MONTENEGRO
MINISTRY OF FINANCE
Department for Economic Policy and Development

MONTENEGRO PRE-ACCESSION ECONOMIC PROGRAMME

2011-2014

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CONTENTS

1. ECONOMIC POLICY FRAMEWORK AND GOALS

Montenegro confirmed its firm commitment to the European Union membership and its determination to persevere in following this road through achievement of the candidate country status at the end of 2010. Owing to the successful implementation of the recommendations of the European Commission during this year, it was given an indication of the date of negotiation commencement for June 2012. Through harmonisation of the institutional and legal framework with the standards of the European Union, economic policy in Montenegro acquires an additional instrument for increasing competitiveness of economic environment, reduction of negative effects of the new crisis wave and establishment of stable grounds for long-term sustainable growth. Another acknowledgment of the political and economic efforts of the new Government team constituted at the end of 2010 is the membership with the World Trade Organisation acquired in December 2011.

The step forward made in the process of European integration requires that entities responsible for economic policy should provide a higher level of quality in the areas of macroeconomic and fiscal programming and detailed analysis of economic policies, for the purpose of quality decision-making and standardised monitoring of economic and fiscal developments in Montenegro. In this context, it is also necessary to monitor the preparation of the Pre-accession Economic Programme that Montenegro as a candidate for accession to the European Union is to submit to the European Commission this year for the first time.

Economic policy and strategic development directions

Favourable impacts of the recovery of the world economy in the first half 2011 had additional positive effects on the growth of the most of economic indicators in Montenegro. The summer 2011 indicated the possibility of a new crisis wave. This adverse trend became more certain by the end of the year, primarily due to the growth of scepticism in the international financial markets regarding the capability of the entities responsible for economic policy to stop the trend of aggravation of public-financial performance indicators in their countries and particularly the growing trend of public debt. In addition to the lowering of the projection of the world economic growth for 2011 and the following year, in the last months the fiscal and financial risks increased in developed countries which will have an adverse effect on the economic growth in 2012. Deepening of negative trends in Europe is not only the consequence of the continuation of the crisis in peripheral countries of the Euro area but also its overflow to the central countries of this area.

Based on the statistical indicators, the new crisis wave of the economic activity in Montenegro in the second half of 2011 had no adverse effects on some segments of the real sector. The growth of tourism above all expectations (10.2% in the first 9 months 2011), contributed by extended summer season enabled by favourable weather conditions, had positive effects on related industries in the area of services and food and drink production. However, the overflow of adverse effects from external markets will condition the slowdown of economic activity in 2012.

The recovery of the above mentioned segments of economy is noted in the circumstances of continuous fall of bank loans, foreign direct investments, and therefore additional aggravation of the liquidity in real sector. In the next year, the economic activity will be mostly determined by the liquidity of real sector, i.e. lending activity of banks and foreign direct investments. Mid-term projections are based on such assumptions. Positive trends in the banking sector are high and continuous growth rates of retail deposits, maintenance of banking sector liquidity and establishment of lending capacities of the Prva Banka. The reaction of the market through confidence of citizens in the banking sector and relation of multilateral financial organisations, such as the World Bank, through granting financial resources under favourable conditions acknowledge the progress on the road to establishment of financial stability in Montenegro. In spite of the high share of non-performing loans in the total loans, it can be noted that they went down from 26% in August to 18% in October 2011, as a result of relocating non-performing assets to mother banks.

The basic instruments of economic policy in 2011 that Montenegro used to react on the indication of the new crisis wave were the consistent policy of establishing the fiscal consolidation and enhancement of business environment.

The period 2010-2011 is mostly characterised by the consolidation of public finances both on central and local level, the stagnation of public revenues and growth of government debt and deficit. Although the trends in the overall public finances of Montenegro are dominantly determined by the trends in budgetary developments, it should be noted that there also were additional substantial fiscal adjustments on the local level on both revenue and expenditure side during this period. Special progress has been achieved with regard to improvement of business environment through shortening of particular procedures (construction permits, employment of foreigners, tax and contribution collection, registration of property, etc.), as well as reduction of transaction costs (administrative duties).

An open, small and euroised economy such as Montenegro will not remain immune to crisis shocks from the Euro area. Developments in the neighbouring region and the world economy create challenges for economic policy management in Montenegro. Dependence on external markets makes the Montenegrin economy more vulnerable, and also emphasises the need for policies to provide the base for reducing adverse crisis effects. The primary task is to create an institutional framework for efficient and flexible decision-making. The main challenge in creating economic policy is to achieve balance between the short-term benefits of implementation of economic policy measures in the next year, short-term objectives and long-term growth. After two crisis waves, Montenegro may not afford itself the luxury of short-term resolution of problems that might undermine the grounds for gradual and sustainable improvement of the quality of life of individuals.

Priority goal of economic policy 2012 is to increase credibility of Montenegrin economy with the view of long-term economic growth and increase of employment. Short-term policies for achieving economic policy goal in 2012 are to strengthen fiscal and financial stability and carry out certain investments. The instruments for their implementation are the Budget for 2012, consistent regulation of banking market and further enhancement of business environment. Solid starting assumptions for achieving stability are the Budget 2012 and agreement of trade unions and the Government, as well as fiscal rules to be defined in 2012.

Stability strengthening implies the decrease of dependence on foreign financing in the public and banking sector. Given that the international market can be “closed” for financing in the following year, even now it is important to plan and ensure alternative sources with multilateral financial organisations, preferably long-term under favourable terms and conditions. In this way, the budgetary costs for external interest payments would lower in relation to those that would be paid for more expensive borrowings and thus the space for priority public expenditures and investments is created.

- *Regarding the fiscal area,* it is necessary to continue the initiated consolidation. It implies the reduction of the government spending and increase of tax revenues through: tax base expansion; higher taxation of property and goods not in the function of generating income; creating conditions for new investments and reduction of grey economy. Lower government spending and higher revenues imply lower deficit and, consequently, lower need for borrowings, lower dependence on international market and higher funds for infrastructure projects.

- *Regarding the banking sector,* it is necessary to strengthen the capital of banks, maintain high liquidity and ensure support by “mother” foreign banks to “daughter” banks doing business in Montenegro. It is important to restructure (clean) the balances of banks and lower “bad” loans. Sooner or later, the burden of bad decisions from the past has to be suffered, and in order to reduce insecurity, i.e. financial distrust and to create conditions for new lending, it is desirable for these processes to take place as soon as possible. At the same time, the Government and judicial institutions must create a favourable systemic environment for efficient enforcement of contracts and protection of ownership rights and reduction of problems of internal financial indiscipline, i.e. non-payments in the private sector and local self-governments.

- *As regards the enhancement of the business environment and international competitiveness of Montenegro, Foreign Direct Investments (FDI)* have the key role. Given that Montenegro is a small and open economy, not that high absolute amounts of investments have a significant impact on GDP growth and economic progress, as well as the growth of current account deficit due to import dependence. A precondition and one of the pillars of the future economic prosperity in Montenegro is a flexible labour market. The results of eliminating of business barriers are visible through the progress in Doing Business rating (World Bank Report) in the recent years, and together with the structural reforms in the labour market they contribute to the competitiveness of the economic system[1]. The progress in the competitiveness of Montenegro is best evidenced by the fact that it was ranked 60th out of 142 analysed countries, measured by the World Economic Forum in the Global Competitiveness Index 2011-2012. The main emphasise of the competitiveness analysis of Montenegro is on the future. The resolution of the problem of concentration of Montenegrin export on just a few products and rigidity of the labour market, as well as identification of internationally competitive products would improve competitiveness[2] considerably. Acknowledgement of the sector competitiveness, i.e. tourism, is the fact that Montenegro is first ranked by the World Travel and Tourism Council as a country with potentially highest average long-term tourism growth rate of 16.4% in the period 2010-2021.

In 2011, a range of activities were carried out in Montenegro, which are very significant from the aspect of long-term consolidation of public finances of the country. Adopted pension reform implies stricter requirements for exercise of rights in respect of pension and disability insurance, as well as the change of the pension indexation formula. The impact of the pension reform on sustainability of public finances is reflected through reduction of pension expenses in the period of 30 days to the level of 10.2% GDP, while the non-reformed pension system would burden the budget with 13% share in GDP.

In addition to the pension reform, another recent indicator of effectiveness of the agreement between the Government and trade unions, particularly with regard to understanding risks inherent to the crisis is the agreement on giving up various forms of trade union fight, cooperation of trade unions in the process of reducing the number of staff in the public sector and their participation in allocation of budgetary money. At the time of the crisis shocks and adverse experiences of many countries in achieving agreement with trade unions, this is an important step in progressing towards the reduction of the social pressure while consolidating public finances.

The creation of an institutional framework for implementation of public-private partnership projects, particularly in the system of education, health, and outsourcing, will contribute to long-term sustainability of finances and at the same time quality and productivity in delivery of public services and exploitation of public resources.

Through the development of the National Development Plan, Montenegro acquires a clear view of projects, whose implementation contributes to elimination of the systemic barriers to economic growth and achievement of goals set through "smart growth", "inclusive growth" and "sustainable growth". The National Development Plan implies a detailed analysis of all existing policies and strategies so the Plan would be formulated and projects defined with the view of carrying out the strategic priorities. At the same time it

[1] IMF recommendations in the Montenegro Report, April 2011
[2] Montenegrin economy competitiveness, Ministry of Finance, 2010

is an excellent opportunity for each project that is categorised to a specific area according to the EU Strategy Development until 2010 to have a clearly planned financial structure, which, inter alia, determines if there is a need for IPA funds.

In a nutshell, the fiscal policy of Montenegro in the coming period will be based on the consistent fiscal policy, where the consistency implies the continuation of fiscal consolidation, decrease of deficit and creating of conditions for reduction of public debt, while providing fiscal reserves. The consistency also implies that the basic tax rates (VAT, profit tax and income tax), which make Montenegro recognisable as a competitive investment destination, should be kept unchanged. At the same time, the expansion of the tax base and reduction of grey economy, as well as higher collection of property tax and concessions create space for increase of budgetary revenues. The continuation of structural reforms and improvement of business environment and administration efficiency create the base for more dynamic growth.

Basic features of individual chapters

Chapter 2 – "Economic framework"; The recovery of economic activity in Montenegro in 2010 exceeded all earlier projections. The real growth of 2.5% was generated by the growth in the sector of tourism and electricity generation and it represented a sound base for continuation in 2011. In spite of the crisis in the Euro area, Montenegrin economy continued to grow in the sector of services, while favourable prices of aluminium in the international market affected the increase of its production and export. Although the fiscal crisis has shaken the European market since summer 2011, the third quarter in Montenegro saw extremely positive results in almost all sectors. The odds are that the projected economic growth of 2.5% in 2011 will come true. However, the issue of illiquidity of economy still remains in the list of priorities to be resolved, intensified by inaccessibility of financial resources in the next year and restrictive fiscal policy.

Two macroeconomic scenarios: "base scenario" and "low-growth scenario" are developed for the period 2012-2014. Although carried positive effect of economic activity from 2011 can be expected, the recent experience with delayed overflowing of the crisis from developed countries to Montenegrin economy in 2009 made the forecasting starting assumption very conservative. Given the adverse developments in the international market and significant lowering of growth rates in the EU and Euro area, this year's PEP has not articulated an optimistic scenario. Moreover, the developments in the EU in the fourth quarter 2011 make the "low-growth scenario" more certain than the "base scenario". Growth projection is given through analysis of expected developments in specific sectors of economy, with emphasise on the projection of trends of the components of the expenditure side of GDP.

Economic developments in the period 2009-2011 in the real, monetary and external sector partly indicate the recovery of economy; however the risks indicate intensifying of an already existing problem – its illiquidity. Trend analysis of individual sectors is expenditure-based. The calculation of potential growth and "output gap", as a mandatory element of the Programme starting this year, provides for a growth perspective of Montenegrin economy from one side, and improves the forecasting system and therefore the quality of decisions made in the medium term from the other side.

Chapter 3 – "Public finances"; Adverse impact of the crisis on public finances in 2009 and experiences of the countries of the Euro area affected by debt crisis are the grounds for implementation of a conservative and accountable fiscal policy in Montenegro. The significance of the fiscal policy is intensified by the fact that Montenegro has no monetary policy instrument available. The proposal Budget Law 2012 ensures financial stability for functioning of all government institutions, as a prerequisite for continuation of economic recovery and continuation of the integration process, which are the absolute priorities of the government policy. Public Finance Plan 2012 is based on the real growth of economy of 2%, with creation of conditions for economic growth to accelerate in 2013 and 2014 to 3.5% and 4% respectively (base macroeconomic scenario). Revenues are planned to exceed the revenues from 2011 by over EUR 40 million, with accent on expansion of the tax base and reduction of grey economy. Nominal and real reduction of government expenditure is envisaged. For the first time the consolidated government expenditure has been reduced to below 40% GDP. Mid-term budgetary framework defines the reduction of the current government expenditure to below 35% GDP, which will create space for capital investments in the amount of around 5% GDP. Deficit of public finances is reduced to 1.05%, and public debt will amount to 46.8% GDP at the end of the year, which classifies Montenegro among the rare countries, not only in the Euro area but in Europe, that will comply with Maastricht criteria.

The following mid-term period will be the continuation of the consistent fiscal policy of establishing balanced public finances. The goals set in 2009 to further reduce the current expenditure and public debt remain valid for the following years. Balanced budget is planned for 2013, and surplus over 1% GDP for 2014, which creates conditions for reduction of government debt to around 41% GDP. Guarantees appear to be one of potential risks, and it again depends on their individual quality. Fiscal policy is additionally characterised by observance of the gold fiscal rule which will imply that (future) net borrowings cannot exceed the amount of capital investments, and by the creation of the fiscal reserve fund, which is particularly important for strengthening the stability and credibility of fiscal policy. Through achievement of the fiscal goals of the consolidation of public finances, Montenegro prepares the grounds for the case of potential risk of closing markets and opening doors with multilateral financial organisations for disbursement of funds under favourable conditions.

Chapter 3 introduces new analytical dimension of public finances through estimation of the structural balance, sustainability analysis in the long term and sensitivity analysis of public finances. In line with macroeconomic scenarios, two fiscal scenarios are produced for public finances and public debt, as a contribution to consideration of the effects of adverse economic developments on the fiscal sector. Although the Budget for 2012 is planned according to the base macroeconomic scenario, equal analytical attention is paid to the low-growth scenario taking into account the developments in the international economic scene at the end of 2011.

Table 1. Macroeconomic and fiscal framework in the period from 2011 to 2014 (in % GDP)

Macroeconomic and fiscal framework (in % GDP)		ACTUAL DATA			ESTIMATE	BASE SCENARIO			LOW-GROWTH SCENARIO			
		2008	2009	2010	2011	2012	2013	2014	2011	2012	2013	2014
Macroeconomic indicators	GDP nominal growth	15.1	-3.4	4.1	6.1	4.0	5.6	6.1	6.1	2.0	3.3	5.6
	GDP real growth	6.9	-5.7	2.5	2.5	2.0	3.5	4.0	2.5	0.5	1.5	3.5
	Inflation	7.1	3.4	0.5	3.5	2.0	2.0	2.0	3.5	1.5	1.8	2.0
	Import	82.7	65.9	63.7	63.5	63.2	63.0	62.6	63.5	62.2	63.0	62.6
	Export	38.9	32.8	35.6	37.8	38.6	39.1	40.0	37.8	38.0	39.1	40.5
	Other	3.8	3.0	3.0	3.0	3.1	3.1	3.1	3.1	3.1	3.1	3.1
	Current account deficit	-40.0	-30.1	-25.1	-22.6	-21.6	-20.8	-19.5	-22.6	-21.1	-20.8	-19.0
	Net foreign direct investments	18.8	35.8	17.8	15.3	14.1	12.7	11.4	15.3	13.5	12.5	10.6
	Domestic loans	88.5	77.7	68.6	63.0	63.6	65.1	66.5	63.0	62.8	64.5	66.0
	Bank deposits	50.5	48.5	46.8	45.8	45.7	45.8	45.8	45.8	44.8	44.9	44.9
Fiscal indicators	Current public revenues	50.05	45.39	42.34	39.37	39.42	39.24	39.04	39.37	38.81	38.76	38.58
	Public expenditure	50.45	51.13	47.21	42.62	40.47	39.12	38.01	42.62	41.27	41.02	40.25
	Deficit/Surplus	-0.40	-5.74	-4.87	-3.25	-1.05	0.13	1.03	-3.25	-2.47	-2.27	-1.66
	Interest	0.77	0.86	1.01	1.36	1.79	1.77	1.77	1.36	1.83	2.09	2.26
	Primary deficit/surplus	0.37	-4.88	-3.86	-1.89	0.74	1.89	2.8	-1.89	-0.64	-0.18	0.59
	Government debt	28.99	38.25	40.94	43.82	46.93	45.37	42.93	1.79	49.27	49.70	47.37

Chapter 4 "Structural reforms" is characterised by introduction of three new sub-chapters in relation to the last year's EFP document: Agriculture, Environmental Protection and Regional Development, which for the first time illustrate the basic guidelines of the previous development and future plans and activities in these areas. In addition, a detailed estimation of budgetary effects of proposed measures is presented, while an integral part of the chapter, for the purpose of easier monitoring of implementation of the planned measures, is the tabular review of results achieved in relation to the measures defined by the last year's EFP document. Below follows a short overview of results by areas.

Company sector. Due to the global economic crisis, which resulted in decreased interest of potential investors, in 2011 a significantly lower number of *privatised projects* were implemented in relation to what was initially planned. Accordingly, in 2012 the privatisation process will be primarily directed to implementation of projects where there were no public invitations announced, as well as the failed projects from previous years. In the *competitiveness area,* it is important to point out further improvement of legislative and institutional framework that resulted from establishment of the Law on Protection of Competitiveness. *State aid* is characterised by the process of implementation of EC recommendations, while the future activities will be focused on the analysis of the local self-government practice and harmonisation of local regulations, as well as monitoring of allocated aid. New *Public Procurement Law* was adopted and its implementation will commence in 2012. Striving to additionally *improve the business environment and tax policy,* in 2011 Montenegro undertook numerous activities aimed at providing additional incentives for elimination of barriers to business development, primarily through establishment of "One Stop Shop", application of the system of unified collection of personal income tax and contributions for compulsory social insurance and single revenue deposit account, and preparations for introduction of RIA, starting from 2012. *Development of small and medium size enterprises* is defined by the SME Development Strategy 2011-2015 and Strategy for Promotion of Competitiveness at Micro Level 2011-2015 with indicative action plans. In the area of *network industries,* activities continue with the focus on further development of energy, transport and telecommunications. The basic guidelines for improvement of the *energy sector* in the coming period are related to exploitation of hydro potential (through future construction of hydro power plants) and construction of undersea inter-connective cable between EES Montenegro and Italy. In the area of transport, activities are continued with regard to the commencement of implementation of the high-way Bar-Boljare project, which will be decided by the Government after the completion of Technical Study of the Realization Options and Study of Impact on Environment. In the area of telecommunications, significant activities are undertaken in the field of further improvement of legislation and preparations for implementation of full digitalisation starting from 2013.

Financial sector. Stability of the financial sector is estimated with a moderate level of risk. After individual plans are prepared, in 2012 a joint Contingency Plan will be prepared to define acting in cases of crisis-induced disruptions in the markets. Still remaining basic features of the banking sector are the burden of non-performing assets and loans and lowered lending capacity, while the liquidity and solvency are satisfying. It is planned that in the coming period the capital market should be additionally strengthened through: harmonisation of regulations with EU regulations, development and adoption of accompanying rules for the Law on Investment Funds, adoption of the law on securities and development of the supporting rules for the mentioned law, etc.

Labour market. In the first 10 months of 2011 the labour market saw positive trends. The data of the Employment Agency of Montenegro show that registered unemployment rate has been constantly dropping since March 2011, and the number of advertised vacancies at the beginning of October 2011 was by 18% higher in relation to the same period 2010. A significant number of non-residents are still engaged in the labour market, so the number of issued work permits to foreigners until the beginning of October 2011 was by 43.5% higher in relation to the same period 2010. Identified problems and the need for their systematic resolving are recognised in the National Employment and HR Development Strategy 2012-2015, and special incentive for ensuring labour market flexibility is expected through implementation of the Law on Amendments to the Labour Law. The measures related to adjustment of the demand and supply are still in focus, and they are reflected through linking of education and training from one side and needs of the economy from the other, for the purpose of timely affecting primarily the reduction of youth unemployment, and also the problem of high share of long-term unemployment in the total unemployment. In line with the Government Agenda of Structural Reforms in the area of health, education, science and research, labour and pension system, a significant number of activities contributing to long-term sustainability of public finances were completed in 2011.

Agricultural sector. Agriculture has been recognised as one of the key branches for further overall development of Montenegro. The main measures and activities that are to be undertaken in the coming period are focused on the following: improvement of efficiency of the market of agricultural products, adoption of the Law on Agricultural Land, improvement of administrative framework, establishment of IPARD system, development of rural areas and continuation of providing state aid to agriculture.

Administrative reforms. In 2011, the Government paid special attention to the issue of state administration reform, completing the strategic and regulatory framework through adoption of the Public Administration Reform Strategy 2011-2016, and drafting and establishing a set of laws. In the coming period the key activity of the Government in the area of administrative reforms will relate to reduction of the number of state administration bodies and reduction of the number of staff in the state administration bodies, continuation of the reform of the inspection supervision reform and introduction of RIA.

Environmental protection. Acknowledging the fact that the area of the environment will represent one of the most demanding negotiation chapters, the Government of Montenegro is paying and will continue to pay special attention to this area, particularly focusing on the issues of: air quality and climate changes, waste management, water management, nature protection, industrial pollution and chemicals and ionising and non-ionising radiation and noise.

Regional development. For the purpose of mitigating many-year regional disparities, the Government will continue to make efforts to additionally complement the strategic base for resolving the problem and ensure efficient planning and monitoring of policy implementation. In addition, the Government will continue to carry out specific investment and development projects, which will directly or indirectly ensure the incentives for regional development.

2. ECONOMIC FRAMEWORK

Montenegrin economic activity in 2010, when expressed as GDP growth, was 2.5% and exceeded the projected level of 1.1%. The main reasons for this deviation were the significantly higher growth in the electricity generation sector resulting from an extremely favourable hydrological situation, the growth in other utility sectors, and a higher-than-expected contribution from the tourism and retail sectors. In 2011, the estimated growth rate was also 2.5 %, and resulted from a good tourist season, a complementary and above-average growth in the retail turnover, as well as transport growth. As regards the processing industry, aluminium exports were significantly higher in the first ten months 2011, but aluminium prices were extremely unfavourable in the last quarter and jeopardized the positive effects of the first three quarters. A significant and adverse contribution to growth is expected from electricity production in 2011 due to unfavourable weather conditions. This will adversely affect the expenditure side through its contribution to an increased need for energy imports.

The beginning of 2011 was marked by moderate optimism due to the growth of Euro area economies in the first quarter. However, adverse trends became more frequent as more time passed. This made the slowdown in the growth of the European economies more certain and, according to some announcements, the euro economies entered into recession in the fourth quarter and in the first half of 2012. Given that the Balkan region and Montenegro are substantially exposed to developments in the Euro area (and that the key trading partners are those countries that are most exposed to the crisis), it is realistic to assume that there will be difficulties in achieving the goals that were set for the real, financial and the fiscal sectors. Due to these uncertainties, i.e. due to the crisis deepening in the Euro area and certain adverse implications for our country, the Pre-accession Economic Programme 2012-2014 (PEP) includes both a baseline macroeconomic scenario and low-growth scenario. In the baseline scenario, the medium-term framework for 2012-2014 foresees a growth rate of 2% in 2012 that is expected to accelerate in 2013 and 2014 when the rates will reach their potential values (of 3.5% and 4% respectively). Growth rates are lower in the second scenario and GDP is projected to increase by 0.5% in 2012 and to accelerate to 1.5% in 2013 and 3.5% in 2014. A rapid deterioration in the situation in the Euro area and the decrease in projected growth rates in the last quarter has increased the probability that the low-growth scenario will come true.

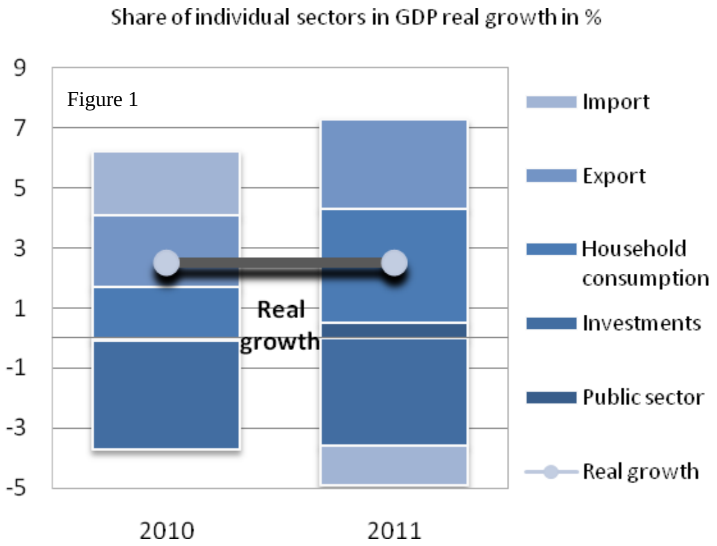
Like the Economic Fiscal Programme (EFP) 2010-2013, the PEP also includes a standard description of developments in the economy by sectors, a more detailed elaboration of sectors by GDP output and the GDP spending side under the base scenario. It incorporates a brief overview of the Montenegrin economy, as well as the topics that are to be further elaborated in the Ministry of Finance to contribute to the mid-term planning improvement, and the trends of basic economic indicators that are mostly used for projection of economy developments in 2011. An output gap is produced by application of one of the standard procedures recommended by the European Commission – the HP (Hodrick-Prescott) filter. The absence of quality data series and the fact that the laws related to tax revenues were subject to frequent amendments in the previous three years made the calculation of the structural and cyclical government deficits very difficult, so there was a simple trend calculation. A map of economic risks was developed, which summarises which key factors could lead to a low-growth scenario and describes potential adverse developments more generally.

2.1. Macroeconomic developments in the period 2010-2011

2.1.1. Gross domestic product

After a downturn in the economy of 5.7% in 2009, Montenegro came out of recession in 2010 and generated real GDP growth of 2.5%, which was significantly higher than the projected growth of 0.5% (and exceeded early estimates of growth of 1.1%).

