to address large and long-standing underinvestment in infrastructure, increased total government expenditures by over 9 percentage points of GDP during 2008. The third phase began in 2010 when the Government, in response to the crisis, adopted a sounder macroeconomic policy posture and took fiscal and financial sector measures to stabilize the economy, to restructure and strengthen the supervision of the banking system, and to limit the social impact of the crisis.

6. **During the first phase, following the adoption of the euro as legal tender in 2002, Montenegro's inflation and interest rates fell and reforms accelerated.** By late 2006, Montenegro's economy found itself increasingly flushed by a large inflow of external capital, which financed an economic, real estate, and credit boom. Foreign firms and individuals (many from Russia, the United Kingdom and other countries in Western Europe) acquired significant local assets, mainly land, housing, and other real estate.

7. **During the second phase, large capital inflows fueled a local credit boom, and government spending increased, adding to the overheating pressures.** The general government was running surpluses of about 4 percent of GDP on average in both 2006 and 2007. But with a large revenue windfall, spending went up from 42 percent of GDP in 2006 to over 50 percent of GDP in 2008, mainly driven by a surge in capital expenditure, partly catching up from years of underinvestment in basic infrastructure. Current expenditures increased as well, especially wages and current transfers. During this boom period, Montenegro had one of the highest economic growth rates (9 percent) and per capita foreign direct investment (FDI) in Europe, and the gross fixed investment-to-GDP ratio averaged 37 percent over the same period. The overheating resulted in the widening of the current account deficit, albeit financed to a significant degree by large FDI inflows.

8. **In the third phase, as the real estate and credit bubble burst, domestic credit flow and liquidity suddenly stopped and the Montenegrin economy went into recession in 2009.** Growth plummeted, from almost 7 percent in 2008 to -5.7 percent in 2009, one of the sharpest growth declines among European and Central Asian economies. External demand (in particular for aluminum and steel) dropped, while liquidity problems in the financial and corporate sectors escalated. Total employment declined by almost 7 percent from the second half of 2009 to end-2010, despite a gradual moderation of wages and shortened working hours. Unemployment increased to 16.5 percent in 2010.[2] As a result, the absolute poverty rate doubled to close to 7 percent in 2010.

9. **In response, the Government implemented emergency financial, fiscal and social measures to stem the impact on the economy while continuing EU-accession related structural reforms.** An announcement of a bank deposit guarantee in October 2008 stopped the run on deposits. The Central Bank responded with a menu of measures aimed at easing the liquidity crisis while strengthening inspection and supervision. On the fiscal front, the Government implemented cuts in nominal wages and increased spending on active labor market programs targeting the youth and new job entrants. It also began preparing the ground for a significant further tightening of the budget in the considerably changed external environment.

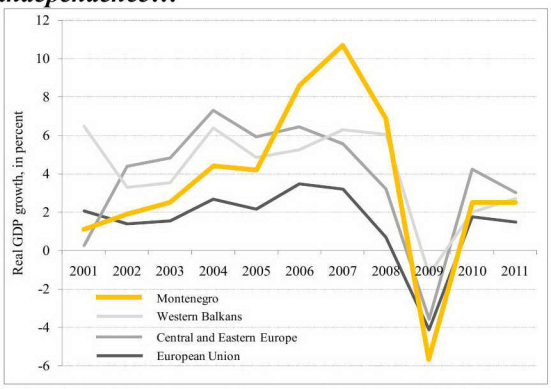
10. **With a sharp drop in economic activity, domestic demand and imports, a significant external adjustment took place from 2009 onwards.** The current account deficit declined by half between 2008 and 2010, but remained high at about 25 percent of GDP in 2010. But this should be seen in the context of the small size of Montenegro's

[2] This was largely due to the implementation of the social program at Aluminum Company (KAP) and affiliated companies, which cut the work force by half from the pre-crisis level of more than 4,000 workers.

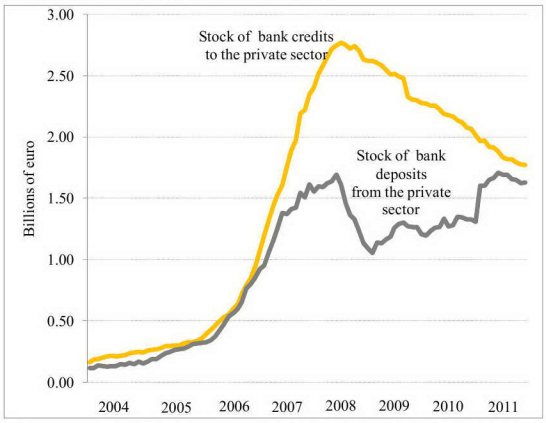
economy and the fact that during 2006–2010, net FDI financed on average 70 percent of the current account deficit. Since Montenegro's economy is significantly foreign owned and euroized, the external current account deficit corrected for the net FDI flows is a better measure of the external account position and financing pressures. This measure shows more moderate, though still high deficit levels in the order of 10-12 percent of GDP (except in 2008, Figure 2). Access to capital was retained through foreign banks' increased financial support to their Montenegrin subsidiaries, which contributed to the rise in private external debt to about 60 percent of GDP, while total external debt (public and private) rose to close to 102 percent of GDP in 2010.

**Figure 1: Montenegro: Crisis and Its Aftermath**

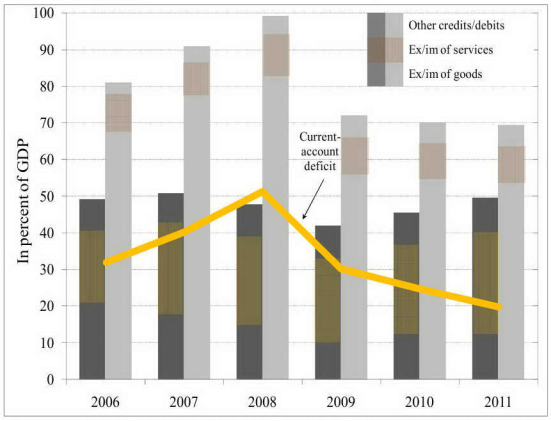
***Rapid growth following country's independence…***



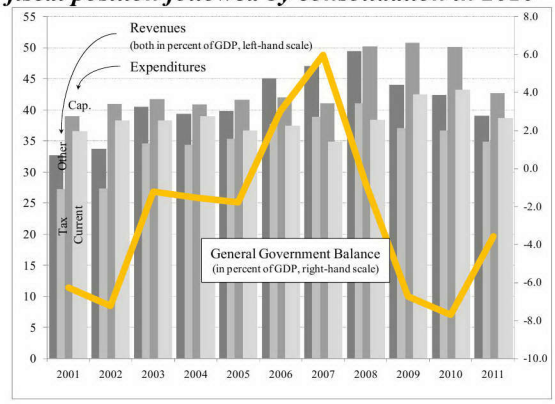

***…driven by external capital inflows as well as credit and real estate booms…***




***…led to a build-up of external vulnerability which was…***

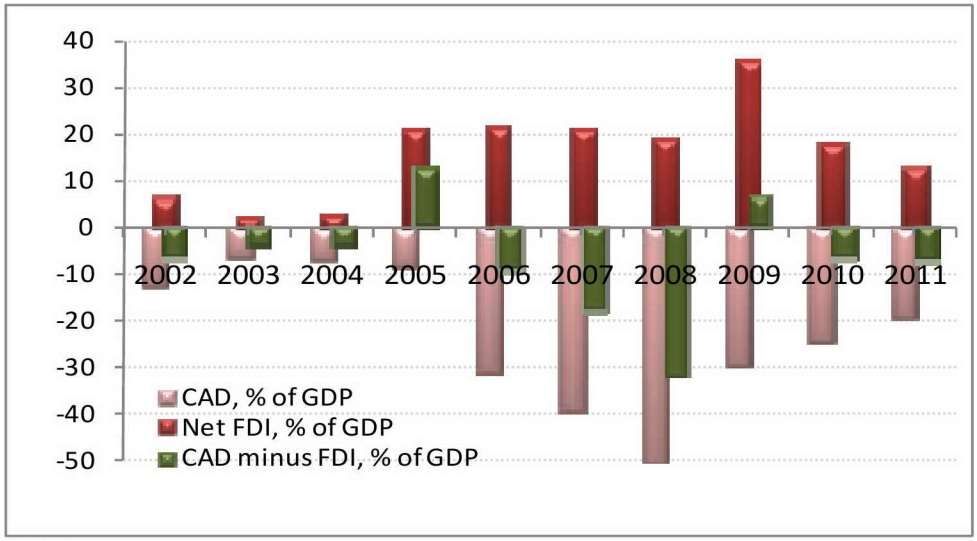



***…accompanied by a rapid deterioration in the fiscal position followed by consolidation in 2010***




*Source: MONSTAT, CBOM, MOF, staff calculations.*

**Figure 2: Montenegro: External Current Account Deficit (CAD)—Standard Measure, CAD Corrected for FDI, and Net FDIs**




*Source: CBCG.*

## B. Recent Economic Developments

11. **Gradual economic recovery and external adjustment ensued in 2010-2011**. In this period, growth averaged about 2.5 percent per year (Table 1). The 2011 growth was broad-based, supported by improving terms of trade and a good tourist season. However, the sluggish recovery of credit and labor markets continues to constrain the economic recovery.[3] The rise in global commodity prices and excise taxes, as well as the recovery of domestic demand led to a moderate rise in inflation from 0.5 percent in 2010 to 3.1 percent in 2011. With growth and import recovery, the external adjustment continued in 2011. The current account deficit (CAD) declined to below 20 percent of GDP in 2011. This was mostly due to a surge in exports of goods (led by aluminum and electricity) and services. Imports recovered moderately by 11 percent over the same period. The FDI-to-CAD ratio still stood at 61 percent. Despite difficult external conditions, the Government was able to issue first Eurobonds to cover the financing needs.[4]

[3] Reflecting the process of deleveraging taking place in Montenegro, inter-enterprise arrears reached 11.3 percent of GDP in December 2011 and the private sector has accumulated tax arrears in the amount of about 6 percent of GDP.

[4] A five-year, €200-million Eurobond was issued in September 2010 at a rate of 7.875 percent, was followed by another €180-million Eurobond in April 2011 at 7.375 percent after receiving a positive outlook on the reconfirmed credit rating by Moody's (at Ba3).

**Table 1: Montenegro: Key Economic Indicators, 2006-2011 (percent of GDP)**

| | 2006 | 2007 | 2008 | 2009 | 2010 | 2011prel |
|---|---|---|---|---|---|---|
| Real GDP growth (%) | 8.6 | 10.7 | 6.9 | -5.7 | 2.5 | 2.5 |
| Consumer prices (period average, %) | 3.0 | 4.2 | 7.4 | 3.4 | 0.5 | 3.1 |
| Gross national savings | -5.9 | -5.4 | -10.0 | -2.4 | -1.8 | 3.6 |
| Gross investment | 25.4 | 32.3 | 40.6 | 27.1 | 22.8 | 22.9 |
| **Fiscal sector** | | | | | | |
| Revenues and grants | 44.6 | 46.3 | 49.4 | 44.0 | 42.4 | 39.0 |
| Expenditures | 42.0 | 41.0 | 50.2 | 50.7 | 50.1 | 42.6 |
| Primary fiscal balance | 4.1 | 7.0 | 0.0 | -5.9 | -6.7 | -2.1 |
| Overall fiscal balance | 2.6 | 5.3 | -0.7 | -6.7 | -7.7 | -3.6 |
| Public Debt | 32.6 | 26.3 | 32.4 | 41.8 | 51.0 | 56.9 |
| o/w Public guarantees, % of GDP | 0.0 | 0.0 | 3.4 | 3.6 | 10.1 | 10.7 |
| **External sector** | | | | | | |
| External Debt | 58.3 | 79.3 | 97.7 | 102.8 | 101.6 | 100.7 |
| Private debt, % of total | 49.8 | 71.7 | 77.3 | 71.1 | 61.1 | 56.2 |
| Current account balance | -31.3 | -37.7 | -50.6 | -29.6 | -24.6 | -19.4 |
| Foreign Direct Investment (net) | 21.9 | 20.2 | 18.9 | 35.8 | 17.8 | 11.9 |
| **Memo item:** | | | | | | |
| Alternative measurement of the overall fiscal balance 1/ | 2.6 | 6.7 | -3.1 | -5.3 | -4.7 | -6.3 |

*Note: External debt does not include intercompany debt. External private debt does not include any private debt guaranteed by the state which is recorded under public external debt.*
*1/ The government's overall fiscal balance records guarantees at the time that they were issued, which is when they had much of their demand impact on the economy; the alternative measure of the fiscal balance records guarantees when they are called (see footnote 12 for a more detailed discussion).*
*Source: MONSTAT, CBOM, MOF, IMF Staff Report April 2012, and World Bank staff calculations.*

12. **The Government started fiscal consolidation in 2010-11.** On the fiscal side, the Government pursued a strong adjustment, mostly on the expenditure side: by 2011, the Government had cut total public expenditures by about 8 percentage points of GDP from its peak in 2009 (Table 1)[5]. A freeze in public sector wages, staffing rationalization, and expenditure restraint in operations and maintenance costs, and the capital budget helped reduce spending so that the government deficit is estimated at about at 3.6 percent of GDP in 2011. This was achieved despite the declining revenue-to-GDP ratio and a rise in tax arrears, the bankruptcy of the steel mill that triggered a call on government guarantee equivalent to 0.8 percent of GDP, and increases in military pensioners as part of the adjustment in the context of the Government's efforts towards NATO membership. Total public debt in 2011 reached 56.9 percent of GDP, including guarantees. External private debt declined, dropping by 20 percentage points of GDP from 2008, reflecting significant deleveraging.

13. **In parallel, the Government intensified its efforts to promote competitiveness, recognizing the criticality of structural reforms and investment climate.** This included improvements in: (i) the Doing Business 2012 indicators, which

[5] The public expenditures have been adjusted upwards in 2009 and 2010 to include the issued guarantees to the steel mill and the aluminum companies which were called in 2011 and 2012; when guarantees were issued is when these had the largest demand impact (see footnote 12 for further details).

ranked Montenegro as 56th from among 183 rated countries, second most favorable rating in the Western Balkans after FYR Macedonia; (ii) labor market regulations, through the passage of the new Labor Law; (iii) restructuring and privatization of non-strategic state-owned companies, (iv) simplifying business and tax registration under the one-stop-shop concept; (v) reducing complexity and time to obtain construction permits; (vi) adopting new bankruptcy and enforcement laws; and (vii) reducing non-tax fees and the time necessary for connection to electricity grids. In 2012, the Government is deepening these reforms by introducing a Regulatory Impact Assessment, finalizing the regulatory guillotine work, and further simplifying business licensing.

14. **Social sector reforms, in which Montenegro is among the more advanced countries in the ECA region, continued.** After previous increases in the retirement age, the latest amendments to the Pension Insurance Act in 2011 resulted in automatic annual increases in the retirement age from 60 (women) and 65 (men) to 67 for both men and women by 2040. The authorities introduced amendments to the Labor Law to reduce dismissal costs and simplify hiring. The Parliament has also adopted: (i) the amendments to the Law on Social Security to introduce a voluntary insurance premium to cover 20 percent of the basic health package, which would otherwise be subject to copayments, and (ii) the amendments to the Law on Child Care, which limit the maternity leave benefits at the average wage. The aim of these measures is to ensure fiscal sustainability and limit work disincentives since the labor force participation and employment rates (at 60 and 56 percent, respectively) are low in Montenegro. Notably, owing to past technical assistance, including from the World Bank, Montenegro has one of the best targeted and fiscally affordable social assistance systems in Europe and Central Asia.

## C. Banking Sector

### *Pre-Crisis Development*

15. **Montenegro's banking system had experienced a particularly strong credit boom prior to 2008 financed by parent bank lending.** Total credit grew by 145 percent annually on average in 2006 and 2007, increasing from 39 percent of GDP to 84 percent of GDP, and was concentrated particularly in the real estate sector.[6] The high credit growth was coupled with lax credit underwriting standards that led to a large accumulation of credit risk in banks' loan portfolios; much of this credit increase was financed by parent bank lending, resulting in high liquidity risk exposures. Funding from parent banks increased significantly from 8 percent of total liabilities in 2006 to 21 percent in 2008. And as a result, the loan-to-deposit ratio (LTD) ratio increased from 79 percent in 2006 to 150 percent in June 2009.

16. **The CBCG as a prudential supervisor implemented several regulatory measures to curb the credit boom.** In 2006 and 2007, the CBCG widened the deposit base subject to reserve requirements to include savings deposits, and differentiated the reserve requirement rate for demand (19 percent) and savings (5 percent) deposits. The

[6] A large portion of the increase in real estate development financing was driven by the surge in tourism and development of the tourism sector.

main restrictions imposed by means of regulatory measures concerned quantitative limitations to credit growth of the largest banks, which were introduced in 2007. The aim was to both slow down credit growth and improve the maturity structure of banks' deposit financing. Further, a new Banking Law was adopted and further implemented in early 2008. The aim was to increase banks' capitalization, and to improve the quality of supervision. Credit growth slowed down in 2008 in response to the prudential measures, however, banks became concerned about their deteriorating liquidity position as the global financial crisis unfolded at the same time.

17. **But in the absence of monetary policy instruments, more could have been done through macroprudential policy.** Given Montenegro's full euroization, monetary policy was not available as a tool to curb the increasing risk associated with fast credit growth. Although macroprudential policy instruments were not widely used by policy makers at that time, some successful examples in the region existed (e.g. Poland and Croatia). Therefore, at least from an ex-post perspective, more could have been done using macroprudential policy tools to manage the capital inflows to the banking sector and the accumulating risk exposures.

***Crisis Impact***

18. **The rapid expansion came to a halt and Montenegro experienced a severe credit crunch with the onset of the global crisis in late 2008.** Total bank assets that stood at 111 percent of GDP by end-2007 have been contracting since 2008 (Table 2). The credit crunch reached its peak in 2009 with a 14 percent decline year on year, due to banks' rising asset quality problems and a decline in demand for loans from a corporate sector affected by the weakening economy. The availability of parent bank credit declined and Montenegro's banks were forced to adjust their liquidity risk exposures. Borrowings from parent banks as a share of total liabilities dropped from 20 percent (21 percent of GDP) in 2008 to 13 percent (11 percent of GDP) in 2011. Consequently, the system's LTD decreased from 150 percent in June 2009 to 108 percent by December 2011. Further, as banks have focused on cleaning up their balance sheets in 2010 and 2011, credit continued to decline throughout 2010 and 2011 (Table 2).

**Table 2: Basic Indicators of the Banking System**

| | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|---|
| Number of Banks | 10 | 10 | 11 | 11 | 11 | 11 |
| Number of Foreign Banks | 7 | 7 | 9 | 9 | 9 | 9 |
| Asset/GDP | 67 | 111 | 107 | 102 | 97 | 88 |
| *Assets Growth y/y* | 106 | 108 | 11 | -8 | -3 | -4.5 |
| Deposits/GDP | 50 | 78 | 65 | 61 | 59 | 57 |
| *Deposit Growth y/y* | 120 | 94 | -5 | -8 | -2 | 1.5 |
| Credit/GDP | 39 | 84 | 91 | 80 | 73 | 67 |
| *Credit Growth y/y* | 125 | 165 | 25 | -14 | -8 | -8 |

*Source: CBCG*

19. **The weak condition of banks shattered depositors' confidence, and increasing non-performing loans (NPLs) made banks draw down on capital buffers.** A massive withdrawal of deposits undermined the banking system's liquidity in late

2008. Between September 2008 and 2011, the banking sector lost more than 21 percent of its total deposits. The system's liquid assets to short term liabilities ratio reached a low of 21 percent in 2008.[7] As a consequence of rapidly increasing NPLs[8], nine out of 11 banks had to be recapitalized by their shareholders, as bank profitability turned strongly negative (ROE at -10 percent) at the same time, reaching its low of -27.1 percent in 2010 (Table 3).

20. **Parent banks supported their Montenegrin subsidiaries with necessary liquidity support and substantial capital injections**. This helped partially offset declining domestic deposits and capital erosion. Importantly, the parent banks provided about EUR230 million in new capital from end-2008 to March 2011. The bank liquidity situation was also helped by large cash inflows from partial privatization of electricity production and distribution.

**Table 3: Key Prudential Indicators of the Banking System**

| | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|
| **Liquidity** | | | | | |
| Liquid assets to short term liabilities | 32.0 | 20.9 | 25.8 | 32.9 | 32.8 |
| Liquid assets to total liabilities | 24.4 | 12.0 | 17.1 | 21.4 | 22.4 |
| **Capital Adequacy** | | | | | |
| Regulatory capital to risk-weighted assets | 17.1 | 15.0 | 15.8 | 15.9 | 16.5 |
| Capital to Assets | 8.0 | 8.4 | 11.0 | 10.6 | 10.9 |
| **Asset Quality** | | | | | |
| NPLs/loans | 3.2 | 7.2 | 13.5 | 21.0 | 15.5 |
| Provisions/ NPLs | 73.6 | 55.6 | 43.3 | 30.7 | 32.8 |
| NPLs net of provisions, in percent of capital | 20.8 | 46.9 | 52.5 | 102.8 | 66.9 |
| **Earnings and Profitability** | | | | | |
| ROA | 0.7 | -0.6 | -0.7 | -2.8 | -0.1 |
| ROE | 6.2 | -6.9 | -7.8 | -27.3 | -1.1 |

*Source: CBCG*

21. **An emergency anti-crisis Law on Measures for Protection of the Banking System (MPBS) was implemented in October 2008 as a policy response to the crisis situation.** The provisions of the MPBS Law were generally consistent with crisis responses seen in other countries, giving the Government the authority to: (i) fully guarantee the deposits of all individuals and legal persons; (ii) facilitate credit guarantees for interbank loans; (iii) provide emergency liquidity support to a bank for a period of up to one year; (iv) upon a bank's request, make a prepayment of state borrowings from that bank (including loans carrying a government guarantee); and (v) provide funds for a bank's recapitalization, to protect the banking system's stability. The Law also allowed

[7] The minimum liquidity ratio (liquid assets to due liabilities) required by the regulation is one. The ratio is calculated as an average over all working days in a ten-day period. Liquid assets include cash and near cash. Due liabilities include: loan payables; interest and fee payables; due time deposits; 30 percent of demand deposits; 10 percent of liabilities for granted but not-performed irrevocable loan liabilities (credit lines); other due liabilities.

[8] The rapid rise in NPLs during 2010 was driven by several factors, including: (i) the contraction in total loans as banks ceased lending; (ii) large banks (particularly CKB and Hypo) "cleaning" their loan portfolios in 2010 in anticipation of spinning off large volumes of NPLs to their foreign parents, and (iii) Prva Banka's delayed recognition of its NPLs.

the CBCG to: (i) approve the use of required reserves; and (ii) use up to 50 percent of its capital for granting short-term loans to banks.[9] The MPBS served its intended purpose and expired at the end of 2009. Furthermore, a number of banks benefited from state guarantees given by the MoF for credit lines provided by the European Investment Bank (EIB) and KfW totaling EUR122 million to support lending to small and medium enterprises (SMEs).

22. **Prva Banka - the largest domestically owned bank - experienced the most significant outflow of deposits and was the only bank to receive emergency support from the State.** A controlling interest in Prva Banka was acquired in 2006 by a group of local investors related to the then Prime Minister. Subsequently, the bank's assets grew explosively (by 1,600 percent from 2006 to end-2008) to make it the country's second largest bank and the only domestically owned bank of systemic importance. Following a massive outflow of deposits, the bank started to experience severe liquidity problems at the end of 2008 that threatened to undermine confidence in the entire banking system.

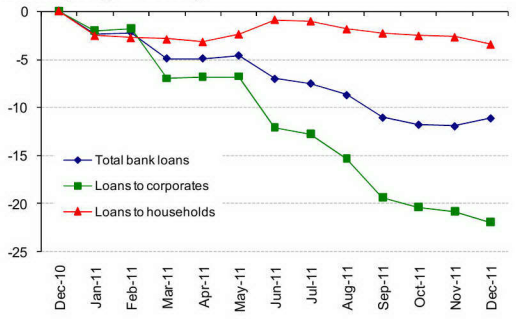
23. **Faced with chronic asset-liability mismatches and the rapid withdrawal of deposits, Prva Banka ceased to function as a normal commercial bank as of the fall of 2008, when the CBCG imposed a freeze on new lending activities.** The management of the bank was replaced in late 2008, at the same time as Prva received a EUR44 million emergency loan from the Government of Montenegro (GoM). The loan was repaid in 2009, but underlying asset quality problems remained, with a negative impact on the bank's capital position. The bank also continued to rely heavily on deposits from the Central Government and other majority state-owned entities. The authorities have been implementing a comprehensive restructuring strategy for Prva Banka (see Section III and Section V), including a staged withdrawal of Government deposits and recapitalization of the bank.

***Recent Developments***

24. **Banks are completing their recapitalization efforts and focusing on decreasing their liquidity risk exposures by trying to raise more local deposits.** Due to the low collections from loans, many banks faced liquidity pressures and have thus been striving to reduce their liquidity risk exposures by raising more local deposits. In the first three quarters of 2011, deposits showed some signs of recovery increasing around 6 percent and mirroring slow improvements in the overall economy with a slowdown towards the year end (Figure 4). As a result of previous recapitalization efforts, the capital adequacy ratio (CAR) of the system stood at 16.5 percent as of December 2011, above the prudential minimum requirement of 10 percent.

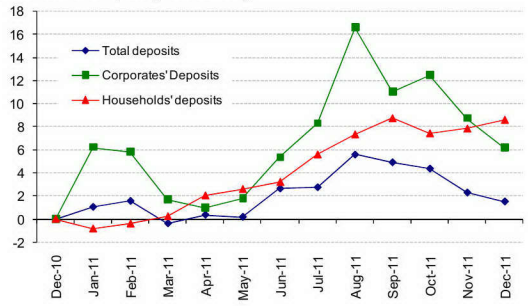
[9] CBCG was proactive in introducing a number of temporary changes in prudential regulations to respond to the special challenges presented by the global financial crisis, such as lowering reserve requirements to ease liquidity pressures on banks and revising loan loss provisioning rules to facilitate loan restructuring.

**Figure 3: Cumulative Credit Growth as of 2011 (in percent)**




*Source: CBCG*

**Figure 4: Cumulative Deposit Growth as of end-2011 (in percent)**




*Source: CBCG*

25. **Mid-size banks that were conservative during the credit boom lead the new lending activity, supported by direct booking of loans with parent banks.** Banks have tightened credit standards in light of the uncertainty from the on-going economic slowdown in the Eurozone and the still high NPL levels in the system. Banks with low NPLs continue increasing their lending while those with high NPLs have reorganized internally to work out NPLs with clients and resume stronger lending activity in the short-term. By December 2011, aggregate annual credit growth was still negative, but very heterogeneous across individual banks, ranging between -17 percent and 20 percent. Especially healthier, midsize banks have been growing their loan portfolios. The NPL situation that hinders lending at some banks is complicated by the stock of bad debt and payment arrears in the real economy, and overall bottlenecks in the insolvency and debt restructuring legal frameworks.[10] The limited amount of new lending to the economy is concentrated in consumer lending and SMEs (including self-employed) as banks try to diversify their loan portfolios away from large enterprises (Figure 3). There are also indications of an increase in cross-border claims on the Montenegrin non-banking sector (at 33 percent year-on-year by September 2011), suggesting that domestic clients access directly parent bank financing.

26. **As of end-2011, the priorities for Montenegro's banking sector are continued strengthening of banks' capitalization and liquidity positions, and resolution of the NPL stock in the economy.** Although banking system profitability is bouncing back to positive territory in Q1 2012, the financial soundness indicators suggest that the banking sector is still to find a decisive recovery trend. Thus, restoring soundness across the system remains a priority in order to fully resume new lending to creditworthy enterprises and projects. In this regard, through the recently strengthened legal framework, the CBCG is adequately empowered to foster financial stability, and the authorities have been developing contingency plans in the view of the Eurozone crisis to be able to cope with any future external shocks.