On the expenditure side, the key contribution to GDP growth in 2010 was from net exports. This was made up of an increase in exports of goods and services (that contributed 2.4% to the overall growth rate) and a relative decrease of the share of imports of goods and services (that made a positive contribution of 2.1% to overall growth). Household consumption made a positive contribution of 1.7% to GDP growth. The key adverse item in growth generation originated from a decrease in gross investments in fixed assets. Its negative effect amounted to 3.6%, while government spending had an insignificant adverse contribution of 0.1%.



For 2011, household consumption (with a contribution of 3.8%) is thought to have made the main contribution to estimated GDP growth of 2.5%. A positive contribution to growth also came from net exports—this is estimated at 1.8% and consists of a positive contribution of 3% from exports and an adverse contribution of 1.3% from imports (indicating an increase in imports). The Government sector had a slightly positive contribution of 0.5%. The main adverse contribution to growth came from a further reduction in gross investments that is estimated to have lowered GDP by 3.6%.

Table 2. Key macroeconomic developments 2009-2011

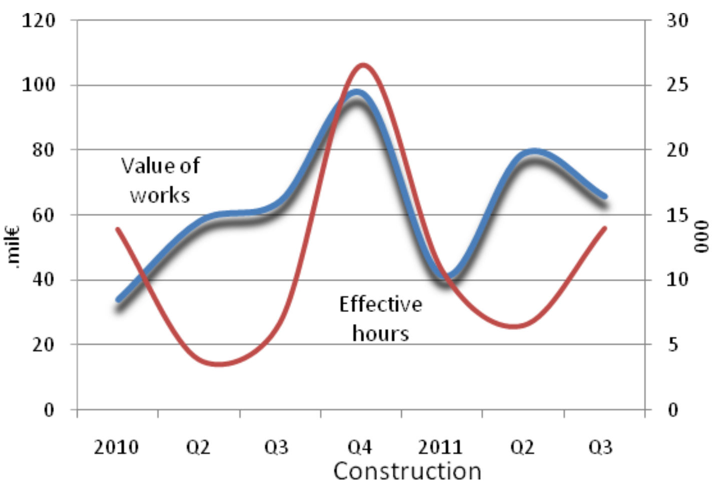
	2009	**2010**	**2011**
GDP (in million €)	2981	3104	3273
Real growth	-5.7	2.5	2.5
Nominal growth	-3.4	4.1	5.6
Deflator	2.4	1.6	3.0
Share in growth in percentage			
GDP real growth	-5.7	2.5	2.5
Household consumption	-11.8	1.7	3.8
Investments	-13.6	-3.6	-3.6
Public sector	0.2	-0.1	0.5
Net export	19.6	4.5	1.8
Export	-8.8	2.4	3.0
Import	28.4	2.1	-1.3
Share in GDP structure (in percentage)			
Current account balance	-30.1	-25.1	-22.6
Export	32.8	35.6	37.8
Import	-65.9	-63.7	-63.5
Other	3.0	3.0	3.1
Private deposits	47.6	47.2	45.8
Domestic loans	81.5	71.5	63.0
Household consumption	84.0	82.2	84.0
Investments	27.1	22.8	18.7
Public sector	22.2	23.4	23.4
Source: Monstat, CBM and MF			

If we consider the output side of the economy, the key drivers of the recovery in 2010 were the generation of electricity, mining and quarrying, other utilities, social and personal service activities and transport.

Estimated growth in 2011 is unchanged from the 2.5% rate projected in the EFP for 2010-2013. Growth is estimated on the basis of results achieved in the first nine months and expected trends to the end of the year. These show significant growth in tourism, exceptional growth in retail trade and transport services, an abrupt fall in the electricity generation, and slight growth in the areas of processing industry and construction.

Industrial production fell by 5.9% in the first ten months of 2011 after growth of 17% in 2010. The fall resulted from different developments in sub-sectors. The mining and quarrying sector saw growth of 2% after a leap of nearly 57% in 2010. Growth in the sub-sector of coal mining was due to maximum generation in the Pljevlja Thermal Power Plant due to bad hydro-energy situation (and minimum water levels in hydro reservoirs). Processing industry increased by 8.7% in the first ten months of 2011 because production in KAP was maintained on a relatively high level. The production of base metals and metal products increased by 19% during this period. The electricity generation sector saw a fall of 30% after growth of 50% in 2010. This fall resulted from an extremely unfavourable hydrological situation in 2011, but the fall of production is lower due to maximum generation in the Thermal Power Plant Pljevlja. (Because of the serious energy situation the regular autumn overhaul of the thermal power plant was postponed).

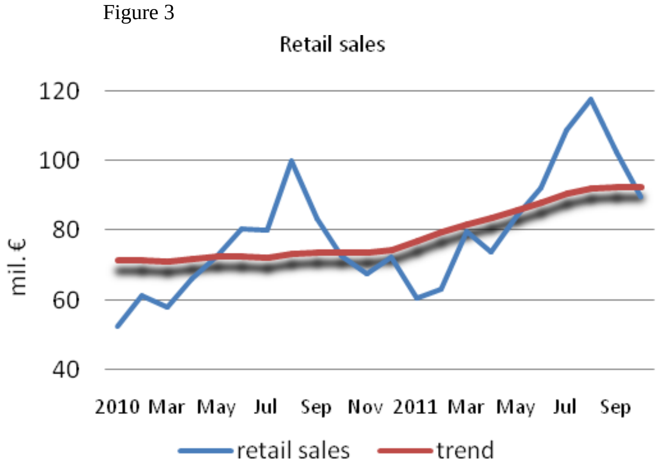
Figure 2



Indicators relating to **construction** show the vitality of this sector in spite of adverse expectations. Namely, during the first three quarters of 2011, the value of performed works was 19% higher in comparison to the previous year. New orders for residential buildings were 27% higher while there was an abrupt fall (of 56%) in new orders for other building structures.

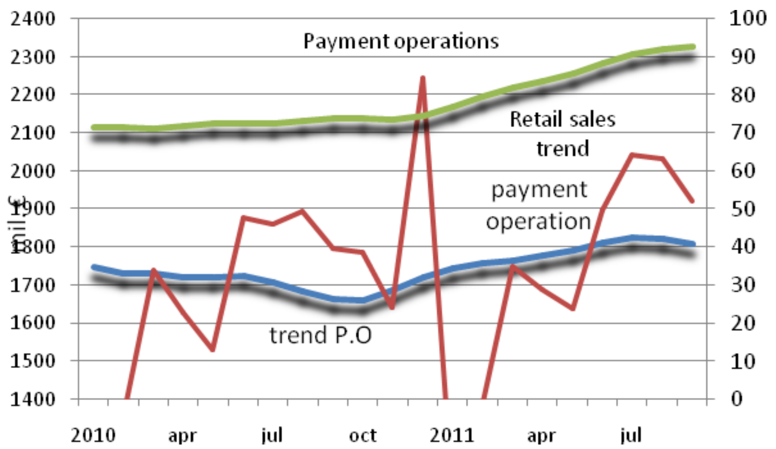
Trade (comprising wholesale and retail; the repair of motor vehicles, motorcycles and items for personal use and households) saw a slight real growth of 0.9% in 2010 and its total share in GDP amounted to 12.1 %. In the first ten months of 2011, the trade sector saw extremely high growth of 20%. Given that this indicator is very important as an indicator of household consumption, some additional explanation is required for such a high rate. Although there are recognisable seasonal oscillations in the retail turnover – a peak in August and growth in the period preceding the New Year's and Christmas holidays – Figure 3 shows that there was a pickup during most of the year in relation to the previous year (after February 2011). Larger trading chains squeezed the smaller ones out, in an unstoppable merger process, and turnover is thus more fully reflected in legal flows, making the generated turnover appear higher. The turnover of large food trade chains makes up over 60% of total turnover. Also, the strong tourist season and over 1.3 million tourists affected the achievement of the high growth rate. And there was

Figure 3



a higher value of fuel turnover in spite of lower consumption because, in 2011 (compared to 2010), the price of derivatives increased considerably. An unexpectedly high value of sales of automobiles also had its impact on higher trade. It should be expected that such high growth rates will reflect on trade companies' balances, so a real turnover growth of around 17% (with the trade having the share of 12.1% in the total GDP for 2010) would mean that this sector alone will contribute 2%to growth in 2011.

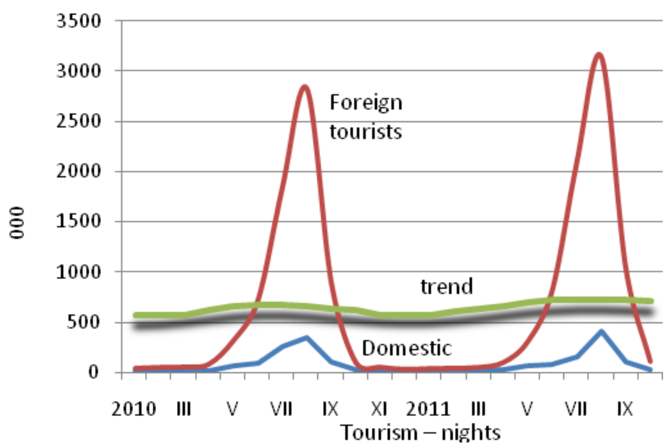
Figure 4



Payment operations are an extremely important and reliable indicator of economic activity. Payment operations for the first nine months of 2011 were 5.2% higher than in the same period of the previous year. Inter-bank payment operations (with a share of 42.4%) increased by 6.6% and internal payment operations (with a share of 57.6%) increased at the rate of 4.2%. If the same period of 2010 is compared to 2009, total payment operations were higher by 1.4% and inter-bank payment operations fell by 4.4% while the internal payment operations went up at the rate of 5.7%.

Tourism and its supporting sectors are an area where Montenegro has the potential for significant growth through distinct comparative advantages. Montenegrin tourism is characterised by flexibility and competitiveness, so this sector succeeded in achieving good results in 2010—particularly with regard to number of nights, which exceeded even the record number achieved in 2008. According to Monstat data, Montenegro was visited by 1.3 million tourists in 2010 which was 4.6% higher than in 2009, and the number of incoming foreign tourists went up by 4.2% while domestic tourists increased by 7%. In 2010, there were 7.96 million nights spent by tourists, which is 5.5% higher than in the previous year. There were almost a million domestic tourists, which was 15.3% higher than in 2009, while the share of foreign tourists was 6.98 million nights, which marked an increase of 4.2%. The share of the coastal locations in the total nights was 96%, while the share of mountain locations was 1.5%, the share in the capital was 1.4%, and the share of other tourist locations was 1.1%. Tourists from the following countries had the higher number of nights in 2010 in relation to the previous year: Russia (14.9%), Ukraine (87.2%), France (20.6%), Germany (38.2%), Great Britain (45.3%), as well as tourists from neighbouring countries: Kosovo (40.3%), Slovenia (25.3%), Macedonia (6.1%), and Croatia (10.6%).

Figure 5



The tourist season for 2011 is thought to have been extremely successful since the main indicator – the number of nights spent by tourists in the first ten months -increased by 10.2%. There was a falloff in domestic tourists' nights by 2.5% but growth in foreign tourists' nights by 12%. Such trends are clearly visible in Figure 5. At the same time, the number of arrivals went up by 8.8% for domestic, and 10.2% for foreign tourists. The implementation of announced investments in this area will contribute further to growth and this sector, with support from complementary sectors, is set to become one of the branches that will create new jobs and have a stronger share in the overall economic activity.

Productivity growth is the key determinant of GDP growth in the economy of a country. However, the unreliability and inaccessibility of data required for productivity measurement (including unit labour costs, the number of the employed persons including those working overtime or less than full time hours, and the number of self-employed persons) are a limiting factor for the calculation of data. Therefore, GDP per capita is used to make comparisons with other EU countries and countries from the region.

Table 3

Country	**GDP per capita 2010 EU 27=100**	**Index**
EU 27	24,400	100
Bulgaria	4,800	20
Croatia	10,400	43
Macedonia 330	3,300	14
Slovenia	17,300	71
Montenegro	**5,000**	**20**

Source: EUROSTAT

The comparison of national accounts based on GDP could lead to underestimation or overestimation of indicators due to different price levels in different countries. A generally accepted indicator is the comparison of purchasing power parity (PPP) which takes into account not only GDP but also price differences in the observed countries. The following table shows the PPP adjusted data for selected countries in comparison to the EU27 average.

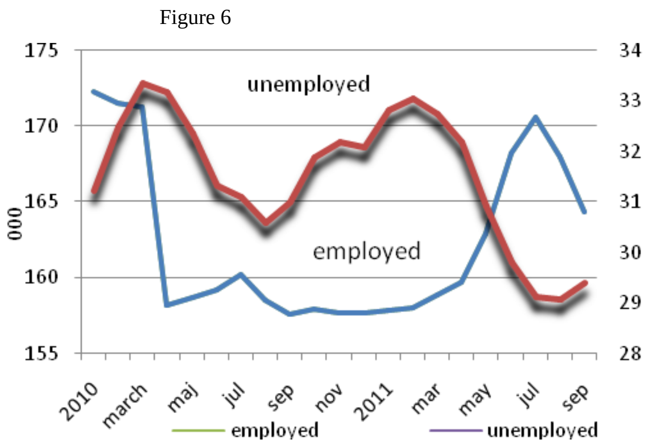
Table 4

Country	**GDP per capita 2010 EU 27=100**	**Actual personal consumption**	**Price level**
EU 27	100	100	100
Bulgaria	44	42	45
Croatia	61	56	71
Macedonia	36	41	39
Slovenia	85	80	84
Serbia	35	43	47
Albania	28	31	43
Bosnia and Herzegovina	31	37	51
Montenegro	**41**	**51**	**52**

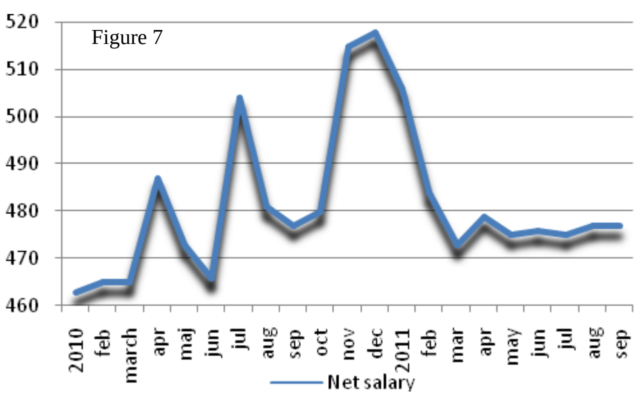
Source: EUROSTAT

Productivity enhancement is certainly crucial for the very important issue of economic competitiveness, so in the coming period it will be important to secure increases through structural reforms. This will be particularly important to the process of EU integration and will strengthen resilience to future exposure to the common EU market.

2.1.2. *Labour market*



The labour market was affected by the crisis with delay in 2010 and there was a fall in employment by 1.7% and a growth in the number of unemployed of 6.4%. In the period January – July 2011, unemployment rate decreased and employment rate increased, which is in correlation with the seasonal trends of the Montenegrin economy, as is the case with the fall of employment that began in August and continued through September. The number of persons employed on a seasonal basis (amounting to 8,400) explains to a certain degree the fact that there was no significant growth in the unemployment rate since these persons are mostly foreigners from neighbouring countries. According to the Labour Force Survey, the unemployment rate amounted to 19.5% in the third quarter 2011, which is a rate that more realistically reflects the actual situation. According to data from the Employment Agency of Montenegro (EAM), the unemployment rate amounted to 11.0% in July 2011, while in the same month of the previous year it amounted to 11.7%. At the end of November, the unemployment rate increased insignificantly and amounted to 11.54% (EAM). Employment and unemployment rates have inverse trends, which can be seen in the Figure, and strong distortion of employment data coincides with the change of institution responsible for the production of employment data. In April 2010, the Tax Administration became the source of these data. During the time taken by the system to start running smoothly, there was an abrupt fall in the number of employed persons which is not based on real trends.

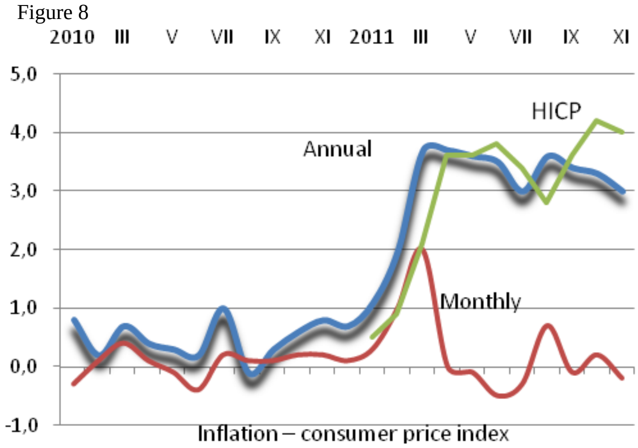


Salaries in 2010 had an increasing trend, and they grew faster than GDP. Real growth of salaries in comparison to 2009 amounted to 3% so the real salary in 2010 amounted to €479 net or €715 gross. It should be noted that the salaries went up in the productive sectors, while there was a fall in the state administration and health. The real salary in state administration is lower by 4.6%, and by 2.8% in health, while in education it is higher by 0.4%.

At the end of the third quarter 2011, the salaries had a decreasing trend in relation to the comparative period. Average gross salary in Montenegro at the end of the third quarter 2011 amounted to €712, and it is slightly lower in relation to the comparative quarter (when it amounted to €717). The average salary excluding taxes and contributions amounted to €477 at the end of the third quarter of this year, and it also saw a fall in relation to the same comparative period (€481). Average salaries excluding taxes and contributions in September 2011 really increased by 0.5% in relation to the previous month. For the mid-term framework 2012-2014 it is envisaged that the public sector salaries will be frozen, as a measure for achieving the planned fiscal goals (balanced budget), so the real salary will decrease which will also be a signal for the real sector of economy.

2.1.3. Inflation

Figure 8

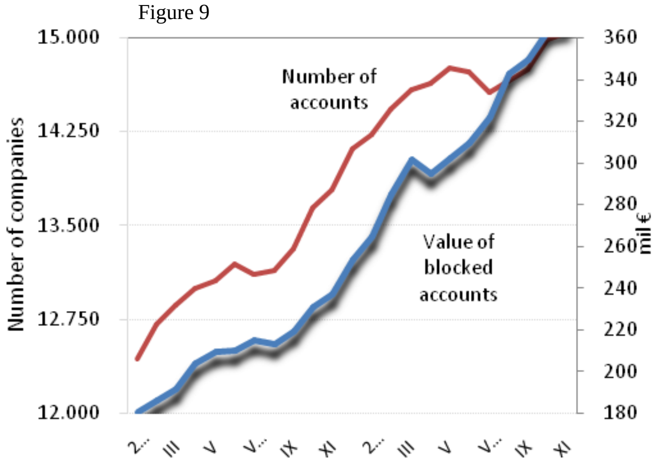


Price developments in Montenegro in 2010 fully reflected the situation in the internal and external market. Reduced aggregate demand and fall of fuel prices resulted in a very low annual inflation of 0.7%, expressed in consumer prices. In 2011, there was a more significant inflation growth resulting from the overflow of effects from the global market in the form of growth of food and energy prices, which was not possible to be avoided by Montenegro as a small and open economy and a large importer of these goods. The oscillation of prices of oil and oil derivatives directly resulted in the growth of transport prices and indirectly in the growth of prices of food and other products. In August 2011, annual inflation amounted to 3.6%. At the beginning 2011, Montenegro commenced the harmonisation of the price index, which was implemented in cooperation with Eurostat. The trend of this index in 2011 saw increase from 1.3% in January to 3.6% in August, while the highest inflation rate was in October when it amounted to 4.2%. Significant growth of factors affecting inflation are not expected to increase considerably until the end of the year, which makes more realistic the assumption that inflation in 2011 will be at the level of around 3.0%, i.e. 0.8% above the inflation projected by EFP 2010-2013.

2.1.4. Monetary aggregates and loans

Recapitalisation of banks in 2010 affected the stabilisation of the banking system. The growth of non-performing assets affected the carrying out of a restrictive lending policy, which resulted in the fall of approved loans by 8.2% in 2010 in relation to 2009. Deposits fell by 1.9% in relation to 2009 which resulted from the adjustment to crisis under the conditions of lowered lending activity, while it is positive that the savings of citizens increased by 12.8% in relation to 2009 as a confirmation that the credibility crisis is over. The situation in the banking market in 2011 is characterised by the increasing share of non-performing loans and a further downturn in lending activity. The share of non-performing loans in the total loans constantly grew until May 2011 when it again reached the level of 25.95% or €521.2 million after a two-month period of a slight fall. The key reasons for the fall of approved loans should be sought in the impossibility of daughter banks to repay money to mother banks due to low economic activity and high business risk. In September 2011, bank loans went down by 0.8% in relation to the previous month, and 11.8% in relation to December 2010. In October, non-performing loans were lower than in the previous month by 6.8%, and 22% in relation to the end of the previous year. The total deposits with banks also saw an annual fall, while retail deposits constantly and significantly went up, so in September 2011 they were higher by nearly 9% in relation to the end of 2010.

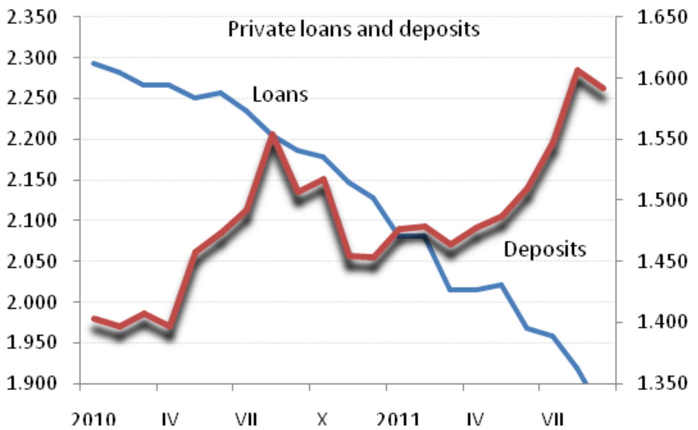
Figure 9



At the end of November 2011, out of 57,233 firms and individuals doing business, 15,038 had their accounts blocked, which is by 0.37% higher in relation to October 2011. In terms of value, the total debt based on which the accounts were blocked amounted to €364.9 million, which is by 0.52% higher in relation to the previous month. The concentration of debt was relatively high, so for example, 10 largest debtors, or only 0.07% of the total registered debtors had the share of even 21.69% in the total amount of blockade, meaning that their blocked accounts amounted to €79.1million. Fifty largest debtors, making 0.33% of the total registered debtors, had the share of 43.46% in the total amount of the blockade, meaning that their blockade amounted to €158.6million. 2,029 judgment debtors were under constant blockade for the period to one year, and their blockade amounted to €82 million, which makes 22.52% of the total amount of the blockade, while 13,009 judgement debtors were under blockade for the period exceeding one year, and their blockade amounted to €282.7 million, which makes 77.48% of the total amount of the blockade.

Out of 50 judgement debtors with the highest amount of debt, as of 30 November 2011, 36 judgement debtors were under constant blockade for the period exceeding one year and their blockade amounted to €109 million which makes 30.02 % of the total amount of debt, while 14 judgement debtors were under blockade for the period up to one year and the blockade amounted to €49 million, which makes 13.43% of the total amount of the blockade. The problem of account blockade is the problem of illiquidity and it threats to significantly jeopardise or block the normal functioning of economy. It can be seen in the Figure that the value and number of blocked companies are in correlation and there is a strong increasing trend for both indicators.

Figure 10



In a one-year comparative period (September 2010 - September 2011), banks in Montenegro saw the fall of assets, loans and capital, and the growth of deposits and liquid assets. The parameters of assets quality on aggregate level saw aggravation, save the defaulted loans. In September, the following positive changes took place in Montenegro in relation to August 2011:

- Fall of non-performing assets. Non-performing assets of banks went down by EUR50.3 million, or 8.79%, and its share in the total assets decreased from 19.59% to 18.07%;
- Fall of non-performing loans. Non-performing loans of banks decreased by EUR47.8 million, or 9.18%, as well as their share in the total loans by 1.76 percent points;
- Fall of defaulted loans. The total defaulted loans decreased by EUR 139 million, or 23.51%;
- Fall of rescheduled loans. The total rescheduled loans in banks decreased by EUR7.8 million or 2.58%;
- Retail deposits increased by EUR13.3 million or 1.31%;
- Growth of capital in banks. The total capital of banks went up by EUR7.3 million or at the rate of 2.56%;
- Substantial improvement of the loan to deposit ratio in the system. The ratio improved by 2.07 percentage points and in September 2011 it amounted to 104.21%. The ratio of these sources of funds and placements reduced in a month from EUR118.7 million to EUR 79.1 million;
- Increase of liquid assets of banks. According to daily data, liquid assets of banks increased by EUR7.7million or 1.76% in September 2011 in relation to August 2011. The share of liquid assets in the total assets of banks improved too.

On the other side, the following are **adverse changes** that took place in September 2011 in relation to August 2011:

- Reduction in the assets of banks. The total assets in the banking sector decreased by EUR32.6 million or 1.12% in relation to August. Eight banks saw the fall in assets of EUR44.2 million, while the remaining three banks had their balance sum increased by EUR11.6 million;
- Credit portfolio saw decrease in September in relation to August by EUR 51.3 million or 2.55%. Eight banks in the system had a fall in loans in the total amount of EUR59.2 million, and Prva Banka C.G. had the highest nominal fall of EUR 23.7 million. Three banks generated the growth of loans in the total amount of EUR 7.9 million, where Erste Banka had the highest nominal growth of EUR3.5 million;
- Fall of deposit potential. The total deposits with banks decreased by EUR11.6 million, or 0.62%.
- Fall of corporate deposits by EUR25 mil or 2.88%.

2.1.5. External sector

In 2010, the **balance of payment deficit** amounted to 25% GDP and was by 13% lower in relation to the previous year. The decreasing trend of the current account deficit that has been present since the beginning of the crisis is to the largest extent a result of the adjustment to the crisis and reduction of investment and personal expenditures. Positive results in the area of tourism and high inflow of current transfers mitigated already high foreign trade deficit. The exception in 2010 is the fact that for the first time there was a deficit in the income account which resulted from an increased outflow in respect of interest and dividends.

The current account deficit for the first three quarters of 2011 amounted to €375 million, which is by 25% lower in comparison to the deficit generated in the same period last year. Account of goods was in deficit by €984 million, which is the same as last year, while the remaining accounts of the balance of payment were in surplus. The net inflow of foreign direct investments in 2010 amounted to €552.1 million or 17.8% GDP, which is by 48% lower in relation to 2009, when »Elektroprivreda Crne Gore« was privatised and partially recapitalised. In the period January – September 2011, the net inflow of foreign direct investments amounted to €265 million, which makes a fall of 35.50% in relation to the same period of the last year, resulting from the high base in 2010 due to the recapitalisation of banks and the mobile operator M-tel, and weaker investment activity in the international market. It should be emphasized that the high percentage of errors and omissions in the balance of payments—amounting to 13.1% of GDP in 2010—leads to doubts about the overall deficit due to the fact that it is possible that some of current account inflows were underestimated by the same amount.