[10] The Montenegrin authorities have recently requested assistance from the World Bank to diagnose the situation and implement reforms that would aid the workouts of current bad debts and prevent their excessive build-up in the future.

## D. Macroeconomic Outlook and Debt Sustainability

### *The Government's macroeconomic and fiscal program*

27. **Real GDP is projected to slow down to 0.5 percent in 2012, but recover to 3-3.5 percent over the medium term, supported by FDI in energy, tourism and construction (Table 4 and Table 5).**[11] The growth outlook for 2012 has been revised downwards from what was envisioned at the time the original 2012 budget was approved and reflects the deteriorating external environment facing countries that are closely integrated to Western Europe. On April 25, 2012, the Government approved an amended budget to reflect these developments and introduced additional revenue and expenditure measures. The Parliament approved the amended budget on May 24, 2012. This section reflects the revised macroeconomic framework of the amended budget. Over the medium term, growth is expected to become more diversified, driven by moderate domestic demand growth as disposable income rises and investments recover. Investment levels are expected to stabilize at about 21 percent of GDP. With the continued strengthening of the financial sector and gradual firming of economic activity and incomes, national savings are projected to gradually rise to an average of about 8.7 percent of GDP in 2014-2015, reducing somewhat reliance on foreign savings. However, growth recovery will only gradually translate into labor market improvements. The inflation projection is set at 2.5 percent on average throughout 2012-2015 (Table 4).[12]

---

[11] Since last year, the turmoil in the Middle East and Greece has resulted in some diversion of tourist flows to other summer tourist destinations, including Montenegro. Several potential investments are at various stages of discussion, including: (i) a highway connecting the coastline areas to the Corridor X; (ii) hydro-power plants with an undersea energy cable to Italy; and (iii) leasing of several largely undeveloped beaches for the construction and management of high-end tourist facilities. In addition, the privatization of the Port Bar is expected to proceed after the restructuring of the company; the restructuring process is being supported by an EBRD loan (EUR 66 million).

[12] The Government's amended macroeconomic framework, described in this document, reflects the recently revised outlook for growth in 2012-15 and the fiscal measures developed in the budget amendment approved by Parliament in May 2012. Reflecting the Government's recognition of a deteriorating external environment, growth is estimated at 0.5 percent in 2012, significantly below the assumptions in the original budget; the medium term growth is projected to gradually increase towards 3.5 percent by 2015. Also, fiscal outturns record called guarantees in 2011 and 2012 for the steel mill and aluminum company when they were issued (EUR42.2 million to the aluminum company in 2009 and EUR108.3 mill to the steel and the aluminum company in 2010); 2009 and 2010 is when much of the aggregate demand impact of these guarantees took place. The alternative measure of the overall fiscal balance in the tables of this document records these guarantees at the time they were called. The repayment of the called guarantees is treated as public debt repayment from 2011 onwards (following the original repayment schedule) and interest payments are also recorded as they take place. As noted in the IMF's recent Article IV, the fiscal position tightened in 2011 by 0.7 percent of GDP if called guarantees are excluded; the demand boost of these guarantees took place in earlier years (see Montenegro Article IV Consultation, May 2012). In addition, cyclical developments contributed as much as 1.6 percent of GDP to the 2011 fiscal deficit. It is also worth noting that the Government's fiscal accounts adjust cash spending by the rise in net payment arrears using data provided by the Budget Department of the Ministry of Finance while the alternative measure of the overall fiscal balance includes estimates of local government arrears; the latter also contributes to the difference between the two reported measures of the overall fiscal balance.

**Table 4: Montenegro: Macroeconomic Outlook (percent of GDP)**

| Indicators | *Outturn* | | *Projections* | | | |
|---|---|---|---|---|---|---|
| | *2010* | *2011* | *2012* | *2013* | *2014* | *2015* |
| **National Accounts** | | | | | | |
| Real GDP growth | 2.5% | 2.5% | 0.5% | 1.5% | 3.0% | 3.5% |
| Total Investment | 22.8 | 22.9 | 20.3 | 20.7 | 21.1 | 21.1 |
| Gross National Savings | -1.8 | 3.6 | 3.4 | 5.0 | 7.4 | 10.3 |
| Foreign Savings | 24.6 | 19.4 | 16.9 | 15.7 | 13.7 | 10.9 |
| **Public Sector** | | | | | | |
| Primary Balance | -6.7 | -2.1 | -0.2 | 0.5 | 1.2 | 1.8 |
| Interest payments | 1.0 | 1.5 | 2.1 | 2.0 | 2.0 | 1.9 |
| Overall Fiscal Balance | -7.7 | -3.6 | -2.3 | -1.5 | -0.8 | 0.0 |
| **Balance of Payments** | | | | | | |
| Trade Balance | -40.8 | -39.9 | -36.7 | -35.9 | -34.8 | -33.3 |
| Current Account Balance | -24.6 | -19.4 | -16.9 | -15.7 | -13.7 | -10.9 |
| FDI | 17.8 | 11.9 | 14.8 | 14.5 | 14.0 | 13.5 |
| **Debt** | | | | | | |
| Foreign Debt | 101.6 | 100.7 | 97.2 | 95.8 | 92.7 | 91.7 |
| Public Debt | 51.0 | 56.9 | 55.9 | 54.8 | 52.1 | 48.7 |
| Gross Internat. Res. (in months of Imports) | 2.7 | 1.9 | 2.0 | 2.3 | 2.3 | 2.4 |
| *Memo items:* | | | | | | |
| *GDP (EUR millions)* | 3,104 | 3,273 | 3,389 | 3,525 | 3,722 | 3,948 |
| *Inflation (p.a., %)* | 0.5 | 3.1 | 2.5 | 2.5 | 2.0 | 2.0 |
| *Debt service to export ratio* | 39.6 | 40.9 | 43.1 | 32.5 | 31.0 | 39.1 |
| *Exchange rate EUR:US$ (p.a.)* | 0.75 | 0.71 | 0.73 | 0.74 | 0.75 | 0.75 |

*Source: MONSTAT, CBCG, MOF, and staff calculations.*

28. **Recent developments with the aluminum company have also resulted in unexpected budgetary outlays and fiscal risks moving forward.** First, in February 2012, the Government converted the EUR22 million guarantee to Deutsche Bank on a loan to the aluminum company into public debt. The loan was repaid in full and raised Government's current debt service by about 0.67 percent of GDP). Second, the aluminum company, currently majority owned by the Russian CEAC group, had accumulated payment arrears to the electricity company in the amount of EUR28 million and tax arrears of about EUR[20] million, which triggered the Parliamentary request to the Government to launch the cancellation of the privatization contract. The resolution of the contractual terms and future ownership is pending. Third, another potential liability for the budget could arise from the Government's ongoing negotiations with the Hungarian OTP and Russian VTB on rescheduling of the other two guaranteed loans in the amount of EUR42.2 million and EUR60 million, respectively, to the company. While the current loan schedule spreads repayments over a three to five-year period, these pressures together add up to an additional EUR102 million (3 percent of 2012 GDP) public debt service.

29. **As a result of these developments, the Government has intensified its fiscal consolidation efforts to contain the overall fiscal deficit (Table 5).** On the revenue side, the Government in January 2012 increased key excises and the property tax rate, stepped up revenue collection efforts and took steps to expand the tax base, including by reducing exemptions. However, given the weaker growth and revenue outcomes in the

early months of the year, the 2012 budget amendment adopted by the Government in April 2012 and approved by the Parliament on May 24, 2012 raised further excises on alcohol and other products; increased tax on privileged pensions; introduced levies on mobile telephony SIM cards, smoking public place areas, meters measuring electricity, and cable TVs; and additional measures to improve tax compliance. These new measures are expected to generate about 0.6 percent of GDP in additional revenues during 2012. On the expenditure side, a conservative indexation mechanism for wages and pensions has already been adopted and is backed by a formal agreement with the unions on a further reduction of public sector wages and employment. These measures are expected to reduce wage bill[13] and transfers to the social insurance funds but, reflecting the government's careful budget planning, have not been included in the 2012 budget amendment. The budget also includes rationalization of some subsidies (state aid) and social transfers (e.g., labor market programs) and maintenance of critical capital expenditures. The issuance of new government guarantees is limited to EUR10 million (about 0.3 percent of GDP), signaling a shift to a much more restrictive policy towards guarantees. In addition, on the expenditure side, the budget amendment features further cuts in current expenditures by 0.34 percent of GDP and delays in some non-essential capital expenditures that will result in savings of about 0.14 percent of GDP in 2012. Importantly, the primary deficit will also be cut—relative to the 2011 outturn—by 1.9 percentage points to 0.2 percent of GDP. As a result of the downward revision of growth and revenues, the budgetary impact of the recent developments with the aluminum company, and the revised fiscal consolidation package, the fiscal deficit in 2012 is projected to be 2.3 percent of GDP, somewhat higher than the original fiscal deficit of 1.2 percent projected for 2012 but 1.3 percentage points lower than the outturn for 2011.

30. **In parallel to the revised 2012 budget, the Government has adopted additional measures that are likely to generate additional savings.** For example, the government (i) adopted a law on a 7-percent cut in wages of top government officials, diplomats and judiciary; (ii) reduced per diems allowances for official travel by 20 percent; (iii) reduced privileged pensions for sportsmen, and launched a review and revision of disability pensions; (iv) abolished governing boards' allowances in health, social, cultural and educational state institutions; and (v) ordered a reduction in salaries of management at SOEs.

31. **Over the medium term, the amended fiscal framework aims to deepen fiscal consolidation, move towards fiscal surpluses, and reverse the debt dynamics, setting the public debt of Montenegro on a downward trajectory (Table 4 and Table 5).** The Government's objective is to stem further growth in public debt which, along with guarantees, reached 57 percent of GDP in 2011. The medium-term strategy is built on a plan to reduce general government spending by additional 4.5 percentage points of GDP, down to about 38.1 percent of GDP, by 2015 (from close to 53 percent of GDP in

[13] With 12.8 percent of GDP spent on wages, Montenegro stands out as an outlier compared to larger regional economies such as Serbia or Croatia (at 10.5 percent), but is on par with many small states facing higher fixed cost of basic functions of the state. Montenegro's wage bill is similar to Slovenia (12.7 percent) and below Bosnia and Herzegovina (13.1 percent of GDP). Importantly, the centralized wage bill calculation and payment system led to the upward adjustment of the wage bill by roughly 2 percent of GDP on the account of health sector workers' wages, which is not necessarily reflected in regional peers data.

2009)—a reduction in total public expenditures-to-GDP ratio by 13 percentage points over a five year period 2009-13. The Government's long-term objective is to reach the expenditure ratio of about 30-35 percent of GDP. The Government has either prepared or implemented significant measures to further restrain spending and improve its efficiency over the medium term (see Box 1). The most important of these relate to the control of pension increases and moderation of wage bill in line with formal agreements with the labor unions.

**Table 5: Medium-Term Fiscal Framework (percent of GDP)**

| | Outturn 2008 | Outturn 2009 | Outturn 2010 | Preliminary 2011 | Revised Budget 2012 | Projection 2013 | Projection 2014 | Projection 2015 |
|---|---|---|---|---|---|---|---|---|
| **Total Revenues and Grants** | **49.4** | **44.0** | **42.4** | **39.0** | **38.1** | **38.4** | **38.2** | **38.1** |
| **Current Revenues** | **49.3** | **43.5** | **42.2** | **38.8** | **38.0** | **38.3** | **38.1** | **38.0** |
| Tax Revenues | 41.0 | 37.0 | 36.6 | 34.8 | 34.1 | 34.7 | 34.6 | 34.5 |
| Nontax Revenues | 8.3 | 6.5 | 5.6 | 4.0 | 3.9 | 3.6 | 3.5 | 3.5 |
| **Grants** | **0.1** | **0.4** | **0.2** | **0.2** | **0.1** | **0.1** | **0.1** | **0.1** |
| | | | | | | | | |
| **Total Expenditure and Net Lending** | **50.2** | **50.7** | **50.1** | **42.6** | **40.4** | **39.9** | **38.9** | **38.1** |
| **Current Expenditure** | **38.3** | **42.5** | **43.9** | **39.0** | **37.0** | **36.4** | **35.3** | **34.2** |
| Wage Bill 1/ | 11.1 | 11.0 | 11.2 | 13.3 | 12.8 | 12.3 | 11.7 | 11.3 |
| Other purchases of goods and services | 6.7 | 5.8 | 6.5 | 5.7 | 5.9 | 5.8 | 5.6 | 5.5 |
| Interest payments | 0.8 | 0.9 | 1.0 | 1.5 | 2.1 | 2.0 | 2.0 | 1.9 |
| Subsidies and current transfers | 19.7 | 24.9 | 25.2 | 18.6 | 16.3 | 16.3 | 16.0 | 15.6 |
| o/w steel mill and aluminum guarantees 2/ | | 1.4 | 3.5 | | | | | |
| **Capital Expenditure** | 10.1 | 8.4 | 5.6 | 4.6 | 3.4 | 3.5 | 3.6 | 3.9 |
| **Net Lending** | **1.8** | **-0.2** | **0.6** | **-1.0** | **0.0** | **0.0** | **0.0** | **0.0** |
| | | | | | | | | |
| Current Surplus/Deficit | 11.0 | 1.1 | -1.7 | -0.2 | 1.0 | 1.9 | 2.8 | 3.7 |
| Primary Surplus/Deficit | 0.0 | -5.9 | -6.7 | -2.1 | -0.2 | 0.5 | 1.2 | 1.8 |
| **Overall fiscal balance** | **-0.7** | **-6.7** | **-7.7** | **-3.6** | **-2.3** | **-1.5** | **-0.8** | **0.0** |
| | | | | | | | | |
| **Total Financing** | **0.7** | **6.7** | **7.7** | **3.6** | **2.3** | **1.5** | **0.8** | **0.0** |
| Domestic financing (net) | -0.3 | -3.2 | -3.4 | 0.2 | -2.4 | -1.0 | -1.8 | -0.5 |
| Privatization receipts | 1.2 | 4.4 | 0.9 | 0.5 | 0.5 | 0.5 | 0.5 | 0.3 |
| Foreign financing (net) | -0.2 | 5.5 | 8.7 | 3.1 | 4.2 | 2.0 | 2.1 | 0.3 |
| Increase in payment arrears (+) | | | 1.5 | -0.2 | 0.0 | 0.0 | 0.0 | 0.0 |
| **Memo:** Alternative measurement of the overall fiscal balance 3/ | **-3.1** | **-5.3** | **-4.7** | **-6.3** | | | | |
| **Public debt with guarantees** | **32.4** | **41.8** | **51.0** | **56.9** | **55.9** | **54.8** | **52.1** | **48.7** |

1/ From 2011, health sector wages are included under the wage bill (approximately 2 percent of GDP), reflecting reallocation from current transfers.
2/ This expenditure item includes guarantees in the years they were issued. Debt service of guarantees are recorded as they take place; see footnote 12 for a detailed discussion.
3/ The alternative measurement of the overall fiscal balance includes one-time adjustments for steel mill and aluminum company guarantees and records differently government arrears in 2010-2011; see footnote 12 for a detailed discussion.
*Source: Ministry of Finance, IMF Staff Report April 2012, and World Bank staff estimates.*

32. **Beyond fiscal consolidation, the Montenegrin Government plans to continue strengthening competitiveness of its economy and prepare the ground for more robust long-term growth.** This strategy includes: (i) creating fiscal buffers and protecting macroeconomic stability; (ii) continuing restructuring of the financial and real sector; (iii) accelerating structural reforms in social, labor, and education sectors as well as public administration to ensure sustainability of public finances; and (iv) strengthening the enabling environment for private sector growth.

**Box 1: The Government's medium-term fiscal reform measures**

- The **pension system reform**, in line with good international practice, resulted in the increase in the retirement age from 55/60 to 67 for men and women, following automatic adjustments with the transition period of 20 years. The pension indexation was changed to a more conservative 75 percent of CPI and 25 percent of the average wage, a more conservative mechanism than the so-called Swiss formula (50-50).
- The public administration reform through **staff downsizing implemented a "two-for-one" principle**, i.e., one employed for two staff leaving the public sector or three retiring; the central payroll calculation and a wage freeze;
- The **state aid reform**, whereby subsidized electricity to metal industries will cease by end-2012;
- The **rationalization of social security costs and transfers** through capping total health and social benefit expenditures, consolidating insurance funds under the Single Treasury Account, and imposing central oversight of the use of budget funds;
- **Centralized authorization/management of public procurement** and the Single Treasury Account commitment module to prevent further accumulation of arrears;
- Moderation of **capital spending** and their protection to 3.5 percent of GDP throughout the period;
- Drafted amendments to the organic budget act to formally introduce the **Medium-Term Expenditure Framework and the fiscal rule** in 2012; and
- Stepped up efforts in **tax collection and gradual increases in property tax and excise duties** (also required as a part of the EU accession program).

### *External financing requirements*

33. **The resulting fiscal consolidation and the ongoing deleveraging process are expected to reduce external financing needs over the medium term**. The large stock of private sector foreign debt (around 60 percent of total) and corresponding obligations maturing over the medium term suggest significant external vulnerabilities. However, as noted above, private external debt is being reduced significantly through the ongoing process of deleveraging. About 70 percent of the private sector debt is concentrated in a few sectors, such as the financial sector, metals and processing, and construction and real estate. This debt is also owed by a small number of large private, wholly or predominantly foreign owned banks and enterprises, often to their parent affiliates.[14] During 2012-2015, the external financing requirements will amount to about 26 percent of GDP, gradually declining as the economy recovers. Public debt refinancing needs amount around 7 percent of GDP in 2012, of which half is due to domestic creditors. With the proposed FSPBG and the regular disbursement profile, the IBRD might cover around 4.8 percent of GDP of overall gross financing needs. Over the 2012-2015 period, debt service to the IBRD will be around 7.4 percent of total debt service (Table 6).

[14] The highly concentrated private external debt suggests that large parts of the private sector are not heavily indebted.

**Table 6: External Financing Requirements and Sources (in EUR terms, percent of GDP)**

| *Indicators* | *Outturn* | | *Projections* | | | |
|---|---|---|---|---|---|---|
| | *2010* | *2011* | *2012* | *2013* | *2014* | *2015* |
| **Requirements** | 34.1 | 31.8 | 30.8 | 28.8 | 23.6 | 19.5 |
| Current Account Deficit | 24.6 | 19.7 | 17.2 | 16.0 | 14.0 | 11.2 |
| (of which scheduled interest payments) | 6.0 | 5.3 | 5.8 | 5.9 | 5.8 | 5.1 |
| Principal Repayments | 9.0 | 15.3 | 13.3 | 11.3 | 9.4 | 7.6 |
| Official creditors | 1.0 | 1.2 | 1.4 | 1.5 | 1.6 | 1.6 |
| o.w. IBRD | 0.3 | 0.2 | 0.3 | 0.3 | 0.3 | 0.4 |
| Banks | 0.6 | 2.0 | 4.9 | 1.1 | 0.9 | 5.3 |
| Other private | 7.3 | 12.1 | 7.0 | 8.7 | 6.9 | 0.7 |
| Increase in net official reserves | 0.5 | -3.2 | 0.3 | 1.4 | 0.3 | 0.8 |
| **Sources** | 34.1 | 31.8 | 30.8 | 28.8 | 23.6 | 19.5 |
| Foreign Investment (net) | 17.8 | 12.5 | 14.8 | 14.5 | 14.0 | 13.5 |
| Portfolio Investment (net) | 6.1 | 5.2 | 4.6 | 0.3 | 0.3 | 0.4 |
| MLT Disbursements | 10.9 | 11.3 | 19.1 | 16.9 | 12.1 | 8.2 |
| Official creditors | 1.1 | 1.5 | 3.6 | 1.3 | 0.6 | 0.4 |
| o.w. IBRD | 0.1 | 0.2 | 2.6 | 1.5 | 0.2 | 0.2 |
| Banks | 11.5 | 8.4 | 5.4 | 2.9 | 3.5 | 6.3 |
| Other private | -1.7 | 1.4 | 10.0 | 12.7 | 8.1 | 1.5 |
| Short-term & other capital (net) | -0.6 | 2.7 | -7.7 | -2.9 | -2.7 | -2.6 |
| Debt and debt service indicators, % | | | | | | |
| TDO/XGS | 285.8 | 254.9 | 255.5 | 248.3 | 238.2 | 234.1 |
| TDO/GDP | 101.6 | 100.7 | 97.2 | 95.8 | 92.7 | 91.7 |
| TDS/XGS | 39.6 | 41.9 | 43.4 | 32.7 | 31.2 | 39.4 |
| Interest payments/GDP | 3.3 | 3.4 | 3.5 | 3.5 | 3.4 | 2.8 |
| IBRD exposure indicators (%) | | | | | | |
| IBRD DS/public DS | 15.5 | 5.9 | 4.0 | 8.4 | 10.9 | 5.4 |
| IBRD DS/XGS | 1.1 | 0.8 | 0.8 | 1.0 | 1.0 | 1.1 |
| IBRD TDO (US$m) | 173.9 | 174.0 | 253.0 | 295.9 | 289.0 | 281.1 |

*Source: MONSTAT, CBCG, MOF, WB staff calculations.*

34. **External imbalances are projected to continue moderating over the medium term.** The current account deficit is expected to decline to 17.8 percent of GDP by 2015, led by growth in exports of goods, transport and, especially, tourism services, and a moderate rise in imports (at 4 percent). With FDI projected conservatively at 14 percent of GDP over the 2012-2015 period (much lower than in the pre-crisis period), such a deficit would be financeable and within the country's debt-stabilizing level. FDI, driven by the already launched privatizations in energy and tourism, would cover three fourths of the current account deficit, reducing financing pressures.

***Debt sustainability analysis***[15]

35. **Montenegro's total external debt is projected to decline to 91 percent of GDP by 2016, after reaching a peak of 103 percent of GDP in 2009**. However, the projection remains highly sensitive to changes in macroeconomic assumptions. In particular, assuming a moderate export recovery, the debt-to-export ratio will decline to about 230 percent by 2016 (from its peak in 2010 of 286 percent). Debt service as a

[15] The debt sustainability analysis, both for external and public debt, is based on the 2012 and medium-term growth assumptions described earlier and incorporate the expected effect of the amended budget approved by Parliament in May 2012, including the government's plan to continue with its fiscal consolidation efforts over the medium- and long-term.

share of exports is expected to decline to around 33 percent by 2016 from 43 percent in 2012. The sensitivity analysis suggests that the combined shock of an implicit interest rate of 4.3 percent, real growth at zero percent throughout the observed period (as opposed to 2.4 percent in the baseline), and a non-interest current account deficit at 7 percent (as opposed to 10 percent) would widen the external debt by 12 percentage points of GDP compared to the baseline.

36. **Public debt with guarantees is estimated to decline to 45 percent of GDP by 2016, reflecting the conversion of guarantees to the aluminum company into public debt and a 1.1 percentage point spending reduction per year**. The Government also intends to build over the medium term some fiscal reserves as a cushion against future unforeseen shocks. The sensitivity analysis, however, shows that under the growth shock scenario of real growth at zero percent throughout the observed period (as opposed to 2.4 percent in the baseline) and no policy response, public debt would widen by almost 17 percentage points of GDP compared to the baseline. Thus there are significant risks to debt sustainability, suggesting the criticality of implementation of the government's medium term fiscal consolidation plans.

**Figure 5: Public Debt Sustainability**

Baseline and growth shock scenarios

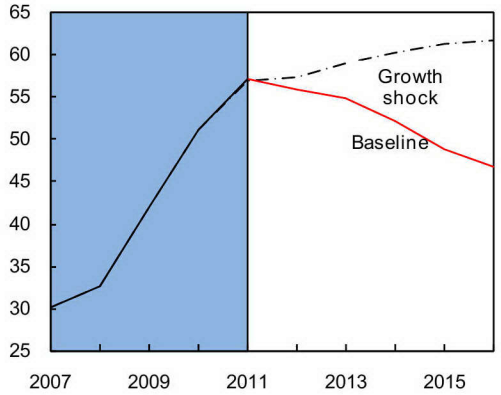
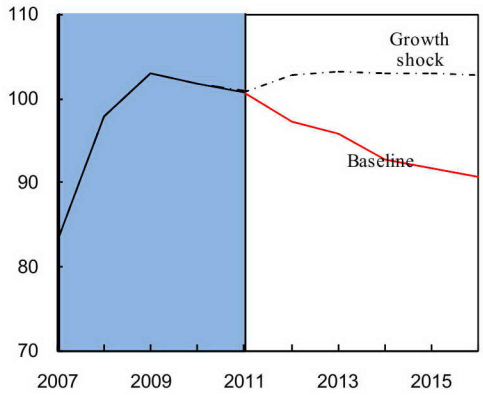



**Figure 6: External Debt Sustainability**

Baseline and growth shock scenarios




Note: Public debt includes guarantees. The *growth shock scenario* envisages improvements in CAD and non-debt creating inflows in percent of GDP by half and two-thirds of the 2011 level, respectively, the contraction in 2012 by 1.5 percent and stagnation in the rest of the projection period, and a 20-percent increase of nominal interest rate throughout the projection period. The *baseline scenario* follows the Government's amended budget scenario, which assumes 0.5 percent growth in 2012 and the pick-up thereafter.
*Source: CBCG and MoF data, staff calculations.*

### *Risks and the Government's contingency fiscal plans*

37. **Policy and external risks to the implementation of the Government's program remain substantial.** First, there is a risk that social tensions and political pressures weaken the fiscal consolidation efforts. So far, however, the Government has shown resolve in pursuing the proposed fiscal strategy and reached a key agreement with

the unions regarding wage and pension adjustments; it is also preparing the introduction of an explicit fiscal rule in 2013 to institutionalize fiscal discipline over the long term. Second, the heavy reliance on tourism revenues, FDI, and exports to the neighboring Western Balkans countries makes the country vulnerable to the recession in the EU. Third, deleveraging and low capital inflows may put further pressures on the private sector and households, worsening the payment discipline. Fourth, as explained above, the Government could be forced to take over additional public debt as a result of triggered guarantees (as happened in February 2012), which this medium-term fiscal framework already accounts for. Fifth, Montenegro is also vulnerable to natural (e.g., earthquakes, floods) and climatic risks. To the extent these risks materialize further policy efforts would be required. The Government is keenly aware of these risks and is committed to implementing substantial contingency measures, as laid out below and, in more detail, in its Letter of Development Policy (to be added). Given these risks and increasing uncertainties in the Eurozone, and in addition to the May 2012 revisions to the budget, the Government is considering an increase in the standard Value-Added tax rate (currently the lowest in the region at 17 percent) if this were to be needed; the consideration being given by the government to possible increases in VAT rates is part of the public discourse in Montenegro, thus serving to signal the government's commitment to consolidation efforts. These measures are likely to be activated later in the year if a further deterioration in economic conditions materializes.

38. **The macroeconomic policy framework on which the budget amendment is based and the Government's ongoing efforts, although subject to substantial risks described above, are considered adequate for the purposes of the proposed operation.** The set of macroeconomic policies proposed in the Government's program, if implemented within the outlined scenario, should enable gradual recovery of Montenegro's economy beyond 2011 along with steady improvements in the fiscal position and declines in the public and overall external debt. Furthermore, the declining public sector deficit throughout the observed period would reduce financing risks.