Table 5. Balance of payment of Montenegro, in EUR 000

	2010				2011		
	Iq	**IIq**	**IIIq**	**Ivq**	**Iq**	**IIq**	**IIIq**
A. CURRENT ACCOUNT (1+2+3+4)	**-243.2**	**-267.8**	**10.1**	**-278.5**	**-188.0**	**-255.0**	**67.7**
1. GOODS	**-254.3**	**-353.9**	**-381.8**	**-327.4**	**-229.3**	**-369.0**	**-386.4**
1.1. Export	60.3	94.8	93.8	107.6	115.7	110.0	122.8
1.2. Import	314.6	448.7	475.6	435.0	345.0	479.0	509.1
2. SERVICES	**-17.2**	**60.1**	**390.7**	**11.8**	**-4.5**	**82.1**	**444.1**
2.1. Revenues	50.5	138.3	472.4	85.9	61.3	155.7	534.8
2.2. Expenditures	67.7	78.2	81.7	74.1	65.8	73.5	90.7
3. INCOME	**5.0**	**-2.9**	**-26.2**	**2.4**	**20.2**	**3.3**	**-17.2**
3.1. Revenues	38.4	40.0	42.1	45.3	44.7	46.3	47.6
3.2. Expenditures	33.5	42.9	68.3	42.9	24.5	43.0	64.8
4. CURRENT TRANSFERS	**23.4**	**28.8**	**27.4**	**34.7**	**25.6**	**28.6**	**27.1**
4.1. Transfers to Montenegro	30.4	36.2	35.8	43.9	33.9	39.3	36.6
4.2. Transfers from Montenegro	7.0	7.4	8.4	9.2	8.3	10.7	9.5
B. CAPITAL AND FINANCIAL ACCOUNT	**195.8**	**131.6**	**-245.7**	**289.2**	**157.4**	**139.8**	**-288.9**
1. CAPITAL ACCOUNT	**-0.3**	**0.0**	**-0.1**	**-0.2**	**-0.1**	**0.0**	**0.0**
2. FINANCIAL ACCOUNT (1+2+3+4)	**196.1**	**131.5**	**-245.6**	**289.4**	**157.6**	**139.8**	**-288.9**
1. Direct investments-net	138.2	185.0	89.3	139.6	114.2	64.6	87.1
2. Portfolio investments -net	-1.7	1.1	188.2	0.6	14.1	161.5	-4.2
3. Other investments –net	4.8	-95.3	-354.4	92.5	-78.2	16.1	-414.5
4. Change in CBM reserves	54.8	40.7	-168.7	56.7	107.4	-102.4	42.7
C. NET ERRORS AND OMISSIONS (-A-B)	**47.3**	**136.2**	**235.5**	**-10.7**	**30.6**	**115.1**	**221.3**

The deficit in the current account of the balance of payment in the period January – September 2011 amounted to EUR374.7 million, which is by 23.5% lower than in the same period 2010. The basic reasons for such trends are the slight increase in the deficit of the account of goods and strong positive developments in the accounts of services, transfers and factoring income. In the capital financial account there was net inflow in respect of direct and portfolio investments, while at the same time there was net outflow in the account of other investments. In the period January – September, foreign trade deficit, according to the preliminary data of Monstat, amounted to EUR 1,032 million, which is by 3.5% higher than in the same period 2010. Although in the observed period there was higher growth of export than import of goods expressed in percentage, according to absolute numbers import was higher. The total export of goods, according to preliminary data of Monstat, amounted to EUR 331.5 million, which is by 44.7% higher in comparison to the same period 2010. The increase in the export of goods was affected by the increase in the scope of production of domestic exporters, as well as the growth of export prices which were in the period January – September 2011 higher by 10.4%[3] in comparison to the same period of the previous year. Positive balance in the account of services in nine months of the current year is the basic generator of decrease of the current account deficit.

Table 6. Foreign direct investments by sectors

	2010				**2011**		
	IQ	**IIQ**	**IIIQ**	**IVQ**	**IQ**	**IIQ**	**IIIQ**
Investments in domestic companies and banks	75.0	129.8	19.2	37.0	53.77	32.40	40.79
Inter-company debt	45.8	46.3	28.7	51.9	33.99	22.57	26.90
Sale of real estate in Montenegro	31.1	46.2	53.8	55.6	29.46	42.14	53.91
Other	5.8	0.1	11.0	15.3	8.21	4.31	0.32
Total inflow	**157.8**	**222.4**	**112.7**	**159.9**	**125.4**	**101.4**	**121.9**
Total outflow	19.6	37.4	23.5	20.3	11.22	36.82	34.81
Net FDI	**138.2**	**185.0**	**89.3**	**139.6**	**114.2**	**64.6**	**87.1**

2.2 Macroeconomic Scenario for the period 2012-2014

The c*ore message of the Scenario* is that the economic recovery, which commenced in 2010, even though not enough to achieve potential growth rates, will continue in the period 2012-2014. Risks concerning the liquidity of the economy, the banking sector, high foreign trade deficits, as well as risks from the broader European environment and reduced growth rates of large European economies are still present. Thus, the *starting approach in forecasting* the growth for the following medium-term period is a cautionary one, and reflects a rapid deterioration of the situation in the surrounding environment. Such approach reflects also a difference with the IMF's projections on the European economy, and especially the economy of the region in which is Montenegro located. According to that projection, 3.5% is the envisaged growth rate for the Montenegrin economy for 2012. The reason for the approach is the deferred impact of the crisis that affected the European Union in the second half of 2011, which will have an impact on Montenegro due to its openness and vulnerability to external shocks (in the form of reduced financing sources and a decline in investments). Furthermore, with a view that the Montenegrin market is oriented towards the European market, the growth forecasts for the Central and Eastern Europe of 2.7% were also taken into account, as well as the Euro area growth rate of 1.1% in 2012. It should be noted that the OECD in its last report of November 2011 reduced further the expected growth rates for the Euro area economies, thus the envisaged growth rate is only 0.2% in 2012 and 1.3% in 2013. As already noted, since our economy is open, those are more than just unfavourable signals. Inflation projections of 2% for each year in the period 2012-2014 are based on the IMF's forecasted rates and forecasts of the Central Bank of Montenegro, and are somewhat higher than in the Euro area (1.5%).

[3] Source: Price indices of manufacturors of industrial products for export in Montenegro, September 2011, Monstat

2.2.1. Base Macroeconomic Scenario for the period 2012-2014

The Base Scenario encompasses conservative and moderate real GDP growth rates in the period 2012-2014 as follows: 2% in 2012, 3.5% in 2013 and 4% in 2014; and nominal GDP growth rates of 4% in 2012, 5.6% in 2013 and 6.1% in 2014. This Scenario is based on the following *key and necessary assumptions*:

- Foreign direct investments will be maintained—despite a decline in terms of their relative share in GDP—at a high level of around 12% of GDP, albeit with a decreasing trend. Expected concrete investments in the medium term period are: the „Luštica Resort", hotel „Sveti Stefan", Porto Montenegro, the privatisation of the hotel company HTP Ulcinjska Rivijera, the implementation of small hydro-power plants (HPP) projects, HPP Morača, and a thermal power plant at Maoče;
- Bank loans will grow in support of the real economy at an average rate of 7.1% per annum;
- Exports growth will be at an average rate of 7.3% per annum, with moderate growth in their share of GDP. Imports will grow at a somewhat lower rates than the exports, being at 4.7% annually, as a support to the growth of economy and a consequence of the high import-dependency of growth rates. A moderate acceleration of economic activities will have a commensurate impact on import trends.

Table 7: Base Macroeconomic Scenario 2012-2014

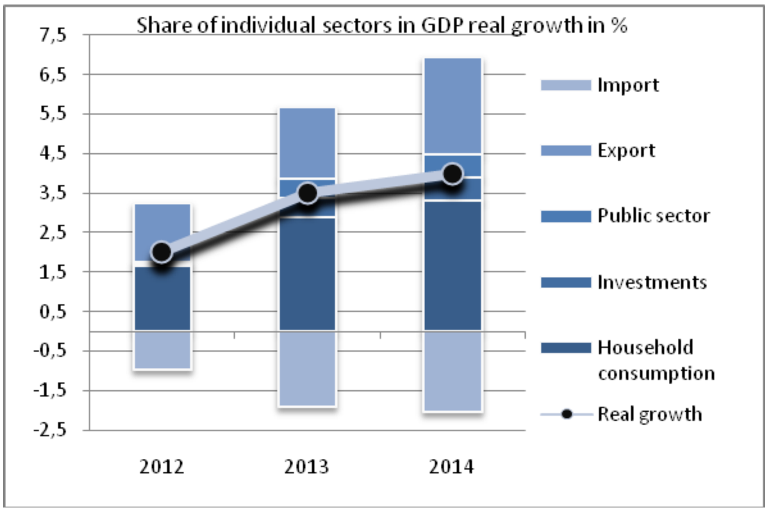
	Base scenario		
-	2012	2013	2014
Nominal GDP (million EUR)	3,405	3,595	3,814
Real growth	*2.0*	*3.5*	*4.0*
Deflators growth	*2.0*	*2.0*	*2.0*
Core items:			
Current Account Deficit	-21.6	-20.8	-19.5
Exports	38.6	39.1	40.0
Imports	-63.2	-63.0	-62.6
Other	3.1	3.1	3.1
Private deposits	45.7	45.8	45.8
Domestic bank loans	63.6	65.1	66.5
Household consumption	84.0	84.0	84.0
Gross investments in fixed assets	18.1	17.7	16.7
Current government spending	23.0	22.7	22.4
Current Account Deficit	-0.8	1.8	-0.7
Exports	6.2	7.0	8.6
Imports	3.6	5.1	5.4
Other	4.0	5.6	6.1
Private deposits	3.8	5.9	6.1
Domestic bank loans	5.0	8.0	8.4
Household consumption	4.0	5.6	6.1
Gross investments in fixed assets	0.6	2.9	0.1
Current government spending	2.3	4.2	4.7
Real GDP (million EUR)	**2.0**	**3.5**	**4.0**
Household consumption	1.6	2.9	3.3
Gross investments in fixed assets	-0.3	0.2	-0.3
Current government spending	0.0	0.5	0.6
Net exports	0.5	-0.1	0.4
Exports	1.5	1.8	2.4
Importss	-1.0	-1.9	-2.1

Difference between the Base Scenario and last year's projections

Last year's medium-term base macro-economic scenario predicted that the positive trends, which commenced at the end of 2010, would continue and that the economy would grow by 3.5% in 2012. However, this scenario did not take into account the deepening and worsening of the euro area crisis. Since this year's Baseline Scenario (covering the period 2012-2014) does take this into account, forecasted growth rates are practically shifted back by one year. Thus, as a consequence of the negative impact of the euro area crisis, the GDP growth rate for 2012 is reduced to 2% and any acceleration and recovery would only take place in 2013 and 2014. All other items in the National Accounts are practically mirroring these shifts.

Core components of the GDP growth, expenditure side

Figure 11



Household consumption will have a constant share in GDP of 84% for the forecasting period, and its contribution to growth will be a consequence of moderate growth of wages and growth of employment. Gross investments will have a downward trend in terms of their share of GDP, even though announcements for 2012 and outer years (including requests for issuing building permits) give some grounds for optimism. Announced greenfield investments in small power plants and hotel facilities have a value of EUR 156 million (the value of requests for issuing building permits). Expected investments over a medium-term horizon are: „Luštica Resort", Hotel „Sveti Stefan", Hotel complex "Expo hotels partners" d.o.o. - Budva Fair grounds, "Expo Budva" d.o.o. - Budva, reconstruction and extension and upgrade of the hotel "Crna Gora", the Island of "Sveti Marko", Porto Montenegro, privatisation of the hotel company HTP Ulcinjska rivijera, privatisation of Montenegroairlines, implementation of small hydropower plants projects, thermal power plan (TPP) Maoče. The current government spending will have a low share in growth rates, therefore it will, due to fiscal objectives to balance budget in 2013 and have surplus in 2014, have a decreased share in GDP from 23% in 2012 to 22.4% in 2014. Current government spending will decline as a share in GDP will therefore have a slightly negative effect on the growth of the economy. The adverse contribution to growth is a consequence of a planned consolidation in public finances, in terms of a reduction in the deficit in 2012 and moving toward a surplus in 2014.

Due to higher growth rates in exports, they will increase their share in GDP from 38.6% to 40%. Export growth will come because of a further strengthening of the tourism sector—through improved offers and the construction of new facilities—and investments in agriculture and its increased share in future exports. Imports will continue to have a share of around 63% of GDP in the period 2012-2014 but imports needed in support of investment will make a negative contribution to growth (since imports are a negative item in the GDP calculation). The Current Account Deficit in the Balance of Payments will have a decreasing trend so that in 2014 it will be down to 19.5% of GDP and it will be financed with a relatively high level of FDI, as well as with somewhat improved lending activity.

The following Table presents a breakdown—by growth rates and share in real growth rates of some GDP sectors—from the production side of the forecasts:

Table 8: GDP output approach for 2012-2014

	Real growth rates 2012	Contribution to growth 2012	2012 GDP breakdown	Real growth rates 2013	Contribution to growth 2013	2013 GDP breakdown	Real growth rates 2014	Contribution to growth 2014	2014 GDP breakdown
GDP		**2.0**	**100.0**		**3.5**	**100.0**		**0.7**	**100.0**
Net taxes	2.0	0.3	16.9	3.5	0.6	16.9	4.0	0.7	17.0
Gross value added		**1.6**	**83.1**		**2.9**	**83.1**			**83.0**
Agriculture, hunting, forestry and fisheries	5.0	0.4	7.7	5.0	0.4	7.8	6.0	0.5	8.0
Mining and Quarrying	5.0	0.1	1.2	5.0	0.1	1.3	5.0	0.1	1.3
Manufacturing industries	2.0	0.1	4.9	4.0	0.2	4.9	2.0	0.1	4.8
Electricity, gas, and water production and supply	4.0	0.2	4.5	3.0	0.1	4.5	2.0	0.1	4.4
Construction	-5.0	-0.2	4.6	4.0	0.2	4.7	5.0	0.2	4.7
Wholesale and retail trade, repair of motor vehicles	4.0	0.5	12.8	4.0	0.5	12.8	4.0	0.5	12.8
Hotels and restaurants	5.0	0.3	5.7	5.0	0.3	5.7	6.0	0.4	5.9
Transportation, storage and communications	3.0	0.3	10.2	5.0	0.5	10.3	5.0	0.5	10.4
Financial intermediation	4.0	0.2	4.0	4.0	0.2	4.0	5.0	0.2	4.0
Real estate activities, rental and leasing and business activities	0.0	0.0	8.6	0.0	0.0	8.3	3.0	0.3	8.2
Public administration and defence; compulsory social security	-1.0	-0.1	7.9	2.0	0.2	7.8	2.0	0.2	7.6
Education	-1.0	0.0	4.3	2.0	0.1	4.2	2.5	0.1	4.2
Human health and social work activities	-1.0	0.0	3.8	2.0	0.1	3.7	2.5	0.1	3.7
Other communal, social and personal service activities	0.0	0.0	3.0	2.0	0.1	3.0	2.0	0.1	2.9

Divergent trends of various production factors are expected ***in the real sector of economy***. The implementation of the Agro-budget, to support agricultural producers, creates a realistic prerequisite for the agriculture sector to have a more significant share in the future growth and consolidation of agricultural production. The Ministry of Agriculture and Rural Development, as part of the Montenegro Institutional Development and Agricultural Strengthening Project (MIDAS), approved some 300 projects in October that will provide grant support for 50 percent of the value of realized investment. It is predicted that Montenegro will, in three to four years, begin to obtain significant funds from the European Union for support to the development of agriculture. The mining sector, which primarily deals with the coal mining for the use of the coal-fired thermal power plant „Pljevlja" (as well as the investments into new pits and possible investments in the coal-fired thermal power plant "Maoče") also provides grounds for the expectation of significant growth.

Since KAP has a major share in manufacturing industry (and accounts for 44% of exports of goods), developments in this company are significant in marking trends for this sector and doubts about the business operations of the company make it difficult to make projections over a medium-term horizon.

Several major factors could determine activities in this company: (i) poor growth outlook in the global economy decreases resource demand, influencing adversely the aluminium price, even though the effect is somewhat offset by improving position of euro against US dollar; (ii) the planned abolition of electricity subsidies will increase production costs and possibly create an adverse effect on the future viability of the operation; (iii) debt levels of this company are also significant and could eventually represent a threat to medium-term operations. The company „Plantaža" (a significant *wine producer*) also has a significant share in the overall manufacturing industry sector. Business operations in 2010 and 2011 are such that an expansion of this company could be expected over the medium term. Positive indicators are the export of wine to China and commencement of purchase of grapes from registered producers. Purchasing grapes from individual producers represents also a support for the development of agriculture and should have a positive effect on both the growth in agriculture and general production, as well as of the exports.

Electricity generation is affected by well-known seasonal trends, and since 75% of generation capacities are hydro power plants, it is largely dependent on hydrological events. Any investment in this sector reinforces the production base and directly affects the production increase. Submitted requests for building permits for construction of small hydro power plants are a good indicator that investments in this sector will take place (the value of investments is expected to be EUR 47.8 million). Announced investments for reconstruction and construction of new facilities, which would translate into strengthening of the tourism sector, will further improve growth for this sector which is important for Montenegro. A good confirmation of these expectations are also requests for issuing building permits, valued at EUR 277 million (Expo Budva-fair complex, Expo Hotels Budva, reconstruction and extension of the Hotel Crna Gora, facilities on the island „ Sveti Marko", projects on the Luštica peninsula and possible construction of hotels in Porto Montenegro). Notwithstanding these prospects (and positive trends in the first half of 2011), prospects for the construction sector are stagnating relative to the past. The value of contracted works for the forthcoming period is expected to be substantially reduced (by 50%), and we expect a negative contribution from this sector in future growth. Turnover in retail and wholesale trade, as well as in transportation is generally in line with the average of all other factors, therefore we expect a slight growth in these sectors.

Inflation: The Base Scenario does not envisage a significant increase of inflation, measured by the consumer prices growth, because it is not expected that prices of imported energy sources will be increased, nor a significant increase in food prices is expected either, as a result of slower growth rates of the European and global economy (imported inflation). Planned growth rates over a medium-term are at the level of 2%. Certain risks concerning inflation increase come from the fact that the EPCG requested correction of prices for 2012, due to high level of imports, shortage of electricity resulting from extremely unfavourable hydrological situation in 2011 (around 50% of average precipitations).

Financial sector: Based on the analysis of the banking sector trends in the last part of 2011 (see chapter 2.1.4 on monetary aggregates and loans) and due to improved financial strength and achieved financial results in the banking sector during 2012, a gradual moderate growth of lending activity could be expected in the forthcoming period, i.e. 5.0% in 2012, 8.0% in 2013 and 8.4% in 2014. This will primarily depend on conditions in the real sector over the coming period, and developments therein represent at the same time the first and the highest risk for the financial sector stability.

External sector and medium-term sustainability: One of the core assumptions of the Baseline Scenario is a gradual recovery in export potential, primarily through productivity growth but also supported by real wage restraint. This would improve the sustainability of the Balance of Payments—the current account deficit represents one of the key possible sources for macroeconomic instability if inflows on the capital account of the Balance of Payments come up short. On the import side, a low aggregate demand (with particular emphasis on public sector spending and to a certain extent on household consumption) will generate a moderate growth in imports (that will be slightly over 5%) during 2013 and 2014. During the same period, a significant decline in the FDI inflow as a share of GDP is expected. FDI inflow trends are based on rather conservative assumptions and there are no major single investments that would significantly influence the economic growth of Montenegro over the medium term.

2.2.2. Low-growth Macroeconomic Scenario for the period 2012-2014

The low-growth scenario predicts real GDP growth rates for the period 2012-2014 as follows: 0.5% in 2012, 1.5% in 2013, and 3.5% u 2014; and nominal GDP growth rates of 2% in 2012, 3.3% in 2013, and 5.5% in 2014. The c*ore assumptions for the low-growth scenario* are as follows:

- Foreign direct investments record a more pronounced decline of their relative share in GDP, as compared to the Baseline Scenario, and are declining from 13.5% of GDP in 2012 to 10.5% in 2014;
- Bank loans in this Scenario in 2012 have growth of only 1.7%, where a delayed recovery would happened in 2013 and 2014, with growth rates of 6% and 8% respectively;
- Exports in this scenario have lower growth of only 2.7% in the first year, and a recovery would take place only in the last two years;
- Imports will stagnate in 2012 (in line with investment), and their recovery will only take place with higher growth in the last two years so that growth in these two years will be at an average rate of 4.8%.

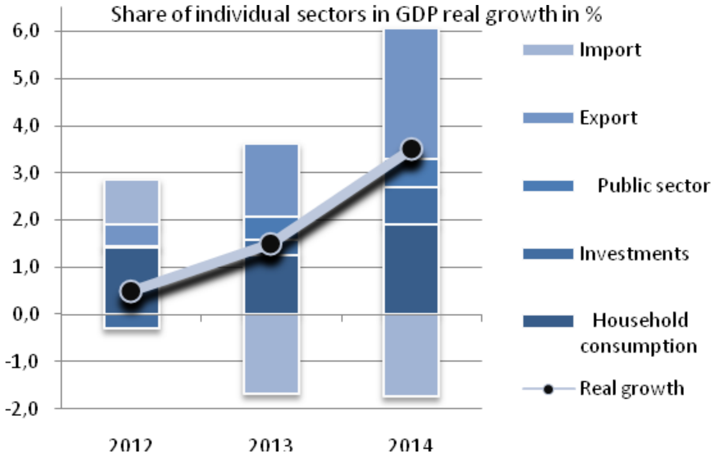
Table 9: Low-growth macroeconomic scenario 2012-2014

	Low-growth Scenario		
	2012	**2013**	**2014**
Nominal GDP (million EUR)	3,339	3,448	3,640
Real growth	*0.5*	*1.5*	*3.5*
Deflators growth	*1.5*	*1.8*	*2.0*
Core items:			
Current Account Deficit	-21.1	-20.8	-19.0
Exports	38.0	39.1	40.5
Imports	-62.2	-63.0	-62.6
Other	3.1	3.1	3.1
Private deposits	44.8	44.9	44.9
Domestic bank loans	62.8	64.5	66.0
Household consumption	85.0	85.0	84.0
Gross investments in fixed assets	16.6	16.4	15.6
Current government spending	23.0	23.0	23.0
Current Account Deficit	-4.9	2.0	-3.8
Exports	2.8	6.1	9.4
Imports	0.0	4.5	4.9
Other	2.0	3.3	5.6
Private deposits	-0.2	3.6	5.6
Domestic bank loans	1.7	6.0	8.1
Household consumption	3.2	3.3	4.3
Gross investments in fixed assets	-9.5	1.7	0.4
Current government spending	0.3	3.3	5.6
Real GDP (million EUR)	**0.5**	**1.5**	**3.5**
Household consumption	1.4	1.2	1.9
Gross investments in fixed assets	-2.0	0.0	-0.3
Current government spending	-0.3	0.3	0.8
Net exports	1.4	-0.1	1.0
Exports	0.4	1.6	2.8
Imports	1.0	-1.7	-1.7

Key assumptions:			
Foreign Direct Investments	13.5	12.5	10.6
Bank loans	1.7	6.0	8.1
Exports -growth	2.8	6.1	9.4
Imports - growth	0.0	4.5	4.9

Core components of the GDP growth, expenditure side

Figure 12



Household consumption will have a constant share in GDP of 85% in 2012 and 2013 and its share would be reduced to 84% only in 2014. Its contribution to growth will be a consequence of the lower growth of wages and growth of employment. Gross investments will have a downward trend in terms of their share of GDP since the assumption in this scenario is that there will be a decline in investments in fixed assets. Since some of the planned investments will not take place, the share of gross investments in the forecasted GDP for 2014 will be just 10.3%. Current government spending will have a lower share in GDP of 23%, due to low elasticity and narrow space for fiscal adjustments on the consumption side. One of the important factors for stable share is also achieving objectives concerning the budget balancing.

Lower growth of exports in 2012 is foreseen under this Scenario (2.8%), and any acceleration would be delayed until 2013 and 2014 when a somewhat stronger growth of economic activity is foreseen. The lower growth of exports is a consequence of an assumed slowdown of economic activity in the euro area and its contribution to the growth will be lower (in particular, in the first year of the period). The share of exports in GDP would be almost at the same level as in the Baseline Scenario but this is a consequence of the lower GDP level. The Scenario foresees a reduction of imports in 2012 (to 62.2% of GDP) having, as a consequence, a positive contribution of imports to GDP growth of 1%. Stronger import growth will take place in 2013 and 2014 (rates of 4.5 and 4.9% respectively) and this will produce a negative contribution to GDP growth of 1.7% in those years.

GDP growth on the output side in the lower-growth scenario must reflect assumptions of reduced economic activity and consumption/spending. Lower growth rates could be expected in the retail trade, tourism, agriculture, and transportation sectors. Negative trends are also possible in manufacturing industry, due to a possible deepening of the crisis in KAP and the Steel Mill. A positive contribution to growth could be expected in this scenario from the participation of the State since the low-growth fiscal scenario envisages maintaining consumption/spending at the same level as in the Baseline Scenario.

Inflation: A more significant increase of inflation measured by the consumer prices index is not expected in the low-growth scenario, even though price shock could take place due to an increase of the electricity prices resulting from increased imports and higher prices. Increased electricity imports in 2011 could have impact on the increase of electricity prices from July 2012. According to the IMF projections, a more significant increase of the energy-source prices (oil derivatives) is not expected, nor a more significant increase of food prices. Inflation forecast is the same as in the Baseline Scenario and is 2%.

Financial Sector: Positive trends in the banking sectors are even a prerequisite in achieving the low-growth scenario. Thus, this Scenario for 2012 predicts a lending activity growth of 1.7%, in support for the real sector in achieving forecast activity growth rates. In 2013 and 2014, the credit growth would increase to an average of 7%, which is a support necessary for higher GDP growth for these years. Numerous things depend on the success in resolving the euro area crisis and correlated crisis of financing of the European banking system and links to the developments in the banking sector of Montenegro. Any deterioration would lead to a stagnation or further reduction in the credit support and negative implications on the real sector.