### E. Eligibility for Policy-Based Guarantee

***Criterion A:*** ***The country should have a strong track record of performance, and its structural, social and macroeconomic policy package should be satisfactory.***

39. **Montenegro has established a track record of policies to achieve macroeconomic stability, despite significant challenges brought about by exceptional external capital inflows and the global crisis in 2008-2009.** Macroeconomic stability was established following the adoption of the euro in 2002: inflation and interest rates fell to single digits and the re-monetization of the economy continued at a healthy rate until Montenegro's independence in 2006. In 2007, exceptionally large external capital inflows triggered a credit and real estate boom. During the 2007-2008 period, the Government and the Central Bank implemented financial and macroprudential policy measures to lean against the private sector savings-investment imbalances and correct the credit boom. Although in the right direction, these measures fell short of the desired outcomes. The Government ran fiscal surpluses, repaid some expensive debt, and raised previously compressed capital expenditures on basic

infrastructure but temporary increases in public consumption added to the overheating pressures. Despite this, when facing the negative spillovers of the global financial crisis in late 2008 and 2009, the Government maintained stability and avoided a generalized banking crisis using a combination of confidence enhancing and liquidity supporting measures. Moreover, since 2010, the Government continued strengthening the fiscal and financial sector positions, despite the difficult external environment.

40. **Further, the Government has remained committed to fiscal prudence in the context of the fully euroized economy** (see Section II.D). Since the peak reached in government spending during 2009, government expenditures have been reduced by 8 percentage points of GDP; the fiscal deficit was reduced from 6.7 percent of GDP in 2009 to 3.6 percent in 2011. In addition, the Government is committed to pursuing longer term fiscal consolidation leading to the restoration of fiscal surpluses and building of fiscal buffers as well as introducing formal fiscal rules, limiting the size of deficits and public debt in the future. An independent central bank (which does not issue domestic currency) regulates, and supervises the banking system and manages the macro economy with price stability and financial sector stability objectives. The capacity in key agencies to analyze, plan and implement policies has been continuously improving, in particular as the country continues to strengthen its institutions along with the EU *acquis* harmonization process.

41. **The Government has been pursuing a program of financial sector reform.** Facing the spillovers of the global financial crisis, the authorities responded with significant measures and managed to contain the financial turmoil in the banking sector, including stabilization of the systemically important Prva Banka that had had a central role in the excessive credit growth during the pre-crisis period. This Government program merited the first World Bank-supported Financial Sector Development Policy Loan (FSDPL1) that was approved in September 2011 and successfully disbursed in February 2012.

***Business climate and restructuring***

42. **Restructuring of public enterprises helped transform the ownership structure in the economy and boost private sector investments.** The privatization process gained momentum after 2001, and so far, more than 85 percent of state-owned capital has been privatized. Foreign owners now dominate in many sectors of the economy, including banking, metals, and tourism. This process supported entrepreneurial behavior, concomitantly reducing state subsidies. A number of uncompetitive enterprises were closed, however, structural unemployment rose as a result. Nonetheless, public support for further privatization has weakened over time owing to the perceptions of inadequate transparency, accountability, and corruption.

43. **The improving business climate helped attract investment and stimulate competition.** As a result, Montenegro's Doing Business Rank improved from 64$^{th}$ to 56$^{th}$ between 2006 and 2011. Further, a Council for Foreign Direct Investments chaired by the Prime Minister was established to monitor and guide further reforms. A comprehensive business-enabling regulatory reform started in 2009 and, by 2011, some

690 regulations and 320 administrative proceedings have been reviewed. Gains are particularly evident in the reduced time and costs required to start a business, but also in improved taxes and contributions' collection. Property and creditors' rights are being strengthened. Reforms of the land registry and cadastre have advanced increasing the territorial coverage by more than 11 percent since 2008. Further improvements in property registration are expected after the adoption of the spatial planning documents that is underway. The court system is better organized and new laws, including those on Administrative Procedures and Enforcement, strengthened the enforcement of court judgments.

44. **Financial sector reforms implemented since 2002 played a crucial role in providing competitive and stable financing to the private sector.** A new regulatory regime, following sound international practice, was put in place in 2002. As a result, unviable state-owned banks were closed and Western European banking groups entered the banking sector.[16] Due to increased competition, the banking sector deepened significantly. Improved financial sector regulation and enforcement facilitated the privatization and consolidation of the insurance sector. In parallel, the 2002 mass voucher privatization supported capital market development.

45. **Labor market reforms have continued, improving labor market flexibility.** The 2008 labor regulation reform made the Montenegrin labor market one of the more flexible labor markets in Europe, as measured by the EPL Index (Employment Protection by Legislation Index), the value of which improved from 4.1 to 1.7 between 2003-2008 (the OECD average being 2.0). The flexibility of the labor market was further increased by the enacted Amendments to the Labor Law in 2011.

***Human resources***

46. **The authorities have commenced a broad reform program to improve education and social outcomes.** Since 2005, primary and secondary Vocational Education and Training reforms modernized the curricula and improved access to education services. Public funding of education was increased in constant terms by an estimated 63 percent over 2005-2009. In 2008, the primary and secondary enrollment rates reached 98.2 and 87.6 percent. Over 2005-2010, two new private universities were established, and the number of students enrolled in higher education increased by 64.3 percent.

47. **A well-targeted social assistance program, albeit still with low coverage, has been put in place.** The Family Material Support (FMS/MOP) for low income households is well targeted. The health system has broadly adequate resources and is gradually improving health outcomes.

[16] Only two banks have majority domestic ownership. These are Prva Banka and Invest Banka Montenegro.

*Public sector reforms*

48. **A series of tax and public expenditure reforms beginning in 2001, including the introduction of VAT in 2003, established a modern statutory tax system** that helped strengthen revenue collection.

49. **Public expenditure and debt management reforms have advanced notably since 2007.** The amended Budget Law established medium-term budget planning and integration of state funds into a single treasury account, and enabled internal control of spending by administrative units and an internal audit function. Further, the adopted Law on Public Internal Financial Control Development in 2008 improved financial management and control. The first external audit was prepared for the 2005 budget, following the establishment of the State Audit Institution. The Law on Public Procurement as of 2007, amended 2011, introduced a centralized approval process for procurement plans to streamline public expenditures and improved governance.

50. **Montenegro has achieved substantial improvements in key international indicators on governance as well as political and economic performance**, and is a strong performer among South Eastern Europe (SEE) countries. However, the prior actions for EU membership negotiations define further rule-of-law reforms as priorities.

**Table 7: WBI governance indicators (percentile rank)**

| Indicator | 2006 | 2010 |
|---|---|---|
| Voice and Accountability | 54.8 | 55.5 |
| Political Stability | 39.4 | 64.6 |
| Government Effectiveness | 43.7 | 57.9 |
| Regulatory Quality | 32.7 | 51.7 |
| Rule of Law | 41.0 | 55.0 |
| Control of Corruption | 40.8 | 47.4 |

*Source: Worldwide Governance Indicators.*

***Criterion B:* The country should have a sustainable external financing plan.**

51. **The country's total external debt is high but its financing structure is relatively robust, and debt is decreasing with the ongoing private and public sector adjustment.** Gross external debt (public and private) at end-2011 was around 100.7 percent of GDP and is expected to gradually decline to 91 percent of GDP by 2016. Government and government-guaranteed external debt account for almost 40 percent of GDP. Non-government external debt accounts for about 56 percent of GDP; however, only 8 percent of GDP is short-term debt. *Net external debt* reached 73 percent of GDP at end-2011, where its predominant financing by FDI and the decent foreign reserves coverage moderate substantially any related risks. The exposure to volatile capital flows is small and short-term debt is largely associated with green-field and other FDI which further diminishes its reversibility. Debt servicing indicators are generally adequate.

52. **External financing requirements will remain moderate from 2012 onwards.** The current account deficit is predicted to decline to 17 percent of GDP (from 20 percent in 2011) and the FDI pipeline for 2012 even under conservative projections remains

sufficiently strong. The ratio of debt service to exports of goods and services will decline to below 32 percent by 2014 from around 42 percent in 2011. The repayment of Eurobonds in 2015 and 2016 will increase Government's financing needs, but these are expected to be rolled over at maturity with contained refinancing risk.

53. **The ongoing fiscal consolidation will keep financing requirements manageable.** The Government financing needs (deficit and debt repayment) will decline from 10.6 percent of GDP in 2011 to 7 percent of GDP in 2015. The debt issuance supported by the proposed FSPBG will cover around 31 percent of Government financing needs in 2012. A sizeable portfolio of projects with bilateral and multilateral creditors (including IBRD, EBRD, EIB, Council of Europe Development Bank, and KfW) will also bring foreign financing, as will the increasing absorption of EU pre-accession funds.

***Criterion C:* The country should have a coherent borrowing strategy, which will enable it to become a borrower in its own name without a guarantee in the medium term.**

54. **The public debt management operations and debt portfolio risk management follow a medium-term debt management strategy.** The medium-term strategies provide guidelines for managing risks, setting the operational framework for debt and cash management, and the management of guarantees. The 2005-2007 strategy was focused on diverting public debt financing from (at that time) more expensive domestic to less expensive foreign financing; the 2008-2010 strategy focused mostly on pre-payment of public debt liabilities deriving from restitution, foreign frozen savings and foreign loans.[17] The current strategy for the 2011-2013 period focuses on extending maturities and fixing interest rates. To date, the average maturity of General Government debt is 9.4 years, while the interest rate on 70 percent of debt is fixed. Approximately 89 percent of external debt, and all domestic debt, is denominated in euro.

55. **About half of Montenegrin public debt has been contracted on concessional terms.** Approximately 44.2 percent of total public external debt from IFIs comprising mostly rescheduled debt from the former Yugoslavia. Additional 12.4 percent of total external debt is in the form of "soft" bilateral loans. Domestic debt predominantly relates to arrears incurred during the former Yugoslav era (44 percent), which are in the form of non-interest bearing instruments.[18] Commercial debt of the GoM includes short term securities (up to 18 months) and borrowings from domestic banks with an average life of five years.

56. **The authorities have so far issued 10.7 percent of GDP in guarantees (as of end-2011) and shown reasonably good capacity for management of contingent liabilities**. Guarantees have mostly been issued for the loans granted by IFIs to state-owned companies and credit guarantees to domestic banks in support of credit flow to the economy during the crisis period. Exceptionally during 2009-2010, the GoM issued guarantees for commercial bank loans to two companies of systemic importance for the

[17] In 2007 some EUR70 million of the IBRD loan was pre-paid.

[18] Such as frozen assets bonds issued to compensate holders of saving deposits held in state-owned banks and restitution bonds.

economy, in exchange for equity stakes.[19] With the 2012 budget, the Government has significantly tightened the policy of guarantees to the critical infrastructure projects. In addition, the authorities showed interest in further strengthening of their capacity for contingent liabilities management, and the WB team has a dialog with the authorities on possible TA arrangement for FY13.

57. **The GoM has commenced a broader transition to market-based debt financing and accessed international markets independently on two occasions.** Montenegro issued EUR200 million five-year Euro bond in 2010 and EUR180 million five-year Euro bond in 2011. The bonds are currently very thinly traded in secondary markets. Concurrently, the GoM has tapped the domestic market, mostly through selling T-bills (largely bought by banks), and less through commercial loans (2.2 percent of the total General Government debt), aiming to prevent a crowding-out effect.

### F. IBRD Guarantee and the Debt Instrument

58. **In line with the IBRD's policy on PBGs, the proposed operation would**: (a) provide incremental market access; (b) leverage the Bank's capital better than a DPL; and (c) improve Montenegro's borrowing terms considerably.

#### ***(a) Provide Incremental Market Access***

59. **Montenegro aims to gain access to markets during challenging times** and believes that the PBG will facilitate their funding. Specifically, the Government intends to utilize an IBRD guarantee of EUR60 million to raise a EUR80-100 million loan and thus cover its financing gap in 2012. An alternative Eurobond issue of a similar amount would be prohibitively expensive at prevailing market rates (Figure 7)[20]. In addition, the markets remain volatile and, despite some improvement in the trend in recent weeks, they can turn for the worse in the near future.[21]

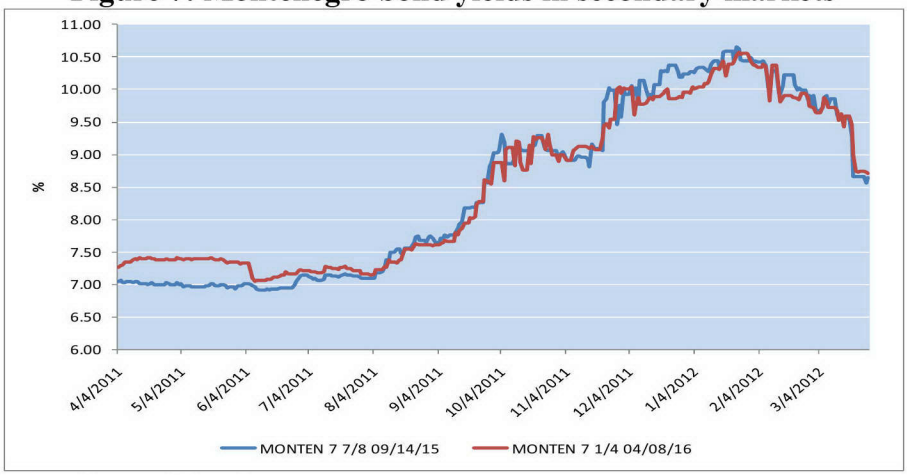
---

[19] As of February 2012, the Government has converted a EUR22 million guarantee to Deutschebank on a loan to the Aluminum company (0.6 percent of GDP) into public debt, which was repaid at once and raised the principal and interest in the 2012 budget by about 0.7 percent of GDP.

[20] A short term bridge loan from commercial banks would generally be even more expensive than a bond issue.

[21] Although in mid-April, 2012, Montenegro was able to borrow EUR150 million from Credit Suisse, this transaction was privately placed and was not cleanly priced. The deal was partially collateralized by gold and structured into transferable notes. Without the underlying collateral, which was re-priced and recycled from a previous financing that the Government had arranged with CS, the latter bank believes that the margin would have closed at closer to 800 basis points or higher, and well above the 650 basis points margin that was agreed with Credit Swiss for their facility. This structured loan does not constitute a benchmark for access to future financing for Montenegro.

**Figure 7: Montenegro bond yields in secondary markets**




Source: Bloomberg.

60. **The experiences of FYR Macedonia and Serbia with using the IBRD PBGs are encouraging.** Most recently, in a virtually closed market environment, FYR Macedonia issued debt at competitive rates (Table 8).

**Table 8: Market Conditions at PBG Negotiations**

| Spread | Macedonia PBG October, 2011 | Serbia PBG April, 2011 |
|---|---|---|
| EMBI Global | 450 | 300 |
| EMBI Europe | 440 | 230 |
| EMBI Country | 610 | 380 |
| Market issuance (total, all countries) | No transaction as of September 21, 2011 | 5 transactions - 5.3 USD bln. |

61. **The Guarantee approach is most beneficial for countries like Montenegro that find themselves with very impaired access to market funding, particularly during periods of high market volatility.** Montenegro has opted for a PBG in order to make optimal use of membership in the IBRD, at a critical juncture. Montenegro is extremely reluctant to borrow independently at the very high yields demanded by markets, as doing so would be very costly, and it would set an undesirably high benchmark for the credit, which may constrain the Government's ability to borrow efficiently in the near future. Moreover, investors may charge disproportionately more in terms of yield if the Government is observed attempting to borrow under unsustainable terms. Montenegro also believes that the PBG approach has far less transaction risk than an attempt at unsecured borrowing, which could easily fail, should these volatile markets take a turn for the worse.

***(b) Leverage the Bank's Capital Better than a DPL***

62. **The PBG will be used to leverage significant private sector resources, with only 60 percent of principal risk covered**, or roughly 50 percent of the cash flow risk for investors, in a transaction targeting EUR100 million. In this sense, there is a significant "crowding-in" of the private sector envisaged, even more than observed in the

Serbia and Macedonia transactions undertaken last year – where 85 percent and 65 percent respectively of cash flows were covered by the PBG. A transaction targeting EUR80 million would have leverage similar to levels achieved in Macedonia's borrowing.

63. **The proposed FSPBG would leverage Bank's capital better than a DPL and help Montenegro increase the amount borrowed.** A single transaction involving both guaranteed and unguaranteed lending will allow Montenegro to raise the needed amount of EUR80-100 million. The alternative of two transactions involving a World Bank loan and a separate unsecured market borrowing poses high risk in current market conditions. Although Montenegro can obtain competitively priced loan (DPL) from the World Bank in the amount of US$20 million (approximately EUR15 million), unsecured market borrowing may not materialize under any acceptable terms in these volatile markets. Additionally, through a PBG, IBRD capital may be recycled more quickly than would occur in the case of a DPL with longer maturity. By tying up IBRD capital for only five years, resources will be made available sooner for other development initiatives in Montenegro.

64. **The IBRD Guarantee and the structure of the guaranteed debt instrument will provide the security necessary for lenders to extend credit to Montenegro in the desired volume and under acceptable terms.** The overall transaction will concentrate the full guarantee coverage on a final balloon payment at maturity, and allow unsecured borrowed amounts to be amortized in preceding years. For a five year borrowing of EUR100 million, approximately EUR60 million will be paid at maturity, with full guarantee provided by the FSPBG, while the remaining EUR40 million in principal will be evenly distributed over preceding years.[22] At current yields, the structure described above, involving up to EUR100 million for five years, may imply a borrowing spread of 350-450 basis points, according to preliminary estimates.

***(c) Improve Montenegro's Borrowing Terms Considerably***

65. **The IBRD Guarantee approach strikes the best balance between tradeoffs of tenor, size and participation by the private sector.** The targeted volume is set at the limit of what markets will efficiently bear in current circumstances. The maturity sought is set directly in response to financial sector's feedback about limits of liquidity available for Montenegro and is longer than existing Montenegro Eurobonds in the Government's debt portfolio. This type of leveraged approach is only feasible in the loan markets, as Emerging Markets bond investors do not sufficiently value partially guaranteed structures, an even less so for very small, non-benchmark-size, issues. Market sounding suggests that, in a transaction involving the IBRD guarantee, the credit risk of the Borrower would be priced more aggressively due to: (i) a more competitive bidding process, (ii) minimal to zero capital charges applied to the AAA (PBG) component, (iii) the transaction cost efficiency of a single borrowing, (iv) more favorable maturity limits on a combined transaction, and (v) a likely "halo effect", where unsecured borrowed

[22] Scenarios involving smaller (EUR80 million) or larger (EUR120 million) amounts of total borrowing, and those with longer maturity (seven years) would be structured in the same fashion.

amounts are also credit-enhanced by guaranteed amounts in a single transaction. A summary of the Guarantee instrument, along with its indicative terms and conditions, is provided in Annex 5.

66. **The PBG-supported bank loan would cost Montenegro 5-6 percent, generating a savings of up to 4 percent per annum over the life of the loan.** Conditions in credit markets globally have improved somewhat in recent months and banks and investors are moving carefully toward a "risk on" strategy in both equity and debt markets. In Europe, there is reduced risk perception in the Eurozone periphery, at least relative to a few months ago. At the beginning of the year, yields on Montenegro's outstanding bonds, which have three and four year remaining maturities, were around 10.5 percent (Figure 7). These have now fallen slightly to just under 9 percent, which reflects some modest improvement in risk perception. However, these assets are infrequently exchanged, and caution should be taken in interpreting yields on illiquid bonds. For a bond issue of the size and tenor of the proposed operation, the estimated cost to Montenegro would be 9.5-10.0 percent in current markets. Market soundings for the PBG-supported bank loan suggest that the cost to Montenegro, including the guarantee fee, would be in the order of 5-6 percent, which could generate a savings of over 4 percent per annum over the life of the loan.

67. **The Montenegro FSPBG compares favorably with the Macedonia and Serbia operations and supports Montenegro's refinancing risk management in volatile markets.** This operation compares favorably with the savings achieved in the Serbia and Macedonia operations, which had a higher percentage of their cash flows guaranteed. Because Montenegro may be perceived as a weaker credit by the market, the credit support may have a "larger bang for the buck". Although the market's pricing of Montenegro has improved in recent weeks, it is not at all clear what the future will hold. This operation, therefore, supports refinancing risk management by the authorities, by reducing execution risk and providing access to source of financing that is largely insulated from market volatility.

## III. THE GOVERNMENT'S REFORM PROGRAM

### A. Overall Reform Program

68. **The goals of Montenegro's reform program are to strengthen its EU integration, improve economic performance, and increase the living standards of its citizens.** The Government's program focuses on reforms needed to improve the business environment, increase human and physical capital, and meet EU accession priorities, in particular those related to the rule of law and the fight against corruption. The Government Economic and Fiscal Program for 2012–2015 and the harmonized Pre-Accession Economic Program 2011-14 outline consolidation efforts to ensure the medium-term sustainability of public finances supported by structural reforms to address competitiveness and financial sector stability as core priorities. Reforms in the fiscal area focus on reducing public spending, curtailing public debt growth, and implementing further reforms in health, social benefits and public administration areas. In the financial

sector, the authorities aim to step up supervisory efforts, and further strengthen the regulatory framework for banks and harmonize it with international practices and EU directives. This will make the sector and regulatory bodies better prepared for any future shocks.

## B. Financial Sector Reforms

69. **Confidence in the banking sector was maintained through an emergency anti-crisis Law on Measures for Protection of the Banking System and support extended by parent banks to their Montenegrin subsidiaries.**[23] The provisions of the MPBS Law were generally consistent with crisis responses seen in other countries, giving the Government the authority to: (i) fully guarantee the deposits of all individuals and legal persons; (ii) facilitate credit guarantees for interbank loans; (iii) provide emergency liquidity support to a bank for a period of up to one year; (iv) upon a bank's request, make a prepayment of state borrowings from that bank (including loans carrying a government guarantee); and (v) provide funds for a bank's recapitalization to protect the banking system's stability. The Law also allows the CBCG to: (i) approve the use of required reserves; and (ii) use up to 50 percent of its capital for granting short-term loans to banks.[24] The MPBS served its intended purpose and expired at the end of 2009.

70. **In parallel, under the FSDPL1, the authorities implemented legislative and institutional reforms to**: (a) enhance depositor confidence; (b) strengthen the banking sector liquidity framework; (c) address vulnerabilities in the banking sector; (d) improve the regulatory framework; and (e) conduct problem bank restructuring. These reforms supported Montenegro's EU accession strategy as they aim to bring the supervisory and regulatory framework for the banking sector closer to EU practices.

71. **The reform program started under FSDPL1 has been continued by the authorities through policy reforms implemented under the FSPBG.** Due to the on-going Eurozone crisis, the authorities focused on systemic risk monitoring, crisis preparedness and strengthening banks financial soundness, but also on leveling the play field in the banking sector to allow for sound and fair competition in the provision of financial services. The reforms include: (i) strengthening systemic risk monitoring and the crisis management framework, (ii) addressing banking sector vulnerabilities, (iii) completing restructuring of *Prva Banka,* (iv) enhancing the depositor protection scheme, and (v) further improving the regulatory framework for banks. These reforms support Montenegro's progress towards aligning its legal and policy frameworks with good international practice and its strategy for harmonization and convergence towards the EU.

---

[23] Only one domestic bank (Prva Banka) received an emergency loan from the state, which was repaid within 12 months. A number of banks benefited from state guarantees given by the MoF for credit lines provided by the European Investment Bank (EIB) and KfW totaling EUR 122 million to support lending to small and medium enterprises (SMEs).

[24] CBCG was proactive in introducing a number of temporary changes in prudential regulations to respond to the special challenges presented by the global financial crisis, such as lowering reserve requirements to ease liquidity pressures on banks and revising loan loss provisioning rules to facilitate loan restructuring.

*Strengthening Systemic Risk Monitoring and the Crisis Management Framework*

72. **A new law on the Central Bank of Montenegro (CB Law) was enacted in mid-2010 that provides the CBCG with expanded powers to act as the lender of last resort.** Under the new CB Law, emergency liquidity loans can be made to solvent banks for 90 days against collateral, extendable to a maximum of 180 days when necessary to preserve the stability of the financial system. The new Law also provides legal protection to the CBCG and its staff from prosecution for acts taken during the performance of their duties. The new CB Law has been widely recognized for its role in bringing Montenegro closer to the EU's sound practices for central bank governance and operations.[25]

73. **The Financial Stability Council (FSC) established by the Financial Stability Council Law of 2010 (FSCL) has become operational.** So far the FSC has held eight meetings (the FSCL requires the FSC to meet at least quarterly). Members of the FSC include the Minister of Finance, the Governor of the CBCG, and the heads of the Insurance Supervision Agency and Securities and Exchange Commission. The Research and Statistics Department acts *de facto* as the secretariat of the FSC.

74. **The FSC has been behind the strengthening of systemic risk monitoring and the crisis management framework.** The FSC has been meeting regularly to monitor systemic risk, in line with the developed systemic risk assessment methodology, and considering adequate macroprudential policy response. The FSC put in place a new crisis management framework by developing crisis contingency plans at the level of the three financial sector supervisors, MoF and the FSC. In addition, the FSC prepared a *lex specialis* (draft Financial Stability Law), which the FSC adopted during its March 12, 2012 meeting. If enacted, the *lex specialis* would grant the authorities, upon declaration of a financial crisis by the FSC, additional powers to intervene in the financial system by providing liquidity and capital support. Implementing regulations and procedures will also need to be prepared by the CBCG, MoF, Insurance Supervision Agency and Securities and Exchange Commission to operationalize the emergency powers already provided by the FSL and additional powers to be provided by the proposed *lex specialis*.

*Addressing Banking Sector Vulnerabilities*

75. **The CBCG has employed a range of supervisory techniques to identify vulnerabilities in the banking sector and required bank management and owners to undertake prompt corrective actions as necessary.** The supervisory framework combines full scope on-site examinations, targeted on-site examinations, off-site monitoring, and quarterly stress testing for credit, liquidity, and market risks. The CAMELS rating system is in place and is updated for all systemically important banks at least quarterly. With technical assistance provided by the World Bank, the CBCG has also now introduced an improved credit assessment and risk rating methodology. The

[25] The new law generally upholds the operational independence of the Central Bank with one caveat. The new CB Law included a provision, which terminated the mandates of the CBCG Council, including the CBCG Governor, and required the appointment of a new Council. As communicated by the WB and the IMF to the authorities, this move could be perceived as an infringement upon the independence of central bank.

CBCG conducts periodic on-site examinations of banks, with all of the five largest banks (Montenegro Commercial Bank (OTP), Hypo Alpe Adria Bank (HAAB), and NLB Montegrobanka (NLB), Pordgoricka (Societe General), and Erste) and a number of smaller banks subjected to full-scope examinations in 2009, 2010 and 2011. Supervisory Action Plans (SAPs) were prepared for banks of special concern, approved by CBCG management, and periodically updated. In the context of SAP implementation, the CBCG maintains an ongoing dialogue with management and shareholders of the banks to address specific weaknesses, including requiring capital increases to offset both shortfalls identified during the inspection process and projected capital needs identified by stress tests.

76. **The CBCG continues to implement the SAPs approved for 2012 for all systemic banks, and Prva Banka.** The banks of systemic importance include Montenegro Commercial Bank (OTP), Hypo Alpe Adria Bank (HAAB), and NLB Montegrobanka (NLB), Pordgoricka (Societe General), and Erste. Prva Banka is no longer classified by the CBCG as a systemic bank (due to its reduced size in relation to the banking system), but remains of special concern due to the potential fiscal and reputational risks it presents. All of the systemic banks have been the subject of annual on-site inspections by end-2011, are monitored by off-site supervision department and their capital adequacy assessed by regular stress tests. The World Bank will continue to provide technical assistance and participate in the review of the draft on-site supervision report for *Prva Banka*. The respective SAPs have been updated and approved with the CBCG's planned 2012 supervisory activities by end-February 2012.