External sector and medium-term sustainability: Explanation for developments and risks in the external sector in the case of the low-growth scenario are similar as in the Baseline Scenario, but growth components are at a lower level in the low-growth scenario and the risks are heightened. In this scenario, the FDI would have lower growth than in the Baseline Scenario, precisely 2.8% over a three-year period or 76 million euro in absolute terms. The Balance of Payments deficit in this scenario would be reduced to 19% of GDP in 2014.

2.2.3. Risks for the Montenegrin Economy in the period 2012-2014

Table 10 presents a summary of differences between both scenarios. The differences point also to the important risks to the Montenegrin economy in the period 2012-2014 in terms of non-realisation of the Baseline Scenario.

Table 10: Main differences between the Base Scenario and Low-Growth Scenario 2012-2014

	2012	2013	2014
(Contribution to real growth in %)			
Total:	**-1.5**	**-2.0**	**-0.5**
First-order effects	-2.8	-0.4	0.4
Exports	-1.1	-0.3	0.3
Gross investments in fixed assets	-1.8	-0.2	0.1
Second-order effects	1.4	-1.6	-0.9
Household consumption	-0.2	-1.7	-1.4
Current government spending	-0.3	-0.1	0.2
Imports	1.9	0.2	0.3
(as % GDP in the Base Scenario)			
Memorandum items:			
Lowe FDI	-0.9	-0.7	-1.2
Lower bank loans	-2.0	-3.2	-3.4

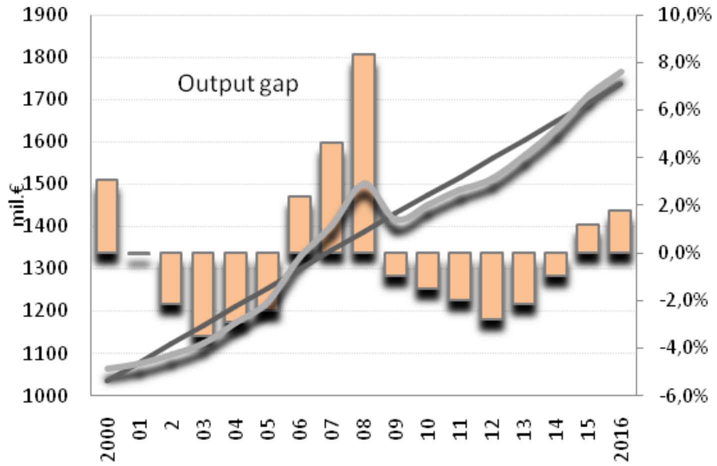
When projecting macroeconomic and fiscal indicators for the future period, the following factors should be taken into account. These factors could represent a risk for the Montenegrin economy in general and for the public finances of Montenegro over the observed medium-term horizon and, unfortunately, many of these concerns have even heightened as time has elapsed:

– *Banking sector crisis:* One of the key risks for the economy of Montenegro is a high level of loans in arrears (and they are still rising) and exposure to sectors primarily affected by the crisis, such are manufacturing industry, trade, and construction. Due to the need to recapitalise European banks, daughter companies of large parent banks may end up as collateral casualties, even those operating in Montenegro. As per present trends and expectations in the very banking sector, a significant growth in bank loans should not be expected in the near future, nor can they be expected to be a greater impulse to growth in the economy. In the event of the uncontrolled bankruptcy of the indebted European periphery countries, a preventive withdrawal of deposits may take place resulting from the fear of depositors of losing their deposits.

- *Recession in neighbouring and partner countries:* The announced hold on growth in Europe's economy, with a possible entering into recession, makes a recession possible in neighbouring countries and countries that are the main trade partners.
- *Significant decline of tourism revenues*: This decline is possible only in case of rather unfavourable weather or crisis in the tourism-originating countries.
- *Public debt sustainability – crisis in manufacturing industry:* A possible call upon the state issued guarantees for manufacturing industry companies to be honoured will also represent a fiscal risk for the forthcoming period. According to expectations, KAP production in 2011 will be somewhat higher than in 2010, which should bring this company into a more favourable position, along with plans to implement social programme and lay-off redundant employees. However, the latest trends in the aluminium market (a drop in prices and expected demand decline) are not instilling optimism that in the near future KAP will have positive business operations. Bankruptcy procedures were opened in the Steel Mill, with uncertainty of finding a new strategic partner. Issued guarantees for loans used by these two companies, in the case of an adverse scenario when they are called upon to be honoured, may mean in increase of the Government debt of 5-6% of GDP and, by doing so, would increase the cost of debt servicing. In 2011, the state has already paid €26.3 million on account of called guarantees for the Steel Mill.
- *Increase in unemployment*: The increase is possible in the event of even slower growth of the economic activity. Due to the possible reoccurrence of the economic crisis or its deepening, an increase in unemployment would be certain as companies would need to adjust to harsher operating conditions and one method is to reduce costs by reducing wages and laying off some employees. High employment in the public sector makes a rationalisation of the number of employees over the medium term a necessity.
- *Fiscal crisis*: Uncertainty in terms of the collection of tax revenues resulting from an increasing liquidity problem of the real sector, which resulted in a constant growth of tax debt (uncollected tax liabilities) since 2009, represents a possibly important fiscal risk. At the end of the third quarter of 2011 total uncollected tax liabilities were €178 million, which is almost 6% of GDP, and continue to show an upward trend. In the environment of negative bank lending or slow growth and stagnation in new employment, it could be expected that there will be a certain increase in the tax debt even in the forthcoming period, until the economy starts growing at the faster paste. The fiscal crisis is possible over a medium term as a consequence of lower income levels due to deepening and harshening of the crisis in the euro area and its effects on the economy of Montenegro.
- *Considerable decline in FDI, along with a delay in large-scale infrastructure facilities:* A sizeable fall in FDI is possible due to a deepening of the crisis in the euro area and a prudential approach of investors resulting in a delay of planned investments. Presently it is certain that the construction of the highway Bar-Boljare will be delayed and there is little interest from investors in the project for a hydropower plant on the Morača River. Because of our economic growth model, which has a built-in assumption of dependency on foreign direct investments, this could represent a considerable risk over a medium term.

2.2.4. Output gap – Difference between the potential growth and generated growth

Figure 13



GDP in constant prices in 2000 with Hodrick-Prescot filter

The value of purely statistical methods for measuring the potential[4] level of the economy in Montenegro is limited by a lack of data availability and breaks in series caused by a quickly transforming economy. However, despite this, the calculation of potential output and evaluation of past employment and labour productivity trends are important for the assessment of the future growth path. The analysis uses a comprehensive (longer-term) horizon for potential output, in order to evaluate past trends, which would then serve as a basis for analysis and projections of the future growth of the economy. Considering the lack of quality data series the HP-filter calculation is used—the data for calculation using the Cobb-Douglas function are not available.

The Figure above presents a path for potential GDP growth, compared to real generated or forecast growth rates in the period 2000-2016. The potential growth rate over this period is 3.2%. The potential growth rate of 3.2% can be divided into a rate of 1.2% that is a consequence of an increase in employment and residue that could be attributed to the productivity growth. These components depict an interesting image: in the period 2000-2005, there is a weak growth due to a weak increase in employment and the post-2005 boom is marked by a period of increased employment including its delayed fall in 2010[5] after the crisis of 2009.

What is visible from the Figure is that GDP was below potential for the first 5 years of the analysed period, a boom and bust took place in the period 2006-2009, and a balanced rate is achieved at the end of the observed period in 2015. The boom is visible in the graph in the period 2006-2008. In 2008, GDP was 8.3% above potential while, in 2009, it again went below the potential and there was a further decline in 2011 and 2012 (in line with expectations for weak growth of the European economy). According to this perspective, a 20-year economic cycle started in 2005 from a balanced position and after sharp increase and decline reached its lowest level in 2012, with a recovery and return to potential level in 2015. The range of the economic cycle, from top to bottom, is around 11%, indicating strong oscillations within the range.

The overall scenario is consistent with the view that the period of 5-6 years (from 2006-2011), was accompanied with strong oscillations (boom and bust). This scenario is also consistent with expectations that the three-year period of 2013-2016, with growth rates of around 4%, will be a period of returning to a balanced (potential) GDP level. This Scenario is probably a conservative one, in relation to the outlook for future growth, even though a possibility of negative trends should not be excluded (as a consequence of trends from the wider euro area environment and the European Union). Regarding rather turbulent trends at the end of 2011 and forecasts for further problems in 2012, there is not much room for optimism that the projected rates in the Montenegrin Baseline medium-term scenario will be achieved. A reduction of forecasted growth rates (OECD), which cut forecasted growth rates for the euro area to 1.6% in 2011, 0.2%

[4] Potential growth level of an economy is such where all production factors are optimally employed.

[5] It should be noted that the Tax Administration is in charge for employment data since April 2010, as due to introduction of consolidated wage tax and contributions collection its has all of the data on employees. Initial breaking in and learning curve resulted in nominal decline in the number of employees in April 2010, which in our opinion is not reflecting actual trends, and this creates difficulties for analysis and projections concerning this topic.

in 2012 and 1.3% in 2013, certainly must influence the Balkan region, since the euro area is the most important trade partner of this region.

2.2.5 Policies to Achieve the Macroeconomic scenario

The link between the Macroeconomic Scenarios and policies presented in the Chapters 3 and 4 is of a dual nature; on one side, the Macroeconomic Scenario determines trends in public finances and other area, and on the other hand, implementation of policies in public finances and structural reforms strive towards achieving the Baseline Scenario.

The primary long-term objective of the economic policy of Montenegro is to provide incentives for economic growth while increasing employment. Since Montenegro does not have an option for adjustments by changing exchange rates, as it uses euro, fiscal policy is key for carrying out the Macroeconomic scenario. Stability in the public finances is a priority in the present situation, in the context of external instability. Namely, the issue of confidence in the sustainability of the public finances, in light of the severe crisis of confidence in public finances of the euro area countries, makes achieving the fiscal objective of crucial importance to maintaining the confidence of financial markets and a corresponding credit rating. Any inconsistency in this segment could cause an increase in borrowing costs or an exclusion from markets due to unsustainably high borrowing rates, and that could cause a public finance crisis. The issue of public debt sustainability is also connected with this issue, which represents a first-rank issue due to the known situation in the euro area and in the surrounding environment. Conducting a prudential, proactive fiscal policy is primarily reflected in achieving a surplus in the public finances in 2014. It is clear that such a policy has negative repercussions for economic growth—any reduction in public spending drives down economic growth rates.

The envisaged macroeconomic scenarios are entirely driving the developments in the fiscal sphere. Namely, the projected growth rates of tax revenues are projected in full correlation with nominal GDP growth rates, while for non-tax revenues the increase is correlated with the inflation rate, since the majority of these revenues are not related with economic growth rates. Revenue projections are connected with achieving the fiscal objectives (a surplus in 2014). The low-growth fiscal scenario is based on the low-growth macroeconomic scenario which predicts a lower economic growth rate. That scenario envisages a decline in source revenues if compared to the base scenario, as a logical consequence of slower economic growth, and their stagnation to the level of around 38% of GDP. At the same time, an assumption of an unchanged absolute level of public spending is used, meaning that the public spending has a relative growth in comparison to the Baseline Scenario in percent of GDP as a consequence of a lower nominal GDP. In the low-growth scenario, the deficit is higher than in the Baseline Scenario, as a result of the decline of revenues, and compared to the baseline scenario the budget would not be balanced and it would not shift into surplus in the medium term. Required financing in the period 2012-2014 would be at the level of 6.7% of GDP in the observed period (use of deposits).

3. PUBLIC FINANCES

3.1. Public finances and Government debt

The structure of public finances of Montenegro consists of the Budget of Montenegro including state funds (Pension and Disability Insurance Fund, Health Insurance Fund, Employment Agency and Labour Fund), and local government budgets (Historical Capital Cetinje, Administrative Capital Podgorica and 19 municipalities). The Budget of Montenegro makes around 90% of public finances, while the remaining 10% is related to local government.

This sub-chapter provides an analysis of the basic trends in public finances in the period following the last EFP (2010-2011), as well as mid-term fiscal projections presented in two fiscal scenarios: "base fiscal scenario" and "low-growth fiscal scenario". Both scenarios are developed in line with corresponding macroeconomic scenarios presented in Chapter II. "Base fiscal scenario" is defined by the Budget Law for 2012 and it covers the period 2012-2014. Corresponding scenarios of government debt trends "Government debt base scenario" and "Government debt low-growth scenario" have been elaborated in line with the fiscal scenarios.

In order for Montenegro to approach systematic achievement of strategic economic goals and respond to crisis shocks, it was required to stabilise its public finances. After several years of exceptionally rapid economic growth accompanied by high cyclical increase in public revenues, in 2009 Montenegro faced a deep crisis characterised by a drastic downturn of economic activity, as well as major aggravation of the condition of public finances. Deficit in public finances reached the level of 5.7% GDP, and there was significant increase in government debt expressed as GDP share.

As explained in details in the last year's EFP, already in 2010 Montenegro initiated certain public-financial adjustments, which on the expenditure side were based primarily on the reduction of current expenditures, capital investments and other discretionary expenditures resulting in the reduction of deficit to the level below 5% GDP.

In 2011, the stabilisation trend of public finances drastically strengthened and became much more systematic. Thus, it is estimated that deficit in that year will be at the level of 3.25% GDP, and full balancing of public finances is envisaged for 2013. For this period it is envisaged that the government debt expressed as GDP share will go down and tax rates will be kept at the low level, which together with more restrictive policy for issuance of government guarantees should increase the sustainability of public finances of the country to medium term, reduce its exposure to external shocks and boost the credibility of Montenegro in the international financial market. For a small and extremely open economy, this is of an exceptional importance, particularly under the current unpredictable conditions of the world economy, and particularly under the conditions in the Euro area.

Further in the chapter the following is presented: the analysis of public finances for the period 2010-2011, fiscal forecast for mid-term framework 2012-2014 under both scenarios, analysis of long-term sustainability, structural balance, fiscal risk sensitivity analysis, as well as the review of the quality of public finances and institutional framework.

3.1.1. Strategy and mid-term goals of the public finance policy

Like in the previous period, the strategy for development of Montenegrin economy is based on stability strengthening, with creation of solid grounds for dynamic economic development and recognition of Montenegro as a competitive economy in relation to the EU countries. In the mid-term period, the priority goal is to continue the integration process, sustain stability of public finances and encourage economic development and growth. Therefore, the basic directions in the mid-term period are to keep low tax rates, which are a prerequisite for further expansion of the tax base, through contribution to maintaining a high share of investments in GDP and creating a business environment for new business start-ups. For the purpose of keeping the competitive tax policy, another important goal of economic policy is to reduce public spending in order to reach the sustainable level of public expenditures, with the emphasise on the reduction of current expenditures and encouragement of capital investments that will result in faster economic growth.

Under the conditions of fully Euroised economy such as the Montenegrin economy, fiscal policy is *de-facto* the only significant instrument in the hands of drivers of economic policy for stabilisation of economy, and therefore for creation of conditions for stable economic growth in the coming mid-term period. In addition, the fiscal policy is of great importance for stabilisation of the banking sector and financial sector in general, and it also plays a significant role in creating favourable business environment required for expanding the volume of investments.

Through internationally competitive and consistent tax policy we create an image of an attractive investment destination, with the view of keeping the current level of investments and attracting new ones, which will directly result in the growth of public revenues, reduction of unemployment and growth of standard of living. In order to achieve the mentioned goals, the planned activities that need to be carried out are: better efficiency of administrative capacities, introduction of new technologies for audit of taxpayers, stricter penalty measures that will directly result in the reduction of grey economy.

Implemented structural reforms in the area of pensions, health and education create prerequisites for maintaining the stable system of public finances. New pension reform contributes to gradual reduction of the share of pension expenditures aimed at creating a long-term sustainable system of public finances.

Taking into consideration the macroeconomic and fiscal risks (given in the previous chapter and below in this chapter), the fiscal policy for the following mid-term period defines the basic goals that are related to establishment of a sustainable system of public finances by determining the fiscal “anchors” and rules. The chief fiscal anchors in the period 2012-2014 are (in order of importance):

1. **Reduction of public sector deficit in 2012 to around 1% GDP, balance in 2013 and public sector surplus in 2014;**

2. **Reduction of the current public spending to below 35% GDP and government debt to below 43% GDP;**

3. **Reduction of relative share of mandatory spending in the total public expenditures;**

4. **Utterly restrictive issuance of guarantees and further signing of loan facilities, except for deficit financing, i.e. development projects;**

5. **Maintaining of the level of public capital investments between 3.5-4 % GDP in the period 2012-2014.**

The continuation of the restrictive fiscal policy in the mid-term needs to ensure the balancing of the public sector in 2013, with the aim to avoid additional long-term borrowings. According to the projections, it will be only in 2015 that the requirement for additional borrowings will stop, contributed by the reduction of interest expenditures and growth of capital expenditures, required as an additional impulse for economic growth.[6] Directly it is important for stabilisation of macroeconomic and fiscal parameters and indirectly for more favourable reports by IMF and credit agencies, which will lead to improvement of confidence and attraction of additional investments.

It is particularly important to point out the projected developments of the system of public finances and their sustainability in the context of European integration process. Namely, the new crisis wave that affected the Euro area and whole of the EU confirmed the concerns that without a consistent, harmonised and even single fiscal policy, even the survival of the EU may become questionable. Consultations are in process among the EU members regarding the rearrangement of relations within the Union, which should move in the direction of firmer fiscal and budgetary discipline. Montenegro as a candidate country will be scrutinized closely by the EU institutions in the coming period, and the closer we get to the membership the more demanding requirements will be. Therefore, it is already important in this phase of accession to establish firm fiscal policy foundations which will ensure that Montenegro will comply with the Maastricht and Copenhagen criteria in the mid term.

3.1.2. Developments in public finances in the period 2010-2011

This sub-chapter provides an analysis of fiscal developments in the period 2010-2011. The final data for 2010 and the latest MF projections for 2011 are presented. The sub-chapter is structured to track the trends of public current revenues, public spending and deficit in the period 2010-2011. In relation to estimations from the last year's EFP there was a decrease in the revenues with an increase in the public spending, which resulted in the public sector deficit higher than projected by the last year's EFP. The period 2010-2011 is to the largest extent characterised by the consolidation of public finances on the central and local level, the stagnation of public revenues, growth of government debt and deficit.

The effects of the economic crisis in the previous period were still present in the area of public finances, and therefore they had a negative impact on the government debt. Like in most economies, 2010 is featured by a deficit level higher than planned, which partly resulted from lower collection of tax and other revenues, and partly from higher level of some categories of public expenditures. In spite of the crisis, through fiscal policy instruments Montenegro strived to create conditions for a favourable business environment for development of entrepreneurship, attraction of investments and generation of revenues required for financing of public functions. Also, tax policy measures were directed to mitigation of financial crisis effects and overcoming illiquidity issue, including the application of the institute of rescheduling tax and non-tax debt, payment of profit tax in instalments with concurrent abolishing of its advanced collection, and deferred payment of customs debt. Priority goal of the fiscal policy in the previous period was the creation of fiscal stability.

Public current revenues

Public current revenues in 2010 were generated in the amount of €1,314 million or 42.34% GDP for 2010 (€3,104 million). In relation to estimates for 2010 given in the last year's EFP (see the table in the Annex), the current revenues went down by 1 p.p. GDP, which resulted from the growth of illiquidity, and therefore increase in tax receivables. For reminder purposes, the growing trend of uncollected tax receivables has been present since the breakout of the crisis, and in the period 2010-2011 they affected the growth of tax

[6] In the period 2015-2016 refinancing of issued Eurobonds is expected, so the interest-related costs will continue to burden the budget.

debt. However, the termination of the growth of receivables and collection of a part of such receivables should be expected in the future period.

Public revenues in 2011 are estimated in the amount of €1,288.5 million or 39.37 % GDP for 2011 (€3,273 million). It is estimated that due to slight stagnation of the collection of revenues, current revenues will be lower by 3% than planned by the Budget Law 2011.

Table 11. Current public revenues 2010-2011

	Outturn 2010		Budget 2011		Estimate 2011	
	million	% BDP	million	% GDP	million	% GDP
CURRENT REVENUES	**1314.33**	**42.34**	**1331.90**	**40.69**	**1288.49**	**39.37**
Tax revenues	**1136.99**	**36.63**	**1170.75**	**35.77**	**1158.32**	**35.39**
Direct taxes	**515.10**	**16.59**	**506.09**	**15.46**	**515.05**	**15.74**
Personal income tax	115.07	3.71	113.58	3.47	114.62	3.50
Corporate profit tax	20.27	0.65	32.90	1.01	36.64	1.12
Contributions	379.76	12.23	359.61	10.99	363.80	11.12
Indirect taxes	***621.89***	***20.04***	***664.67***	***20.31***	***643.26***	***19.65***
Tax on turnover of immovables	16.46	0.53	17.90	0.55	14.31	0.44
Value added tax	364.18	11.73	401.26	12.26	388.65	11.87
Excise	134.26	4.33	147.48	4.51	144.40	4.41
Tax on foreign trade and transactions	50.81	1.64	53.53	1.64	47.50	1.45
Local taxes	44.59	1.44	41.33	1.26	42.13	1.29
Other Republic tax	11.59	0.37	3.16	0.10	6.27	0.19
Non-tax revenues	**177.34**	**5.71**	**161.15**	**4.92**	**130.17**	**3.98**
Duties	26.28	0.85	30.02	0.92	21.64	0.66
Fees	102.00	3.29	82.84	2.53	60.43	1.85
Other revenues	44.09	1.42	43.95	1.34	43.76	1.34
Loan repayment receipts	4.97	0.16	4.34	0.13	4.34	0.13

In the Table 1. it can be clearly seen that tax revenues had a significant share in public current revenues of around 86 % in 2010, which is followed by an increase of their share to nearly 90% in 2011, while the share of direct and indirect taxes is approximately the same in all years (45:55 in favour of indirect taxes). Non-tax revenues saw a decreasing trend over the years, which resulted from the lack of revenues in respect of investment activities which were substantial in the period of intensified economic growth.

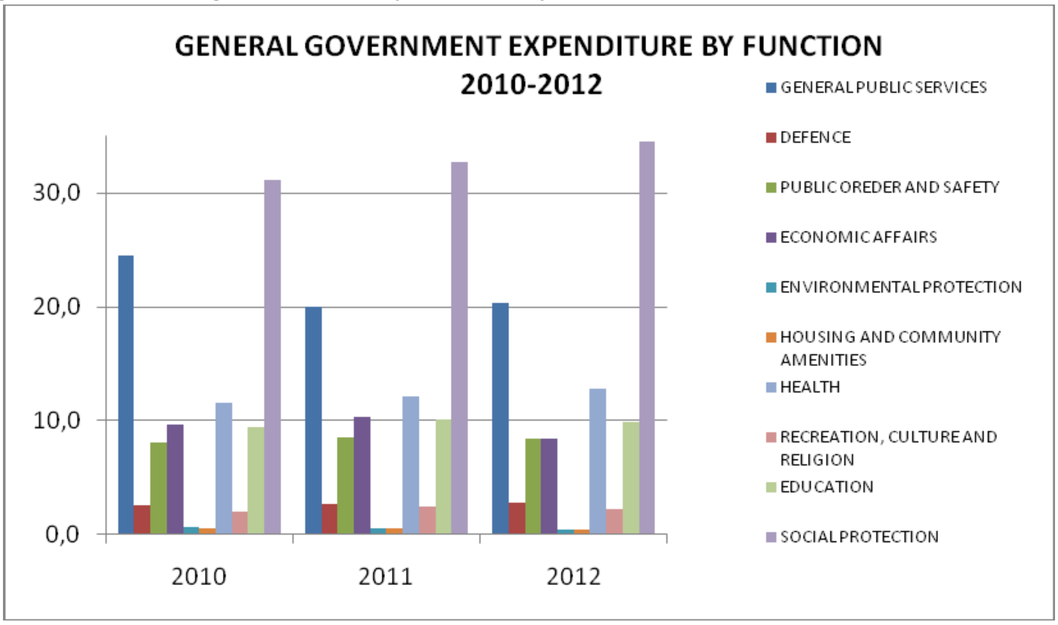
Taxation policy in the period 2010–2011 represented the continuation of previous activities and it was directed primarily to creating favourable business environment for development of entrepreneurship, attraction of investments and generation of required revenues. Also, specific tax policy measures were focused on mitigation of the effects of the financial crisis and overcoming of illiquidity issue, including the application of the institute of rescheduling tax and non-tax debt, payment of profit tax in instalments with abolishment of advanced collection of this tax form, as well as deferred payment of customs debt. Activities related to harmonisation of tax and customs legislation with Acquis was particularly emphasised. Tax and customs legislation of Montenegro, particularly related to customs tariff and indirect taxes (excise and VAT), has been mostly harmonised with Acquis communautaire.

Public spending

Public spending in 2010 amounted to €1,465 million or 47.21 % GDP of which € 1,319 million or 42.49 % GDP is related to current and €146.40 million or 4.72 % GDP to capital expenditures. In relation to estimates for 2010 given in the last year's EFP, public spending increased by 2.6 p.p. GDP. This situation was contributed by the growth of liabilities that were not possible to be estimated at the time of preparation of the previous EFP. Public spending for 2011 is estimated to the amount of €1,394.8 million or 42.62 % GDP. Current public

expenditures are estimated to €1,283.5 million or 39.22 % GDP, while 3.40 % GDP is related to capital expenditures. The Table of public expenditures by functional classification is given in the Annex, Table 3.
Public finances by functional classification 2010-2012.

Figure 14. General government expenditure by functions 2010-2012



Viewed by functions, social security has the largest share in public expenditures with over 34% in the total public-financial expenditures in 2012. Second largest share is related to the function of general public service which includes local self-government expenditures and a part of capital projects related to these purposes and its share has seen a decreasing trend over the years, from 24% share in 2010 to 20% in 2012. The function of healthcare is very important with regard to its share that in the previous years was 10.5 %, and in 2012 the healthcare will make 12.8 % of the total public expenditures. Then follow the function of education with 10% in 2012 and the function of economic affairs whose share decreased in the previous years from 9.7% to 8.4 %, while the share of the function - public order and security in 2012 is planned to 8.4%. The functions with lowest share are the defence with 2.7%, sports, culture and religion with 2.2%, housing and community affairs with 0.4% and environmental protection with 0.4% share in the public spending.