***Completing Restructuring of Prva Banka***

77. **As the only bank with severe liquidity and asset quality problems, Prva Banka represents the most critical challenge faced by the authorities.** Suffering from chronic asset-liability mismatches and rapid withdrawal of deposits, Prva Banka ceased to function as a normal commercial bank in the fall of 2008, when the CBCG imposed a freeze on new lending activities and subsequently installed a special representative at the bank with the right to attend all management and board meetings. The management of the bank was replaced in late 2008, and Prva received a EUR44 million emergency loan from the GoM, which was subsequently repaid. Strong restructuring efforts by the new management have resulted in a dramatic downsizing of the bank. Its assets were cut almost in half over the past two years, and the bank dropped from second to sixth largest in Montenegro between 2008 and September 2011. By early 2011, the CBCG assessed that Prva's condition had stabilized with adequate liquidity, and allowed the bank to resume limited lending activities, in order to attract new deposits and begin increasing operating income.

78. **Notwithstanding the recent stabilization of Prva Banka, the authorities recognize that it remains a significant fiscal risk due to its reliance on state-related**

**deposits, and a potential threat to the banking system stability**.[26] The bank continues to rely heavily on deposits from the Central Government and majority state-owned enterprises, primarily EPCG (the second largest shareholder of Prva Banka). Reported NPLs and past due loans have fallen, a new management team and strengthened risk management procedures have been put in place, and the bank has reoriented its strategy to focus on SME and retail lending. Total lending had decreased as of end-June 2011, and deposits and liquid assets overall have declined, posing potential liquidity risk in view of Prva Banka's still unsatisfactory liability structure.[27] In the 2011 SAP for Prva Banka, the CBCG required Prva Banka to comply with the 12 percent minimum CAR and the minimum liquidity ratio. The CBCG conducted an on-site inspection of Prva Banka in October 2011. The results of the on-site examination reveal that the CAR of Prva Banka stood at 11.4 percent by end-December, 2011, and the bank was required, by a CBCG order, to come up with, and implement, a strategy to meet the 12 percent CAR by end-March 2012. Prva has met the 12 percent CAR requirement through further balance sheet shrinkage and recapitalization.

79. **In parallel, the MoF has been proceeding with a gradual withdrawal of central government deposits from Prva Banka based on a schedule agreed under the FSDPL1**. A time-bound schedule was agreed between the MoF and Prva Banka to withdraw, in monthly tranches of EUR1.5 million, all remaining Government deposits from Prva Banka by end-June 2012. The MoF consulted the withdrawal schedule with the CBCG to ensure that the withdrawals would not destabilize the bank's liquidity position. The MoF is current on its withdrawal obligations as of end-January 2012. The Bank team is notified by the MoF on the completion of the withdrawals monthly, and will collect evidence on the amount of the completed withdrawals by end-March 2012 for the FSPBG appraisal. Furthermore, the GoM issued guidelines to all majority state-owned enterprises, municipalities and other state-sponsored institutions to use clearly defined eligibility criteria for procurement of financial services from commercial banks.[28] The guidelines should ensure that no bank, including Prva Banka, receives disproportionate business concerning state-related financial services. According to the MoF, the impact of the guidelines is being felt more widely in the banking system (one example being a significant reduction in municipality deposits in Prva Banka).

***Enhancing the Depositor Protection Scheme***

80. **A new Deposit Protection Law was enacted in mid-2010 to replace the blanket deposit guarantee, which was a temporary measure in the emergency anti-crisis Law on Measures for Protection of the Banking System.** The law: (i) gradually

[26] Although non-systemic by CBCG classification, accounting for less than 10 percent of the system's deposits, Prva Banka can be seen as systemically important based on e.g. its large branch network and presence in the regions, and involvement in payment systems.

[27] Following its partial privatization in the fall of 2009, EPCG is under a management contract with the private strategic investor (Italy's A2A utility company), which also has a representative on Prva's Board of Directors.

[28] Specifically, the document instructs to use bank solvency and profitability as criteria for placement of deposits, in addition to deposit interest rates. These guidelines also set a limit for the maximum share of deposits that should be kept with a single bank.

increases the ceiling for deposit insurance coverage in line with regional norms and EU directives; (ii) shortens the timeframe allowed for insured deposit payouts; and (iii) provides a legal instrument to mobilize external funding sources that would enhance the Deposit Protection Fund's (DPF) financial capacity to make large deposit insurance payouts. The latter change allowed, later in 2010, approval of a stand-by credit line from EBRD for the DPF (with a sovereign guarantee), which can be drawn upon in the event that the DPF's own funds are not sufficient to deal with a large insured deposit payout. The DPF's financial resources amounted to up to EUR28 million at end-September 2011, and with the extra emergency buffer of EUR30 million provided by the EBRD stand-by credit line, DPF has EUR58 million available for guaranteed deposits' payouts.

81. **The Deposit Protection Fund adopted several pieces of implementing regulation under the Deposit Protection Law to improve its operation.** In order to improve the function of informing depositors about an upcoming increase of the coverage from EUR20,000 to EUR35,000, the DPF recently adopted a by-law on providing information to depositors. Its implementation through regular communication to depositors should start in Q1 2012. In addition, the DPF adopted a regulation on payouts of guaranteed deposits to increase the transparency and efficiency of the process. This regulation, governing the general payout process including selection of the payout agent bank, was drafted and approved by the DPF Management Board. At the same time, an internal regulation that governs activities and processes within the DPF during the payout process, including a clear assignment of responsibilities, has been adopted by the DPF board.

***Enhancing the Regulatory Framework for Banks***

82. **The authorities have taken steps to harmonize the regulatory framework for banks with relevant EU Directives and with prevailing practices in EU member states.** The CBCG now has the full range of instruments and authority for effective supervision and, in particular, for dealing with problem banks. In mid-2010, amendments to the Law on Banks were enacted, which enhance the CBCG's enforcement powers, improve corporate governance in banks, and strengthen the interim administration process for problem banks.[29] Amendments to the Bank Bankruptcy and Liquidation Law were also enacted to ensure that insolvent banks can be promptly resolved using least cost solutions. As confirmed in a recent report by the EC[30], the new set of laws has brought Montenegro substantially closer to compliance with EU countries' regulatory frameworks for bank supervision and resolution.

[29] More specifically, the deficiencies that were addressed in the amendments to the Law on Banks included, inter alia: (i) harmonizing fit and proper requirements with the EC directive; (ii) clarifying the definition of related parties in line with international good practices; (iii) strengthening the CBCG's enforcement powers by increasing the types of enforcement actions available to the CBCG; (iv) limiting the powers of the courts to suspend or revoke CBCG decisions; and (v) establishing legal protection for the CBCG as a supervisory authority and its personnel.

[30] European Commission Opinion on Montenegro's application for membership of the European Union, November 2010, and the Montenegro 2011 Progress Report acknowledged further improvements to the legislative framework for banks.

83. **The CBCG made further progress in bringing its banking regulations closer to the EU and international good practice.** The newly developed law and regulations concern: (i) implementation of the Basel II Standardized Approach, (ii) implementation of IFRS for banks, and (iii) enacting the Law on Financial Collateral.

a. **The CBCG has prepared and issued a majority of the regulations required to implement the Basel II standardized approach**: (i) Capital Adequacy Decision, Official Gazette 38/11, July 1, 2011 on capital adequacy; (ii) Decision Supplementing the Decision on Temporary Measures for Credit Risk Management in Banks, Official Gazette 2/12, December 29, 2011 on credit risk management; (iii) General Guidelines for Granting Approval to Use Ratings Assigned by External Institutions, CBCG Internal Regulation, November 14, 2011 on the use of credit rating agency ratings; (iv) Decision on Public Disclosure of Information and Data by Banks, Official Gazette 2/12, December 29, 2011 on banks transparency and information disclosure under Pillar 3 of Basel II; and (v) Decision on the manner of calculating bank exposures (regulation on large exposures), Official Gazette 15/12.

b. **The CBCG continues to work towards implementation of IFRS by banks on January 1, 2013**. The CBCG is preparing a regulation requiring banks to implement IFRS 39 as of January 1, 2013. The MoF and CBCG have established a working group to assess the tax implications of the IFRS introduction. In addition, the CBCG has developed and adopted an IFRS capacity building plan for bank supervisors.

c. **The Law on Financial Collateral.** The CBCG drafted the Law on Financial Collateral based on EC Directive 47 to improve access to and handling of financial collateral by financial institutions. The affected entities include a broad range of financial institutions that are subject to prudential supervision. The main objective is to achieve easier access to collateral, including introduction of collateral agreements in an electronic form, disposition with the collateral for the purpose of secondary pledging, and its execution. This shall in turn improve the capacity of the subject financial institutions in management of liquidity risk. The Law was approved by the Government on March 29, 2012 and will be subsequently adopted by the Parliament.

## IV. BANK SUPPORT TO THE GOVERNMENT'S PROGRAM

### A. Link to the Country Partnership Strategy

84. **The objectives of the FSPBG are consistent with key priorities and expected outcomes supported under the current Country Partnership Strategy (CPS).** The FY11-FY14 CPS for Montenegro, endorsed by the Board in January 2011, envisaged a series of two programmatic financial sector DPLs. The second DPL in that proposed series has been converted into this self-standing financial sector PBG, which, inter alia, supports the same goals and reform program foreseen under the financial sector DPL program. These operations constitute over half the CPS lending envelope and fall under the first of the two main priority areas, namely, "support EU accession through

strengthening institutions and competitiveness." The CPS clearly states that one of its key outcomes is expected to be "a stronger banking system governed by a modern regulatory framework and central institutions, which is more resilient to future shocks."

## B. Collaboration with the IMF and other Donors

85. **There is no IMF-supported program in Montenegro, but this operation has been prepared in consultation with the IMF.** The two institutions have been working together on improving the legal and regulatory environment for the banking sector, in line with the joint recommendations recorded in the most recent Financial Sector Assessment Program (FSAP) Update Report (FY07). Specifically, the Bank and the IMF have jointly reviewed and provided technical assistance to the authorities on the legal amendments to the draft Law on Banks and the Bank Bankruptcy and Liquidation Law; e.g. the IMF has taken the lead on reviewing the draft Law on the Central Bank, and the Bank has done the same concerning the Law on Deposit Protection Fund. Both institutions are also coordinating their policy advice on crisis preparedness and contingency planning.

86. **The Bank is coordinating its policy program under this FSPBG with the European Commission, Montenegro's most important current and future economic and political partner.** The structural and regulatory reforms supported by this operation are essential for achieving the goals set by the Stabilization and Association Agreement, to ensure the gradual convergence of Montenegro's economy with the EU. The ongoing large twinning project financed by the EU and implemented by the Central Bank of Bulgaria provides extensive TA to the CBCG to further strengthen its supervision capacity. In addition, throughout 2011 the CBCG has participated in preparation, dry runs and the final run of the home-host crisis simulation exercise organized jointly by the Bank and the ECB in Frankfurt in November 2011.

87. **The Bank has also maintained a robust dialogue with other donors active in Montenegro, in order to avoid duplication of efforts and leverage support for the GoM's reforms.** In the context of a joint International Financial Institutions initiative, the EBRD has been very pro-active in providing additional debt and equity support to the Montenegrin banking sector since the start of the crisis; e.g. the EBRD approved a EUR30 million stand-by loan to the DPF. Germany's KfW has also provided several lines of credit to commercial banks and a TA program for the DPF.

## C. Relationship to Other Bank Operations

88. **The FSPBG continues the reform program started under FSDPL1, approved by the Bank's Board in 2011**. Not only does the FSPBG have similar development objectives, as the FSDPL program, but several of its prior actions, concerning implementing regulations, derive directly from the primary legislation developed and enacted under FSDPL1. In addition, the FSPBG builds on two earlier operations that supported the development of Montenegro's financial and enterprise sector. The series of Structural Adjustment Credits (SAC 1 approved in 2002 and SAC 2 approved in 2004) supported key structural reforms to enhance fiscal sustainability and

promote private-sector led growth. The SACs supported reforms in a number of areas including the business environment, financial sector and public administration. The financial sector component sought to resolve non-performing assets carved out of the banking sector, and complete the privatization of large banks.

## D. Analytical Underpinnings

89. **The design of this operation is based on considerable analytical and TA work.** The FSAP Update (FY07) assessed overall financial system stability and vulnerabilities. Some of the main policy issues identified in the FSAP Update have been addressed in this operation (FSDPL1 and FSPBG), including improvements in the regulatory environment for the banking system, strengthening the liquidity management framework, and improving the crisis management framework. An FY09 Early Warning Toolkit grant funded by FIRST helped develop and test new methodologies for on-site bank examinations and stress-testing models for credit risk. The Bank subsequently advised the CBCG on conducting in-depth on-site examinations and stress-testing of systemic banks, which served as an analytical foundation for developing bank-specific supervisory action plans (including for Prva Banka).

90. **The Bank was also closely involved in assisting the Montenegrin authorities in designing the least-cost restructuring strategies for problem banks.** Other related recent analytical work includes an FY07 Report on Observance of Standards and Codes (ROSC) analyzing Montenegro's financial and auditing standards, and an FY10 grant from FIRST to support the development and adoption of a Country Strategy and Action Plan to enhance the quality of corporate sector financial reporting to comply with EU standards.

91. **Most recently the operation's design was supported by, and derives from, Bank, ECB and IMF TA on crisis preparedness and Bank TA on capacity building for auditors.** The CBCG's participation in the home-host crisis simulation exercise organized by the Bank and the ECB underscored the needed focus on systemic risk assessment and crisis preparedness in the view of the possible spillovers of adverse shocks from the EU and the region. The operation was also informed by the IMF TA on contingency planning emphasizing the need for extraordinary powers for the Financial Stability Council to resolve possible future crisis situations under a transparent legal framework. The Bank through its Vienna-based Centre for Financial Reporting has been providing TA to build capacity of the auditors especially in the view of the future introduction of IFRS for banks and corporates.

92. **The authorities requested that the World Bank prepare a structured TA activity on NPL workouts, as high NPL levels remain a major challenge for Montenegro's financial sector and the economy.** The proposed activity will assist the authorities in developing a Montenegro-specific debt restructuring strategy to reduce the level of NPLs within the financial sector and aid in the resumption of the flow of credit to the real sector. The design of a comprehensive debt restructuring strategy will have two phases: (i) a comprehensive diagnostic to better understand the key issues, and (ii) technical assistance to implement the recommendations contained in the diagnostic.

Developing and implementing a strategy to reduce NPLs requires close coordination and cooperation among several institutions, and the engagement strategy will be to foster this required level of collaboration.

### E. Lessons Learned

93. **The proposed operation has incorporated lessons from the Bank's experience in 2008-2009 crisis, as well as in previous economic and financial crises.** A recent comprehensive review of the Bank's responses to financial crises[31] underscored the following lessons:

- ***Early response.*** The Bank fielded a mission within a few weeks from receiving the request for budget support. Addressing early on the systemic vulnerabilities in the banking sector helped contain the crisis and minimize fiscal costs.
- ***Need for focus.*** During crises, operations should focus on selected key areas for good outcomes. The proposed operation thus focused on key areas of addressing vulnerabilities in the banking sector and its resilience to possible future shocks.
- ***Government ownership.*** The FSDPL1 and this FSPBG were prepared in direct collaboration with the top leadership of the MoF and the CBCG, the Government's key agencies.
- ***Communication strategy.*** The staff of the Country Management Unit and the World Bank Field Office in Podgorica played a critical role in this regard. The Bank also kept civil society and the general public informed of its position on critical issues through interviews to national media and press releases.
- ***Coordination among development partners.*** Coordination is critical for better results. This operation incorporates this lesson by consulting and working closely with the IMF, EC, and EBRD.

## V. THE PROPOSED OPERATION

### A. Objective and Rationale

94. **The objective of the proposed operation is to support the authorities' reform program for strengthening the banking sector and maintaining financial stability, which is a critical pre-condition for sustained economic recovery and balanced private sector-led growth.** The operation supports strengthening of the systemic risk monitoring and crisis preparedness frameworks, the banking sector soundness and transparency, and depositors and market confidence, thus increasing Montenegro's financial sector resilience to possible future adverse shocks. More specifically, this operation's support derives from reforms in the following areas: (i) systemic risk monitoring and crisis preparedness; (ii) resolution of problem banks; (iii) restructuring of Prva Banka; (iv) depositor protection; and (v) the regulatory framework for banks.

[31] "Lessons from Past Financial Crisis", Independent Evaluation Group, the World Bank, 2009.

95. **The negative impact of the global financial crisis and the possible spillover of the consequent Eurozone crisis on Montenegro's economy provide a strong rationale for this operation.** The FSPBG is designed to provide a coherent policy response to address systemic risks in the banking sector and improve its soundness. It also lays the foundation for healthy future growth by advancing the regulatory reform agenda in the financial sector including increased transparency and competitiveness. The prior actions proposed under this operation are listed in Box 2. The overall structure of the proposed Program is shown in the attached Policy Matrix (Annex 1).

96. **The FSPBG program continues the reform agenda started under FSDPL1, with greater emphasis on systemic risk monitoring and crisis preparedness**. The FSPBG program reprioritized the FSDPL1 policy areas in the view of possible spillovers from the Eurozone crisis to put more emphasis on building the crisis management capacity in Montenegro at the level of the FSC. Some triggers were dropped and others added to reflect the most recent reform priorities and efforts of the Government. The continuation of the reform program from FSPDL1 to FSPBG is illustrated in Annex 2.

97. **The design of the Government's reform program and this operation has benefited from consultations with relevant stakeholders (as required by OP 8.60).** The authorities have pro-actively communicated with the public on the objectives of the program. The MoF and the CBCG representatives made frequent appearances on TV and in printed media, regularly issued press releases (published on MoF and CBCG websites in both Montenegrin and English), and organized roundtables to explain the measures taken by the authorities to boost market confidence and restore healthy financial intermediation. The changes in legislation and regulation were extensively discussed with industry stakeholders. The Bank team has also consulted widely with stakeholders, including banking sector representatives, academic experts, and representatives of the key development, and political and economic partners including the European Commission.

**Box 2: Prior Actions for PBG**

The following constitute prior actions for presentation of the Loan to the Bank's Board of Directors:

FSC has:

**(i)** carried out periodic systemic risk monitoring and taken appropriate macroprudential decisions as evidenced by written minutes of meetings and the assessment methodology used;
**(ii)** adopted the national contingency plan including a draft *lex specialis* [the draft Financial Stability Law] granting extraordinary powers to CBCG and the Government to provide emergency liquidity and capital, if necessary, on declaration by the FSC of a financial crisis.

The CBCG has:

**(i)** updated and approved supervisory action plans (SAPs) for 2012 for banks of special concern, based on completed on-site examinations, off-site monitoring and stress-test results as of December 2011, and made satisfactory progress in such SAPs implementation.

The Borrower and the CBCG have presented evidence showing that:
**(i)** *Prva Banka* has made satisfactory progress in the implementation of all actions required by the 2012 SAP, maintains a CAR above 12 percent pursuant to the order issued by CBCG, and complies with all other regulatory requirements; and
**(ii)** the Borrower has withdrawn central government deposits from *Prva Banka* in accordance with the agreed withdrawal schedule between the MoF and Prva Banka to ensure *Prva Banka's* future financing on market terms.

The Borrower has enacted:

**(i)** Regulation on Informing Depositors and Potential Depositors about Deposit Protection Scheme (Official Gazette 16/12, March 19th 2012), to bring public communication protocols vis-a-vis insured depositors in line with EU Directive on Deposit Guarantee Schemes 94/19/EC and 2009/19/EC.;

**(ii)** Decision on Detailed Conditions, Manner and Procedure of the Guaranteed Deposit Payout (Official Gazette 16/12, March 19th 2012), to improve the efficiency and transparency of guaranteed deposit payouts.

The CBCG has, in order to implement the Standardized Basel II Approach, adopted the following regulations:
**(i)** Capital Adequacy Decision, Official Gazette 38/11, July 1, 2011 on capital adequacy;
**(ii)** Decision on the manner of calculating banks' exposures, Official Gazette 15/12, March 5, 2012on large exposures; and,
**(iii)** Decision on Public Disclosure of Information and Data by Banks, Official Gazette 2/12, December 29, 2011 on banks transparency and information disclosure under Pillar 3 of Basel II.

The CBCG has adopted the decision on Minimum Standards for Credit Risk Management in Banks, Official Gazette 22/12, April 12, 2012, implementing IFRS 39 for the banking system as of January 1, 2013.

The Government has, by its decision dated March 29, 2012, approved the Law on Financial Collateral, and thus improved the legislative framework for financial collateral and facilitated enhanced liquidity management at financial institutions.

## B. Operation Description and Policy Areas

98. **A sound macroeconomic framework needs to be in place for this budget support operation.** As described in more detail in Section III.B, the macroeconomic policy mix has, on the whole, been adequate and appropriate for addressing the spillovers from the global economic and financial crisis (also see Annex 4 for the Fund Assessment Letter – *to be added after the IMF Board Discussion of the 2012 Article IV Report*).

***Strengthening Systemic Risk Monitoring and the Crisis Management Framework***

99. **Under this operation, the FSC has developed a methodology to assess systemic risk, regularly monitored systemic risk and taken needed macroprudential actions.** Namely, the Financial Stability Council, including the CBCG, the MoF and other financial sector supervisors, has developed a methodology for systemic risk assessment described in the methodology paper submitted to the Bank. The FSC has monitored systemic risk on a regular basis in line with the methodology, and taken macroprudential policy actions to foster financial stability as confirmed through the minutes of its meetings.

*Status: Completed.*

100. **Further, a national contingency plan including the *lex specialis* (Financial Stability Law) was prepared and adopted by the FSC to strengthen the FSC's powers to manage any future crisis situations effectively and transparently.** Namely, the FSC has developed a *lex specialis* (Financial Stability Law). Upon declaration of a financial crisis by the FSC, this draft Law[32] would be immediately submitted to the Parliament for enactment. The Law would then grant extraordinary powers to the CBCG and the Government to provide emergency liquidity and recapitalize systemic banks, if needed, thus improving Montenegro's capacity to rapidly resolve any future banking crisis situations.

*Status: Completed.*

***Addressing Banking Sector Vulnerabilities***

101. **Under this operation, the CBCG has conducted on-site and off-site examinations of problem banks, and implemented the updated Supervisory Action Plans (SAPs) to restore banking sector soundness.** Based on the methodology agreed with the WB, the CBCG has completed onsite examinations, off-site monitoring reports

[32] This approach is based on the successful model of the emergency anti-crisis Law on Measures for Protection of the Banking System enacted by the Parliament in October 2008, which followed similar procedure. The Bank team concurs with the authorities that passing the draft Law for approval to the Parliament in current market conditions, when depositors' and market confidence is very fragile, is undesirable. This is because the public can misinterpret this step, and a run on banks can occur. However in the medium term, once the global financial crisis has abated, the Bank team is to stay engaged with the authorities to consider a more permanent solution in the form of an adopted Financial Stability Law. Effectiveness of this adopted Law would then be triggered by FSC's declaration of a financial crisis. This is to further address moral hazard problems and introduce greater transparency to resolution of systemically important financial institutions and any future crisis situations.

and stress-testing of systemic banks (CKB, NLB Montenegro Banka, Hypo Alpe Adria Banka, Erste Bank and Podgoricka Banka) as of December 2011 to determine the current and projected level of capital adequacy. Further, the CBCG has approved and enforced implementation of the 2012 SAPs for systemic banks. The SAPs recorded identified weaknesses and risks, and included specific targets and deadlines for addressing any non-compliance with regulations, with the focus on current and projected capital needs. All systemically important banks have SAPs in effect and are currently in compliance with key requirements of those plans updated as of end-February 2012.

*Status: Completed.*

***Completing Restructuring of Prva Banka***

102. **Under this operation, the CBCG has enforced that Prva Banka implemented actions required by its SAP and the CBCG Order to ensure its financial soundness.** Following the completion of a full-scope on-site examination in November 2011, using terms of reference developed jointly with the World Bank, the CBCG updated the time-bounded SAP for Prva Banka. The bank is required by a CBCG order to reach and maintain the minimum solvency ratio of 12 percent as of end-March 2012 throughout 2012. The CBCG has been enforcing that *Prva Banka* implements all corrective actions required by the SAP based on its latest on-site examination and off-site supervision reports, maintains its CAR above 12 percent and complies with all other regulatory requirements, most notably those on liquidity.

*Status: Completed.*

103. **In parallel, the MoF made progress with the gradual withdrawal of central government deposits from Prva Banka (to be completed by end-June 2012) to ensure Prva Banka's market-based financing.** The MoF adopted a schedule for complete withdrawal of central government deposits of EUR28 million (end-2010 figure) from Prva Banka by June 2012, in equal-sized monthly tranches. In order not to endanger the bank's liquidity position, the schedule for further withdrawals of central government deposits has been calibrated in consultation with the CBCG. Under this schedule the MoF has completed the withdrawal of 65 percent of the initial deposits (about EUR18.2 million) from Prva Banka by end-December 2011, 90 percent by May 29, 2012, and is expected to withdraw 100 percent by June 2012.

*Status: Completed.*

***Enhancing Depositor Protection Scheme***

104. **Under this operation, the Deposit Protection Fund (DPF) has issued implementing regulation to improve transparency and awareness of the Deposit Protection Scheme, and the guaranteed deposits payout procedures.** Namely, the enacted Law on the Protection of Deposits has been implemented by the DPF as evidenced by adoption of the regulation on informing depositors on DI scheme in line with the relevant EU directive. Further, the DPF has adopted and tested the regulation on guaranteed deposit payout procedure to increase transparency and efficiency of deposit payouts including shortening the timeframe for the payout to converge to the EU best

practice.

*Status: Completed.*

***Further Improving the Regulatory Framework for Banks***

105. **Under this operation, the CBCG has issued several regulations to bring banks' credit risk management, capitalization, and regulatory reporting closer to EU and international best practice.** Namely, the CBCG has implemented the Standardized Basel II Approach and adopted supporting regulations on (a) capital adequacy; (b) large exposures; and, (c) bank information disclosure. These regulations are expected to significantly improve banks' capitalization against unexpected losses, and increase the quality of regulatory reporting while decreasing its burden on banks.

*Status: Completed.*

106. **Further, the CBCG has adopted a decision to implement International Financial Reporting Standards (IFRS) 39 for banks to increase transparency of the financial conditions of banks and improve their market discipline.** Namely, the CBCG has adopted decisions on implementing IFRS 39 governing the accounting of impaired losses and creating corresponding provisions as of January 1, 2013. The transition to IFRS should make Montenegro's banks more transparent to the markets and potential investors, subject the banks to greater market discipline, and enable greater comparability of the Montenegro's banking system financial condition to other, especially EU, countries.

*Status: Completed.*

107. **Moreover, the Law on Financial Collateral has been adopted to facilitate better access to financial collateral and thus improve liquidity management at subject financial institutions, most notably banks.** The CBCG has developed the Law on Financial Collateral based on EC Directive 47 to improve access to and handling of financial collateral by financial institutions, and the Law has been adopted by the Government.[33] The affected entities include a broad range of financial institutions that are subject to prudential supervision. The main objective is to achieve easier access to collateral, including introduction of collateral agreements in an electronic form, disposition with the collateral for the purpose of secondary pledging, and its execution. This shall in turn improve the capacity of the subject financial institutions to manage their liquidity and thus potentially diminish liquidity risk in the financial sector.

*Status: Completed.*

[33] The transposition of EC Directive 47 is part of the process of harmonizing Montenegro's legal framework with that of the EU, as Montenegro obtained its EU candidate status in 2011 and is preparing for EU accession negotiations. The transposition of the EC Directive 47 typically occurs at a later stage of the harmonization process. However the authorities prioritized the transposition of this Directive in order to aid the financial institutions, most notably banks, in their liquidity management efforts. The fact that the Financial Collateral Law is a transposition of an EC Directive ensures that the principles of the Directive will be maintained as the Directives set the floor (the minimum requirements) in the harmonization process.