Public sector deficit and its financing

Public sector deficit[7] for 2010 is generated in the amount of EUR 151.08 million, which makes 4.87 % GDP for 2010. In relation to the estimates for 2010 given in the last year's EFP, deficit is higher by 1 p.p. GDP, which resulted from lower generation of revenues and concurrent execution of expenditures higher than projected in the last year's EFP. The required financing in 2010 amounted to 11.2 % GDP, and the funds were dominantly provided by loans from foreign sources (issue of Eurobonds in the amount of € 200 million).
Public sector deficit for 2011 is estimated in the amount of €106.33 million, which makes 3.25% GDP for 2011, and is by around 1 p.p. GDP higher in relation to the deficit planned by the Budget Law for 2011. Financing in 2011 is estimated to €322.48 million or 9.85 % GDP, and funds were provided by borrowings and loans from foreign sources in the amount of €188 million, privatisation receipts in the amount of €12.7

[7] According to the cash based calculation, the deficit in 2010 would amount to 3.9% GDP, but due to the outstanding liabilities, primarily at the level of local self-government, deficit in 2010 amounted to 4.87% GDP. Article 16 of the Budget Law defines cash deficit or surplus which makes the difference between the receipts and expenditures, where the receipts are reduced by borrowings, received transfers, donations and receipts from sale of property, and expenditures by principle repayment in the country and abroad in respect of debt incurred by loans or issue of securities and application of net liabilities from previous years that have no nature of a borrowing. The change in net liabilities from previous years is presented as difference in the balance of liabilities at the beginning and at the end of the fiscal period. Accodingly, cash deficit includes net change of outstanding liabilities.

million, borrowings and loans from domestic sources in the amount of €7.7 million, donations in the amount of €1.9 million, while the use of government deposits is estimated to the amount of €112.16 million.

The following table provides the balance of public finances with the outturn for 2010 in comparison to the plan and the projection for 2011 (in million and % GDP):

Table 12. Public finances 2010-2011

	Outturn 2010		Plan 2011		Estimate 2011	
	million	% GDP	million	% GDP	million	% GDP
CURRENT REVENUES	**1314.33**	**42.34**	**1331.90**	**40.69**	**1288.49**	**39.37**
Taxes	**757.23**	**24.40**	**811.15**	**24.78**	**794.52**	**24.27**
Contributions	**379.76**	**12.23**	**359.61**	**10.99**	**363.80**	**11.12**
Duties	**26.28**	**0.85**	**30.02**	**0.92**	**21.64**	**0.66**
Fees	**102.00**	**3.29**	**82.84**	**2.53**	**60.43**	**1.85**
Other revenues	**44.09**	**1.42**	**43.95**	**1.34**	**43.76**	**1.34**
Loan repayment receipts	**4.97**	**0.16**	**4.34**	**0.13**	**4.34**	**0.13**
PUBLIC SPENDING	**1465.41**	**47.21**	**1408.64**	**43.04**	**1394.82**	**42.62**
CURRENT PUBLIC SPENDING	**1319.01**	**42.49**	**1264.43**	**38.63**	**1283.53**	**39.22**
Current expenditures	**609.71**	**19.64**	**699.69**	**21.38**	**695.99**	**21.26**
Social security transfers	**423.59**	**13.65**	**439.54**	**13.43**	**455.25**	**13.91**
Transfers to institutions, individuals, NGO and public sector	**203.07**	**6.54**	**109.78**	**3.35**	**113.57**	**3.47**
CAPITAL EXPENDITURES	**146.40**	**4.72**	**144.21**	**4.41**	**111.29**	**3.40**
Borrowings and loans	**5.04**	**0.16**	**3.81**	**0.12**	**3.85**	**0.12**
Reserves	**15.84**	**0.51**	**11.61**	**0.35**	**14.87**	**0.45**
SURPLUS / DEFICIT	**-151.08**	**-4.87**	**-76.74**	**-2.34**	**-106.33**	**-3.25**
PRIMARY DEFICIT	**-119.68**	**-3.86**	**-28.19**	**-0.86**	**-61.80**	**-1.89**
DEBT REPAYMENT	**196.85**	**6.34**	**174.44**	**5.33**	**216.15**	**6.60**
Principle repayment to residents	62.14	2.00	41.51	1.27	25.10	0.77
Principle repayment to non-residents	45.34	1.46	56.34	1.72	63.20	1.93
Repayment of liabilities from previous period	89.37	2.88	76.59	2.34	94.93	2.90
Repayment of guarantees	0.00	0.00	0.00	0.00	32.92	1.01
FINANCING NEEDS	**-347.94**	**-11.21**	**-251.18**	**-7.67**	**-322.48**	**-9.85**
FINANCING	**347.94**	**11.21**	**251.18**	**7.67**	**322.48**	**9.85**
Borrowings and loans from domestic sources	42.12	1.36	5.00	0.15	7.70	0.24
Borrowings and loans from foreign sources	205.66	6.63	151.00	4.61	188.00	5.74
Donations	5.86	0.19	1.92	0.06	1.92	0.06
Revenues from privatisation and sale of property	27.42	0.88	22.00	0.67	12.70	0.39
Use of government deposits	66.88	2.15	71.26	2.18	112.16	3.43

Pension expenditures are the highest deviation in relation to the plan for 2011, where the expenditures are expected to exceed the planned expenditures, incurred by adjustment of military pensions, higher inflow of pensioners than expected and change of legislative framework. In addition to the mentioned expenditures, higher execution than planned is also estimated in case of benefits from the area of social security and subsidies. At the same time, savings can be expected in case of expenditures for material and services (primarily in case of contracted services), and in the Capital Budget of MNE. What additionally burdened the fiscal balance in 2011 is the proclamation of bankruptcy in the Steel Mill Nikšić, which caused the government guarantees to Credit Suisse to be called on and honoured in the amount of €32.92 million.

There were additional substantial fiscal adjustments at the local level, both on revenue and expenditure side. On the revenue side current revenues of local self-government went down significantly, conditioned by the fall in investment activities (revenues in respect of sale of property and fees for communal development of buildable land, and abolishment of tax on consumption, tax on company's title or name and tax on games of chance or entertainment games). This automatically reflected on the expenditure side due to the fact that municipalities were forced to balance their budgets because of the limited possibility of borrowings and shortage of deposits. At the same time, there was significant increase of outstanding liabilities on the local level.

Outstanding liabilities of municipalities considerably worsened the quality of public finances of the country in the previous two years, primarily deficit, although the share of the spending of municipalities in the total public spending is only 10%, so the settlement of these liabilities is very important, not only from the aspect of public finances but also from the aspect of general liquidity of economy.

3.1.3. Projections of public finances for the period 2012-2014

This sub-chapter presents two fiscal scenarios: “base fiscal scenario” and “low-growth fiscal scenario” that are based on two corresponding macroeconomic scenarios presented in the previous chapter. The base fiscal scenario is adopted within the Budget Law of Montenegro for 2011 and it represents the central scenario for implementation of the fiscal and budgetary policy of the Government of MNE in the subsequent mid-term framework. Low-growth fiscal scenario shows the implementation of measures of fiscal and budgetary policy in case the economic growth from the macroeconomic low-growth scenario comes true. In both scenarios the level of expenditures is kept unchanged, while in the low-growth fiscal scenario the interest expenses went up, due to higher borrowings.

Base fiscal scenario

The projections of public revenues for mid-term period are developed in line with the projected growth rates of economy, inflation trends in the mentioned period and resilience of revenues in relation to GDP growth rates. For the period 2012-2014, gradual growth of current revenues is projected in the absolute amount from € 1,342 million in 2012 to € 1,489 million in 2014, while as GDP percentage slight fall is expected from 39.42 % GDP to 39.04 % GDP. The growth in line with the growth rates of economy is expected for tax revenues (taxes and contributions), while in case of non-tax revenues the projected growth is in line with expected inflation rates.

Table 13. Base fiscal scenario 2011-2014

BASE FISCAL SCENARIO	2011	2012	2013	2014
GDP nominal growth	6.1	4.0	5.6	6.1
GDP real growth	2.5	2.0	3.5	4.0
Current public revenues	39.37	39.42	39.24	39.04
Public spending	42.62	40.47	39.12	38.01
Deficit/Surplus	-3.25	-1.05	0.13	1.03
Interest	1.36	1.79	1.77	1.77
Primary deficit/surplus	-1.89	0.74	1.89	2.8
Government debt	43.82	46.93	45.37	42.93

The goals presented in the mid-term fiscal projections imply the continuation of the fiscal consolidation process initiated in 2009, so the plan for 2012 and midterm framework envisage key fiscal indicators of the quality of public finances considerably better than in the previous years.

In order to create a stable and sustainable system of public finances in the mid-term period, it is planned that public spending should go down from 40.47 % GDP in 2012 to 38 % GDP in 2014. This will be implemented through restrictive fiscal policies, i.e. freezing of the wage fund in public sector, and fall in the expenditures for material and services – primarily contracted services, where there is still room for fiscal consolidation, although given the previous substantial reduction, allocations to development projects may be subject to delay. At the same time, further growth of expenditures for pensions and social benefits is expected. It is anticipated that in the coming years there will be increased inflow of pensioners, particularly from the area of processing industry and mining, due to the concessions/easements approved to the largest companies from this area. For the same reason and expected rationalisation in the public sector, increased volume of social benefits is expected in the mid-term framework, since it is difficult to anticipate that the growth of employment will fully offset the reduction in the number of staff in these sectors.

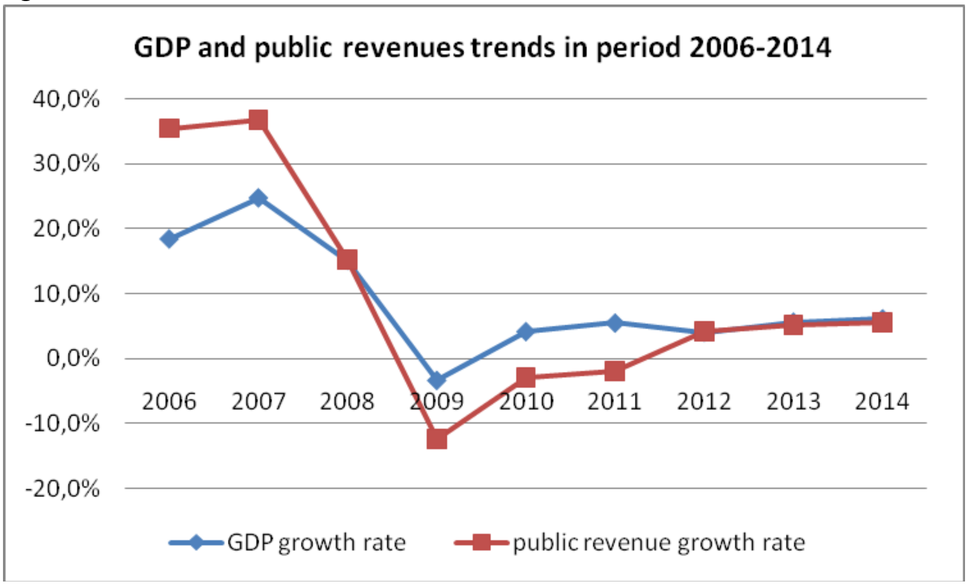
As a result, in the mid-term period 2012-2014 it is estimated that in 2012 public sector will generate a slight deficit of 1.05% GDP, which will grow into surplus in 2013, projected to amount to 0.13 % GDP, while in 2014 it is projected that public sector surplus will amount to 1.03 % of the projected GDP.
In case of capital investments it is important to point out that there are available funds of loans signed with international financial institutions (WB, EIB, EBRD, KfW) in the amount of €146.7 million for infrastructure projects (for more details see the section Quality of public finances), which are approved under favourable conditions.

In spite of all significant fiscal consolidation, the need for borrowings of the public sector will not stop in the observed period due to the high level of debt repayment. With conservative planning of privatisation receipts and uncertain level of donations, it is expected that in the coming period the basic source of finances will be foreign borrowings, probably through continuation of Eurobond issue.

It is planned that government deposits, in the observed period, should remain at the level of €60 million, which is according to estimates sufficient as reserve in case of an external shock, which will increase the need for borrowings in 2012 from around €170 to €230 million, depending on the generated privatisation receipts.

Figure 2 shows comparative trend of GDP nominal growth for the period 2006-2010 according to official data of MONSTAT and projections of the Ministry of Finance for 2011-2014, with generated and projected growth rates of current revenues for the same period.

Figure 15



It can be clearly seen that in the period of strong growth of economy, revenues grew faster than GDP, while in the crisis period an opposite effect is visible, i.e. higher fall or slower growth of revenues than GDP nominal growth. The reason is increased illiquidity of real sector, growth of tax debt and grey economy in the crisis period. The stabilisation of trends is forecasted for the period 2012 -2014, where the growth of current revenues is slightly lower than projected GDP growth. The reason for such conservative planning is mostly the uncertainty in the trend of outstanding tax receivables (tax debt) in the forthcoming period, as well as uncertainty in the continuation of FDI inflow, which in the boom period significantly contributed to the growth of current revenues (through growth of aggregate demand and expenditure).

Public current revenues in the mid-term are projected at the level of somewhat over 39% GDP. Conservative scenario of the projection of tax revenues takes the following assumptions into account:

- Non-existence of significant foreign direct investments;
- Tax debt at the same level without mid-term economic growth effects on its reduction and
- Growth of non-tax revenues (duties, fees and other revenues), aligned with inflation growth, so their projected growth is lower than nominal growth of economy.

Like in previous years, the basic funding sources will be direct taxes (income tax and contributions), as well as the most significant categories of indirect taxes (VAT and excise).

A large part of public spending is pre-defined by the legislative framework and it includes mandatory expenditures (general and sector-level collective agreements, laws and contracted obligations) – salaries and other personal income, pensions, transfers for social security, transfers to the University of Montenegro, transfers to political parties, interest, subsidies, etc. Salaries and pensions are key components of fixed, i.e. mandatory costs whose share in the public spending was over 80% in the period 2010-2011, while the estimate for 2012 is that the level of mandatory spending will grow due to further rationalisation of discretionary spending.

Table 14. Public finances 2011-2014

	Estimate 2011		Plan 2012		Projection 2013		Projection 2014	
	Million	% GDP	Million	% GDP	million	% GDP	million	% GDP
CURRENT REVENUES	**1288.49**	**39.37**	**1342.25**	**39.42**	**1410.82**	**39.24**	**1489.08**	**39.04**
Taxes	**794.52**	**24.27**	**841.81**	**24.72**	**886.92**	**24.67**	**938.52**	**24.61**
Contributions	**363.80**	**11.12**	**371.99**	**10.92**	**392.82**	**10.93**	**416.79**	**10.93**
Duties	**21.64**	**0.66**	**29.60**	**0.87**	**30.25**	**0.84**	**30.92**	**0.81**
Fees	**60.43**	**1.85**	**51.39**	**1.51**	**52.61**	**1.46**	**53.85**	**1.41**
Other revenues	**43.76**	**1.34**	**43.03**	**1.26**	**44.00**	**1.22**	**45.00**	**1.18**
Loan repayment receipts	**4.34**	**0.13**	**4.43**	**0.13**	**4.22**	**0.12**	**4.01**	**0.11**
PUBLIC SPENDING	**1394.82**	**42.62**	**1377.91**	**40.47**	**1406.30**	**39.12**	**1449.88**	**38.01**
CURRENT PUBLIC SPENDING	**1283.53**	**39.22**	**1270.72**	**37.32**	**1294.30**	**36.00**	**1332.88**	**34.95**
Current expenditures	**695.99**	**21.26**	**724.53**	**21.28**	**719.04**	**20.00**	**734.45**	**19.26**
Social security transfers	44.53	1.36	61.01	1.79	63.54	1.77	67.66	1.77
Transfers to institutions, individuals, NGO and public sector	**455.25**	**13.91**	**477.86**	**14.03**	**508.53**	**14.15**	**530.61**	**13.91**
PUBLIC SPENDING	**113.57**	**3.47**	**53.36**	**1.57**	**53.17**	**1.48**	**54.13**	**1.42**
CAPITAL EXPENDITURES	**111.29**	**3.40**	**107.19**	**3.15**	**112.00**	**3.12**	**117.00**	**3.07**
Capital budget MNE	71.29	2.18	70.19	2.06	75.00	2.09	80.00	2.10
Capital budget of local self-government	40.00	1.22	37.00	1.09	37.00	1.03	37.00	0.97
Borrowings and loans	**3.85**	**0.12**	**3.47**	**0.10**	**3.18**	**0.09**	**3.23**	**0.08**
Reserves	**14.87**	**0.45**	**11.49**	**0.34**	**10.38**	**0.29**	**10.45**	**0.27**
SURPLUS / DEFICIT	**-106.33**	**-3.25**	**-35.65**	**-1.05**	**4.52**	**0.13**	**39.20**	**1.03**
PRIMARY DEFICIT	**-61.80**	**-1.89**	**25.35**	**0.74**	**68.06**	**1.89**	**106.86**	**2.80**
DEBT REPAYMENT	**216.15**	**6.60**	**158.84**	**4.66**	**142.65**	**3.97**	**150.61**	**3.95**
Principle repayment to residents	25.10	0.77	27.45	0.81	29.40	0.82	26.89	0.70
Principle repayment to non-residents	63.20	1.93	65.38	1.92	62.30	1.73	75.80	1.99
Repayment of liabilities from previous period	94.93	2.90	66.01	1.94	50.95	1.42	47.92	1.26
FINANCING NEEDS	**-322.48**	**-9.85**	**-194.49**	**-5.71**	**-138.13**	**-3.84**	**-111.40**	**-2.92**
FINANCING	**322.48**	**9.85**	**194.49**	**5.71**	**138.13**	**3.84**	**111.40**	**2.92**
Borrowings and loans from domestic sources	7.70	0.24	6.00	0.18	6.00	0.17	5.00	0.13
Borrowings and loans from foreign sources	188.00	5.74	218.49	6.42	104.17	2.90	78.47	2.06
Donations	1.92	0.06	2.00	0.06	2.00	0.06	2.00	0.05
Receipts from privatization and sale of property	12.70	0.39	18.00	0.53	18.00	0.50	18.00	0.47
Use of government deposits	112.16	3.43	-49.37	-1.45	8.60	0.24	8.60	0.23

Low-growth fiscal scenario

Although it was repeated many times, it should be pointed out once again that Montenegro as a small and open economy is exposed to shocks of not only positive but also adverse nature. The continuation of crisis expansion in the countries of Euro area, which overflowed from primary financial to the public sector, had a significant impact on reduction of confidence of investors on the global level, with potentially high risk for economy of Montenegro.

Low-growth fiscal scenario is based on the macroeconomic low-growth scenario. The basic difference in relation to the base fiscal scenario is the fall in the current public revenues, due to lower level of economic activities, fall of aggregate demand and expenditure. The table provides the basic macroeconomic and fiscal indicators according to the low-growth scenario:

Table 15. Low-growth fiscal scenario 2011-2014

LOW-GROWTH FISCAL SCENARIO	2011	2012	2013	2014
GDP nominal growth	6.1	2.0	3.3	5.6
GDP real growth	2.5	0.5	1.5	3.5
Current public revenues	39.37	38.81	38.76	38.58
Public spending	42.62	41.27	41.02	40.25
Deficit/Surplus	-3.25	-2.47	-2.27	-1.66
Interest	1.36	1.83	2.09	2.26
Primary deficit/surplus	-1.89	-0.64	-0.18	0.59
Government debt	43.82	49.27	49.70	47.37

As a result of the fall in revenues, under the mentioned scenario, deficit is at the level higher than the one in the base scenario, and unlike the base scenario, in the mid-term there would be no balancing and growing into surplus. In table 5 it can be seen that the needs for financing in the period 2012-2014 are by around 6.7 p.p. GDP higher in the observed period in relation to the base fiscal scenario.

Given the decision to continue the low tax policy and to maintain the favourable environment for foreign direct investments, as well as limiting potentials for further decrease of spending, without jeopardising the development and social component, the low-growth fiscal scenario forecasts that the fall of revenues will be offset by additional borrowings. In this case there would be no reduction in the aggregate demand or additional contraction of economy, but the government debt would increase, as well as interest and repayment of debt in the following years, which would have an adverse impact on the sustainability of public finances. Additional borrowings would be provided from domestic or foreign banks, or international financial institutions.

At the same time, unchanged absolute level of public spending is assumed, while in relation to the base scenario, public spending increases on relative basis, as a result of lower GDP nominal amount.

The following table shows the projection of public finances according to the **low-growth fiscal scenario**:

Table 16. Public finances 2011-2014 according to low-growth scenario

	Estimate 2011		Projection 2012		Projection 2013		Projection 2014	
	million	% GDP	million	% GDP	million	% GDP	million	% GDP
CURRENT REVENUES	**1288.49**	**39.37**	**1295.60**	**38.81**	**1336.54**	**38.76**	**1403.79**	**38.58**
Taxes	**794.52**	**24.27**	**803.32**	**24.06**	**829.60**	**24.06**	**873.21**	**24.00**
Contributions	**363.80**	**11.12**	**371.07**	**11.12**	**383.32**	**11.12**	**404.40**	**11.12**
Duties	**21.64**	**0.66**	**22.35**	**0.67**	**22.83**	**0.66**	**23.34**	**0.64**
Fees	**60.43**	**1.85**	**51.39**	**1.54**	**52.57**	**1.52**	**53.82**	**1.48**
Other revenues	**43.76**	**1.34**	**43.03**	**1.29**	**44.00**	**1.28**	**45.00**	**1.24**
Loan repayment receipts	**4.34**	**0.13**	**4.43**	**0.13**	**4.22**	**0.12**	**4.01**	**0.11**
PUBLIC SPENDING	**1394.82**	**42.62**	**1377.91**	**41.27**	**1414.78**	**41.02**	**1464.28**	**40.25**
CURRENT PUBLIC SPENDING	**1267.11**	**38.71**	**1258.07**	**37.68**	**1290.29**	**37.41**	**1330.79**	**36.58**
Current expenditures	**679.57**	**20.76**	**711.88**	**21.32**	**715.03**	**20.73**	**732.36**	**20.13**
Social security transfers	44.53	1.36	61.01	1.83	72.02	2.09	82.06	2.26
Transfers to institutions, individuals, NGO and public sector	**455.25**	**13.91**	**477.86**	**14.31**	**508.53**	**14.75**	**530.61**	**14.58**
PUBLIC SPENDING	**113.57**	**3.47**	**53.36**	**1.60**	**53.17**	**1.54**	**54.13**	**1.49**
CAPITAL EXPENDITURES	**127.71**	**3.90**	**119.84**	**3.59**	**124.49**	**3.61**	**133.49**	**3.67**
Capital budget MNE	71.29	2.18	70.19	2.10	75.00	2.17	80.00	2.20
Capital budget of local self-government	40.00	1.22	37.00	1.11	37.00	1.07	37.00	1.02
Borrowings and loans	**3.85**	**0.12**	**3.47**	**0.10**	**3.18**	**0.09**	**3.23**	**0.09**
Reserves	**14.87**	**0.45**	**11.49**	**0.34**	**10.38**	**0.30**	**10.45**	**0.29**
SURPLUS / DEFICIT	**-106.33**	**-3.25**	**-82.31**	**-2.47**	**-78.24**	**-2.27**	**-60.50**	**-1.66**
PRIMARY DEFICIT	**-61.80**	**-1.89**	**-21.30**	**-0.64**	**-6.22**	**-0.18**	**21.56**	**0.59**
DEBT REPAYMENT	**216.15**	**6.60**	**158.84**	**4.76**	**142.65**	**4.14**	**150.61**	**4.14**
Principle repayment to residents	25.10	0.77	27.45	0.82	29.40	0.85	26.89	0.74
Principle repayment to non-residents	63.20	1.93	65.38	1.96	62.30	1.81	75.80	2.08
Repayment of liabilities from previous period	94.93	2.90	66.01	1.98	50.95	1.48	47.92	1.32
FINANCING NEEDS	**-322.48**	**-9.85**	**-241.15**	**-7.22**	**-220.89**	**-6.41**	**-211.10**	**-5.80**
FINANCING	**322.48**	**9.85**	**241.15**	**7.22**	**220.89**	**6.41**	**211.10**	**5.80**
Borrowings and loans from domestic sources	7.70	0.24	6.00	0.18	6.00	0.17	5.00	0.14
Borrowings and loans from foreign sources	188.00	5.74	265.14	7.94	187.26	5.43	164.72	4.53
Donations	1.92	0.06	2.00	0.06	2.00	0.06	2.00	0.05
Receipts from privatization and sale of property	12.70	0.39	18.00	0.54	18.00	0.52	18.00	0.49
Use of government deposits	112.16	3.43	-49.37	-1.48	8.27	0.24	22.05	0.61

However, given the current adverse developments in the international financial market, there is a certain risk related to additional borrowings. In that case, the consolidation of public finances would have to be provided in some of the following ways:

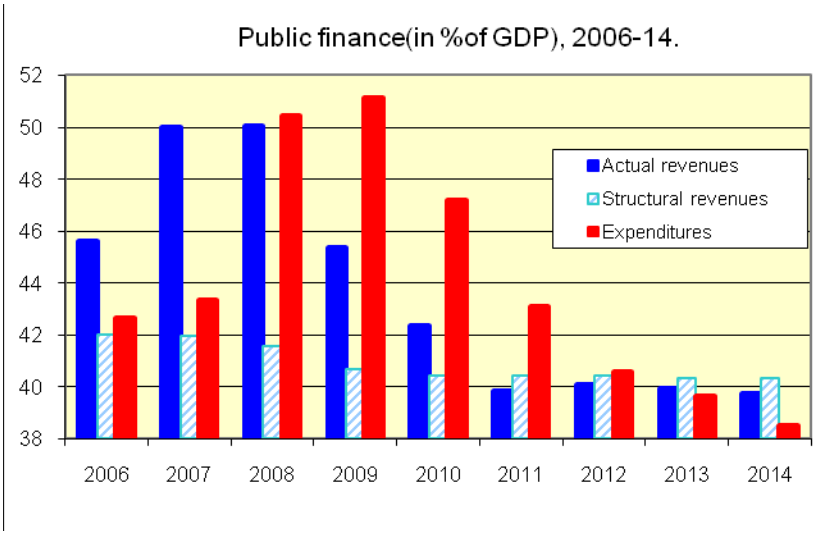
- The reduction of spending to the corresponding level of over 2 percentage points GDP on average on annual basis would decrease the deficit and the need for additional borrowings. However, at the same time this fiscal consolidation would have an adverse effect on the recovery of economy. Also, it should be pointed out that already in the period 2009-2011 public finances were significantly consolidated and due to the high level of mandatory spending the space for further rationalisation was considerably narrowed, so further reduction of public spending in one part would definitely lead to abolishment of development projects, primarily the capital ones. However, it should be noted that there is space for further reduction of spending and, if the adverse scenario comes true, the Ministry of Finance will propose further reduction of discretionary spending.

- One of the ways to finance the same level of spending could be to increase current revenues, through introduction of new tax forms and/or increase of the existing tax rates which would eventually lead to increase of revenues. However, there are numerous threats that would accompany the increase of tax rates: uncertainty of growth of revenues due to low resilience (relatively small amount of available income and limited financing), aggravation of the standard of living, aggravation of the business environment, etc.

3.1.4. Structural balance

The trends of budget revenues are determined by GDP trends and the trends of its components. Furthermore, the growth of budgetary revenues is faster than the growth of potential GDP, and lower in the periods when GDP is lower than the potential or in other words: budget revenues vary in parallel with the cycle of economic activity. Therefore, budget revenues in the boom periods grow above those that would have been generated if the economy had been balanced.

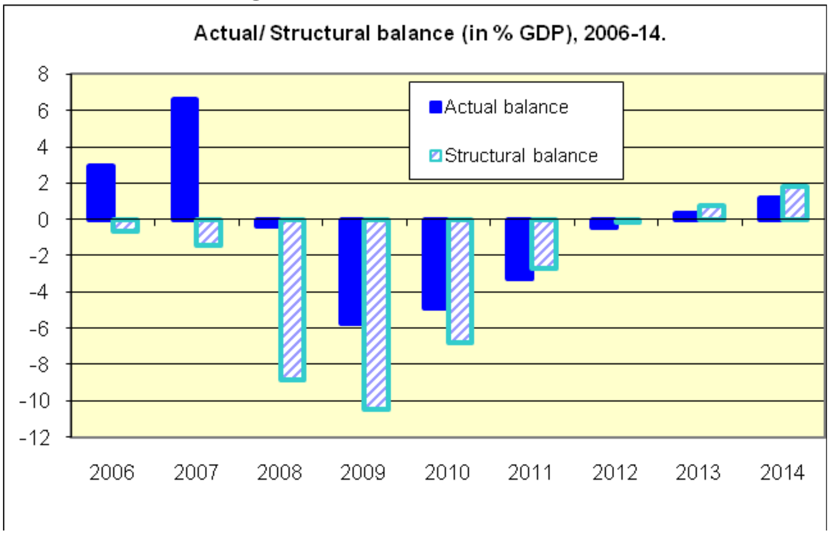
Figure 16



At times of economic activity bust, the budget revenues are lower than their mid-term potential level. Thus, the potential level of revenues must be taken as the base for planning of expenses in the mid-term. At times of boom, high pressure for increase of budgetary spending which is conditioned by growth of revenues should be resisted. Also, at times of lower revenues (GDP below the potential level) it is necessary to encourage spending through increased borrowings in order to stimulate the weakened aggregate demand. It is clear that such trends during the overall economic cycle would annul. Higher budget revenues at times of boom should be annulled by lower revenues at lower levels of the cycle including adjustments with growth rates, while balanced trend is in correlation with the potential GDP.

Montenegro was not an exception to these rules, so the budget revenues during the boom period were far higher than the potential or structural revenues. As shown in Figure 3, budget revenues went up from the level of 46% GDP in 2006 to the level of 50% GDP in 2007 and 2008 before they returned to the lower level again. In this period, budget revenues were "boosted" by economic boom, GDP was significantly higher than the potential – structural revenues were only around 42% GDP. Due to the amendments to the legislative framework (reduction of income tax) in the period 2008-2010 the revenues went down by 2 % GDP. It is expected that in the post-2010 period, the generated revenues will be lower than the structural in correlation with the lower level of GDP in relation to the potential, but the picture is blurred to a certain extent by significant increase of outstanding liabilities towards the budget, intensified by the effects of economic crisis, so a reliable calculation of the cyclical component by the method of aggregate procedure is made difficult.

Figure 17



All this means that public finances during the boom period were not in such a good condition as it seemed (surplus). This is particularly visible in 2007 when the budget surplus was 7%, overestimated by boom effects, although the structural deficit was around 1% GDP (Figure 4). As a result of huge surplus, the budget spending went up by 8 % in 2008 and this certainly caused a high structural deficit which continued in 2009. Since 2009, the structural balance, encouraged by the measures of budget consolidation, has been slowly returning to the balanced level, so in 2014 it is expected that structural surplus will amount to 2% GDP.

The measurement of structural revenues, i.e. separation of the cyclical component from the total generated revenues is very difficult under the conditions of transition economy of Montenegro, frequent amendments to the legislative framework, increased location competitiveness until 2010, as well as amendments to legislative framework aimed at increase of budget revenues or their allocation (local self-government and budget).

Policy of location competitiveness improvement is built in through:

- Amendments to the Law on Corporate Profit Tax (2009), where the rate was reduced from 15 to 9 percent (40% reduction),
- Amendments to the Law on Corporate Profit Tax from 2010 when advance payment of this tax was abolished, so in practice this meant that one year of collection of this revenue was "lost",
- Decree on deferred payment of corporate profit tax, enabling legal entities to pay this tax in six monthly instalments 2010,
- Amendments to the Law on Personal Income Tax where the tax rates were reduced from 15% in 2008 to 12% in 2009 and 9 % in 2010 (20% and 25% reduction respectively),
- Amendments to the Law on Contributions for Compulsory Social Insurance where the total contribution rate was reduced from 34% in 2008 to 32% in 2009 and increased to 34% in 2010. Redistribution was made to increase the share in respect of gross salary of an employee and reduce the share of employer.

In view of carrying out the fiscal policy that envisages the balancing of the budget:

- amendments were made to the Excise Law from 2010 which increased the excise on mineral oils by 10 cents/L, which makes average increase of around 25% and
- according to the Amendments to the Excise Law the excise on tobacco, tobacco goods and alcohol beverages were increased from the beginning of 2011, and its effect was estimated to around € 28 million.

Due to all these amendments, a rough correction of collected revenues was made as to take into account financial effects of the amendments to the laws and obtain the base for calculation of the cyclical component. Revenues are divided into three groups:

Direct taxes, adjusted in line with the amendments to the legislative framework are by simple regression correlated to the GDP nominal amount as to separate the cyclical component.

Indirect taxes – VAT, excise and customs – are in correlation with the output level (or GDP). Due to the high level of expenditures related to import, there was a significant growth in indirect taxes since they had significant correlation with its level in the period 2007-2009. Simple regression is also applied here in order to separate the cyclical level of revenues. The calculation does not include the amendments to the law on excise or unpaid part of these revenues (either through deferral of payment approved by the Government or due to illiquidity).

Other revenues – the most difficult part of this analysis is establishment of the ratio for other revenues, given that this category consists of elements that have divergent trends or are not dependent on GDP trends at all. For the purpose of consistent approach, simple correlation was applied in this case too. It should be noted that with regard to this part of revenues there are amendments to the legislative framework related to introduction of new liabilities for taxpayers, change or abolishment of the existent ones. Significant growth of these revenues is not expected in the forthcoming period.

The following table shows the obtained results:

Table 17. Structural balance

	2006	2007	2008	2009	2010	2011	2012	2013	2014
Public revenues	**980.3**	**1,340.0**	**1,544.4**	**1,353.0**	**1,314.3**	**1,303.7**	**1,365.6**	**1,435.5**	**1,515.2**
Structural	916.5	1,142.0	1,302.7	1,232.3	1,268.2	1,333.1	1,382.4	1,449.3	1,528.9
Structural	951.4	1,262.7	1,383.8	1,368.8	1,338.6	1,335.8	1,413.7	1,474.3	1,533.4
Direct	458.1	588.7	702.8	632.1	576.1	566.6	589.3	620.0	655.0
Adjusted to legal changes	458.1	588.7	702.8	677.1	626.1	566.6	589.3	620.0	655.0
Structural	436.9	557.4	631.9	586.9	546.3	577.2	604.0	631.8	660.6
Indirect	347.0	494.3	555.0	462.1	549.2	596.6	637.5	673.2	714.3
Import	1,699.8	2,323.9	2,900.4	1,950.1	1,958.9	2,060.6	2,135.3	2,245.3	2,366.5
Structural	285.5	400.4	471.5	511.3	586.2	618.2	638.9	676.2	725.0
Other	175.1	257.0	286.7	258.7	188.9	140.4	138.8	142.3	145.9
Structural	194.1	184.2	199.3	134.1	135.7	137.7	139.5	141.4	143.4
Public expenditures	**917.1**	**1,161.8**	**1,556.6**	**1,524.0**	**1,465.4**	**1,410.2**	**1,381.6**	**1,424.5**	**1468.96**
Balance	**63.2**	**178.3**	**-12.1**	**-171.1**	**-151.1**	**-106.5**	**-16.0**	**11.1**	**46.3**
Structural	-0.6	-19.7	-253.8	-291.8	-197.2	-77.1	0.8	24.9	60.0
Generated revenues	45.6	50.0	50.0	45.4	42.3	39.8	40.1	39.9	39.7
Structural revenues	42.6	42.6	42.2	41.3	40.9	40.7	40.6	40.3	40.1
Expenditures	42.7	43.4	50.4	51.1	47.2	43.1	40.6	39.6	38.5
Structural									
Generated balance	2.9	6.7	-0.4	-5.7	-4.9	-3.3	-0.5	0.3	1.2
Structural balance	0.0	-0.7	-8.2	-9.8	-6.4	-2.4	0.0	0.7	1.6

3.1.5. Government Debt

The Government debt of Montenegro, as of 30 September 2011, was 1,459.9[8] million euro or 44.6% of the gross domestic product (GDP). Internal debt was 392.3 million euro, or 12.0% of GDP, while the external debt was 1,067.6 million euro or 32.6% of GDP. The Ministry of Finance deposits, as of 30 September 2011, were 132.3 million euro, including also 38,477 ounces of gold, so that the net Government debt stock was around 40.5% of GDP.

Table 18: Government debt trends in the period 2008 – Sept 2011

Government debt and guarantees	31 Dec 2008	30 Dec 2009	31 Dec 2010	30 Sep 2011
GDP	3,085.6	2,981	3,104	3,273
Foreign debt	481.7	699,9	917.7	1,067.6
Internal debt	413.0	440,3	361.5	392.3
Government debt	894.7	1,140.2	1,270.7	1459.9
Government debt/GDP	**28.9%**	**38.2%**	**40,9%**	**44.6%**
Guarantees	62.6	149.6	355.6	373.1
Guarantees/GDP	**2.02%**	**5.01%**	**11.45%**	**11.39%**

In the period from 2008 to 2011, the Government debt stock increased substantially, and based on projections it will be around 1,434 million euro at the end of 2011. The major reason for the stated increase of debt is the global economic crisis which led to reduction of economic activities, and by doing so to the reduction of economic growth, which also resulted in reduction of revenues, budget deficit, and consequently the need for additional borrowing increased. As presented in the Table 8, the main factor in the increase of the Government debt is the increase of its external component, which grew in 2009 and 2010 some 218 million euro and 212 million euro respectively. The key reason for the increase of the Government debt is the borrowing aimed at covering of financing needs, from 2009 until present time, this amounted to around 500 million euro (380 million euro – Eurobonds and 130 million euro from financial institutions – Credit Suisse and Erste Bank).

During first three quarters of 2011, the foreign debt grew by 155.1 million euro if compared to the end of 2010. The foreign debt stock was increased by around 206 million euro, and that was done through issues of Eurobonds of 180 million euro and disbursement of funds from other infrastructural projects of 26 million euro. Foreign debt stock was reduced through regular servicing of principal in the amount of around 41.0 million euro. Exchange rates fluctuations have also affected the foreign debt stock, in addition to disbursement from some loans.

Internal debt increased by some 34.0 million euro during the first three quarters of 2011, if compared to the end of 2010. The increase of internal debt for the first three quarters of 2011 is caused by the debt increase resulting from issue of Treasury Bills of 6.0 million euro, debt assumption of around 20.0 million euro, continued implementation of projects by the Transportation Directorate aimed at resolving traffic bottlenecks, debt increase on the account of restitution, as well as increased borrowing by municipalities. On the other hand, internal debt was decreased by around 19.7 million euro resulting from repayment of loans taken with commercial banks and credits with non-financial institutions resulting from continued implementation of projects of the Transportation Directorate, repayment of the sixth regular instalment of the debt arising from compensation to pensioners of around 14.9 million euro, repayment of regular restitution instalment of around 2.0 million euro, as well as by repayment of regular instalment of the foreign currency savings obligation of around 9.8 million euro.

[8] Annex 1: Public Debt Stock as of 31 September 2011

Total restitution liability at the end of the third quarter was around 80.2 million euro and was increased by some 1.7 million euro, if compared to the end of 2010.

The consolidated municipal debt was around 108.5 million euro, according to the latest data provided by municipalities, and it was done in two ways:

- Foreign debt stock includes debt of municipalities based on contracts signed by the Government of Montenegro with foreign creditors and on-lending agreements with municipalities, amount of around 29.0 million euro (amount of disbursed funds);
- Domestic debt stock includes debt of local self-governments to lending institutions, amount of around 79.5 million euro.

In order to attain to more transparent and clearer setting of rules to be used by local self-government units to secure financing for their needs, the Ministry of Finance adopted in May 2011 the Instruction on the Content of Requests for Long-term Borrowing of Municipalities and Meeting of Financial Requirements for their Borrowing, governing in details the borrowing procedure of local self-governments' borrowing.

Government Guarantee Stock

As of 31 September 2011, the government guarantees amounted 373.1[9] million euro or 11.39% of GDP or 25.6% of the Government debt. Foreign guarantees of Montenegro were 345.5 million euro or 10.5% of GDP or 23.7% of the Government debt, while the level of domestic guarantees was 28.57 million euro or 0.89% of GDP, i.e. 1.9% of the Government debt.

An increase of foreign guarantees took place due to disbursement of loans for infrastructural projects of the Electric Power Company (EPCG), Railroad Infrastructure Company, and Montenegrin Navigation (*Crnogorska plovidba*).

It should be noted that issued domestic guarantees were reduced by around 17.8 million euro in 2011, if compared to the end of 2010, because the Government of Montenegro assumed loans for which it issued guarantees. The guarantees were assumed from the following users: Željeznički prevoz Crne Gore a.d. Podgorica (*Railroad Transport Company*) of 7.0 million euro, Regional water supply Company of 7.0 million euro, and the Montenegrin Fund for Solidarity Housing Development of 3.8 million euro. Furthermore, guarantees were increased in the first three quarters of 2011 for additional 4.2 million euro based on issued guarantees to the Montenegro Airlines, Fabrika elektroda „Piva" Plužine (*factory of electrodes)* and Mi-Rai Group DOO Nikšić (*Furniture Company*).

Signing of new foreign guarantees is envisaged for 2011, amounting to 72.8 million euro, out of which 42.8 million euro is envisaged for infrastructural projects with international financial institutions (for procurement of railway passenger cars 13.55 and for wastewater treatment plant 29.25 million), while for the support to economy amount of 30.0 million euro is planned. Out of the stated amount envisaged for the support to economy, 18.5 million euro will be issued by the end of 2011, while the rest remains undistributed.

The Government of Montenegro carried out a strict control of further issuing of government guarantees, aimed at better management of government guarantees and risk reduction. Policy of issuing guarantees for infrastructure projects will be carried out in this segment, as well as for loan facilities for which the assessment is that they contribute to the economic development of the country, and for such activities where the evaluation is that there are no risks that they will be called on. Consequently, the Law on Budget for 2012 envisages 10 million euro for guarantees to be issued, which will be earmarked for the reconstruction of the railway infrastructure.

[9] Annex –Tables 4.2 and 4.3.

In terms of the government guarantee stock, or risk that they will be called on, the Government of Montenegro paid a particular attention to guarantees issued to the Aluminium Plant Podgorica (KAP), amounting to 130 million euro or around 4% of GDP. Taking into account the current situation in KAP, as well as the price on the aluminium market, there is a justifiable risk whether KAP will succeed in securing sufficient funds to cover both costs of regular operation and liabilities arising from concluded loan facilities. Consequently, in order to reduce the risk of such guarantees to be called on, which would represent a significant pressure on the finances and the Budget of Montenegro, the Ministry of Finance initiated negotiations with KAP creditors, in order to find the model for resolving the current situation.

The said situation will be resolved so that it will envisage a step in option, meaning the option of Government to assume the liabilities in case that KAP fails to repay loans. Loans would be repaid at an already established schedule, as it was envisage by signed loan facilities. This would prevent the guarantees to be called on, which would amount over 150 million euro, along with additional loan costs. This will remove the risk and reduce impact on stability of finances during 2012 and forward years. The assumption being that the said negotiations would be finished during the first half of 2012. At the same time, along with the negotiations on debt assumptions, the negotiations are also held with representatives of KAP on how will KAP, in case that the Government would end up repaying the said liabilities, compensate to the State funds that would be paid to creditors.

Moreover, the guarantee issued to the Steel Mill Nikšić of 26.3 million euro represents a considerable risk as well. However, the said guarantee was called on to be honoured in May 2011, when the bankruptcy proceeding against the Steel Mill was initiated, and then it was paid. In order to compensate for paid funds, the State reported its claims in the bankruptcy proceeding opened before the Commercial Court in Podgorica.

Government Debt Trends for the period 2011-2014

The assessment is that at the end of 2011 the Government debt will be 1,434.32 million euro or 43.82% of estimated GDP for 2011. Over the medium-term horizon 2012-2014, a slight increase in debt is expected to 46.93% of GDP, followed by reduction in 2013 to 45.37%, so that it should amount to 1,637.39 million euro or 42.93% of GDP at the end of 2014 according to the projections.

Table 19: Base Scenario – Government Debt trend for the period 2011-2014

	2011	2012	2013	2014
GDP in million EUR	3273	3405	3595	3814
Foreign debt in million EUR	1,061.52	1,259.12	1,324.82	1,360.49
Foreign debt as GDP %	32.43	39.68	36.85	35.67
Domestic debt in million EUR	372.8	339	306.2	276.9
Domestic debt as % of GDP	11.39	9.96	8.52	7.26
Government debt in million EUR	**1,434.32**	**1,598.12**	**1,631.02**	**1,637.39**
Government debt as % of GDP	43.82	46.93	45.37	42.93

A considerable decline of the domestic debt is expected over the observed period, from 11.39% of GDP in 2011 to 7.26% of GDP at the end of 2014. At the same time, the foreign debt will rise in 2012 to 36.98% of GDP and it will be more or less at that level even in 2013, while at the end of 2014 it will be 35.67% of GDP.

According to already settled obligations towards domestic and foreign creditors until the 3rd quarter, repayment schedule through the end of the year, as well as projections for disbursement of additional funds, the assessment is that the total Government debt will be 1,434.32 million euro at the end of 2011. The increase of foreign debt will have the major impact on the debt trend, presented in the Table 9, due to additional borrowings for the needs of the Budget.

The plan is that 230 million euro is provided in 2012 for this segment, 104 million euro in 2013 and 78.5 million euro in 2014. Concurrently, disbursement of funds from other financial facilities is also projected in this period (infrastructure and other concluded projects). There will be a significant drop in domestic debt in the same period, resulting from confirmed repayments or projections of certain liabilities occurring in the forthcoming period.

Table 20: Low-growth scenario – Government Debt trend for the period 2011-2014

	2010	2011	2012	2013	2014
GDP in million EUR	3,104	3,273	3,338.5	3,448.6	3,638.3
Foreign debt in million EUR	912.4	1,061.52	1,305.77	1,407.9	1,446.7
Foreign debt as GDP %	29.39	32.43	39.11	40.83	39.76
Domestic debt in million EUR	358.3	372.8	339	306.2	276.9
Domestic debt as % of GDP	11.54	11.39	10.15	8.88	7.61
Government debt in million EUR	**1,270.7**	**1,434.32**	**1,644.77**	**1,714.1**	**1,723.6**
Government debt as % of GDP	**40.93**	**43.82**	**49.27**	**49.70**	**47.37**

In the Low-growth macroeconomic scenario, projections for the development of the Government debt for the period from 2012 to 2014 are presented in the Table 10. If deepening and harshening of the crisis occurs, that will also reflect on the economy of Montenegro. In that case, there will be a slowdown of the economic growth, which will lead to reduced revenues and increase in deficit. Stated effects will influence the government debt trends for this period as well, and will cause its increase, so that it will be 49.7% of GDP at the end of 2013, after which its decline is expected.

As stated, due to increased deficit there will be a need for additional borrowing. Funds required for the Budget financing will be secured from foreign source. Consequently, in the period from 2012 to 2014, the Government debt level will not be increased because of the foreign debt increase. Thus, according to the low-growth scenario, the budget financing need for 2012 is projected at 265 million euro, 187 million euro for 2013, and around 164 million euro for 2014. The need for additional financing will also be present consequently to finance repayment of additional interests arising from new borrowings, and those were included in the projections.

The very composition of the government debt has a considerable effect on the monitoring of the government debt and its balance, which is very stable and its predominant portion is euro-denominated debt. Share of euro-denominated debt is 91.8% of the total Government debt, followed by 2.1% in US dollars, 2.1% in Swiss francs, while the debt in other currencies makes 4% of the total debt. Based on the presented, it could be concluded that the overall composition of the Government debt further contributes to the stability in its management, preparation of debt repayment projections and determining amounts for debt repayment, which is also creating a clear picture of forthcoming liabilities and of those that need to be serviced.

3.1.6. Budget implications of major structural reforms

Table 11 presents the overview of fiscal effects of programmes and measures adopted and proposed structural policies, which are elaborated in details in the Chapter 4 (see Chapter 4 for details on fiscal effects of individual structural policies). In terms of its methodology, the Table is based on data from segments "Budget effects of programmes and measures" in some sub-chapters of the Chapter 4 – Structural reforms.

In 2011, budget expenditures connected to structural policies amounted to 517.1 million euro. Such amount is then increased to 569.6 million euro in 2012, 569.9 million euro in 2013, and again increased to 572.1 million euro in 2014. At the same time, budget revenues connected to structural reforms are constantly going up, from 225.7 million euro in 2011, to 298.1 million euro in 2014. These developments result in net budget effect connected to structural reforms of -292.3 million euro in 2011, -309.3 million euro in 2012, -296.9 million euro in 2013 and -274.1 million euro in 2014.

Reforms of the pension system, social protection, labour market, energy (subsidies for electricity consumers), current expenditures concerning transport infrastructure and agriculture have major effects on the level of budget expenditures connected to structural reforms. The state aid is in addition to that, however the level of this expenditure item for 2011 is not yet known. Namely, the existing budget does not quantify separately budget effects of the state aid, since the aid is allocated from already planned funds. In 2010, the allocated state aid amounted to EUR 71,745,724.14. On the other hand, the single largest revenue is expected from the pension system reform and of course from privatisation. Aggregate nominal value of companies and assets for privatisation is EUR 246,987,519. Projected revenues from capturing value of former military assets should be added to the previous amount, and those are evaluated at EUR 2,000,000. Additional increase comes as well from revenues resulting from the tax system reform.

Developments in net budget expenditures connected to structural policies in 2012 continue mainly to be a consequence of the pension system reform (the plan is that the deficit will be reduced from EUR 137.65 million in 2011 to EUR 87.1 million in 2014), reduction of expenditures in the transportation sector (from EUR 28.8 million in 2012 to EUR 10 million in 2014), and increased tax revenues (revenue increase from excise taxes of EUR 13 million in 2012). In other areas of structural reforms the net budget expenditures will gradually increase

Sizeable positive fiscal effect is also expected from implementation of the Public Administration Reform Strategy, which will achieve: (i) reduction of share of public spending by 1% of GDP annually, (ii) reduction in number of employees by an average of 7% in the public administration and public services and institutions, (iii) reduction of share of wage bill in consolidated budget by around 1.1% of GDP, (iv) reduction of regulatory risk and administrative burden for citizens and economy, which will result in savings of around EUR 60,000,000 over the next 5 years, (v) suppression of informal economy and "illegal" work by some 25%, which will result in increase of GDP and budget revenues of more than 3% and almost EUR 100,000,000 respectively by 2015.

In addition to abovementioned direct budget effects of structural policies, investments of Montenegro into energy and infrastructure are of great significance. These projects are mainly financed from international loans, but as a rule, the Government of Montenegro secures guarantees for such loans.

Table 21: Fiscal effects of structural policies in euro: summary based on analysis presented in chapter 4*

	2011	2012	2013	2014
4.1. ENTERPRISE SECTOR				
4.1.1. PRIVATISATION**	ND	ND	ND	ND
4.1.2. COMPETITION, STATE AID AND PUBLIC PROCUREMENT				
4.1.2.1. Competition				
Net effects	-189,395.00	-215,792.00	-226,581.00	-237,910.00
Revenues	0	0	0	0
Expenditures	189,395.00	215,792.00	226,581.00	237,910.00
4.1.2.2. State Aid***	ND	ND	ND	ND
4.1.2.3. Public Procurement				
Net effects	-121,156.00	-127,705.20	-167,372.64	-199,171.92
Revenues	0.00	0	0	0
Expenditures	121,156.00	127,705.20	167,372.64	199,171.92
4.1.3. BUSINESS ENVIRONMENT AND TAX POLICY				
4.1.3.1. Improvement of business environment				
Net effects	-180,000	-250,000	-150,000	-150,000
Revenues				
Expenditures	180,000	250,000	150,000	150,000
4.1.3.2. Small and medium-sized enterprises sector				
Net effects	-168,100	-218,530		
Revenues				
Expenditures	168,100	218,530		
4.1.3.3. Tax Policy				
Net effects	-1,500,000	12,000,000		
Revenues	-1,500,000	12,000,000		
Expenditures	0	0		
4.1.4. NETWORK INDUSTRIES****				
4.1.4.1. Energy				
Net effects	-27,000,000	-8,000,000		
Revenues	0	0		
Expenditures	27,000,000	8,000,000		
4.1.4.2. Transportation				
Net effects	-23,950,444	-28,757,888	-9,957,880	-9,957,880
Revenues	42,120	42,120	42,120	42,120
Expenditures	23,992,564.11	28,800,000	10,000,000	10,000,000
4.1.4.3. Telecommunications				
Net effects	-400,000			
Revenues				
Expenditures	400,000			
4.3. LABOUR MARKET				
Net effects	-16,940,000	-14,680,000	-15,750,000	-16,260,000
Revenues	8,200,000	7,460,000	7,010,000	7,140,000

Expenditures	25,140,000	22,140,000	22,760,000	23,400,000
4.4. AGRICULTURE SECTOR				
Net effects	-20,922,000	-26,579,000	-29,714,000	-36,533,000
Revenues				
Expenditures	20,922,000	26,579,000	29,714,000	36,533,000
4.5. ADMINISTRATIVE REFORMS*****	ND	ND	ND	ND
4.6. OTHER REFORM AREAS				
4.6.1. DEVELOPMENT OF KNOWLEDGE SOCIETY				
4.6.1.1. Education				
Net effects	-494,000	-3,100,000	-1,880,000	-1,630,000
Revenues				
Expenditures	494,000	3,100,000	1,880,000	1,630,000
4.6.1.2. Research and Development				
Net effects	-1,530,420	-5,846,000	-5,220,000	-4,850,000
Revenues				
Expenditures	1,530,420	5,846,000	5,220,000	4,850,000
4.6.2. PENSION SYSTEM REFORM				
Net effects	-137,650,000	-124,100,000	-107,500,000	-87,060,000
Revenues	218,350,000	240,000,000	263,880,000	289,890,000
Expenditures	356,000,000	364,100,000	371,380,000	376,950,000
4.6.3. HEALTHCARE PROTECTION				
Net effects	-1,793,520	-7,446,534	-9,400,900	-8,967,180
Revenues				
Expenditures	1,793,520	7,446,534	9,400,900	8,967,180
4.6.4. SOCIAL PROTECTION				
Net effects	-58,690,000	-65,060,000	-67,780,000	-70,100,000
Revenues				
Expenditures	58,690,000	65,060,000	67,780,000	70,100,000
4.6.5. ENVIRONMENT				
Net effects	-767,830	-1,074,018	-2,909,500	-3,831,000
Revenues	629,170	771,982	1,024,500	1,025,000
Expenditures	1,397,000	1,846,000	3,934,000	4,856,000
4.6.6. REGIONAL DEVELOPMENT				
Net effects		-35,894,000	-46,300,000	-34,250,000
Revenues				
Expenditures		35,894,000	46,300,000	34,250,000
NET BUDGET EFFECTS	**-292,296,865.11**	**-309,349,467.20**	**-296,956,233.64**	**-274,026,141.92**
TOTAL REVENUES	**225,721,290.00**	**260,274,102.00**	**271,956,620.00**	**298,097,120.00**
TOTAL EXPENDITURES	**518,018,155.11**	**569,623,561.20**	**568,912,853.64**	**572,123,261.92**

Notes:
ND: No data

3.2. Sensitivity analysis and comparability with the last-year Programme

Taking into account the size of the Montenegrin economy and that is undiversified, as well as current international developments, it could be stated that some fiscal risks could become topical in the forthcoming period. Some of them are related to the international environment while the others are result of internal weaknesses. These risks are quantified in the low-growth fiscal scenario, and in this chapter are presented along with measures for their elimination or mitigation.