## C. Expected Results of the Operation

108. **The progress on the FSDPL1 expected results to date is uneven, but overall positive against the Eurozone crisis, as the banking sector and the economy have not seen a strong recovery take place in recent months.** Depositor confidence has increased and the annual deposit growth reached 2 percent by November 2011 (target rate: positive growth). However, annual credit growth still remains in the negative territory reaching -13 percent by November 2011, far from the targeted positive growth. All banks meet the prudential liquidity ratio prescribed by the CBCG with most banks showing significant additional buffers. The NPL ratio, though dropping from the baseline of 23 percent in March 2011 to 15.5 percent by December 2011, remains well above the targeted 8 percent due to slow NPL workouts and still negative credit growth. The banking system capitalization has improved notably since the baseline of 11.7 percent as of June 2009, standing at 16.5 percent by December 2011. It is the Bank team's assessment that the CBCG supervision has stepped up its efforts in enforcing prudential norms required from banks with more decisive and timely supervisory actions.

109. **The main targeted outcome of the FSPBG is to support broad-based economic recovery through provision of financial services by a sound and transparent banking system operating under regulation and supervision aligned with best EU practice.** Specifically, the measures supported under this FSPBG should contribute to: (i) enhanced macroprudential oversight and the legal authority of the CBCG and MoF to rapidly and transparently resolve any future crisis situations, (ii) enhanced stability and soundness of the banking system; (iii) Prva Banka operating under sound and safe financial condition and a market-based financing structure; (iv) restored confidence in the banking sector with total bank deposits steadily approaching their pre-crisis levels; and (v) effective supervision of the banking system consistent with Basel Core Principles and based on best practice international accounting standards and regulatory reporting. Measurable expected results indicators for each area are presented in the Policy Matrix (Annex 1).

## VI. OPERATION IMPLEMENTATION

### A. Poverty and Social Impacts

110. **The reforms proposed under this operation are expected to have overall positive poverty and social impacts.** Although growth has resumed and economic conditions have improved in 2011, this has not yet translated into significant employment growth or poverty reduction (see Box 3 for more details). This operation is intended to support a more solid financial foundation for sustainable recovery by (i) increasing stability and confidence in the banking sector, (ii) encouraging increased lending activity, and (iii) enhancing CBCG's ability to step up with emergency liquidity assistance. The restoration of credit growth should support new investments and economic activity, with positive impacts on job creation and employment rates (especially in the context of reforms in 2008–09 to improve labor market flexibility), which will in turn increase incomes, including incomes of the poor and near-poor. It is difficult to quantify these expected impacts because of the complex and uncertain links from investor confidence to employment creation to income distribution, especially against a counterfactual of continued instability in Montenegro's financial sector.

**Box 3: Recent poverty trends and social protection**

**Montenegro's economic growth helped reduce poverty significantly through 2008, but this trend was interrupted by the crisis.** MONSTAT and the World Bank estimate that the share of the population living below the absolute poverty line decreased from 11.2 percent in 2005 to 4.9 percent in 2008, and then rose to 6.8 percent in 2009 and decreased marginally to 6.6 percent in 2010 (Table 9). The poverty gap showed a similar decline from 2005 to 2008, followed by an increase in 2009, and a slight decline in 2010. Rural areas and northern Montenegro remain poorer than the national average, but rural/urban and regional differences in poverty rates narrowed substantially in 2010. Notably, those living slightly above the poverty line fared poorly in 2010. If the poverty line were 25 percent higher, the poverty headcount rate would have increased by three percentage points in 2010, from 14.2 to 17.4 percent.

**Table 9: Poverty and near-poverty in Montenegro, 2005–10**

| | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 |
|---|---|---|---|---|---|---|
| National Poverty Line (in EUR/month/adult equivalent) | 140.47 | 144.68 | 150.76 | 163.57 | 169.13 | 169.98 |
| Headcount Poverty Rate (%) | 11.2 | 11.3 | 8.0 | 4.9 | 6.8 | 6.6 |
| Poverty Gap (%) | 2.1 | 1.9 | 1.4 | 0.9 | 1.4 | 1.1 |
| Broad Poverty Line = *125% of National Poverty Line* | 175.59 | 180.85 | 188.45 | 204.33 | 211.28 | 212.47 |
| Headcount Poverty Rate (%) | 25.2 | 23.6 | 16.0 | 11.2 | 14.2 | 17.4 |
| Poverty Gap (%) | 5.3 | 5.0 | 3.6 | 2.3 | 3.3 | 3.2 |

*Source: MONSTAT (June, 2011) and World Bank staff calculations from Household Budget Survey data*
Note: Currency amounts are expressed in current Euros.

**The existing social protection programs mitigate some of the negative impacts of the crisis on poverty.** Unemployment insurance was the first line of government social response in 2009, with unemployment benefit coverage increasing in line with job losses among eligible workers. For the poorest households, the means-tested last resort social assistance program (FMS/MOP) also expanded its coverage in response to the crisis. The FMS/MOP is well-targeted, with 84 percent of program benefits going to the poorest quintile, and benefit levels are relatively generous, among the highest in ECA. The main limitation of FMS/MOP with respect to crisis mitigation is its low coverage rate: in 2009 only 16 percent of the poorest quintile and 23 percent of all poor received FMS/MOP benefits.

111. Potential poverty and social impacts associated with risks to the operation. As noted in paragraph 37, there are substantial policy and external risks to the implementation of the Government's program. Quantifying the expected poverty or social impacts of these endogenous and exogenous factors that would impede program implementation is even more tenuous than quantifying the impacts of the program. With regard to the risk of a worsening fiscal situation, the Government has identified increasing the standard VAT rate (currently 17 percent) as a means of stabilizing revenues. The special VAT rate of 7 percent for basic consumption items such as food, medicines, textbooks, and public transportation, would remain unchanged, offering a significant measure of protection to low income households and those on fixed incomes such as pensioners.

### B. Environmental Aspects

112. **Specific actions under the proposed FSPBG are not expected to have any negative effect on the environment.** The specific country policies supported by the FSPBG are not likely to cause effects on the country's environment and natural resources. The legal and regulatory changes implemented in the context of the FSPBG do not allow the banking sector to circumvent environmental regulations governing investments, nor modify the existing environmental regulatory framework in any way.

### C. Implementation, Monitoring, and Evaluation

113. **The MoF will be responsible for the overall implementation of the proposed operation.** The MoF is the main policy counterpart for the Bank team. The CBCG and, to a lesser extent, the DPF play an important role in the implementation of the banking sector reforms.

114. **The implementation of the policy actions set forth in the policy matrix (Annex 1) has required technical discussions amongst the Bank and the implementing institutions.** The Bank and the Montenegrin authorities have collaborated closely in the preparation of this operation. The Bank has provided policy advice and technical assistance to the authorities on all proposed policies, including the design of macroeconomic framework, drafting of new financial sector legislation and regulation, the methodology for enhanced bank supervision, and problem bank restructuring.

115. **Specific expected results indicators will be used to monitor the implementation of the operation.** The Bank, in collaboration with the Montenegrin authorities, will monitor, inter alia, the following: (i) evolution of bank NPLs and provisioning levels; (ii) bank capital adequacy levels; (iii) bank regulatory liquidity ratios; (iv) progress with the restructuring of Prva Banka and systemic problem banks, (v) evolution of deposits and of non-deposit funding sources; and (vi) evolution of credit growth. These indicators will be employed to evaluate the impact of the policy changes supported by the proposed operation.

### D. Fiduciary Aspects

116. **The guarantee would involve no immediate transfer of funds from the Bank, but sufficient funds would need to be provisioned from the Bank assets to meet a call on the guarantee if required.** When called under conditions provided for under the Agreement, the payment from the Bank will be made as a single payment to the lenders or agent of the lenders. The indemnity agreement between Montenegro and the World Bank provides that the former will repay the latter on demand or as the Bank otherwise directs, if the guarantee is called.

117. **Overall fiduciary risk for the Public Financial Management (PFM) system in Montenegro is considered to be substantial**. Such rating is based on the findings and conclusions of various diagnostic of the Montenegrin public financial management system. Although the Public Expenditure and Financial Accountability Assessment (PEFA) 2009 noted efforts in various areas such as budgeting, reporting, internal control, and internal auditing, further improvements are assessed to be needed.

118. **Procurement:**[34] Montenegro PEFA dated July 2009 stated that "Positive improvements in procurement have been reported, in particular with regard to the legal framework and the organizational structure of the system; however, there are concerns about the institutional capacity of the contracting authorities, the robustness of the data provided by the contracting authorities and the private sector's full confidence in the remedy process." The Performance Indicators Summary (19. Competition, value for money and controls in procurement) states "Procurement is generally good - more than 89 percent of contracts above the low-value threshold are awarded on the basis of open competition". In 2011 a New Public Procurement Law was adopted and has become effective in January of 2012. Its implementation must be observed to objectively measure its impact on Montenegro's public procurement.

119. **Accounting data is assessed to be accurate, however the quality of financial statements should be improved in terms of the standards applied and level of details presented**. Timeliness of submission of financial statements is good with statements being consistently produced by end-July. The information on national budget is publicly available, with basic data on revenues and executions published on a monthly basis on the MoF website. However, financial reporting could be considerably improved by producing budget revenue and execution reports in sufficient detail so as to enable a detailed comparison of budget outturn with the original budget, and producing annual financial statements in accordance with consistently applied and recognized public sector accounting standards.

---

[34] Public procurement environment in Montenegro was rated a high risk country by the Country Procurement Assessment Review of June 2002. Afterwards, the Public Procurement Law was adopted and published in the *Official Gazette of Montenegro* in July 2006, which strived to implement relevant EC Directives. A wide range of efforts to improve Governance by GoM was undertaken: Adoption of Stability Pact Anti-Competition Initiative Compact and Action Plan; strengthening legal framework through the adoption of the Public Procurement Act (2001), adoption of criminal code (2004), of Law on Money Laundering (2004), of Law on Conflict of Interest (2005), which requires high-ranking state officials to report their assets before taking office.

120. **Capacity of the Internal Audit needs further strengthening.** Due to the small number of internal auditors, it is understood that the internal audit manual and Institute of Internal Auditors (IIA) standards are not applied in their entirety in every audit including the application of systems-based audits. Whilst the MoF's Internal Audit Unit performs audits of expenditures in the ordinary course of its work, it has not audited revenues since 2004. All internal audit units, as a matter of course always issue a report after every internal audit assignment, finalize such reports only after discussion and agreement with the audited entity and distribute the finalized report to the management of the audited entity. All the internal audit units were of the view that most recommendations and findings are acted upon by the management of the audited entity. Nevertheless, since the number of repeated audits is rather low, this was confirmed in practice only in sporadic cases.

121. **External scrutiny and audit have improved, but require further strengthening.** With the available limited resources in terms of financing and number of qualified staff, the State Audit Institution (SAI) performs as well as could reasonably be expected but it does require further strengthening. Due to time and resource constraints, audit plans are prepared in order to have all public entities audited at least once in three years. According to the SAI, in any one year it audits entities that account for around 70 percent of consolidated public expenditures. Procedurally, external scrutiny is good in that the Parliamentary Committee on Economy, Finance and Budget receives and is substantially afforded the opportunity to scrutinize the annual budget law as well as external audit reports. However, the committee appears very under-staffed and thus unable to perform its role in as detailed a manner as it would like or could reasonably be expected of it.

122. **The current capacity constraints in the public financial management will not have direct implications on the development policy lending due to the nature of the development policy lending.** There are a number of reform strategies adopted in Montenegro and currently under implementation. Some of the more recent are: Strategy of Public Internal Financial Control (2007), Public Internal Financial Control Law (2008), and Strategy of Management of Public Debt (2008). Other planned PFM reforms relate to planning of the budget, improvement of functional analysis and structure of the budget, as well as of the capital budgeting.

### E. Disbursement Arrangements

123. **Disbursement:** Upon notification by the Bank of the effectiveness of the Guaranteed Loan Agreement among the lenders, the Bank and Montenegro and the effectiveness of the Indemnity Agreement between the Bank and Montenegro, the Borrower may request withdrawal of the loan proceeds from the Private Lenders within a defined drawdown period. The front-end fees and the annualized guarantee fee are expected to be paid out of the proceeds of the IBRD Guaranteed Loan.

124. **Guarantee Fees:** Consistent with the current Bank policy, there is a front-end fee of 25 basis points on the face value of the guarantee exposure and a guarantee fee of

50 basis points per annum (equivalent to the contractual spread for loans) on the present value of Bank's exposure from the transaction. The guarantee fee will also be collected upfront, on a present value basis, to strengthen the transaction terms for all parties.

125. **Callability of the Guarantee:** As the borrower, Montenegro has the obligation to ensure timely repayment to the lenders. Details of the callability of the Guarantee will be defined at a later stage once the instrument is more precisely defined. Following payment by the Bank under its guarantee, the Bank would have sole discretion to decide whether to demand immediate repayment from Montenegro or to extend terms for repayment over time, and in the latter case, would have sole discretion as to the terms to be extended.

### F. Risks and Risk Mitigation

126. **The proposed FSPBG is a high-risk operation.** The key risks are as follows:

- Economic risk
- Financial risk
- Governance risk
- Implementation risk.

***Economic risk***

127. **Both external and public debt levels remain elevated.** Strong growth coupled with fiscal consolidation efforts moderated the imbalances. However, another period of intensified global turmoil may quickly reverse these trends. A global slowdown driven by concerns over fiscal imbalances and the financial sector weaknesses in developed economies, especially in the Eurozone, could undermine the growth prospects of Montenegro. Slower than expected growth in the EU, Montenegro's key trading partner, could dampen Montenegro's economic recovery, in turn placing further strain on the Government's fiscal stance, negatively affecting corporate sector performance and, consequently, hurting the financial sector. Furthermore, the country's euroization, high level of external debt and large debt service requirements over the medium term render the Montenegrin financial sector vulnerable to a slowdown in capital inflows and call for more prudent fiscal policy. Montenegro, being a net oil and food importer, may see a deterioration of its already high external imbalances with limited policy options for import-substitution. Finally, given the small size of the country, even a small shock could have a sizeable impact on the economy.

128. **The Government's substantial fiscal consolidation, build up of fiscal reserves and deepening of structural reforms, together with the financing already mobilized for its 2012 program, provide an important mitigation framework.** Yet given the scale of uncertainty in the external environment, the operation will remain high risk under any scenario. Given the quarterly profile of the government's financing needs, which are concentrated in the first half of 2012, the timing of the proposed FSPBG in the first half of 2012 will also help mitigate the external risks and financing pressures.

*Financial risk*

129. **Existing risk exposures in the banking sector in combination with adverse external shocks could result in financial instability.** A strong 2011 tourist season, foreign investment inflow, and the return of positive economic growth, together with bank recapitalization, should help adjust credit risk exposures and tight liquidity in the banking sector and thus reduce its vulnerabilities. However, the banking sector still remains fragile despite a significant clean-up of banks balance sheets. Deposits have still not recovered to pre-crisis levels and are being significantly reallocated across banks. Nonperforming loans in the system have dropped due to the sale of large portions of bad loans by major banks to sister bad asset management companies and off-shore investment funds. Nevertheless, the amount of non-performing loans in the economy has not changed much and the NPL stock resolution remains a challenge. Several systemically important banks remain fragile. Of special concern is Prva Banka, which remains vulnerable and lacks the support from a strong parent bank or strategic investor (enjoyed by the systemic banks).

130. **This risk is directly mitigated by the policy reforms supported by the operation.** The PBG includes actions that aim to strengthen systemic risk monitoring and the crisis management framework; continue efforts to bring problem banks to sound financial conditions under appropriate supervisory arrangements; complete restructuring of Prva Banka towards sound financial conditions and market-based financing; further strengthen functioning of the deposit insurance scheme; and align the regulatory framework in the banking sector with EU best practice, including through more appropriate bank capitalization against unexpected losses and enhanced regulatory reporting framework. In addition, the structured TA on NPL workouts recently requested by the authorities from the World Bank is expected to help address the issue of high NPLs and contribute to their coordinated workouts and debt restructuring. These reforms, if properly implemented, should enable the authorities to stabilize the banking system in the short-term and strengthen its functioning going forward.

*Governance risk*

131. **A lack of progress on governance improvements could undermine Montenegro's path toward EU accession and thus threaten its efforts to achieve long term macroeconomic and financial sector stability**. The EU and domestic observers have raised concerns in the past about the lack of transparency, and possible influence exercised by organized crime. With encouragement from the EU and other international observers (including the Bank), the Montenegrin authorities are making a concerted effort to correct this perception (see Box 4 for more detail). Specifically, the legislative changes and the more robust supervision effort supported under this operation are expected to strengthen the regulator's standing and improve governance standards in the financial sector. For instance, as a result of more stringent application of fit and proper criteria, the top management of three systemically important banks has been replaced following the start of the crisis.

**Box 4. Montenegro's Recent Progress in Governance Reform**

In recent years Montenegro has made substantial gains in key international indicators measuring governance and political and economic performance, and is a strong performer relative to its SEE neighbors. Montenegro has advanced significantly between 2006 and 2009 on all six of the composite Worldwide Governance Indicators (WGIs) published by the World Bank Institute (WBI). Notable gains were achieved on *political stability*, *regulatory quality*, *rule of law,* and *government effectiveness*. Montenegro's ranking in Transparency International's Corruption Perception Index rose from 85th in 2008 to 69th in 2010, and Freedom House upgraded its rating of Montenegro to *Free* in 2010 from *Partially Free* in 2007. Montenegro's formal regulatory framework and implementation practices are fully in line with the expectation for a country at its income level.

The prior actions for EU membership negotiations define the current rule-of-law reform a priority. The EU stated that membership negotiations could commence once the country had achieved the necessary degree of compliance with, in particular, the Copenhagen political criteria "requiring the stability of institutions guaranteeing notably the rule of law", pointing inter alia to public-administration and judiciary-sector reforms aimed at enhancing professionalization, and fostering de-politicization. The authorities have taken on this challenge. Immediately following the EU's awarding of candidate status, the Government underwent a process of rejuvenation (including the transfer of premiership to the pragmatic and reform-minded former Finance Minister), with a view to strengthening public institutions in those critical areas impacting the country's EU integration perspective. A critical subset of rule-of-law challenges is congruent with structural reforms required to strengthen Montenegro's relative attractiveness as a destination for direct investment—areas in which the Bank has already provided considerable support, and proposes to continue to do so under the current CPS. The Bank's Analytical and Advisory Assistance/Economic Sector Work provides overarching policy advice on challenges related to public administration, fiscal policy priorities, public financial management and procurement, statistics, and financial reporting.

***Implementation risk***

132. **Implementation of the program is dependent on consistent collaboration amongst authorities, especially between the MoF and the CBCG**. With the new legislative framework now in place, the CBCG will need to use its improved mandate to enforce prudential norms, encourage higher capital and liquidity buffers, and take appropriate supervisory measures for banks of special concern.

133. **To mitigate the implementation risk, the Bank has promoted an inclusive, consultative approach in designing the program.** Through a series of technical consultations involving both the CBCG and MoF, the team has sought to foster a mutual understanding and agreement on the content of the reforms, especially on the legal reforms that are necessary to harmonize Montenegrin legislation with EU financial sector legislation. The formed Financial Stability Council should provide a permanent forum for consultation and information sharing between the CBCG, MoF and other financial sector stakeholders. Judging by the recent progress with the reform program, it appears that regulators' actions are fully coordinated with, and supported by the Government, without jeopardizing their operational independence.

134. **There is also a risk that the implementation of politically sensitive and technically complex reforms in the financial sector may stall or even backtrack following the approval of this FSPBG.** To mitigate this risk, the prior actions for the proposed operation entail tangible steps that would be hard to reverse. Most importantly, this involves enactment of regulations rather than their draft preparation, implementation of supervision action plans by banks as opposed to approval of SAPs by the CBCG, and completion of restructuring of Prva Banka instead of significant progress with the restructuring. Furthermore, this operation will be followed up by a Public Expenditure DPL which could provide additional leverage for continued commitment to the FSPBG reform program, including in the context of its component concerning adequate policy mix for ensuring macro-financial stability.

# ANNEX 1. POLICY MATRIX

| POLICY AREA | PRIOR POLICY ACTIONS FOR PBG | KEY EXPECTED RESULTS AND OUTCOMES AT THE END OF THE PROGRAM |
|---|---|---|
| 1. Strengthening Systemic Risk Monitoring and the Crisis Management Framework | FSC has:<br>(i) carried out periodic systemic risk monitoring and taken appropriate macroprudential decisions as evidenced by written minutes of meetings and the assessment methodology used;<br>(ii) adopted the national contingency plan including a draft *lex specialis* [the draft Financial Stability Law] granting extraordinary powers to CBCG and the Government to provide emergency liquidity and capital, if necessary, on declaration by the FSC of a financial crisis. | Enhanced macroprudential oversight and crisis management framework in line with international good practice as appraised by next Financial Stability Assessment Program (FSAP) update. (*Baseline: 2007 FSAP appraisal; next FSAP update expected in 2013-2014*) |
| 2. Addressing Banking Sector Vulnerabilities | The CBCG has:<br>(i) updated and approved supervisory action plans (SAPs) for 2012 for banks of special concern, based on completed on-site examinations, off-site monitoring and stress-test results as of December 2011, and made satisfactory progress in such SAPs implementation. | Improved quality of banks' loan portfolios (baseline: system's NPL ratio at 19.7 percent by September 2011; target: NPLs below 12 percent by mid-2013).<br>Well-capitalized banks (target: average CAR of banking system to remain above 15 percent). |
| 3. Completing Restructuring of *Prva Banka* | The Borrower and CBCG have presented evidence showing that:<br>(i) *Prva Banka* has made satisfactory progress in the implementation of all actions required by the 2012 SAP, maintains a CAR above 12 percent pursuant to the order issued by the CBCG, and complies with all other regulatory requirements; and<br>(ii) the Borrower has withdrawn central government deposits from *Prva Banka* in accordance with the agreed withdrawal schedule to ensure *Prva Banka's* future financing on market terms. | *Prva Banka* has a market based financing structure, and operates in sound and safe financial condition while meeting all prudential norms.<br>(*Baseline: EUR18.2 million of Government deposits by end-December 2011; target: EUR0 by end-June 2012*) |
| 4. Enhancing the Depositor Protection Scheme | The Borrower has enacted regulation:<br>(i) Regulation on Informing Depositors and Potential Depositors about Deposit Protection Scheme (Official Gazette 16/12, March 19th 2012), to bring public communication protocols vis-a-vis insured depositors in line with EU Directive on Deposit Guarantee Schemes 94/19/EC and 2009/19/EC.;<br>(ii) Decision on Detailed Conditions, Manner and Procedure of the Guaranteed Deposit Payout (Official Gazette 16/12, March 19th 2012), | Increased confidence in the banking sector leading to positive annual growth in bank deposits over 2012-2013 to gradually reach the pre-crisis (September 2008) level of deposits (the total decline in deposits from September 2008 to March 2011 reached -19.3 percent). |

| | | |
|---|---|---|
| | to improve the efficiency and transparency of guaranteed deposit payouts; | |
| 5. Further Improving the Regulatory Framework for Banks. | The CBCG has, in order to implement the Standardized Basel II Approach, adopted the following regulations:<br>(i) Capital Adequacy Decision, Official Gazette 38/11, July 1, 2011 on capital adequacy;<br>(ii) Decision on the manner of calculating banks' exposures, Official Gazette 15/12, March 5, 2012, on large exposures; and,<br>(iii) Decision on Public Disclosure of Information and Data by Banks, Official Gazette 2/12, December 29, 2011 on banks transparency and information disclosure under Pillar 3 of Basel II.<br>The CBCG has adopted the decision on Minimum Standards for Credit Risk Management in Banks, Official Gazette 22/12, April 12, 2012, implementing IFRS 39 for the banking system as of January 1, 2013.<br>The Government has by its decision dated March 29, 2012 approved the Law on Financial Collateral, and thus improved the legislative framework for financial collateral and facilitated enhanced liquidity management at financial institutions. | Effective supervision of banking system consistent with Basel Core Principles (No materially non-compliant ratings on BCP assessment in next FSAP update).<br>All banks produce financial statements in international accounting standards (IFRS) as of 2014.<br>Adequate liquidity in the banking sector (target: liquidity ratio in compliance with the CBCG norms). |

## ANNEX 2. FSDPL1-FSPBG REFORM PROGRAM CONTINUATION

| POLICY AREA FSDPL1/(*FSPBG*) | INDICATIVE TRIGGERS FOR FSDPL2 | PBG PRIOR POLICY ACTIONS |
|---|---|---|
| 1. Maintaining Market Confidence | Adoption of the following regulations by the DPF:<br>(i) regulation on informing depositors on DI scheme in line with the EU directive;<br>(ii) regulation on guarantee deposit payout procedure; and<br>(iii) guidelines for DPF's employees during the payout process. | (i) included;<br>(ii) included;<br>(ii) included; |
| 2. Strengthening Liquidity Framework | Adoption of the following regulations by the CBCG:<br>(i) by-law on the Lender of Last Resort function of CBCG; and,<br>(ii) new Policy for Reserve Requirements. | (i) completed; not supported; systemic risk monitoring included instead.<br>(ii) completed; not supported; crisis preparedness included instead. |
| 3. Assessing and Addressing Banking Sector Vulnerabilities | CBCG updates and implements SAPs, as evidenced by recapitalization of banks within the prescribed timetable. | Included; |
| 4. Enhancing Regulatory Framework for Banking Sector | Adoption of the following regulations by CBCG:<br>(i) capital adequacy;<br>(ii) COREP (European Banking Agency common regulatory reporting standards) implementation; and,<br>(iii) credit risk management.<br>Adoption of CBCG decision on the timetable for harmonization of regulations with IFRS and associated bank supervision capacity building plan. | (i) included;<br>(ii) dropped; postponed; regulation on large exposures and information disclosure included instead.<br>(iii) included;<br>Included; |
| 5. Restructuring of Problem Banks | Implementation of PB Supervisory Action Plan, including maintenance of CAR above 12 percent, and compliance with regulatory liquidity ratio.<br>Timely implementation of the MoF decision on withdrawal of central government deposits from *Prva Banka,* aiming to reduce the value of deposits from the same source by (i) further forty (40) percent by December 31, 2011; and (ii) further thirty five (35) percent by June 30, 2012.<br>Implementation of a policy requiring all state and state controlled institutions to conduct price and quality based selection process for banking services. | Included;<br>Included;<br>Completed; not supported; |

## ANNEX 3. OVERVIEW OF THE BANKING SECTOR

1. **The Montenegrin banking sector is dominated by foreign banks.** The banking system comprises 11 banks, nine of which are majority-foreign-owned, and accounting for about 89 percent of banking sector assets (Table 10).

**Table 10: Basic Indicators of the Banking System**

| | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|---|
| Number of Banks | 10 | 10 | 11 | 11 | 11 | 11 |
| Number of Foreign Banks | 7 | 7 | 9 | 9 | 9 | 9 |
| Asset/GDP | 67 | 111 | 107 | 102 | 97 | 88 |
| *Assets Growth y/y* | 106 | 108 | 11 | (8) | (3) | (5) |
| Deposits/GDP | 50 | 78 | 65 | 61 | 59 | 57 |
| *Deposit Growth y/y* | 120 | 94 | (5) | (8) | (2) | 2 |
| Household Deposits/GDP | 23 | 38 | 28 | 28 | 31 | 32 |
| *Household Deposits y/y* | 184 | 104 | (16) | (1) | 13 | 5 |
| Enterprise Deposits/GDP | 17 | 27 | 23 | 20 | 17 | 17 |
| *Enterprise deposits y/y* | 130 | 98 | (5) | (14) | (17) | (2) |
| Credit/GDP | 39 | 84 | 91 | 80 | 73 | 67 |
| *Credit Growth y/y* | 125 | 165 | 25 | (14) | (8) | (8) |
| Household Credit/GDP | 14 | 30 | 34 | 30 | 29 | 26 |
| *Household Credit Growth y/y* | 198 | 155 | 31 | (11) | (6) | (4) |
| Enterprise Credit/GDP | 23 | 52 | 55 | 47 | 42 | 31 |
| *Enterprise Credit Growth y/y* | 102 | 187 | 22 | (18) | (9) | (22) |

*Source: CBCG*

2. **The level of banking system concentration is relatively high.** At end 2011, the three largest banks accounted for 60 percent of total assets and 60 percent of deposits. In particular, the largest bank accounted for 25 percent of assets and 30 percent of deposits (Table 11).