Following fiscal risks could be identified, either explicit or implicit:

- **Government debt service costs**; After years of the economic boom period and high surpluses of public finances (2006-2008), when the government debt was decreased and prepayment of some loans; period 2009-2011 is marked by high level borrowings of the State, in order to finance spending, deficit and debt repayment. In 2010, Montenegro entered the European capital markets for the first time (€200 million), and again in 2011 (€180 million). The debt level in the period 2008-2011 grew by 17 p.p. of GDP, and the level of interest and principal of borrowed funds consequently rose as well. The debt services costs became the single largest expenditure, after expenditures for wages and pensions. In order to prevent the situation where we would not be in position to service the debt, one of the objectives of the medium-term fiscal policy is spending rationalisation and hold on further borrowings, which will happen in 2015 according to the latest projections.
- **Tax debt rise;** One of the fiscal risks burdening public finances since 2009, is the tax debt rise, i.e. increase of uncollected tax liabilities. Sizeable increase of liquidity problems, blocked bank accounts of companies, as well as of the grey economy took place during this period. If those problems are not corrected, similar trend could be also expected in the forward years. In order to avoid such situation, a series of measures is being implemented carried out by the Tax Administration and Customs Administration, and some of the most important are: equalising status of domestic and imported excise products; introducing mechanisms for removing double taxation of corporate profit and personal income taxation; creating legislative and system prerequisites for commencement of unification of registration and collection of taxes and contributions, enabling that all tax liabilities are paid in one place (one-stop-shop). Furthermore, continued tax reform is planned pertaining to reduction of the grey economy.
- **High level of mandatory spending**; Expenditures for wages, pensions, social welfare and similar, make large share of the total public spending. After 2009, those reached the level exceeding 80% of the total spending. An intensive fiscal consolidation in the segment of discretionary spending – materials and services, public procurement and capital expenditures – is taking place during previous three years. While the share of mandatory spending in the total public spending is increasing at the same time. Even though there is some room for reduction of discretionary spending, considerable reduction could affect the loss of the development component or even jeopardize core functions of the state. The Government policy, in the forthcoming period, is such to maintain the development component of the budget – capital expenditures to around 4% of GDP, predominantly for infrastructure projects that would provide momentum for the economy. At the same time, rationalization of number of employees in the public sector is planned, while the new Law on Pension and Disability Insurance is already being implemented, which will provide for sustainability of this segment of public finances.
- **Risks arising from the possibility of the issued government guarantees to be called on;** Fiscal risks from the possibility of the guarantees issued to private companies to be called on are closely related with the risks of deterioration of macro economy. Out of the total issued guarantees, amounting to 12% of GDP, only a part of them are risk-bearing (around 4% of GDP), which were issued to companies in the manufacturing industry, specifically to KAP. In the event of them being called on to be honoured, the total Government debt would have one-off increase of more than €130 million. In 2011, after bankruptcy of the Steel Mill Nikšić, issued guarantees to Credit Swiss were called on to be honoured and were paid in the amount of around €32 million or more than 1% of GDP. In order

to avoid such scenario in the future, the Government communicated with the creditors of KAP to secure possible reschedule of debts or in some other manner try to overcome the problems. Furthermore, thresholds were set for further issuing of guarantees through the annual budget law, and that only for infrastructure projects.

- **Limited access to capital markets**; if negative trends on the European capital market continue a scenario where the cost of borrowing is very high or even where the issue of the Eurobonds would be impossible becomes a realistic one. If such a scenario were to take place, financing of the spending and servicing of the existing debt would be put in question. Even though such a scenario is not plausible, there are several options to overcome this problem: Arrangement with the IMF, so called "precautionary arrangement", where the funds would be reserved but would be used only as a last resort, new loan facilities of the World Bank (in addition to the existing one through DPL), or securing funds needed on some other capital markets (Russia, Asia).

The following table[10] presents a comparative overview of core macroeconomic and fiscal indicators presented in the last-year's EFP and the latest projections presented in this year's PEP:

Table 22: Differences from the last-year's EFP

Comparison EFP 2010/PEP 2011	2010			2011			2012			2013		
	EFP	PEP	Difference	EFP	PEP	Difference	EFP	PEP	Difference	EFP	PEP	Difference
Real GDP growth	0.5	2.5	2.0	2.5	2.5	0.0	3.5	2.0	-1.5	4.0	3.5	-0.5
current public revenues	41.84	42.34	0.50	42.01	39.37	-2.64	42.15	39.42	-2.73	42.01	39.24	-2.77
Public spending	45.83	47.21	1.38	44.43	42.62	-1.81	42.22	40.47	-1.75	40.34	39.12	-1.22
Deficit/Surplus	-3.99	-4.87	-0.88	-2.42	-3.25	-0.83	-0.07	-1.05	-0.98	1.67	0.12	-1.55
Primary deficit/surplus	-3.02	-3.86	-0.84	-0.89	-1.89	-1.00	1.46	0.74	-0.72	3.20	1.89	-1.31
Government debt	41.80	43.82	-2.02	42.90	46.93	-4.03	40.90	45.37	-4.47	37.50	42.93	-5.43

In 2010, according to the final data of the Statistical Office – Monstat, real growth rate was considerably higher than the one projected under the EFP[11]. However, projections of the GDP growth over a medium term were conservative, due to substantial uncertainties concerning the euro area developments and extensive vulnerability of Montenegro to external shocks. It should be noted that the IMF's medium-term projections on the GDP growth in Montenegro are higher than the projections of the Ministry of Finance.

Whereas it is projected that the primary current revenues are growing in line with the economy growth rate, thus the primary current revenues are percentage of GDP are lower than in the EFP. Other reasons for lower estimates of public revenues are revised estimates of revenues concerning the local self-government, which considerably lower than in the EFP.

Even though the public spending in 2010 was higher due to rise in expenditures for pensions and social welfare, the medium-term period projections state that the public spending will decline as percentage of GDP. Consequently, in line with the trends of primary current revenues and expenditures, the balancing of the public finances balance is projected in 2013, however on somewhat lower level than the one projected in the last-year's EFP.

The Government debt is projected at the sizeable higher level than it was in the last-years projections, which is the case for all years, the reason being continued borrowing for financing purposes, increase in local self-

[10] Indicators stated as % of GDP

[11] Detailed explanation presented in the Chapter 2

government debts and assumption of debts. The increase is both in the foreign as well as in the internal debt. The Table presents detailed divergence of the debt stock in PEP form the last-year's projections:

Table 23: Government Debt, EFP 2011 and PEP 2012 compared

	2010	2010	**2011**	2011	**2012**	2012	**2013**	2013
	PEP	EFP	**PEP**	EFP	**PEP**	EFP	**PEP**	EFP
GDP in million EUR	**3,104**	3,025	**3,273**	3,170	**3,405**	3,363	**3,595**	3,585
Foreign debt	**912.4**	911.15	**1,061.52**	1,037.02	**1,259.12**	1,117.66	**1,324.82**	1,153.86
In % of GDP	**29.39**	30.12	**32.43**	32.71	**39.68**	33.23	**36.85**	32.19
Domestic debt	**358.3**	352.9	**372.8**	322.22	**339**	256.72	**306.2**	189.92
in % of GDP	**11.54**	11.67	**11.39**	10.16	**9.96**	7.63	**8.52**	5.30
Government debt	**1,270.7**	1,264.05	**1,434.32**	1,359.24	**1,598.12**	1,374.38	**1,631.02**	1,343.78
In % of GDP	**40.93**	41.79	**43.82**	42.88	**46.93**	40.87	**45.37**	37.48

3.3. Quality of Public Finances

The fiscal stability was strengthened in 2011. Stable revenues from key tax forms were provided, while the activities to suppress the grey economy improved the collection of tax revenues. The budget discipline improved and the austerity and rationalisation measures contributed to a more efficient spending of taxpayers' money. In the period 2010-2011[12], Montenegro had the highest revenue collection as share of GDP (42.2% in 2011), after Bosnia and Herzegovina, if compared to the countries in the region, which is at the EU average. Likewise, after Croatia, Montenegro is the next in line in the region in terms of collected public revenue per capita (€1,840).

The fiscal policy's strategic objectives are to ensure strengthening of fiscal and financial stability of Montenegro, along with fulfilling of its obligations and efficient functioning of the state institutions. Medium-term plan envisages a fiscal consolidation, ergo a sizeable reduction of deficit in 2012 and reaching of primary surplus, while a balanced budget and reduction of the Government debt is envisaged from 2013. Until the end of 2014, the Government debt would need to be reduced by 4 p.p. (percentage points), i.e. to a level below 43% of GDP. Decreasing current spending at the level below 35% of GDP and creating space for increase of capital investments to drive faster economic growth, are also medium-term objectives. On the revenue side, a competitive and consistent tax policy is envisaged, maintaining core tax rates with the broadening of the tax base and reduction of the grey economy (tax burden on non-income generating assets is already increased).

Reforms continued in 2011 in the area of public finances management and budgeting, as well as the implementation of the medium-term budget framework. The medium-term budget framework included planning and budgeting for a 3-year period. It makes a detailed evaluation of and setting the projects' costs contained in medium-term strategic policies of spending units. In order to advance further the medium-term budget framework, the Ministry of Finance included the medium term priorities of the Ministry in the Budget for 2012. Moreover, the quality of the medium-term macroeconomic and fiscal programming is improved by separation functions of projection and planning of public revenues and expenditures. This contributed to achieving of higher independence and increased reality in public finances planned. The schedule of preparation and composition of the rationale of the Budget for 2012, are fully aligned with the structure of PEP for 2012. Namely, fiscal estimates for the current year and projections for the forward three years, performed in October of the current year, are used both in the preparation of the Budget's rationale and for the PEP.

The capital budget for 2012 is planned to amount 70 million euro or 2.1% of GDP, which is at the real level of the previous years' outturn. Concomitantly, in addition to the funds planned under the Budget, it is possible to disburse additional funds for projects being financed by international financial institutions and which were already signed and available to the Government. Including capital expenditures of local self-governments, the total capital budget in 2012 is around 4% of GDP. Composition of the capital budget in 2012, presented by functional classification, states the higher share of Economic affairs of 61.36%, General public services 12.14%, Sports and culture 12.14%, Education 5.14%, and Healthcare 4.49%.

Funds totalling to 43.06 million euro (or 61.36%) are planned for financing expenditures for the Economic Affairs, to continue with the construction of local infrastructure and for reconstruction and capital maintenance of regional and arterial roads. Funds amounting to 8.52 million euro (12.14%) are planned for General Public Services, for projects involving construction and reconstruction of administrative premise for operation of the state authorities.

Part of the funds for realization of projects and reforms are expected from the European Union funds. In the period 2007-2010, Montenegro used IPA funds (components I and II – Support for Transition and Institution-

[12] Data sources are statistical researches of the IMF, EUROSTAT and the World Bank conducted in 2010 and 2011, published in 2011.

Building and Cross-Border Cooperation) in the amount of around 33 million euro annually. By obtaining the candidate status for the EU membership, Montenegro is eligible to use all five IPA components: Component I - Support for Transition and Institution-Building; Component II - Cross-Border Cooperation; Component III – Regional Development; Component IV – Human Resources Development; and Component V – Rural Development. Based on the European Union's assistance proposal in the Multi-annual Indicative Finances Framework (MIFF) for 2011-2013, 35.0 million euro annually is envisaged for Montenegro. However, the establishment of necessary structures and accreditation of the Decentralised Implementation System (DIS) is condition for the use of EU funds for these components, which is planned for 2012 for the first four components and by the end of 2013 for the component V.

Aimed at improving the accounting and auditing practice in Montenegro and to harmonise legislation with the international practice, the Law on Amendments to the Law Accounting and Auditing was adopted in July 2011. New legal provisions are defined in a more precise manner, system of financial reporting and financial disciple is improved, and administrative procedures are simplified. Videlicet, merging of deadlines for filing reports and tax returns is envisage (only once and only to one institution). Furthermore, in line with the Eighth EU Directive, requirements to establish an auditing firm are defined in a more precise manner. Drafting of the new Law on Accounting and Auditing is planned in 2012, which envisages full harmonisation with the Fourth, Seventh and Eighth EU Directives.

Implementation of the Project "Strengthening the Management and Control Systems for EU Financial Assistance in Montenegro" commenced at the end of 2010, being finances from the European Union funds (from the IPA 2009 programme), through the European Commission Delegation to Montenegro. The Project, along with the engaged EU experts, supports budget users in implementation and development of the internal financial control systems in the public sector (financial management and control and internal audit). The objective of the project is efficient use of the EU financial assistance and public funds, in line with the legislative and EU standards. Through implementation of the Project in 2011, the Internal Audit Manual and Manual for Financial Management and Control were adopted, as well as useful tools for introduction and development of the internal control system in the public sector. Internal audit functions were strengthened, in order to ensure better results and higher value for taxpayers' money.

A measure for mitigating problems in the liquidity of economy; In order to mitigate consequences of the financial crisis, the Decree on Deferred Payment of the Customs Debt (VAT and customs) in 2011 was adopted. This Decree creates favourable conditions for payment of the customs debt and by doing so alleviate the problem of the liquidity of economy. This Decree has no negative fiscal impacts on the budget revenues, except for their timing, and it enables continued imports necessary for investments.

Entering the European capital market in 2011; in April 2011, Montenegro issued 180 million euro Eurobonds on the international financial market. Montenegro re-entered the bond market after successful debut in September 2010 and obtaining the candidate status for the EU membership in December 2010. Demand for this issue was double the offered amount. Such interest of investors confirms the confidence in our economic and fiscal policy, which is also confirmed by IMF and by the rating agency Moody's. Bonds have a 5-year maturity and interest rate lower than the first issue, which is 7.25% (in the previous issue the interest rate was 7.875%). Funds obtained from the issue of Eurobonds are in part used to service debt and in part to finance capital expenditure.

Changes to the Equalisation Fund methodology for distribution of funds to municipalities; in order to reduce regional differences and to achieve long-term financial stability of municipalities, criteria for distribution of the Equalisation Fund to the local self-government units were amended in 2011. Basic criteria for distribution of the Equalisation Fund resources were set as follows:

- Average fiscal capacity per capita of a given municipality (compared to the average fiscal capacity per capita for all municipalities), for the last three fiscal years, and

- Budget news of municipalities, which are established based on gross wages amount relative to the number of inhabitants and relative to the territory of the municipality.

Distribution of the Equalisation Fund resources is becoming more transparent, predictable and with higher incentives for very municipalities.

With the view of harmonisation with the EU regulations (Council Directive 92/79/EEC, and Council Directive 2010/12/EU), amendments and supplements to the Law on Excise Taxes in 2011 introduced excises on coffee and carbonated water, and excise taxes were increased for tobacco and tobacco products. The plan is to harmonise excises on cigarettes with the EU minimum once Montenegro joins EU (while other excise taxes are harmonised with the EU minimum). Estimated fiscal impact of these changes to the Law on Excise Taxes in 2012 will be in the range of 13.0-15.0 million euro. Moreover, the increase in sales prices of these products will additionally increase revenues from the value added taxes. Planned amendments to the Law on Value Added Tax in 2012 will provide for further harmonisation with the EU Directive 2006/112/EC on the common system on value added tax and partial harmonisation with the Directive 2008/08/EC as regards the place of supply of service.

3.4. Public Finance System Long-term Sustainability

Pension and disability insurance system

Population ageing with longer life span and lower population growth rates, as well as low rate of employed active population, impose the analysis of financial impacts of these components on public finances, both over a medium and over a long term. Namely, these components drive the increase of pension benefits expenses (and costs of the healthcare) to the level that could jeopardise functioning of the fiscal system and burden future generations with unsustainably high costs. Ratio of these costs and gross domestic product (GDP) is the most important indicator for the sustainability of public finances relative to the problem of ageing population. This ratio is a positive indicator for expenses trends, if it does not have an upward trend. The productivity growth has significant effect on the development of this indicator, which over a long run is the most important generator of the GDP growth. It is clear that a more pronounced productivity growth means faster GDP growth, and consequently growth of budget revenues, thus such trend facilities public finances management, however it does not provide amnesty from prudential monitoring of developments concerning this segment.

This potentially increasing problem was noticed long time ago in Montenegro, so that amendments to the Law on Pension and Disability Insurance from 2004 commenced the reform process for it to be completed with amendments to the Law from 2010. It is clear that amendments to the Law on Pension and Disability Insurance are not the only factor driving the developments in this area, but the previously mentioned GDP growth is a more pressing factor, i.e. its main driver, and ultimately tax revenues correlated with it.

Figure 18

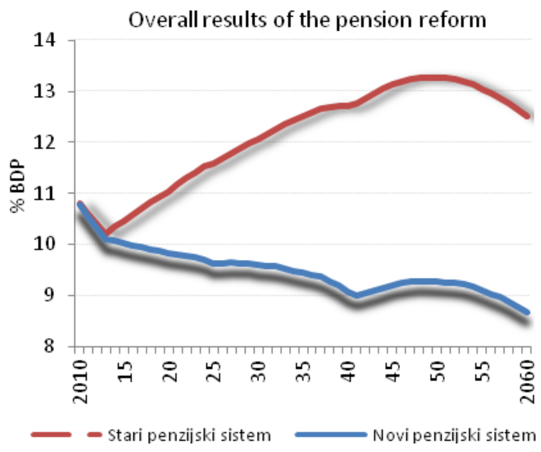


Figure 18 presents overall result of the analysis of public finances sustainability with the focus on the pension reform. Basic assumptions for results obtained analysing changes both of population numbers and of the productivity growth, changes in the pension system and the manner of pension indexation relative to the GDP growth, i.e. wage, as well as change of the unemployment rate. The assumptions in the Base Scenario are as follows: productivity growth of 1.7% and unemployment rate from 2010, as well as existing mechanisms for the wage adjustment.

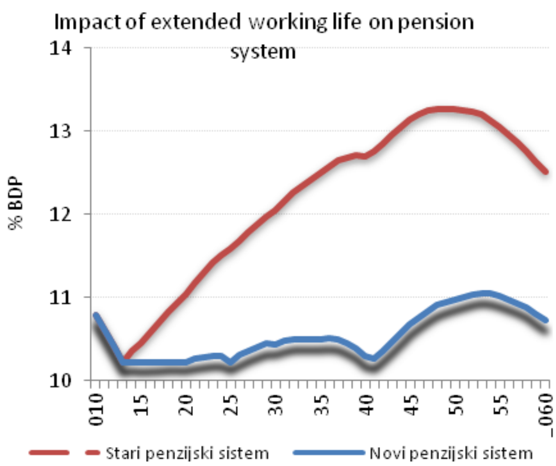
The Figure clearly demonstrates that in order to keep the mechanisms from the old legal framework that would mean an increase in share of pension benefit costs over a long run, as well as that new provision means a gradual reduction of share of these costs. The analysis does not take into account the 2011 Census results, which will change the demographic factors (lower population number compared to the 2003 Census and lower number relative to the present-day projections) to a certain extent, and this number affects the projections of active population and correlated number of pensioners.

The analysis uses variations of all factors influencing the sustainability of public finances over a long run. Assumptions on the productivity growth are the most important, because it determines the GDP growth and related wages, and through trend in wages the level of pensions, by adjusting them using 'Swiss formula'. In old provisions the adjustment was 50:50, while the new provisions call for adjustment of 75:25, where the first part of the ratio is for share of changes in prices measured by the consumer prices index and the second one for changes in wages. Considering the calculation of the long-term growth of productivity done by the European Commission of 1.7%, this was the rate used in Montenegro as well.

Second assumption is that the unemployment rate is unchanged and is 11.6%. This rate is the rate published by the Employment Office of Montenegro and relates to registered unemployment, even though rates published based on labour force surveys (Monstat) are considerably higher.

Important factor that caused and will continue to cause changes in the pension costs share is the calculation of the personal index (base for calculating pensions). Namely, one of the factors influencing the value of the personal index is number of years used for average wage used for its calculation. Changes of the Law from 2004, when 12 best years were used for the average wage calculation, are moving this to 40 best years until 2018. This change will result in pensions lowering by 13%. This calculation is made using the assumption that an employee during working life would have the same coefficient of job complexity, even though the more realistic assumption is that it would have gradual promotion, but due to shortage of micro data this impact was not analysed. This analysis took into account the existing provisions of the Law concerning the increase of the years contributing to service, assuming that an employee would receive additional 0.5% for each year of service for the first ten years, 0.75% for period of 10 to 20 years, and 1% for more than 20 years in terms of increased wage for each year of service.

Figure 19



Extending the working life is a change that will also affect the pensions' trend. Namely, the new Law moves the retirement age starting from 2013 as follows: for men 67 years of age – adjusted from present 65 years in 2014 to 67 years in 2025, for women the age is moved from 60 to 67 years of age in 2040. Figure 19 presents effects of the extended working life, while all other parameters are unchanged. This change has double positive effects to sustainability of public finances. Extending the working life reduces the number of pensioners, and the longer working life increases contribution to the GDP growth. This change is a direct consequence of the extended working life. It should be noted that these changes are not reflecting entirely costs for payment of pensions because increasing the years of service from 35 to 40 for women increases pensions by 14.3%. Relatively sharp decline of pension benefits costs in the period 2010-2013 is a consequence of increase in the required years of service by 1.5 years. Effect of extended years contributing to pension is the strongest in the transition period and in the period immediately following it.

Education System

Montenegro invests considerable funds into the education system, but results, measured by knowledge and skills quality, could be expected only over a long term. Reforms necessary in this segment include (i) improved education output, (ii) reduction of costs per student; rebalancing the costs per student, meaning that the wages of teachers have too high share in total costs. Too many school institutions provide for a broad field for further increase in efficiency in this sector in terms of the rationalisation of their number.

Finally, the strategy dealing with scientific research represents an important step aimed at increased susceptibility of Montenegro towards researchers from the region and wider environment. Montenegro is facing a difficult task to identify resources for improving the quality of education concerning the number of teaching and non-teaching staff.
An increased number of college educated unemployed persons in the records of the Employment Officer is noticed recently. This is an indication of structural disbalance on the labour market of highly qualified labour force. In order to eliminate this trend over a medium or long term, coordination of competent institutions is required – Ministry of Education, Ministry of Science, and Employment Office.

Healthcare System

Montenegro made considerable progress in the reform of the healthcare system, with a special focus on increasing efficiency in particular in the secondary and tertiary care. The very improvement of efficiency and productivity could have a long-term stabilising effect on financing of this sector, coupled with the provision of adequate healthcare, in the following manners:

- Introduction of the diagnosis-related group's payments – essentially the payment according to average costs for certain medical cases. In order to introduce this system, support of the ICT system is planned. An example of Hungary could be used to make a rough estimate of savings; they have saved 14% of total primary healthcare costs upon its introduction.
- Ensuring higher autonomy of hospitals – that would advance the responsibility for efficient operations, but would provide for freedom in choosing allocation of funds. Focus is not on financing inputs (costs) but on financing outputs i.e. focus is on efficient spending of funds.
- Defining basic package of secondary and tertiary care – the previous package was rather "generous". Defining this package is underway and it leaves room for inclusion of new treatments and technologies.
- Taxation of unhealthy food (alcohol, tobacco, food with high saturation of sugar, salt, fats) – directing these funds to healthcare creates conditions for reduction of treatment costs and increase of financing sources.
- Careful monitoring of expenses paid outside of the healthcare system – particularly affecting the poorest part of the population and concerning the payment of medicaments.

3.5. Institutional Framework of Public Finances

During 2011, important institutional changes took place within the internal structure of the Ministry of Finance, aimed at improving the quality of the work of the Government in the areas of macroeconomic projections and analysis, as well as budget programming. Until then the entire activity of the Ministry in all these areas, as well as in the field of budget execution, was within the competence of the Budget Department. Based on a detailed analysis of internal processes, while taking into account "good practices" of other countries, a decision was made where the Budget Department continues to be in charge of programming budget expenditures and for the budget execution, while the Department for Economic Policy and Development takes over tasks in the area of macroeconomic projections and analysis and programming of the revenue side of the Budget. Preparation of the Budget of Montenegro for 2012, as well as preparation of this PEP, for the first time took place under a new organisation of the Ministry of Finance.