**Table 11. Concentration of the top banks[35], 2011**

| | Assets | Loans | Deposits | Equity |
|---|---|---|---|---|
| 1 bank | 24.6 | 17.4 | 30.4 | 13.4 |
| 3 banks | 60 | 51.4 | 60.1 | 42.2 |
| 5 banks | 73.8 | 74.2 | 72 | 52 |

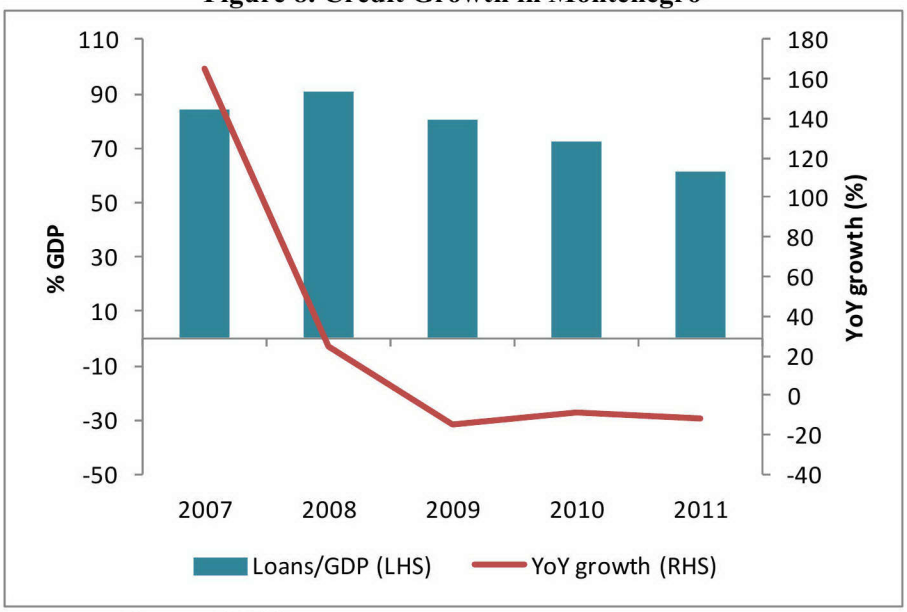
*Source: CBCG*

3. **From 2005 to 2007, the Montenegrin banking system expanded very rapidly, but growth came to a halt since late 2008 due to the impact of the financial crisis.** The rapid growth was driven by the entry of foreign banks, along with increased domestic demand. Total

[35] The structure of the largest banks in the Montenegrin banking system changed in the period 2008-2011. The three largest banks include Montenegro Commercial Bank (CKB), Hypo Alpe Adria Bank (HAAB), and NLB Montegrobanka (NLB). Prva Banka is no longer classified by the CBCG as a systemic bank due to its reduced size in relation to the banking system.

assets increased by more than 100 percent on average in 2006 and 2007, from 67 percent of GDP to 111 percent of GDP. Asset growth slowed down substantially since 2008 due to the impact of the 2008-09 crisis, with assets growing only by 11 percent in 2008 (both due to credit controls applied by the CBCG and the impact of the crisis), and with consistent negative growth rates since then (Table 10).

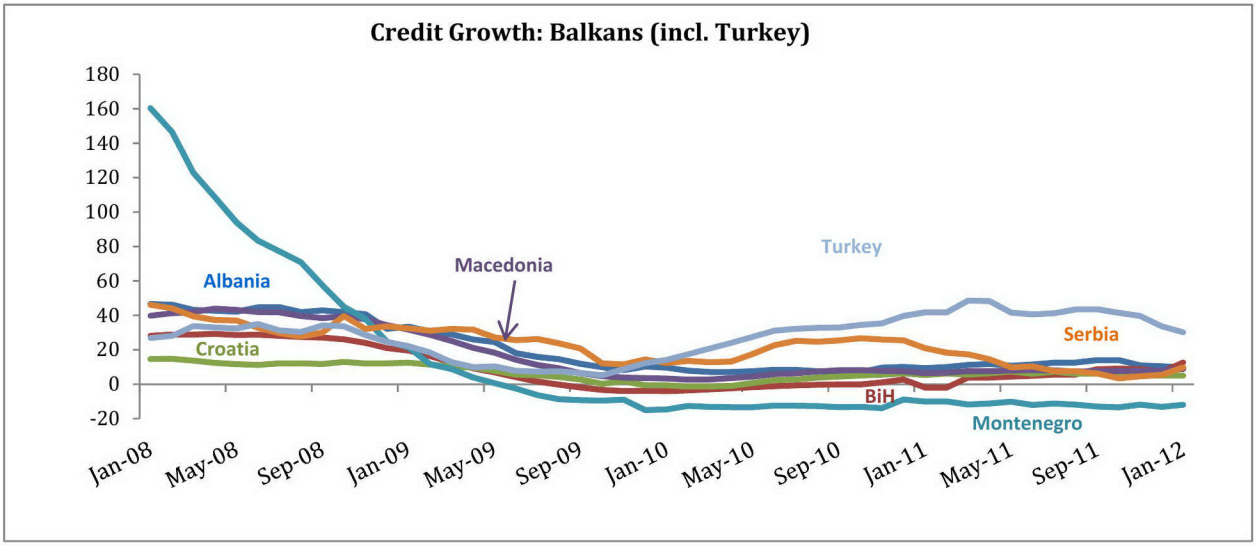
**Figure 8. Credit Growth in Montenegro**

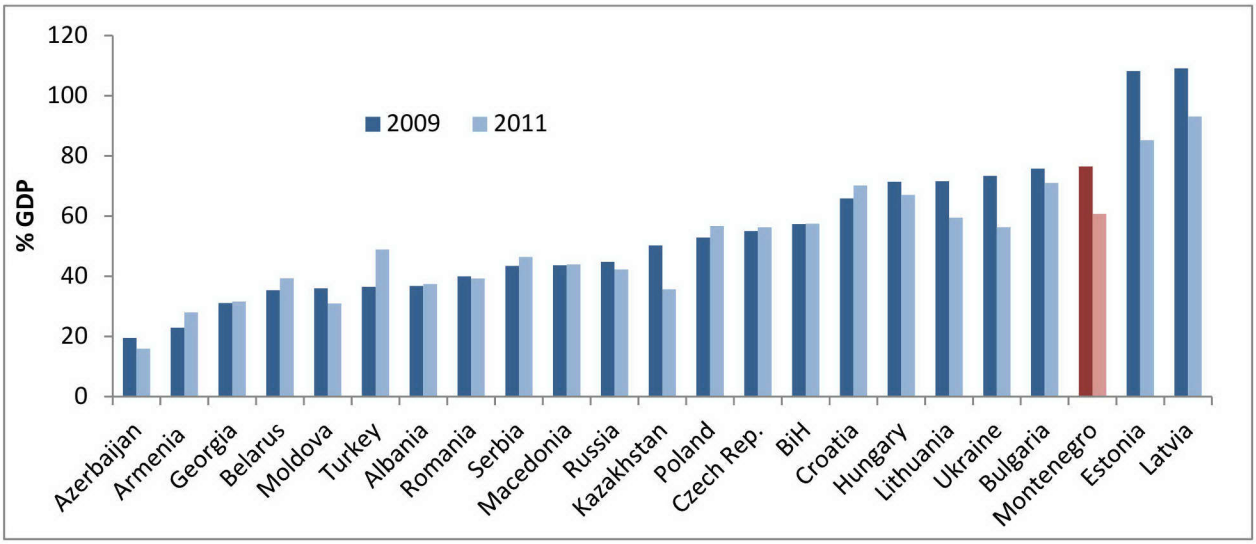



*Source: CBCG*

4. **The expansion of the banking system was underpinned by the exceptionally high credit growth, one of the highest in ECA countries, but a severe credit crunch followed since 2009.** Total credit grew by 145 percent on average in 2006 and 2007. In early 2008, credit growth started to slow down due to the impact of the crisis as well as in response to a series of restrictive measures taken by the CBCG to limit the credit boom (credit growth ceilings and increased minimum solvency requirements). Credit activity started to decline in the last quarter of 2008 as banks became concerned about their deteriorating liquidity situation and ability of their parent banks to provide financing. This declining lending trend has continued in 2009, 2010 and 2011, mainly due to banks' rising asset quality problems and a decline in demand for loans from the corporate sector affected by the weakened economy. Most recent data for 2011 shows a negative credit growth of 11 percent year-on-year.

**Figure 9. Credit Growth in ECA countries**

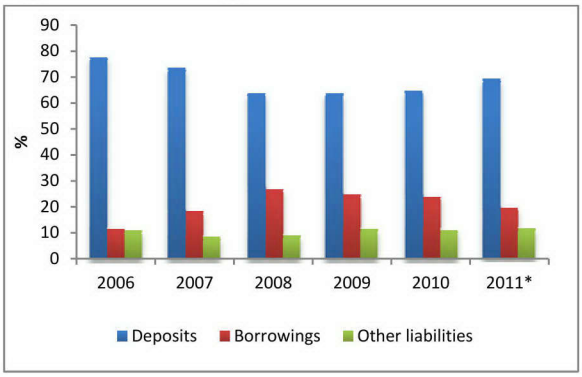



*Source: IFS*

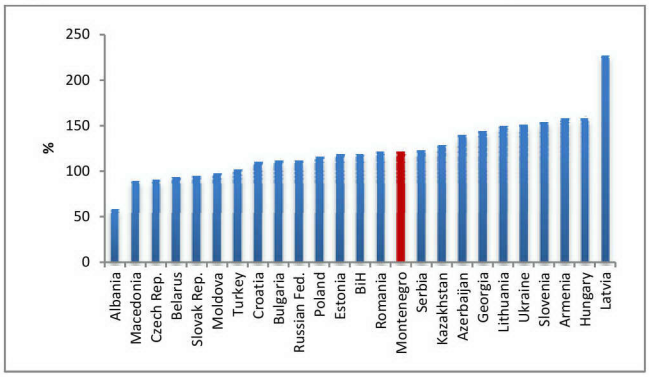
5. **The loan-to-deposit ratio has been slowly adjusting to more sustainable levels but remains high for regional standards.** The high credit growth was largely financed by external borrowings from foreign banks, resulting in one of the highest loan-to-deposit ratios in the region, and exposing the banking sector to substantial liquidity shocks. Financing from parent banks is one of the main sources of financing for banks, as the banking sector is largely foreign-owned (90 percent of system's assets as of end 2011). Funding from parent banks (borrowings from parent banks as a share of total non-equity liabilities) increased from 8 percent in 2006 to 14 percent in 2007, 21 percent in 2008, and has since then decreased to 20 percent in 2009, 17 percent in 2010, and 11 percent in 2011. The high loan-to-deposit ratio exposed the banking sector to substantial liquidity shocks. The LTD increased from 107 percent in 2007, to 140 percent in 2008 and has decreased since then returning to 108 in December 2011.

**Figure 10. Funding Structure**




*Source: CBCG*

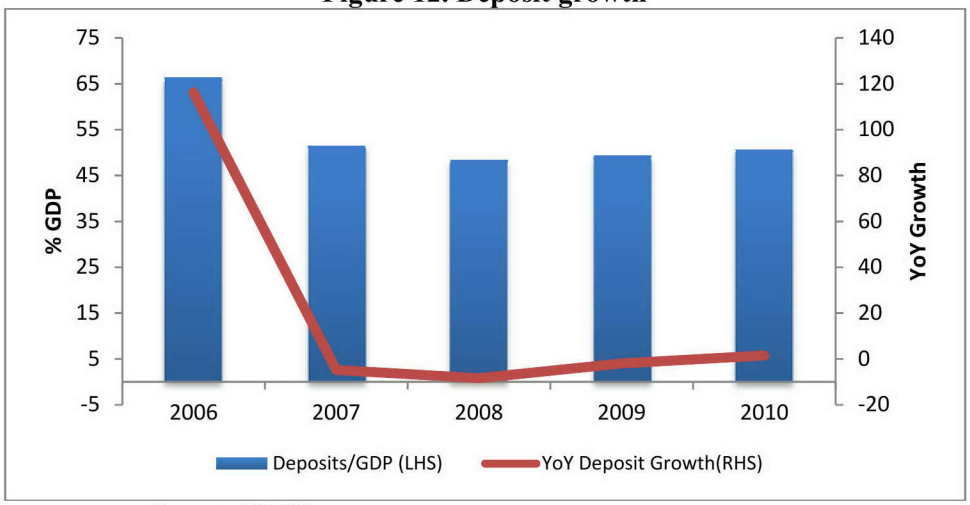
**Figure 11: Selected ECA countries: LTD, 2011**




*Source: IFS*

6. **Deposits also increased rapidly in the years prior to the 2008 financial crisis, during which massive deposit withdrawals undermined banks' liquidity.** Deposits increased by an average of 107 percent in 2006 and 2007, from 50 percent of GDP to 78 percent of GDP. Significant deposit withdrawals occurred throughout the banking system starting in late September 2008. As public nervousness increased with the advent of the global financial crisis, over Q4 2008, deposits declined by 18 percent. The anti-crisis measures implemented by the authorities helped to slow deposit withdrawals, although they did not stop the outflow completely. Between September 2008 and June 2009 there was a loss of about 25 percent of total deposits (about a 33 percent decline of both household and enterprise deposits). In the second half of 2009, deposits showed some signs of recovery. However, a loss of deposits continued in 2010, as deposits declined by 2 percent (13 percent increase from households and 17 percent decline from enterprises) at end-2010. During 2011, deposits increased by 2 percent year-on-year. Overall, between September 2008 and December 2011, the banking sector lost more than 22 percent of total deposits in the system. The withdrawal of deposits was large and persistent, and deposits have not recovered yet to pre-crisis levels.

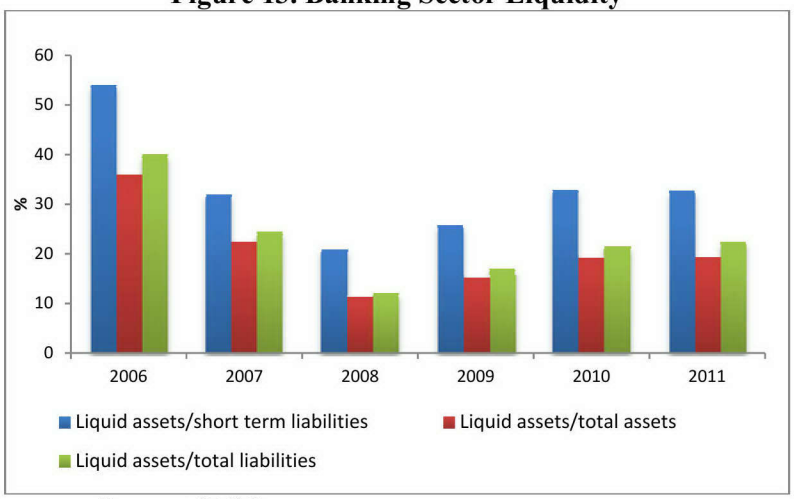
**Figure 12. Deposit growth**




*Source: CBCG*

7. **The withdrawal of deposits, particularly in the largest two banks by size of deposits – CKB and Prva Banka – led to a temporary liquidity crisis in the system.** CKB and Prva Banka lost more than EUR486 million of deposits (more than a third of deposits respectively) from September 2008 to June 2009, accounting for 86 percent of total deposit outflow in the system (CKB accounted for 55 percent of total deposit outflow and Prva Banka for 31 percent of total outflow). The deposit outflow caused deterioration in liquidity, with the liquidity ratio of liquid assets to short term liabilities declining from 32 percent at end-2007 to 21 percent at end-2008. This liquidity ratio was particularly low at Prva Banka at end 2008 with liquid assets to short term liabilities at 7 percent (compared to 21 percent system wide) and liquid assets to total assets at 5.8 percent (compared to 11 percent system wide). Since then, system wide liquidity has improved with a liquidity ratio of 26 percent at end-2009, due to the CBCG measures to improve liquidity in the system by lowering the reserve requirement rate, as well as due to large inflows as a result of privatization of EPCG. In 2010 and 2011, the liquidity ratio improved further to 33 percent in both years.

**Figure 13. Banking Sector Liquidity**




*Source: CBCG*

8. **The banking system entered the crisis with relatively adequate prudential ratios, but preexisting vulnerabilities were accentuated by the crisis**. The banking system reported adequate capitalization as of end Q2-2008, with a capital adequacy ratio of 27 percent (above the regulatory minimum of 10 percent). NPLs had already been rising from 3.2 percent in 2007 to 3.9 percent at end Q2-2008, but still remained at low levels. The banking system was also relatively liquid with the liquidity ratio of liquid assets to short term liabilities at about 27 percent at end-Q2 2009. However, funding liquidity risks were high, especially since banks were heavily reliant on foreign financing.

**Table 12. Key Prudential Indicators of the Banking System**

| | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|
| **Liquidity** | | | | | |
| Liquid assets to short term liabilities | 32.0 | 20.9 | 25.8 | 32.9 | 32.8 |
| Liquid assets to total assets | 22.4 | 11.2 | 15.3 | 19.1 | 19.3 |
| Liquid assets to total liabilities | 24.4 | 12.0 | 17.1 | 21.4 | 22.4 |
| **Capital Adequacy** | | | | | |
| Regulatory capital to risk-weighted assets | 17.1 | 15.0 | 15.8 | 15.9 | 16.5 |
| Capital to Assets | 8.0 | 8.4 | 11.0 | 10.6 | 10.9 |
| **Asset Quality** | | | | | |
| NPLs/loans | 3.2 | 7.2 | 13.5 | 21.0 | 15.5 |
| Past due loans (above 30 days)/ loans | 3.7 | 11.5 | 22.9 | 23.8 | 19.3 |
| Provisions/ NPLs | 73.6 | 55.6 | 43.3 | 30.7 | 32.8 |
| Provisions/ loans | 2.3 | 4.0 | 6.3 | 6.4 | 5.1 |
| NPLs net of provisions, in percent of capital | 20.8 | 46.9 | 52.5 | 102.8 | 66.8 |
| **Earnings and Profitability** | | | | | |
| ROA | 0.7 | -0.6 | -0.7 | -2.8 | -0.1 |
| ROE | 6.2 | -6.9 | -7.8 | -27.3 | -1.1 |

*Source: CBCG*

9. **The main vulnerability facing the banking sector prior to the crisis was liquidity risk, due to the high concentration of deposits in the top banks and banks' reliance on external borrowings.** At end-2008, the top three banks (CKB, Prva, and Hypo Alpe Adria) held 63 percent of total deposits, with the potential to undermine stability in case of a massive deposit withdrawal. In addition, financing from parent banks constituted 76 percent of total borrowings at end-2008, exposing the banking sector to liquidity shocks in case parent banks were unable to sustain financing to their subsidiaries.

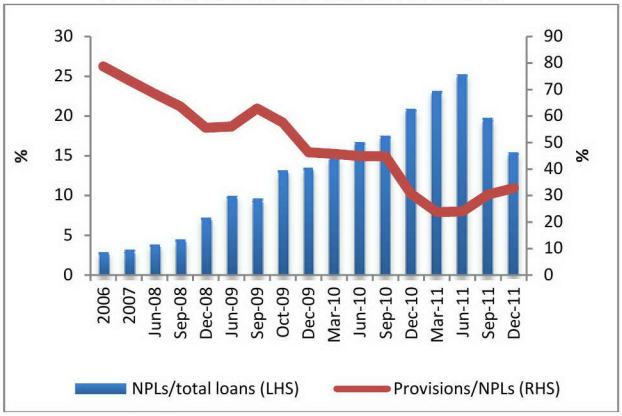
10. **In addition to the liquidity stress, the asset quality in the banking system has deteriorated rapidly since the onset the crisis on the back of accumulated risk exposures during the boom.** The weakened economy, especially with the declining performance of the construction sector and the real estate market, contributed to a high rise in NPLs. NPLs as a share of total loans increased from 7.2 percent at end-2008 to 13.6 percent at end-2009, to 21 percent at end-2010. Total NPLs have decreased slightly to 15.5 in 2011. At the same time, past due loans (loans overdue by more than 30 days) increased from 11.5 percent at end-2008 to 23 percent at end-2009, to 24 percent at end-2010, and further to 19 percent at end-2011. The rapid rise in NPLs during 2010 was driven in part by Prva Banka's delay in recognizing the extent of

its NPLs (which did not occur until after an onsite inspection in December 2010), in part due to the contraction in total loans as banks ceased lending (and thus increased NPLs as a proportion of total loans), and also in part due to other large banks (particularly CKB and Hypo), which "cleansed" their loan portfolios in 2010 in anticipation of spinning off large volumes of NPLs to their foreign parents in the first half of 2011, a process which is now underway. Given estimated GDP growth of two percent in 2011 (after an estimated 1.1 percent growth in 2010), the ending of the cleansing process, and the spin-off of NPLs now underway, NPLs declined to 15.5 percent by end-2011, but stronger recovery in bank lending is yet to resume.

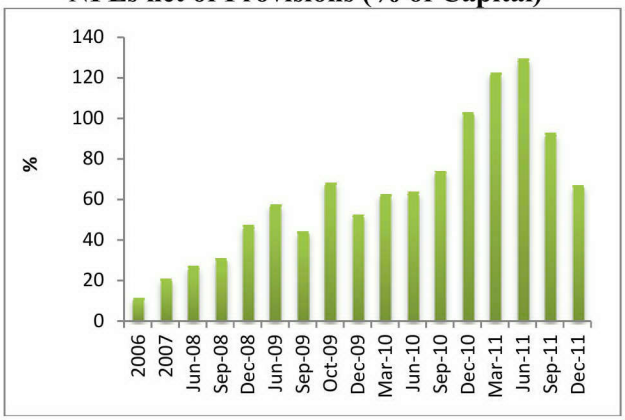
11. **Provisions coverage of NPLs has been on a declining trend.** Provisioning as a share of total loans increased from four percent at end-2008 to 6.3 percent at end-2009 and to 6.4 percent as of end-2010. In 2011, provisions decreased to 5 percent of total loans. Provision coverage of NPLs has been on a declining trend from 56 percent in 2008 to 47 percent in 2009, 31 percent in 2010, and to 33 percent by the end of 2011. This is partly due to a relaxation in asset classification and provisioning requirements for banks that the CBCG has undertaken since June 2009. In addition, net NPLs account for a very high share of banks' capital, at 67 percent by end-2011.

**Figure 14. NPLs, Loan Loss Provisioning, and Capital at Risk**

**NPLs and Loan Loss Provisions**




**NPLs net of Provisions (% of Capital)**



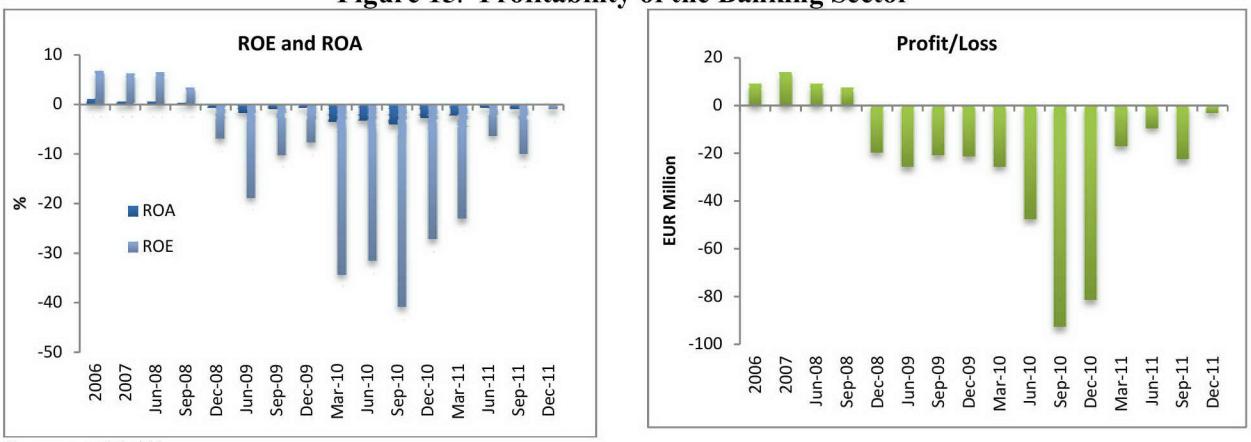

*Source: CBCG*

12. **Due to the deteriorating asset quality, the system's capital adequacy was negatively affected.** The banking system's capital adequacy declined from 15 percent in 2008 to 13 percent in 2009, increased to 15.9 percent in 2010, and stood at 16.5 at end-December 2011. Parent foreign banks were able to provide additional capital in the amount of EUR230 million from Q4 2008 to March 2011 - to their local subsidiaries to offset the losses caused by the crisis. Prva Banka is posing the highest risk since, unlike other systemically important banks, it could not rely on support from a foreign parent.

13. **In response to rising NPLs, banks have been restructuring credit.** In 2009, total restructured loans amounted to EUR205 million (about 9 percent of the loan portfolio) and as of end-2011 to EUR277 million (over 14 percent of the loan portfolio). Loan restructuring consisted mainly of prolonging repayment of the principal or the interest. On December 23, 2009, the CBCG adopted a temporary regulation allowing creditors to negotiate restructuring

with debtors that have loans of above 180 days overdue loans, a change from the previous requirement of restructuring loans of up to 90 days overdue.

**Figure 15. Profitability of the Banking Sector**




*Source: CBCG*

14. **The crisis had a rapid and dramatic impact on bank profitability, which still remains negative due to high provisioning requirements on the back of high NPLs.** The banking sector has incurred heavy losses since December 2008. The ROA decreased from -0.6 percent in 2008 to -0.7 percent at end-2009, to -2.8 percent at end-2010, and improved slightly at -1 percent at end-September 2011. The ROE declined from -6.9 percent in 2008 to –7.8 percent at end 2009, and declined dramatically in 2010 reaching -28 percent at end-2010, and stood at -1 percent at the end of 2011. The banking sector incurred losses throughout 2010 with EUR82 million in losses at end-2010. However, in 2011 the rate of losses declined as banks incurred EUR3 million in losses for the year.

**Table 13. Income Statement**

| | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|---|
| **Net Interest Income** | **38,014** | **75,488** | **110,087** | **120,367** | **113,702** | **106,169** |
| Interest Income | 65,157 | 142,371 | 245,423 | 236,833 | 213,894 | 195,960 |
| Interest Expenses | -27,143 | -66,883 | -135,336 | -116,465 | -100,192 | -89,797 |
| Provision Expenses for Losses | -10,659 | -41,534 | -81,774 | -80,725 | -136,280 | -76,121 |
| **Net Non-Interest Income** | **37,073** | **60,714** | **52,529** | **41,884** | **45,113** | **88,043** |
| Fee Income | 36,172 | 54,816 | 63,462 | 49,262 | 49,708 | 52,157 |
| Fee Expenses | -7,435 | -11,692 | -15,792 | -16,556 | -15,275 | -21,773 |
| Other Income (net) | 8,336 | 17,590 | 4,859 | 9,176 | 10,680 | 6,159 |
| Other Extraordinary Income (net) | -205 | -185 | 1,115 | 550 | -1,710 | 14,113 |
| **Overhead and Other Expenses** | **-53,972** | **-78,101** | **-99,765** | **-101,108** | **-101,676** | **-106,447** |
| Net Income Before Tax | 10,251 | 16,382 | -17,808 | -19,033 | -80,850 | -22,359 |
| Income Taxes and Contributions | -1,242 | -2,475 | -1,879 | -2,536 | -874 | -255 |
| **Net Profit/Loss** | **9,009** | **13,907** | **-19,687** | **-21,569** | **-81,677** | **-3,219** |

*Source: CBCG*

15. **Parent banks supported their Montenegrin subsidiaries with substantial additional funding, thus helping to partially offset the decline in deposits.** In total, Montenegrin banks received around EUR230 million in equity and subordinated debt from Q4 2008 to March 2011, with most of the funds going to CKB, Hypo Alpe Adria, NLB and Podgoricka.

**Table 14. Balance Sheet**

| | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|---|
| **Assets** | | | | | | |
| Cash and deposits | 511,902 | 664,376 | 473,271 | 528,707 | 629,734 | 624,448 |
| Loans | 847,166 | 2,245,684 | 2,797,533 | 2,397,755 | 2,199,974 | 1,955,767 |
| *Loan loss provisions* | *-19,048* | *-52,218* | *-111,928* | *-150,225* | -141,663 | -99,624 |
| Net loans | 828,117 | 2,193,467 | 2,685,605 | 2,247,530 | 2,058,311 | 1,856,143 |
| Securities | 26,270 | 17,667 | 19,076 | 82,353 | 53,303 | 82,275 |
| Financial derivatives | | | | 48 | 6 | 6 |
| Factoring and forfeiting | | | | 5,446 | 12,707 | 48,889 |
| Receivables from custody operations | | | | 19 | 23 | 39 |
| Other assets | 66,126 | 101,374 | 139,925 | 167,215 | 202,807 | 209,974 |
| Provisions for assets other than loans | -1,000 | -1,451 | -8,216 | -6,085 | -13,227 | -12,054 |
| **TOTAL ASSETS** | **1,431,416** | **2,975,432** | **3,309,661** | **3,025,233** | **2,903,513** | **2,809,720** |
| | | | | | | |
| **Liabilities** | | | | | | |
| Deposits | 1,075,769 | 2,091,075 | 1,990,590 | 1,824,688 | 1,789,852 | 1,817,060 |
| Borrowings | 172,351 | 536,249 | 908,161 | 741,822 | 701,386 | 547,113 |
| Financial derivatives | | | | 918 | 614 | 441 |
| Custody Services | | | | 1,097 | 340 | 1,098 |
| Other liabilities | 34,533 | 111,167 | 131,533 | 124,974 | 140,558 | 138,779 |
| **TOTAL LIABILITIES** | **1,282,654** | **2,738,492** | **3,030,284** | **2,693,499** | **2,632,748** | **2,504,491** |
| **TOTAL CAPITAL** | **148,762** | **236,940** | **279,377** | **331,734** | **310,905** | **305,229** |
| **TOTAL LIABILITIES AND CAPITAL** | **1,431,416** | **2,975,432** | **3,309,661** | **3,025,233** | **2,943,655** | **2,809,720** |

*Source: CBCG*

## ANNEX 4. FUND RELATION NOTE

International Monetary Fund

# IMF Executive Board Concludes 2012 Article IV Consultation with Montenegro

Public Information Notice (PIN) No. 12/51
May 16, 2012

***Public Information Notices (PINs)*** form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

On May 11, 2012, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Montenegro.[1]

**Background**

Three years after the sudden end of Montenegro's boom, there has been considerable progress toward recovery. Strong growth in tourism supported real GDP growth of 2½ percent in 2011, bringing output nearly back to its pre-crisis level in 2008. The recovery is at risk of stalling, however, with the projected downturn in the euro area likely to weigh on growth in 2012. The debt overhang continues to linger, moreover, with domestic liquidity shortages a growing constraint. High-frequency economic indicators depict a weakening of activity in late 2011 and early 2012.

In addition, the policy buffers that have supported growth in recent years have been largely depleted. Public debt has risen sharply since 2007, increasing from 28 to 47 percent of GDP at the end of 2011, as fiscal surpluses quickly turned into large deficits following the collapse of the boom.

Fiscal imbalances have proved difficult to rein in, reflecting a large fall in revenue after the collapse of the boom, rising pension expenditures, and costs stemming from public support for struggling enterprises. However, and notwithstanding an increase in the headline deficit, there was some progress toward fiscal consolidation in 2011. Although the headline deficit rose to 6.3 percent of GDP, this partly reflected payment of called loan guarantees that had been extended in 2009-10 but did not have an impact on demand in 2011. Adjusting for these payments, the fiscal stance tightened by 0.7 percent of GDP. The authorities aim for further consolidation this year and over the medium term, and are in the process of identifying

needed measures to achieve this adjustment.

After three years of rapid bank deleveraging, there are indications that conditions are stabilizing. The gradual return of deposits to the banking system continued in 2011, and banks took steps to off-load problem loans and re-align their lending with their domestic deposit base. However, the system remains burdened by high non-performing loans—notwithstanding their recent sharp decline—and is lagging in provisioning. New bank lending remains limited, reflecting the existing debt overhang and the significant uncertainty over the economic outlook.

**Executive Board Assessment**

Executive Directors commended the authorities' efforts to stabilize the economy, and welcomed the progress made since the financial crisis. With the recovery now at risk of stalling, Directors called for intensified efforts to address large fiscal and external imbalances, further enhance financial sector stability, and improve competitiveness.

Directors recognized the sizable public expenditure adjustment over the past few years, but underscored the need for further high-quality deficit reducing measures to put public debt on a declining trajectory. While fiscal consolidation will need to rely on both revenue and expenditure measures, the more sizable adjustment should come from further spending cuts. Directors saw the 2012 supplementary budget, adopted by the cabinet, as a step in the right direction. Going forward, Directors recommended further reducing personnel and entitlement spending. They underscored the importance of ending fiscal and quasi-fiscal support to the metals sector and assessing its viability. Directors stressed that revenue measures should focus on improving tax administration, but saw some scope to raise tax rates that are below regional levels. Some Directors cautioned that tax rate increases should be considered only after tax administration is strengthened, given their potential impact on competitiveness.

Directors commended the authorities' efforts to stabilize the financial sector, and to improve the framework for crisis preparedness and banking resolution. Given remaining vulnerabilities, they stressed the need to further strengthen supervision and regulation, including the macroprudential framework. They underlined the need to enforce capital requirements and improve asset quality, while monitoring liquidity closely and maintaining high prudential buffers.

Directors welcomed progress in advancing structural reforms, and called on the authorities to accelerate efforts to enhance competitiveness and attract foreign investment. In particular, they underscored the need to further improve the business environment and increase labor market flexibility. Directors also saw merit in reforms to ensure that social protection schemes target the neediest and do not impede labor market participation.

Directors called for continued efforts to address shortcomings in economic statistics which hamper policy design and evaluation.

Montenegro: Selected Economic Indicators, 2008-12

| | 2008 | 2009 | 2010 | 2011 Est. | 2012 Proj. |
|---|---|---|---|---|---|
| **Real economy (percent change, unless otherwise noted)** | | | | | |
| Nominal GDP (millions of €) | 3,086 | 2,981 | 3,104 | 3,260 | 3,334 |
| Gross national saving (percent of GDP) | -10.0 | -3.1 | -2.6 | -1.2 | -0.6 |
| Gross investment (percent of GDP) | 40.7 | 27.1 | 22.8 | 19.4 | 20.3 |
| Real GDP | 6.9 | -5.7 | 2.5 | 2.5 | 0.2 |
| Industrial production | -2.0 | -32.2 | 17.5 | -10.3 | ... |
| Tourist arrivals | 4.8 | 1.6 | 4.6 | 8.7 | ... |
| Consumer prices (average) | 9.0 | 3.6 | 0.7 | 3.1 | 2.0 |
| Consumer prices (end of period) | 7.2 | 1.7 | 0.7 | 2.8 | 1.7 |
| **Money and credit (end of period, percent change)** | | | | | |
| Bank credit to private sector | 25.0 | -15.1 | -8.9 | -13.0 | ... |
| Enterprises | 21.3 | -18.0 | -11.2 | -17.6 | ... |
| Households | 31.2 | -10.7 | -5.7 | -2.6 | ... |
| Private sector deposits | -14.2 | -4.1 | 5.9 | 1.2 | ... |
| **General government finances (accrual; percent of GDP)** [1] | | | | | |
| Revenue and grants | 48.4 | 42.6 | 41.3 | 37.9 | 38.0 |
| Expenditure | 51.5 | 47.9 | 46.0 | 44.2 | 43.2 |
| Overall balance | -3.1 | -5.3 | -4.7 | -6.3 | -5.2 |
| Primary balance | 0.5 | -4.4 | -3.7 | -4.6 | -3.3 |
| Privatization receipts | 1.2 | 4.4 | 0.9 | 0.5 | 0.5 |
| General government gross debt (end of period) | 31.9 | 40.7 | 42.4 | 46.9 | 50.2 |
| **Balance of payments (percent of GDP)** | | | | | |
| Current account balance | -50.6 | -29.6 | -24.6 | -19.4 | -19.7 |
| Foreign direct investment | 18.9 | 35.8 | 17.8 | 11.9 | 11.4 |
| External debt (end of period, stock) [2] | 90.8 | 93.5 | 96.4 | 99.9 | 107.3 |
| REER (CPI-based; average percent change, + indicates appreciation) | 1.6 | 6.4 | 0.0 | -3.2 | ... |

Sources: Ministry of Finance, Central Bank of Montenegro, Statistical Office of Montenegro, and IMF staff estimates and projections.

[1] Includes extra-budgetary funds and local governments, but not public enterprises.

[2] Estimate, as private debt statistics are not officially published.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

## ANNEX 5. LETTER OF DEVELOPMENT POLICY

MONTENEGRO
MINISTRY OF FINANCE

No: 06-1556/1

CBCG
CENTRAL BANK OF
MONTENEGRO

br. 0102-2487/1

Mr. Robert B. Zoellick
President
The World Bank
1818 H Street, N.W.
Washington, D.C., 20433

25 May 2012

Dear Mr. Zoellick:

1. We are writing to request, on behalf of the Government of Montenegro and the Central Bank of Montenegro, a Financial Sector Policy-Based Guarantee Facility (FSPBG) of EUR 60 million equivalent to support our economic reform program. This Letter of Development Policy sets out the key actions that the Government is committed to undertake over the near to medium term to maintain macroeconomic stability and further strengthen the financial sector in Montenegro.

2. Since 2002, and following the adoption of the euro as the legal tender, Montenegro's inflation and interest rates declined and reforms accelerated. We have implemented a series of fiscal and social reforms aimed at modernizing the functions of the state, increasing the efficiency of public expenditures and improving targeting of social spending, as documented in the World Bank's recent public expenditure reviews. After independence, by late 2006, Montenegro's economy found itself increasingly flushed with large inflows of external capital, which financed an economic, real estate, and credit boom. Foreign firms and individuals acquired significant local assets, mainly land, housing, and other real estate.

3. Over 2006-2007, we ran fiscal surpluses of about 4 percent of GDP on average. But with the large revenue windfall, spending went up from 42 percent of GDP in 2006 to over 50 percent of GDP in 2008, mainly due to the surge in capital expenditure, partly compensating for preceding years of underinvestment in basic infrastructure. Current expenditures increased as

well, especially wages and current transfers. During this boom period, Montenegro had one of the highest economic growth rates (9 percent) and per capita foreign direct investment (FDI per capita €1600) in Europe, and the gross fixed investment-to-GDP ratio averaged 37 percent over the same period. The overheating resulted in widening of the current account deficit, albeit financed to a significant degree by large FDI inflows.

4. Growth plummeted, from almost 7 percent in 2008 to -5.7 percent in 2009, one of the sharpest growth declines among European and Central Asian economies. External demand (in particular for aluminum and steel) dropped, while liquidity problems in the financial and corporate sectors escalated.

5. In response, we implemented emergency financial, fiscal and social measures to stem the impact on the economy while continuing EU-accession related structural reforms. An announcement of a bank deposit guarantee in October 2008 stopped the run on deposits. The Central Bank responded with a menu of measures aimed at easing the liquidity crisis while strengthening inspection and supervision. On the fiscal front, we implemented cuts in nominal wages and increased spending on active labor market programs targeting the youth and new job entrants. Despite short-term pressures, we also advanced structural pension reform, inter alia, by adopting automatic annual adjustments to the mandatory retirement age, following good international practice. We also began preparing the ground for a significant further tightening of the budget in the considerably changed external environment. By 2011, we had cut total public expenditures by about 8 percentage points of GDP from its peak in 2009, through a freeze in public sector wages, staffing rationalization, and further expenditure restraint in operations and maintenance costs, and the capital budget. Fiscal deficit declined below 4 percent of GDP by 2011, despite the declining revenue-to-GDP ratio, rise in tax arrears, and increases in military pensioners as part of the adjustment in the context of Montenegro's efforts towards NATO membership, as well as an increase in the total number of pensioners (almost three times more pensioners in 2010 and 2011 compared to the average from 2000 to 2009). The social contributions and pensions have increased by 64 million (2% of GDP) in the last two years, and has been on the expenditure side the key reason for not reaching the balanced budget in 2013.

6. With a sharp drop in economic activity, domestic demand and imports, a significant external adjustment took place from 2009 onwards. The current account deficit declined by more than a half between 2008 and 2011 (from 51% of GDP to 19% of GDP). This deficit corrected for the net FDI flows declined to more moderate, though still high, levels of the order of 10-12 percent of GDP. Access to capital was retained through foreign banks' sustained financial support to Montenegrin subsidiaries, which contributed to the rise in private external debt to about 60 percent of GDP, while total external debt (public and private) hovered around 100 percent of GDP in 2011.

## Maintaining Macroeconomic Stability

7. After the economy grew by an average of 2.5 percent over the 2010-11 period, Montenegrin economy recovered at one of the fastest rates since the drop in 2009,real GDP is projected to slow to 0.5 percent in 2012. The growth outlook for 2012 implies a downward revision from what was envisioned when the original 2012 budget was approved and reflects the

deteriorating external environment in the Eurozone. Over the medium term, growth is expected to recover to 3-3.5 percent, become more diversified, and supported by FDI in energy, tourism and construction.

8. In line with the expected deterioration in growth during 2012, we are intensifying our fiscal consolidation efforts. On the revenue side, we had already increased key excises and the property tax rate, stepped up collection and taken steps to expand the tax base, including by reducing exemptions. However, given the weaker growth and revenue outcomes in the early months of the year, the revised 2012 budget amendment adopted in April 2012 raises further excises on alcohol and other products, increases tax on privileged pensions; introduces levies on mobile telephony SIM cards, smoking public place areas, electricity meters, and cable TVs; and implements additional measures to improve compliance. These new measures are expected to generate about 0.6 percent of GDP in additional revenues. On the expenditure side, a conservative indexation mechanism for wages and pensions has already been adopted and is backed by a formal agreement with the unions; this is expected to reduce the government wage bill and transfers to the social insurance funds. The budget aims at rationalizing some subsidies (state aid) and social transfers (e.g., labor market programs, maternity benefits) while maintaining critical capital expenditures. Government guarantees are limited to EUR10 million (about 0.3 percent of GDP), signaling a shift to a much more restrictive policy towards guarantees. In addition, on the expenditure side, the 2012 budget amendment further cuts current expenditures by [0.34] percent of GDP and delays some non-essential capital expenditures, which will result in saving of about [0.14] percent of GDP. As a result, the primary deficit will be cut—relative to the 2011 outturn—by [1.56] percentage points to [0.63] percent of GDP and the overall deficit will be reduced by about 1.3 percentage points to 2.34 percent of GDP.

9. The revised budget also takes into account budgetary implications of recent developments with the aluminum company. As a result of those fiscal pressures and the downward revision of growth and revenues, the fiscal deficit of the Central Government in 2012 will be revised from 1.25 percent to 2.55 percent of GDP in the amended budget. While the current loan schedule spreads repayments over a three to five-year period, these pressures together add up to an additional EUR155 million (5 percent of 2011 GDP) public debt service.

10. In parallel to the 2012 Budget Law amendment, we have also adopted additional measures that are likely to generate further savings: (i) a law on a 7-percent cut in wages of top government officials, diplomats and judiciary; (ii) reduced per diems allowances for official travel by 20 percent; (iii) reduced privileged pensions for sportsmen, and launched a review and revision of disability pensions; (iv) abolished governing boards' allowances in health, social, cultural and educational state institutions; and (v) ordered a reduction in salaries of management at SOEs.

11. Over the medium term, under the amended fiscal framework we aim to deepen fiscal consolidation, move towards fiscal surpluses and reverse the debt dynamics, setting the public debt of Montenegro on a downward trajectory. The Government's objective is to stem further growth in public debt which, along with guarantees, reached 59.6 percent of GDP in 2011. The medium-term strategy is built on a plan to reduce general government spending by additional 4.5 percentage points of GDP, down to about 38 percent of GDP, by 2015 (from over 50 percent of

GDP in 2009). The long-term objective is to reach the public debt ratio of about 30-35 percent of GDP.

12. The Government has either prepared or implemented significant measures to further restrain spending and—importantly—improve its efficiency over the medium term:

- The pension system reform, in line with good international practice, resulted in the increase in the retirement age from 55/60 to 67 for men and women, following automatic adjustments with the transition period of 20 years. The pension indexation was changed to a more conservative 75 percent of CPI and 25 percent of the average wage, a more conservative mechanism than the so-called Swiss formula (50-50).
- The public administration reform through staff downsizing implemented a "two-for-one" principle, i.e., one employed for two staff leaving the public sector or three retiring; the central payroll calculation and a wage freeze;
- The state aid reform, whereby subsidized electricity to metal industries will cease by end-2012;
- The rationalization of social security costs and transfers through capping total health and social benefit expenditures, consolidating insurance funds under the Single Treasury Account, and imposing central oversight of the use of budget funds;
- Centralized authorization/management of public procurement and the Single Treasury Account commitment module to prevent further accumulation of arrears;
- Moderation of capital spending and their protection to priority projects at about 3.5 percent of GDP throughout the period;
- Drafted amendments to the organic budget act to formally introduce the Medium-Term Expenditure Framework and the fiscal rule in 2012; and
- Stepped up efforts in tax collection and gradual increases in property tax and excise duties (also required as a part of the EU accession program).

13. Beyond fiscal consolidation, we plan to continue strengthening competitiveness of our economy and prepare the ground for more robust long-term growth. This strategy includes: (i) creating fiscal buffers and protecting macroeconomic stability; (ii) continuing restructuring of the financial and real sector; (iii) accelerating structural reforms in social, labor, and education sectors as well as public administration to ensure sustainability of public finances; and (iv) strengthening the enabling environment for private sector growth.

14. We are keenly aware of the risks to our economy and fiscal stance and are committed to implementing substantial contingency measures. Given these risks and increasing uncertainties in the Eurozone, and in addition to the April 2012 revisions to the budget, we are considering an increase in the standard Value-Added tax rate (currently at 17 percent), if this were to be needed. These measures could be activated in case of a further deterioration in economic conditions later in the year.

## Strengthening the Financial Sector

15. In the area of financial sector development, we will continue our program to strengthen regulation and supervision of banks consistent with sound international (and specifically, EU) practice, including Basel II compliance. We will continue to ensure that all banks, and especially the systemically important ones, are adequately capitalized; we are committed to improving the resolution framework for failing banks to minimize the potential costs of bank failure to depositors and the State budget and of disruption in the banking sector; we will further strengthen the ability of the Deposit Protection Fund to conduct payouts of insured deposits at failed banks in a timeframe consistent with EU directives; we will continue strengthening the liquidity management framework by enhancing the powers of the CBCG to carry out lender of last resort functions in line with international good practices; we are committed to promote the restructuring of problem systemic banks through timely implementation of supervisory action plans; and, we will complete implementation of our program to level the competitive playing field by withdrawing central government deposits from all banks and ensuring that public institutions purchase financial services and place their deposits using a transparent, competitive, and risk-adjusted procurement framework.

16. Since the beginning of the global financial crisis we have put in place a comprehensive crisis management framework. We have continued the reform program started under the FSDPL1 focused on systemic risk monitoring, crisis preparedness and strengthening banks financial soundness, and also including leveling the playing field in the banking sector to allow for prudent and fair competition in the provision of financial services. By April 2012, we have implemented, with technical support from the World Bank and the EC central bank twinning program, a comprehensive package of reforms to strengthen systemic risk monitoring and the crisis management framework, address existing banking sector vulnerabilities, complete restructuring of *Prva Banka,* enhance depositor protection, and further improve the regulatory framework for banks. These reforms, described below, support Montenegro's progress towards aligning its legal and policy frameworks with good international practice and the EU.

17. First, a new law on the Central Bank of Montenegro (CB Law) was enacted in mid-2010 that provides the CBCG with expanded powers to act as the lender of last resort. The Financial Stability Council (FSC) established by the Financial Stability Law of 2010 (FSL) has become operational and meets regularly, which has greatly strengthened systemic risk monitoring. Further, the FSC has put in place a new crisis management framework by developing crisis contingency plans at the level of the three financial sector regulators and the FSC, including adoption of a national contingency plan. In addition, the FSC has adopted a draft *lex specialis* (Financial Stability Law) which would be submitted to Parliament immediately upon declaration of a financial crisis by the FSC, and, once enacted, would grant the authorities additional powers to intervene in the financial system by providing liquidity and capital support.

18. Second, we have employed a range of supervisory techniques to identify vulnerabilities in the banking sector and required bank management and owners to undertake prompt corrective actions as necessary. The supervisory framework combines full scope on-site examinations, targeted on-site examinations, off-site monitoring, and quarterly stress testing for credit, liquidity, and market risks. By April 2012, updated supervisory Action Plans (SAPs) for banks of special concern and systemic importance were approved by CBCG management and

implemented, and we have developed an intensive plan of on-site supervision activities for 2012. We maintain an ongoing dialogue with bank management and shareholders to address specific weaknesses, including capital and liquidity shortfalls identified during on-site inspections and off-site stress tests.

19. Third, as a result of the October 2011 on-site examination, we have developed a SAP for Prva Banka which has been issued with an Order to maintain at least 12 percent capital adequacy ratio throughout 2012 and required to eliminate all irregularities described in the on-site examination report and SAP. At the same time, Prva Banka must meet all other regulatory requirements. In parallel, the MoF has been proceeding with a gradual withdrawal of central government deposits from Prva Banka based on a schedule agreed under the FSDPL1, and all remaining Government deposits will be withdrawn by end-June 2012. Furthermore, we have issued guidelines to all majority state-owned enterprises, municipalities and other state-sponsored institutions to use clearly defined eligibility criteria for procurement of financial services from commercial banks. The guidelines should ensure that no bank receives a disproportionate share of state-related financial services business.

20. Fourth, we enacted a new Deposit Protection Law in mid-2010, now implemented by the Deposit Protection Fund which has adopted several regulations to improve its functions. In order to improve the function of informing depositors about increase of the coverage from EUR 20,000 to EUR 35,000, the DPF has adopted a by-law on providing information to depositors through regular communications as of Q1 2012. Further, the DPF adopted a regulation on payouts of guaranteed deposits to increase the transparency and efficiency of the process, including the selection of the payout agent bank. In addition, the DPF has adopted an internal regulation that governs its activities and processes during the payout process, including a clear assignment of responsibilities.

21. We have taken steps to harmonize the regulatory framework for banks with relevant EU Directives and with prevailing practices in EU member states. Thanks to reforms implemented under the FSDPL1, the CBCG now has the full range of instruments and authorities for effective supervision and, in particular, for dealing with problem banks. By April 2012, we made further progress in bringing the regulatory framework into alignment with EU and international good practice by adopting new regulations to implement the Basel II Standardized Approach, requiring implementation of IFRS for banks, and by the Government adoption of the Law on Financial Collateral, which is expected to be enacted by the Parliament in the first half of 2012. The adopted Basel II implementing regulations include CBCG Decisions on capital adequacy, credit risk management, large exposures, approvals to use credit rating agency ratings, and bank transparency and information disclosure under Pillar 3 of Basel II. The Government has adopted a draft Law on Financial Collateral based on EC Directive 47 to improve access to, and handling of, financial collateral by financial institutions, and it is expected that the Parliament will enact the Law by end-Q2 2012, and we commit to use our best efforts to secure such enactment. We continue to work towards implementation of IFRS by banks, and have established a working group to assess the tax implications of IFRS introduction. As the first step in this process, the CBCG has issued a regulation requiring banks to implement IFRS 39 as of January 1, 2013. In addition, the CBCG has adopted an IAS capacity building plan for bank supervisors. We are committed to issuing all necessary regulation in the course of 2012 to implement the full IFRS for banks as of January 1, 2013.

22. In the next 18 months, we intend to build on the above-described reforms to further strengthen the legal and regulatory framework for the banking system and complete work on leveling the competitive playing field for banks. This reform program will have five major components (described in more detail below): (i) full implementation of the 2010 CBCG Law including issuance of required regulations and decisions; (ii) continued updates and implementation of the supervisory action plans for systemic banks and banks of special concern to ensure that all of these institutions are capitalized at levels consistent with their risk profiles; (iii) improvements to the transparency and quality of bank financial reporting as a result of the full implementation of IFRS by banks; (iv) further strengthening of the DPF's capacity to execute cost-efficient and timely payouts of insured deposits of failed banks; and, (v) completing the reforms started in early 2011 to level the competitive playing field for financial services provided to central Government and other State entities.

23. By end-2012 the CBCG will complete adoption and implementation of regulations and decisions required to put into practice the provisions of the 2010 CBCG Law, including regulations required to implement the CBCG's expanded lender of last resort powers. In parallel, the FSC will adopt all bylaws and regulations required to formalize the Committee's operations and consultative functions and harmonize these functions with the CBCG's bylaws and regulations.

24. The CBCG completed the issuance of regulations and bylaws required by the amendments to the Banking Law by end-March 2012, and will fully implement them by 31 December 2012. In parallel, the clean-up of the banking system, started in 2009, was completed by end-March 2012 at which point all banks were fully compliant with the terms of their SAPs, and as a result fully compliant with all CBCG regulations. All systemic banks will have their SAPs updated regularly on the basis of onsite inspections and offsite monitoring. Prva Banka in particular has achieved and is required to maintain a capital adequacy ratio of at least 12 percent, and two further on-site inspections of the bank will be carried out in 2012 to ensure that the bank remains in compliance with its minimum capital adequacy ratio of 12 percent and other regulatory norms. These on-site inspections will be reinforced by monthly offsite analysis of the bank's progress, regular meetings with management, and monthly off-site monitoring of its condition.

25. In order to improve the transparency of bank financial reporting and the ability of bank supervisors to detect emerging risks, and to better align Montenegro with financial reporting practices in most EU countries, the CBCG and MoF intend to transition financial and tax reporting requirements to comply with IFRS as of January 1, 2013. To this end, by December 31, 2012, the CBCG will have issued all regulations and decisions required for IFRS implementation. Issuance of these regulations (the first of which, on implementation of IFRS 39 has already been issued by the CBCG) is being supported by a CBCG-MoF joint working group which is assessing potential tax revenue and tax reporting impacts arising from the transition; and, by the CBCG's IAS capacity-building program for its supervisors, which was adopted in February 2012.

26. While the legal powers and credibility of the DPF have been considerably strengthened by the new Deposit Protection Law and putting in place an EBRD's back-up credit line, the DPF still lacks institutional and analytical capacity for assessment of individual banking risks and full

implementation of its responsibilities, in compliance with Core Principles for Effective Deposit Insurance. To address this weakness, the DPF will: (i) complete issuance of regulations and bylaws required to implement the provisions of the DPF Law and EU Directive on Deposit Guarantee, (ii) strengthen its analytical function; (iii) complete implementation of a capacity building program designed to put in place the IT and other systems required to give the DPF rapid insured deposit payout capabilities, and complete training of DPF staff to ensure they are able to carry out their new responsibilities. In addition, DPF will strive to further amend necessary regulation which will allow more efficient usage of deposit insurance funds through purchase and assumption transactions, based on least-cost test.

27. By mid-2012 the process of leveling the competitive playing field for financial services provided to state related institutions will be completed. This process has two main components: (i) the withdrawal of Central Government deposits from commercial banks, including Prva Banka (which remained in compliance with the schedule for withdrawal of deposits as of March 31, 2012); and, (ii) enforcing compliance by all other State institutions (including, *inter alia*, municipalities, State pension and other funds, and state owned enterprises) with the MoF's guidance issued in early 2011.

28. In conclusion, we would like to reiterate the commitment of the Government and the Central Bank of Montenegro to these reforms, which will help strengthen the fiscal and financial sector foundations for long-term economic prosperity. We trust that this request of the World Bank support for their implementation will receive your favorable consideration.

Milorad Katnić, PhD
Minister of Finance
Government of Montenegro

Radoje Žugić, PhD
Governor
Central Bank of Montenegro

## ANNEX 6. IBRD GUARANTEE

### A. Guarantee Instrument

**1. The details of the terms and conditions of the IBRD Guarantee and the guaranteed loan to Montenegro are still being discussed and defined** in close consultation with the Government and global banks. The indicative terms and conditions of the potential IBRD Guarantee of a loan to Montenegro are provided below.

**2. Borrower and Guarantee Amount:** The Borrower is Montenegro and the operation is a Policy-Based Guarantee from the IBRD in the amount of EUR60 million, the equivalent of US$79.2 million.

**3. Structure of the instrument:** The FSPBG will partially guarantee a loan from an international commercial bank or banks. The guarantee will cover EUR60 million of the EUR90-100 million principal of the loan. The obligation will have a five- to seven-year maturity. At the moment the Borrower and the markets are contemplating a structure with IBRD guaranteeing a final balloon repayment of EUR60 million principal at maturity with unguaranteed principal amortized over the term of the loan.

**4. Interest rate:** The authorities are expected to opt for a fixed interest rate loan, to be based on the five- to seven-year euro swap rate plus a spread. The lenders will also charge an arrangement fee to be negotiated with the Borrower.

**5. The procurement process will follow national legislation.** The procedure for selecting the loan is expected to be relatively simple and would involve the issuance of a Request for Proposals by the Ministry of Finance to a number of market participants. According to the national legislation, once the winning bid is selected, a negotiation of the loan terms would follow, without a need for parliamentary approval of the lenders or of the Guaranteed Loan Agreement. The Indemnity Agreement between the Bank and Montenegro would also not require parliamentary approval. The Bank will work closely with the authorities to minimize risks during the process. Furthermore, the Guaranteed Loan Agreement to be signed will have provisions that cover Sanctionable Practices at all stages of the proposed operation. Under these provisions, IBRD is allowed to withhold payment if evidence arises at any time between the date of the Guaranteed Loan Agreement and the final maturity date of the guaranteed loan that the lender has engaged in a Sanctionable Practice in connection with the Guaranteed Loan Agreement.[36]

**6. Disbursement:** Upon notification by the Bank of the effectiveness of the Guaranteed Loan Agreement among the lenders, the Bank and Montenegro, and of the effectiveness of the

[36] The procurement process for the commercial loan is ready to be launched. The GoM will tender the transaction to selected global banks by May 25, and the winner will be selected by June 26. The MoF will solicit bids for the commercial loan from up to a dozen banks that operate in the region and which have demonstrated potential interest in supporting the Government. All bids are conditional upon the World Bank issuing a guarantee for the principal repayment. The GoM will formally announce the winner in late June after a careful review of the offers. Once the World Bank guarantee has been approved by the Board of the World Bank, the loan agreement will be signed with the lender(s).

Indemnity Agreement between the Bank and Montenegro, the Borrower may request withdrawal of the loan proceeds from the lenders within a defined drawdown period. As a condition to effectiveness, Montenegro would also provide IBRD with a legal opinion on the Indemnity Agreement. The front-end fees and the annualized guarantee fee are expected to be paid out of the proceeds of the IBRD Guaranteed Loan.

**7. Guarantee Fees:** Consistent with the current Bank policy, there is a front-end fee of 25 basis points on the face value of the guarantee exposure (EUR60 million) and a guarantee fee of 50 basis points per annum (equivalent to the contractual spread for loans) on the present value of Bank's exposure from the transaction. The guarantee fee will also be collected upfront, on a present value basis, to strengthen the transaction terms for all parties.

**8. Callability of the Guarantee:** As the borrower, Montenegro would have the obligation to ensure timely repayment to the lenders. In accordance with Bank policy on PBGs, the guarantee would be non-accelerable. Following payment by the Bank under its guarantee, the Bank would have the sole discretion to decide whether to demand immediate repayment from Montenegro or to extend terms for repayment over time, and in the latter case, would have the sole discretion as to the terms to be extended.

## B. Outline of Indicative Terms and Conditions of Potential World Bank Guarantee of Loan to Montenegro

*This term sheet contains a summary of indicative terms and conditions of a potential IBRD Policy-Based Guarantee (the IBRD Guarantee) for a private-sector loan to the Republic of Montenegro.*

*This term sheet does not constitute an offer from IBRD to provide an IBRD Guarantee. The provision of the Guarantee is subject,* inter alia*, to satisfactory appraisal by IBRD of the related Program, review and acceptance of the financing structure and transaction documentation, and the approval of the Management and the Board of Directors of IBRD in their sole discretion.*

**IBRD Guarantee and Guaranteed Loan:**

| | |
|---|---|
| **Guarantor:** | International Bank for Reconstruction and Development (IBRD). |
| **Borrower:** | Republic of Montenegro. |
| **Guarantee Beneficiaries:** | Commercial bank lender to be identified (the Lender). |
| **Purpose:** | The proposed Financial Sector Policy Based Guarantee (FSPBG) supports Montenegro's comprehensive program of measures to strengthen the banking sector, with the view to address vulnerabilities of the Montenegrin banking sector and increase the resilience of the sector to possible future shocks. The FSPBG is a stand-alone operation building on the First Financial Sector Programmatic Development Policy Loan (FSDPL1) disbursed during the fiscal year 2011. |

| | |
|---|---|
| **Guarantee Term:** | Term of underlying borrowing, expected to be five to seven years. |
| **Guaranteed Event:** | Failure by the Borrower to repay the outstanding principal amount of the IBRD Guaranteed Loan at stated maturity. |
| **Guarantee Support:** | The IBRD Guarantee would cover up to EUR 60 million of scheduled principal due at maturity, which the Lender would have otherwise received from the Borrower under the IBRD Guaranteed Loan Agreement, but for the occurrence of a Guaranteed Event. |
| **IBRD Guaranteed Loan Amount:** | Principal amount of EUR [100] million. |
| **IBRD Guaranteed Loan Interest Rate:** | A [fixed interest rate equivalent to [5]-year EUR swap rate plus a margin to be determined] [variable interest rate equivalent to EURIBOR plus a margin to be determined]. |
| **Maturity:** | [Five to seven] year maturity, amortizing repayment. |
| **Currency:** | Euro. |
| **Governing Law:** | [England]. |
| **Negative Pledge:** | The terms of the IBRD Guaranteed Loan and the IBRD Guarantee will restrict the ability of the Borrower and IBRD, as the case may be, to create certain liens on their property or assets without equally and ratably securing the IBRD Guaranteed Loan or the IBRD Guarantee, respectively. |
| **Status of the IBRD Guarantee:** | The obligations of IBRD under the IBRD Guarantee will constitute direct, unsecured obligations of IBRD ranking *pari passu*, without any preference among themselves, with all its other obligations that are unsecured and unsubordinated. |
| **Status of the IBRD Guaranteed Loan:** | The IBRD Guaranteed Loan will constitute direct, general, unconditional, unsecured and unsubordinated external indebtedness of the Borrower ranking *pari passu* with all other unsecured and unsubordinated external indebtedness of the Borrower. |

**IBRD Guarantee Provisions:**

| | |
|---|---|
| **IBRD Policy-Based Guarantee:** | IBRD will guarantee to the Lender the payment by the Borrower of the outstanding EUR 60 million principal of the IBRD |

| | |
|---|---|
| | Guaranteed Loan at scheduled maturity and will agree to pay on demand from the Lender\ as provided in the IBRD Guaranteed Loan Agreement the amount of the principal which is due and payable by the Borrower, provided that the maximum aggregate amount of principal for which IBRD shall have liability shall not in any circumstances exceed the amount of the IBRD Guarantee as described above (*see Guarantee Support)*. |
| **Demand Notice for Payment under the IBRD Guarantee:** | No later than 10 business days after the scheduled maturity date, the Lender will notify IBRD of any amount of principal that has fallen due and payable and remains unpaid after the scheduled maturity date. Such notice shall also constitute a demand on IBRD for payment.<br><br>IBRD shall have 30 days from and inclusive of its receipt of such demand notice to make payment in respect thereof.<br><br>The obligations of IBRD under the IBRD Guarantee constitute a guarantee of payment and not of collection. Any demand notice must be received by IBRD within ten (10) business days of the date any amount of principal referenced in such demand notice becomes due and payable under the IBRD Guaranteed Loan Agreement. |
| **Reduction of Demand:** | If after the Lender has made a demand on IBRD for payment under the IBRD Guarantee but before IBRD has made payment of the amount so demanded, the Borrower pays the Lender (or the Lender recovers otherwise than from IBRD) any sum which is applied to the satisfaction of the whole or any part of the such principal amount, the Lender shall promptly notify IBRD of such fact and IBRD's liability under the IBRD Guarantee in respect of such demand shall be reduced by an amount equal to the portion of principal so paid by the Borrower (or so recovered by the Lender) and so applied. |
| **No Discharge:** | Neither the obligations of IBRD under the IBRD Guarantee nor the rights, powers and remedies conferred upon the Lender with respect to IBRD by the IBRD Guarantee or by applicable law or regulation shall be discharged, impaired or otherwise affected by: (i) any insolvency, moratorium or reorganization of debts of or relating to the Borrower; (ii) any of the obligations of the Borrower under the IBRD Guaranteed Loan Agreement being or becoming illegal, invalid, unenforceable, void, voidable or ineffective in any respect; (iii) any time or other indulgence being granted to the Borrower in respect of its obligations under the IBRD Guaranteed Loan Agreement or (iv) any other act, event or omission (other than the failure of the Lender to make a demand under the IBRD Guarantee) which might otherwise operate to |

| | |
|---|---|
| | discharge, impair or otherwise affect any of the obligations of IBRD under the IBRD Guarantee or any of the rights, powers or remedies conferred on the Lender by the IBRD Guaranteed Loan Agreement or be applicable law or regulation. |
| **No Amendment without IBRD Consent:** | The IBRD Guarantee shall terminate and any written demand from the Lender pursuant to the IBRD Guarantee shall be void if any amendment is made to the IBRD Guaranteed Loan Agreement, or any waiver or consent is given in writing with respect thereto, without IBRD's prior written consent. |
| **IBRD Obligations Binding:** | IBRD's obligations under the IBRD Guarantee shall be binding upon IBRD and inure to the benefit of the Lender and shall be enforceable only by the Lender, provided that the obligations of IBRD under the IBRD Guarantee shall not be treated as a separate obligation of IBRD independent from the principal amount guaranteed, and the benefit of such obligations may only be transferred by a Lender in accordance with the provisions below, as more fully described in the IBRD Guaranteed Loan Agreement. |
| **Assignment:** | Except as IBRD may otherwise agree, any assignment of the IBRD Guaranteed Loan may be made only to an assignee established as a bank or financial institution duly licensed to carry out banking or financial business in its country of domicile. Such assignee may be a partly or wholly government-owned institution, but cannot be an export credit agency, multilateral institution or state entity. Such assignee must not have been declared ineligible to be awarded an IBRD- or IDA-financed contract in accordance with World Bank Sanctions Procedures and must not be an entity included on the consolidated list of individuals and entities maintained by the United Nations Security Council Committee established pursuant to United Nations Security Council Resolution 1267.<br><br>The assigning Lender shall provide IBRD with advance notice of potential assignments as provided in the IBRD Guaranteed Loan Agreement. |
| **Subrogation:** | Upon payment by IBRD of amounts under the IBRD Guarantee, IBRD shall, to the extent it has not been reimbursed by the Borrower under the Indemnity Agreement (as discussed below), be immediately entitled to recover from the Borrower the amount so paid by IBRD in respect of principal and for this purpose IBRD shall be immediately subrogated to the rights of the Lender to the extent of the amount in respect of principal so received by such Lender, regardless of whether such Lender has been fully prepaid or repaid by the Borrower, and the Lender shall forthwith |

| | |
|---|---|
| | assign or transfer to IBRD, without representation, warranty or recourse, all of such Lender's claims, interests, rights and security which it then has against the Borrower under the IBRD Guaranteed Loan Agreement in respect of principal so received. |
| **Withholding of Payment:** | If at any time between the effective date of the IBRD Guaranteed Loan Agreement and the maturity date of the IBRD Guaranteed Loan (i) there is substantial evidence that the Lender has, in connection with the IBRD Guaranteed Loan, engaged in fraudulent, corrupt, coercive or collusive practices or (ii) the Lender has been declared ineligible to be awarded a contract financed by the International Bank for Reconstruction and Development or the International Development Association in accordance with the World Bank Sanctions Procedures, then IBRD shall be entitled to withhold payment of all amounts otherwise payable under the IBRD Guarantee by IBRD on account of such Lender. |
| **Role of IBRD:** | The Lender will acknowledge and agree that IBRD will be acting under the IBRD Guaranteed Loan Agreement solely in its capacity as guarantor of the principal of the IBRD Guaranteed Loan as provided therein and in no other capacity. IBRD shall incur no liability under the IBRD Guaranteed Loan Agreement nor have any other duties or responsibilities, except to the extent expressly specified in the IBRD Guaranteed Loan Agreement or in any document delivered by IBRD under or pursuant to that agreement. |
| **Cross-Default Restriction:** | IBRD may require a cross-default provision in the IBRD Guaranteed Loan Agreement, including a restriction on the ability of the Lender to accelerate the IBRD Guaranteed Loan upon a default by the Borrower under any World Bank loans such that the IBRD Guaranteed Loan may only be accelerated in the event of a material default on World Bank loans. |

**IBRD Guarantee-Related Fees:**

| | |
|---|---|
| **IBRD Guarantee Fees:** | IBRD charges a guarantee fee of 0.5 percent per annum on the present value of IBRD's exposure under the IBRD Guarantee, payable up front in advance by the Borrower. IBRD may terminate the IBRD Guarantee if the IBRD Guarantee Fee is not paid by either of the Borrower or the Lender on or before the fourteenth (14th) business day following the date of a notice provided by IBRD to the Lender. |
| **IBRD Front-end Fees:** | IBRD charges a front-end fee of 0.25 percent of its maximum |

| | |
|---|---|
| | exposure (in this case, an amount of EUR 60 million) for Policy-Based Guarantees. This fee is payable by the Borrower. |
| **Stand-by Fees:** | None. |

**Conditions Precedent to the IBRD Guarantee:**

| | |
|---|---|
| **Conditions Precedent:** | Usual and customary conditions for financing of this type including the following:<br>a) Satisfaction of relevant programmatic conditions precedent based on previous IBRD Development Policy Loan to Montenegro;<br>b) Provision of relevant legal opinions satisfactory to IBRD;<br>c) Evidence of payment in full of the Front-end Fee and the Guarantee Fee;<br>d) Conclusion of an IBRD Guaranteed Loan Agreement among the Lender, the Borrower and IBRD and an Indemnity Agreement between IBRD and the Borrower. |

**IBRD Documentation:**

| | |
|---|---|
| **IBRD Guaranteed Loan Agreement:** | The terms and conditions of the IBRD Guarantee would be contained in the IBRD Guaranteed Loan Agreement among IBRD, the Borrower and the Lender.<br>IBRD will represent and warrant to the Lender that (in addition to standard representations about due authorization, enforceability and power to execute) its obligations pursuant to the IBRD Guaranteed Loan Agreement rank *pari passu* with all other unsecured and unsubordinated obligations of IBRD.<br>The Lender will represent and warrant that it has not engaged in and are not engaging in fraudulent, corrupt, coercive or collusive practices, and will covenant, *inter alia*, to apply all amounts received by it under the IBRD Guarantee towards payment of the principal amounts covered by the IBRD Guarantee which were the subject of the demand notice. |
| **Indemnity Agreement:** | The Borrower would enter into a separate Indemnity Agreement with IBRD. Under the Indemnity Agreement, the Borrower would undertake to indemnify IBRD on demand, or as IBRD may otherwise determine, for any payment made by IBRD under the terms of the Guarantee. The Indemnity Agreement will follow the legal regime, and include dispute settlement provisions, which are customary in agreements between |

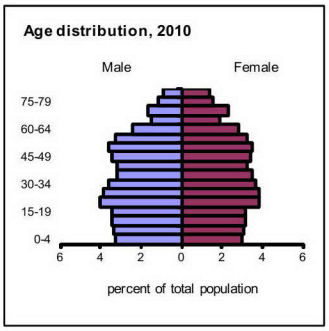
| | |
|---|---|
| | member countries and IBRD.<br>Any obligation by the Borrower to reimburse IBRD for payments made under the IBRD Guarantee will rank *pari passu* with all other external indebtedness of the Borrower, including external indebtedness of the Borrower to IBRD.<br>The Indemnity Agreement will also contain provisions on the deposit and use of proceeds of the IBRD Guaranteed Loan. The Borrower shall agree to deposit the proceeds of the IBRD Guaranteed Loan in an account acceptable to IBRD, with appropriate tracking of amounts deposited therein in the Borrower's budget management system. The Borrower will make withdrawals from such account for use in support of its development policy program, and will agree not to use such withdrawals to finance any excluded expenditures, which shall include, *inter alia*, goods included in groups or subgroups of the United Nations Standard International Trade Classification, Revision 3, military goods, environmentally hazardous goods, certain payments prohibited by a decision of the United Nations Security Council taken under Chapter VII of the Charter of the United Nations, or expenditures with respect to which IBRD determines that corrupt, fraudulent, collusive or coercive practices were engaged in by representatives of the Borrower. If any such withdrawals are used for excluded expenditures, the Borrower shall deposit an equivalent amount in the account or prepay the Lender an equivalent amount.<br>In the event that the Borrower fails to make any payment to or to indemnify IBRD under the Indemnity Agreement or otherwise defaults on its obligations under the Indemnity Agreement, IBRD shall be entitled, in addition to any other rights and remedies it may have, to suspend or cancel in whole or in part the Borrower's right to make withdrawals under any loan or guarantee between IBRD and the Borrower or under any development credit agreement or financing agreement between IBRD and the Borrower, or to declare the outstanding principal and interest of any such credit or loan due and payable immediately. |

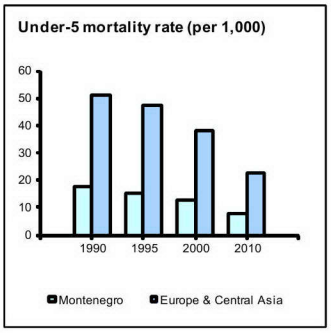
# ANNEX 7. COUNTRY AT A GLANCE

## Montenegro at a glance

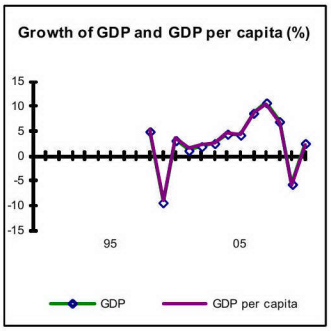
4/5/12

| Key Development Indicators | Montenegro | Europe & Central Asia | Upper middle income |
|---|---|---|---|
| *(2010)* | | | |
| Population, mid-year (millions) | 0.63 | 405 | 2,452 |
| Surface area (thousand sq. km) | 14 | 23,614 | 59,328 |
| Population growth (%) | 0.2 | 0.4 | 0.7 |
| Urban population (% of total population) | 60 | 64 | 57 |
| GNI (Atlas method, US$ billions) | 4.3 | 2,947 | 14,429 |
| GNI per capita (Atlas method, US$) | 6,740 | 7,272 | 5,884 |
| GNI per capita (PPP, international $) | 12,770 | 13,396 | 9,970 |
| GDP growth (%) | 2.5 | 5.7 | 7.8 |
| GDP per capita growth (%) | 2.2 | 5.3 | 7.1 |
| *(most recent estimate, 2004–2010)* | | | |
| Poverty headcount ratio at $1.25 a day (PPP, %) | <2 | 0 | .. |
| Poverty headcount ratio at $2.00 a day (PPP, %) | <2 | 2 | .. |
| Life expectancy at birth (years) | 74 | 71 | 73 |
| Infant mortality (per 1,000 live births) | 7 | 19 | 17 |
| Child malnutrition (% of children under 5) | 2 | 2 | 3 |
| Adult literacy, male (% of ages 15 and older) | .. | 99 | 96 |
| Adult literacy, female (% of ages 15 and older) | .. | 97 | 91 |
| Gross primary enrollment, male (% of age group) | 107 | 99 | 111 |
| Gross primary enrollment, female (% of age group) | 106 | 98 | 111 |
| Access to an improved water source (% of population) | 98 | 96 | 93 |
| Access to improved sanitation facilities (% of population) | 90 | 84 | 73 |




| Net Aid Flows | 1980 | 1990 | 2000 | 2010 |
|---|---|---|---|---|
| *(US$ millions)* | | | | |
| Net ODA and official aid | .. | .. | .. | 77 |
| *Top 3 donors (in 2010):* | | | | |
| Germany | .. | .. | .. | 14 |
| European Union Institutions | .. | .. | .. | 14 |
| Luxembourg | .. | .. | .. | 7 |
| Aid (% of GNI) | .. | .. | .. | 1.9 |
| Aid per capita (US$) | .. | .. | .. | 123 |




| Long-Term Economic Trends | 1980 | 1990 | 2000 | 2010 | 1980–90 | 1990–2000 | 2000–10 |
|---|---|---|---|---|---|---|---|
| | | | | | *(average annual growth %)* | | |
| Consumer prices (annual % change) | .. | .. | *21.9* | 0.5 | | | |
| GDP implicit deflator (annual % change) | .. | .. | *20.2* | 1.6 | | | |
| Exchange rate (annual average, local per US$) | .. | .. | 1.1 | 0.8 | | | |
| Terms of trade index (2000 = 100) | .. | .. | .. | .. | | | |
| Population, mid-year (millions) | 0.6 | 0.6 | 0.6 | 0.6 | 0.6 | 0.4 | 0.0 |
| GDP (US$ millions) | .. | .. | 984 | 4,111 | .. | .. | 4.5 |
| | | | *(% of GDP)* | | | | |
| Agriculture | .. | .. | 12.5 | 9.2 | .. | .. | 0.4 |
| Industry | .. | .. | 23.4 | 19.5 | .. | .. | 3.9 |
| Manufacturing | .. | .. | 10.2 | 5.4 | .. | .. | -2.8 |
| Services | .. | .. | 64.1 | 71.3 | .. | .. | 5.4 |
| Household final consumption expenditure | .. | .. | 70.0 | 86.4 | .. | .. | .. |
| General gov't final consumption expenditure | .. | .. | 21.9 | 18.9 | .. | .. | .. |
| Gross capital formation | .. | .. | 22.4 | 22.8 | .. | .. | .. |
| Exports of goods and services | .. | .. | 36.8 | 35.6 | .. | .. | .. |
| Imports of goods and services | .. | .. | 51.1 | 63.6 | .. | .. | .. |
| Gross savings | .. | .. | 19.6 | -2.5 | | | |

Note: Figures in italics are for years other than those specified. .. indicates data are not available.

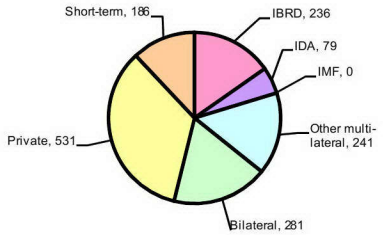
Development Economics, Development Data Group (DECDG).

| **Balance of Payments and Trade** | **2000** | **2010** |
|---|---|---|
| *(US$ millions)* | | |
| Total merchandise exports (fob) | 231 | 473 |
| Total merchandise imports (cif) | 460 | 2,219 |
| Net trade in goods and services | -140 | -1,155 |
| Current account balance | -27 | -1,031 |
| as a % of GDP | -2.7 | -25.1 |
| Workers' remittances and compensation of employees (receipts) | .. | 301 |
| Reserves, including gold | *100* | *785* |

| **Central Government Finance** | | |
|---|---|---|
| *(% of GDP)* | | |
| Current revenue (including grants) | 32.7 | 41.0 |
| Tax revenue | *27.2* | 35.7 |
| Current expenditure | 36.6 | 39.5 |
| Overall surplus/deficit | -5.4 | -2.7 |
| Highest marginal tax rate (%) | | |
| Individual | .. | .. |
| Corporate | .. | *9* |

| **External Debt and Resource Flows** | | |
|---|---|---|
| *(US$ millions)* | | |
| Total debt outstanding and disbursed | .. | 1,554 |
| Total debt service | .. | 99 |
| Debt relief (HIPC, MDRI) | – | – |
| Total debt (% of GDP) | .. | 37.8 |
| Total debt service (% of exports) | .. | 3.9 |
| Foreign direct investment (net inflows) | .. | 760 |
| Portfolio equity (net inflows) | .. | -8 |

**Composition of total external debt, 2010**




US$ millions

| **Private Sector Development** | **2000** | **2011** |
|---|---|---|
| Time required to start a business (days) | – | 10 |
| Cost to start a business (% of GNI per capita) | – | 18 |
| Time required to register property (days) | – | 71 |

| Ranked as a major constraint to business (% of managers surveyed who agreed) | **2000** | **2010** |
|---|---|---|
| n.a. | .. | .. |
| n.a. | .. | .. |
| Stock market capitalization (% of GDP) | .. | 87.7 |
| Bank capital to asset ratio (%) | .. | 10.6 |

**Governance indicators, 2000 and 2010**


*Source: Worldwide Governance Indicators (www.govindicators.org)*

| **Technology and Infrastructure** | **2000** | **2010** |
|---|---|---|
| Paved roads (% of total) | .. | .. |
| Fixed line and mobile phone subscribers (per 100 people) | .. | 212 |
| High technology exports (% of manufactured exports) | .. | .. |

| **Environment** | | |
|---|---|---|
| Agricultural land (% of land area) | .. | *38* |
| Forest area (% of land area) | 40.4 | 40.4 |
| Terrestrial protected areas (% of land area) | 13.2 | 13.3 |
| Freshwater resources per capita (cu. meters) | .. | .. |
| Freshwater withdrawal (% of internal resources) | .. | .. |
| CO2 emissions per capita (mt) | .. | *3.1* |
| GDP per unit of energy use (2005 PPP $ per kg of oil equivalent) | .. | *7.1* |
| Energy use per capita (kg of oil equivalent) | .. | *1,384* |

| **World Bank Group portfolio** | **2000** | **2010** |
|---|---|---|
| *(US$ millions)* | | |
| IBRD | | |
| Total debt outstanding and disbursed | – | 236 |
| Disbursements | – | 5 |
| Principal repayments | – | 10 |
| Interest payments | – | 5 |
| IDA | | |
| Total debt outstanding and disbursed | – | 79 |
| Disbursements | – | 3 |
| Total debt service | – | 1 |
| IFC *(fiscal year)* | | |
| Total disbursed and outstanding portfolio | – | 32 |
| of which IFC own account | – | 32 |
| Disbursements for IFC own account | – | 22 |
| Portfolio sales, prepayments and repayments for IFC own account | – | 1 |
| MIGA | | |
| Gross exposure | – | – |
| New guarantees | – | – |

Note: Figures in italics are for years other than those specified.
.. indicates data are not available. – indicates observation is not applicable.

4/5/12

Development Economics, Development Data Group (DECDG).