The Department for Economic Policy and Development, even though in its early development stage, commenced with systemic monitoring and analysis of economic developments in Montenegro. As early as in June 2011, started with publication of new monthly bulletin of economic trends in the country with standardised table of macroeconomic and fiscal data. In such manner, the Government of Montenegro provides to all interested entities in country and abroad regular information on trends in the Montenegrin economy, which filled up a certain void existing in this area. Plans of the Department for 2012 are to commence with regular publication of two analysis, one in Spring and second one in Autumn, which will provide analysis of macroeconomic developments for the previous period as well as macroeconomic and fiscal projections for the forward 3-year period. Those will serve as an analytical framework for the budget planning process, both for the budget preparation process for the next year as well as for preparation of other medium-term documents, like is for example the PEP.

The Ministry of Finance of Montenegro is in a final stage of reaching agreement with the Republic of Slovakia, whereby its Ministry of Finance would provide technical assistance to certain departments of the Montenegrin Ministry of Finance. Thus, the assistance to the Department for Economic Policy and Development will be aimed at institutional strengthening of the macroeconomic and fiscal programming process, while the assistance to the Treasury Department will be directed at processes necessary for implementation of the ESA 95. Furthermore, the Department for Economic Policy and Development is also a focal point in Montenegro for implementation of the EU Twinning project, having as the primary objective the development of the National Development Plan. Such plan should serve as a base for channelling the medium-term programme for all those investments in Montenegro that will be (co)financed with public funds. In such manner, this document should also become a baseline for programming EU pre-accession funds that are to become available to Montenegro over the coming years.

The Government of Montenegro with the Federation of Trade Unions of Montenegro and Union of Free Trade Unions signed an Agreement on the wage policy of employees financed from the Budget of Montenegro, as well as the General Collective Bargaining Agreement amending that document. Signing of the said Agreement committed representatives of trade unions to cooperate in the process of reduction of number of employees in the public sector, while the Government of Montenegro will allow trade unions to participate in the allocation of budget funds relating to the wages, budget planning, distribution of part of the budget revenues, optimisation of employees. The Agreement is in effect until 2015, while the signatories committed to negotiate on amount and manner of changing the wage level if the real GDP growth exceeds 3.5 percent when the negotiations on amount and manner of increase of wages in public sector will be opened. If the budget is balanced and inflation exceeds two percent, the signatories committed to negotiate about the amount and the manner of increase of wages in the public sector. In the event that during the validity of the Agreement the real GDP growth falls below two percent or budget deficit reaches two percent of GDP or more, the signatories are committed to negotiate about the amount and the manner of reduction of wages in the public sector, and if there is substantial change in fiscal and financial situation, the signatories will negotiate about wages. In addition to all mentioned, the Agreement contributed to improvement of the social dialogue and improvement of the social stability for the next three-year period.

Aimed at establishing an efficient, professional and service-oriented public administration, serving citizens and social and economic entities, in March 2011 the Government adopted the Public Administration Reform Strategy in Montenegro for the period 2011-2016 – AURUM. The Strategy covers measures for public administration reform both on the state and on local level, including reform of system of public services, public agencies and other organisations with public authorisations. Planned rationalisation envisages reduction of number of bodies and agencies, their mergers or inclusion within line ministries, which will contribute to budget savings and reduce share of public spending for about 1 p.p. of GDP annually.

The Law on Amendments to the Law on Public Administration was adopted in 2011, the objective being advancement of the legislative framework for functioning of the public administration system. These amendments rationalised the public administration system by reducing number of bodies and costs for their operation; they as well provide for the public administration to become professional and depoliticised, create prerequisites for participation of the non-governmental sector in the decision making process of the public administration authorities. A “body within the ministry” is a newly introduced mechanism, as well as public competition in a process of appointing heads of authorities, as well as new management-level categories state secretary and general director in the ministries are introduced.

The one-stop-shop system for registration of companies is implemented as part of the regulatory reform and improvement of the business environment in 2011 within the Central Registry of Commercial Court (CRPS). New business entities are able to registry company, register for general tax registration, obtain VAT, excise and customs number all in one place. The administrative procedure is simplified in this manner and new entities (taxpayers) are provided with sizeable savings in time and money. Said activities will have a significant impact on further advancement of the business environment, economic activities growth, improvement of the investment climate, and better positioning of our country in international reports.

4. STRUCTURAL REFORMS

4.1. CORPORATE SECTOR

4.1.1. Privatization

Implementation and deviation from implementation of measures and reasons for the deviation. During 2011, invitations to bid were published for the sale of majority package of shares in NIG Pobjeda AD and for HTP Ulcinjska Rivijera AD including the long-term lease of land for 90 years, and for long-term lease of land owned by Montepranzo–Bokaprodukt AD. For NIG Pobjeda AD, bid submission date was 27 December 2011. The tendering for Montepranzo–Bokaprodukt was completed on 9 December. Two bids were received: from LPGD doo Podgorica and PM Golf Development doo Tivat. After checking the formal compliance of the bids, the Tender Committee will submit its report to the Privatization Council for adoption. The tenders for long-term lease of military barracks Orijenski Bataljon (Kumbor) and the Island of Mamula (Herceg Novi) were published on 14 September 2011 and bid submission deadline was extended to 15 February 2012. The renewed tendering for Valdanos and HTP Ulcinjska Rivijera failed because no bids had been received.

Current and future economic programmes and measures. Process of privatization will in 2012 be focused on the implementation of unsuccessful projects from previous years and the projects for which no public invitations were launched during 2011. The launching and implementation of those projects in 2012 will depend, primarily, on the interest from potential investors which, in current circumstances, is uncertain.

In 2012 it is planned to carry out the procedures for the sale of share in: 1) AD Montecargo, Podgorica, 2) Montenegro Airlines AD, Podgorica, 3) AD Kontejnerski Terminal i Generalni Tereti (Container Terminal and General Cargo Company), Bar, 4) Pošta Crne Gore AD (Montenegro Post), Podgorica, 5) Institut za Fizikalnu Medicinu i Reumatologiju Dr Simo Milošević Igalo AD (Dr Simo Milosevic Institute for Physical Medicine and Rheumatology), Igalo, 6) AD Održavanje Zeljezničkih Voznih Sredstava (Railway Vehicle Maintenance Company), Podgorica, 7) Jadransko Brodogradilište AD (Adriatic Shipyard), Bijela, 8) Luka Bar AD (Port of Bar), Bar, 9) AD Zora (Zora Dairy Plant), Berane, 10) HG Budvanska Rivijera AD, Budva, 11) Institut Crne Metalurgije AD (Institute for Ferrous Metallurgy), Nikšić, 12) Fabrika Elektroda Piva (Piva Electrode Plant), Plužine and 13) Barska Plovidba AD (Bar Shipping Company), Bar.

In the past period, in the circumstances of global economic crisis, the Government of Montenegro has undertaken a series of activities to keep major corporate entities afloat. Accordingly, the Government is presently considering options of including a third partner into the resolution of problems of KAP, having in mind that the Government, as a partner to the Russian CEAC, holds 29% shares in KAP. In addition, the FEP electrode plan is currently under restructuring programme and in case it fails, it is certain that bankruptcy proceeding will be initiated.

Privatization procedures will be carried out for the following tourism sites and former military assets: 1) Ada Bojana (Bojana River Island), 2) Velika Plaža (Long Beach Ulcinj), 3) Bjelasica-Komovi mountains, 4) locality between Njivice and Sutorina river mouth in the Municipality of Herceg Novi, 5) Masline Utjeha inlet near Cape Odrač in Bar, 6) Valdanos Bay, Ulcinj, 7) Ostrvo Cvijeća (Flower Island) and land 8) Prevlaka, Tivat, 9) Bigova Trašte, Kotor.

Budgetary effects of programmes and measures. Total nominal value of companies and assets to be privatized amounts to EUR 246,987,519. This amount should be increased by the projected proceeds from the valorisation of former military property estimated at approx. EUR 2,000,000 (Mediteran Žabljak, Orijenski Bataljon – Kumbor, Ostrvo Mamula). In 2011 there were no budget revenues under the privatization heading. It is planned to conduct privatization procedures for the mentioned companies and assets in 2012, but the success of those procedures is uncertain, primarily due to reduced interest of investors in the circumstances of global crisis, which makes potential annual budget revenues under the privatization heading for 2012-2014 also uncertain.

4.1.2. Competition, state aid and public procurement

4.1.2.1. Competition

Implementation and deviation from implementation of measures and reasons for the deviation. The adoption of the new Law on Competition Protection was planned by the last year's Programme, in order to achieve full compliance with EU rules in this field.

The Government adopted the Proposed Law on Competition Protection, which is in parliamentary procedure now. One of the reasons for the delay in adopting the new law are uniform legislative approaches that still do not allow for full application of direct rules of competition, since it, first of all, required the amendment of applicable systemic laws in order to introduce joint standards with respect to EU competition rules, which would be in full compliance with *Acquis Communautaire*. This refers primarily to the new Law on Misdemeanours, which entered into force in September 2011.

Current and future economic policy programmes and measures. It is planned that, within 90 days from the effective date of the Law, Competition Protection Agency be formed and Competition Protection Administration be closed. The proposed Law on Competition Protection foresees the adoption of a number of enabling regulations (4 draft enabling regulations have been prepared so far), Tariff List, Statute of the future Agency and official capacity instrument.

Table 24. Budgetary effects of programmes and measures

	2011	2012	2013	2014
Implementation of the new Law and actions taken by Competition Protection Agency				
Net budgetary effect	-189,395,00	-215,792.00	-226,581.00	-237,910.00
Direct effect on budget revenues				
Direct effect on budget expenditures	189,395,00	215,792.00	226,581.00	237,910.00

4.1.2.2. State aid

Implementation and deviation from implementation of measures and reasons for the deviation. In accordance with recommendations of the European Commission indicated in the Analytical Report, the programme of adjustment to the EU regulations has been carried out and, accordingly, a number of regulations on the basis of which state aid may be allocated have been adopted, as well as measures for their harmonisation. The following have been adopted: 1) The Law on amendments to the Law on state aid control; 2) Decree on amendments to the Decree on more detailed criteria, conditions and method for granting state aid; 3) Decree on amendments to the Decree on the manner and procedure for applying for state aid. In addition, the Proposed Decision on regional aid map has been prepared and submitted to EC for evaluation, and an IT system for state aid records has been established, increasing the transparency of the system.

In 2010, state aid totalling EUR 71,745,724.14 was granted, which is an increase of 41.92% (EUR 50,553,187.89) in relation to 2009. Participation of state aid in GDP increased from 1.70% in 2009 to 2.37% in 2010. The main characteristic of extended state aid in 2010 is that more state aid was extended for the recovery and restructuring and that so-called "good" state aid was not given. This was the consequence of a need to preclude and cure the consequences of economic crisis.

Current and future economic policy programmes and measures. In the next period, practices of local governments will be analysed and necessary proposals will be prepared for harmonisation of local government rules with the state aid rules, in order to further improve the transparency of state aid system.
Special attention will be paid to monitoring the implementation of the received state aid, i.e., the analysis of effects of received aid.

Although the impact of global financial crisis is still strongly felt, having in mind that major Montenegrin business systems have passed through the stage of restructuring, it is realistic to expect that the share of granted state aid in GDP will be largely reduced in the coming period, particularly in view of the applications received so far. Bail out and restructuring aid is thus expected to decrease and the so-called "good" aid, i.e., aid for employment, support to SMEs, regional aid etc. to increase.

In the coming period, further amendment and harmonisation of state aid legislation is expected, since this is a very dynamic EU policy and modifications in some state aid rules are to be expected in the EU in 2012.

Budgetary effects of programmes and measures. The current budget does not separately quantify budgetary effects of state aid, because the aid has been granted from the already planned funds. State aid is not separately planned in the budget, and each ministry as the grantor of state aid within the funds approved to it provides funds for corporate entities and projects it decides to support.

On the basis of state aid applications submitted by aid grantors, the Committee for state aid control assessed 9 applications to be in compliance in 2011. The state aid granted in 2011 on the basis of those applications amounted to approx. EUR 13,500,000, but some of the projects will not or will not fully be implemented during 2011. The projects implemented during 2011 were those that had been earlier (during 2009 and 2010) assessed as complying by the Committee for state aid control.

The final amount of granted state aid will be known in June 2012, when the Ministry of Finance will prepare the Annual report of granted state aid and submit it the Government and Parliament of Montenegro for adoption.

The Law on Budget for 2012 has allocated for guarantees, as a form of state aid, EUR 10,000,000.

4.1.2.3. Public procurement

Implementation and deviation from implementation of measures and reasons for the deviation. New Law on Public Procurement has been adopted. It will be applied starting from 2012 and subsidiary legislation, samples and standard forms for its application have been prepared. The adoption of this Law is a further step towards the harmonisation of our laws with the EU legislation.

Current and future economic policy programmes and measures. The following will be prepared in 2012: 1) commentary on public procurement regulations, 2) public procurement handbook, and 3) other technical literature that will facilitate the implementation of provisions of the Law. Furthermore, training in public procurement will be intensified.

Draft Rulebook on internal organisation and systemisation of the Public Procurement Directorate provides for the establishment of: Division for compliance and inspection supervision in public procurement, Division for monitoring public procurement procedures and electronic procurement, and Division for education, training and international cooperation.

Table 25. Budgetary effects of programmes and measures

	2011	2012	2013	2014
Establishment and operation of Public Procurement Directorate				
Net budgetary effect	-121,156.00	-127,705.20	-167,372.64	-199,171.92
Direct effect on budget revenues				
Direct effect on budget expenditures	121,156.00	127,705.20	167,372.64	199,171.92

4.1.3. Business environment and tax policy

4.1.3.1. Improvement of business environment

Implementation and deviation from implementation of measures and reasons for the deviation. The Council for regulatory reform and business environment improvement (the Council) and the Ministry of Finance, in cooperation with responsible ministries and private sector, have continued the implementation of measures in all areas of economic system with a view to creating as favourable business environment as possible. The major part of envisaged measures and activities was carried out in 2011, as follows:

- Introduction of one-stop shop system of business registration since 20 May 2011. New corporate entities can register their business, apply for general tax registration, and obtain a VAT, excise and customs number at one place,
- Adoption of the Law on bankruptcy and Law on enforcement and securing claims,
- Amendment of a set of laws simplifying procedures for getting building permit. Introduction of one-stop shop principle in the responsible Ministry and a local authority in charge of issuing minimum technical requirements and building permit,
- Amendment of regulations aimed at increasing efficiency of cadastre services,
- Expansion of scope of credit register in accordance with the new Law on Central Bank of Montenegro,
- Simplification of procedures for the employment of foreigners,
- Action plan for the doing business reform for 2011, defining short-term and mid-term priorities for improving the situation in the areas treated by Doing Business Report,
- Introduction of RIA (Regulatory Impact Assessment) in the Montenegrin regulatory system. The conducted set of trainings for civil servants and prepared RIA Handbook and Methodology represent a good basis for the introduction of RIA. RIA will be applied on laws and subsidiary legislation from 1 January 2012,
- Further implementation of activities on the regulatory guillotine project, the last stage consisting of giving opinions and recommendations for the amendment and cancellation of individual regulations. Regulatory analysis covered about 690 regulations and 320 administrative procedures and about 1,750 recommendations were created.

Current and future economic policy programmes and measures. The following activities are planned for the next period:

- Establishment of electronic company registration,
- Introduction of RIA in the Montenegrin regulatory system,
- Implementation of stage I of inspection system reform,[13]
- Implementation of recommendation of the regulatory guillotine,
- Preparation and adoption of the Law on business licensing,
- Establishment of E-Register of licences and application of licensing simplification measures,
- Implementation of new legislation for building permit issuing procedures,
- Continued training of civil servants in RIA.

[13] More details in *Administrative reforms*

Table 26. Budgetary effects of programmes and measures

	2011	2012	2013	2014
Electronic company registration				
Net budgetary effect	-30,000	-100,000		
Direct effect on budget revenues				
Direct effect on budget expenditures	30,000	100,000		
Training of civil servants – RIA (supported by USAID)				
Net budgetary effect	0	0		
Direct effect on budget revenues	0	0		
Direct effect on budget expenditures	0	0		
Council for regulatory reform and business environment improvement				
Net budgetary effect	-150,000	-150,000	-150,000	-150,000
Direct effect on budget revenues				
Direct effect on budget expenditures	150,000	150,000	150,000	150,000

Financial effects of the foreseen measure for improvement of business environment are covered by budgets of respective institutions. In addition to the above, the envisaged funds for the work of the Council for Regulatory Reform and Improvement of Business Environment for 2012 amount to EUR 150,000 and are projected in the same amount for the following two years as well, while the USAID provides support for the business environment improvement through the Good Governance Activity in Montenegro project. Indicative framework budget of this Project supporting the efforts of the Government in creating better environment for conducting business amounts to EUR 400,000.

4.1.3.2. Small and medium enterprise sector

Implementation and deviation from implementation of measures and reasons for the deviation. During 2011, the Strategy for SME Development 2011-2015 and the Strategy for Improving the Competitiveness at the micro level 2011-2015 were adopted, together with framework action plans. With regard to financial support, the Investment and Development Fund (IRF) of Montenegro has also offered potential loan beneficiaries the following services: loans for entrepreneurs, loans for start-ups and existing companies, credit lines for farmers, credit lines for women entrepreneurs and credit lines for business incubator services.

During 2011, measures were implemented for the strengthening of institutional support, fostering export orientation and competitiveness of SMEs and improving business knowledge through trainings. The credit support was provided by IRF through long-term and short-term loans, via and with the participation of commercial banks, and through direct credit facilities. In 2010, the IRF policy resulted in 107 loans extended to SMEs and entrepreneurs, in the total amount of EUR 9,100,000 from IRF (plus additional EUR 3,100,000 from banks). In 2011, IRF financed 194 projects of SMEs, entrepreneurs and farmers. The total amount approved by IRF for the implementation of those projects was EUR 14,260,000, while the banks supported the same projects with additional EUR 1,720,000. IRF also entered into 6 factoring finance contracts in 2011, through which the users of this product have so far received EUR 3,450,000.

Current and future economic policy programmes and measures. Financial support from IRF will continue in the coming period through the strengthening of existing instrument and the introduction of a new instrument (export insurance), the implementation of which is planned for 2013. In the field of measures for supporting SMEs, the following activities are planned for the next period:

- Institutional support: further improvement of regional/local business centre model, further development of incubators, provision of business information services, continued activities for the establishment of technological park,

- The strengthening of competitiveness and fostering of export orientation: activities for the preparation of feasibility study for the Voucher Scheme for SMEs project have started and the project should include the creation of a registry of consultants; implementation of the project for the improvement of competitive advantages of SMEs; development of Strategy for Women's Entrepreneurship; raising awareness on social responsibility of SMEs; establishment of a system for strategic monitoring and analyses of the SME sector in accordance with EUROSTAT methodology; preparatory activities are underway for the development of the Strategy for Sustainable Economic Growth of Montenegro, through the introduction of clusters by 2016,
- Improvement of business knowledge through training programmes: continuation of already started projects for the development of entrepreneurial competencies and education projects and trainings,
- Continuation of further promotion of European values in the development of SME and entrepreneurship policy through the analysis of Small Business Act (SBA) indicators,
- According to the budget projections of the Investment and Development Fund for 2012, EUR 20,000,000 has been allocated for lending activity and EUR 10,000,000 for guarantees for SMEs. Also, between EUR 7,000,000 and 10,000,000 has been allocated for factoring activities.

Table 27. Budgetary effects of programmes and measures

	2011	2012	2013	2014
Strengthening of institutional support to SMEs				
Net budgetary effect	-66,600	-86,580		
Direct effect on budget revenues				
Direct effect on budget expenditures	66,600	86,580		
Stimulating export orientation and strengthening competitiveness of SMEs				
Net budgetary effect	-72,000	-93,600		
Direct effect on budget revenues				
Direct effect on budget expenditures	72,000	93,600		
Improving business knowledge through training programmes				
Net budgetary effect	-29,500	-38,350		
Direct effect on budget revenues				
Direct effect on budget expenditures	29,500	38,350		

4.1.3.3. Tax policy

Implementation and deviation from implementation of measures and reasons for the deviation. The most important activities in the area of tax policy were the amendments to: 1) the Law on Administrative Fees, abrogating the fees charged by the customs authority and at the same time reducing the amount of a number of administrative fees, 2) the Law on Tax Administration, improving business environment and ease of registration and doing business, and 3) the Law on Excise Duties, increasing excise duties on alcohol and cigarettes and introducing new excise duty subject products (coffee and sparkling water) into the excise system, aimed at harmonisation with the EU legislation. Also, activities related to entry into agreements on avoidance of double taxation have been continued.

The system of unified collection of personal income tax and compulsory social insurance contributions, as well as a single revenue deposit account, have been in application since 1 January 2011. Since the beginning of February 2011, taxpayers can submit their Reports on accrued and paid taxes and contributions on personal income electronically, via the portal of the Tax Administration.

In view of considerable illiquidity of economy, the Ministry of Finance continued to apply tax measures aimed at alleviating the consequences of economic crisis for taxpayer during 2011. In that respect, the Government of Montenegro adopted decrees[14] allowing deferred payment of tax and customs debt, the application of which shall not have a negative impact on the governemnt budget revenues, but only on the speed of execution.

Current and future economic policy programmes and measures. Activities will continue for further simplification of laws and tax forms, in order to additionally improve the tax system and create conditions for a simpler and less expensive tax system for taxpayers and more efficient administration of records, collection and control of fiscalities; for improvement of tax culture of taxpayers and for further harmonisation with the law and practices of the European Union.

Table 28. Budgetary effects of programmes and measures

	2011	2012	2013	2014
Law on amendments to the Law on excise duties				
Net budgetary effect		13,000,000		
Direct effect on budget revenues		13,000,000		
Direct effect on budget expenditures				
Law on amendments to the Law on administrative fees				
Net budgetary effect	-1,500,000	-1,000,000		
Direct effect on budget revenues	-1,500,000	-1,000,000		
Direct effect on budget expenditures				

4.1.4. Network industries

4.1.4.1. Energy

Implementation and deviation from implementation of measures and reasons for the deviation. All measures foreseen in the last year's EFP were implemented during 2011, except for launching the third tender for the construction of small hydro power plants, for which conditions will be created during 2012. The implemented measures refer to the adoption of: the Montenegrin Energy Policy by 2030 and the National Action Plan for Energy Efficiency 2010-2012. Upon the commissioning of the 400 kV Podgorica-Tirana transmission line, the implementation of this project has been completed. Activities on the project for the construction of Adriatic-Ionic gas pipeline have been continuously running, but implementation is not expected before 2014. The same goes for the activities that will result in inviting bids for the exploration of oil and gas, in the first half of 2012. The tender procedure for the construction of hydro power plants on the Moraca River has not been successfully finalized, since the qualified bidders, due to economic crisis, have not managed to provide documentation within the foreseen period. In the next period, the Government of Montenegro will consider options for the implementation of this project.

According to the decision of the Regulatory Agency for Energy which is in application since 1 April 2011, average prices of electricity for end users have been reduced by 11.01%as compared to those approved for 2010. During 2011, the Government of Montenegro subsidized electricity consumers in the amount of EUR 27,000,000. The Law on Budget for2012 has allocated EUR 8,000,000 for subsidies for electricity consumers.

Current and future economic policy programmes and measures. With the adoption of Montenegrin Energy Policy by 2030, the economic and political framework for the energy development has been completed. Within that framework, the present and future economic policy activities will focus on the following:

[14] Decree on deferred payment of customs debt (*Official Gazette of Montenegro*, No. 11/11); Decree on requirements for deferred payment of tax and non-tax liabilities (*Official Gazette of Montenegro*, No. 67/09 and 23/10) and Decree on deferred payment of corporate profit tax (*Official Gazette of Montenegro*, No. 23/10).

- On the basis of completed tender procedures for awarding concessions for the utilization of small water courses for the construction of small hydro power plants and procedures for awarding concessions for the construction of wind mills, activities are running in accordance with signed concession contracts. The said projects do not have any fiscal impact in 2011 and 2012, while in the period thereafter it will depend on the progress of implementation and commencement of generation.
- Activities on the construction of undersea inter-connection cable between the energy systems of Montenegro and Italy and on the Komarnica hydro power plant project are have been progressing in line with the planned time schedule, which does not foresee any fiscal impact before 2014.
- The project of distant bio-mass based heating for the Municipality of Pljevlja with the installed capacity of 18W, will start implementation in 2012, using the EUR 4,000,000 loan for which the Government of Montenegro signed the loan agreement with the European Bank for Reconstruction and Development, while a portion of the Project will be co-financed from a EUR 2,500,000 grant that will be provided within the Western Balkan Investment Framework.

Table 29. Budgetary effects of programmes and measures

	2011	2012	2013	2014
Subsidies for electricity consumers				
Net budgetary effect	-27,000,000	-8,000,000		
Direct effect on budget revenues				
Direct effect on budget expenditures	27.000,000	8,000,000		
Concessions for small hydro power plants and wind mills				
Net budgetary effect	0	0		
Direct effect on budget revenues	0	0		
Direct effect on budget expenditures	0	0		
Undersea inter-connection cable and HPP Komarnica				
Net budgetary effect	0	0	0	
Direct effect on budget revenues	0	0	0	
Direct effect on budget expenditures	0	0	0	
Energy efficiency project (funds provided by donors)				
Net budgetary effect	0	0	0	0
Direct effect on budget revenues	0	0	0	0
Direct effect on budget expenditures	0	0	0	0
Distant heating project for Pljevlja (EBRD loan, WBIF grant)				
Net budgetary effect	0	grace period	grace period	grace period
Direct effect on budget revenues	0	grace period	grace period	grace period
Direct effect on budget expenditures	0	grace period	grace period	grace period

4.1.4.2. Transport

Transport development is defined by the Montenegrin Transport Development Strategy.

Road infrastructure and land transport

Implementation and deviation from implementation of measures and reasons for the deviation. Measures foreseen by the last year's EFP and relating to the regular maintenance of state roads, construction of Bar-Boljare highway and implementation of the Adriatic-Ionic highway project, have been carried out following the planned timeframe.

Current and future economic policy programmes and measures. For the next period, it is planned to:

- Proceed with the harmonisation of national legislation with the EU legislation,

- Provide regular maintenance of state roads that is financed from the general funds of the current budget,
- Complete land expropriation for the purposes of the Bar-Boljare highway project,
- Conduct activities that will facilitate implementation of the Adriatic-Ionic highway project, estimated at approx. EUR 7,000,000,
- Proceed with the implementation of the Program for elimination of bottlenecks in the traffic network in Montenegro,
- Carry out the program of reconstruction of intersections at the state roads in Montenegro,
- Carry out the program of reconstruction and rehabilitation of critical points on state roads in Montenegro, which includes 18 priority critical points.

A grant of EUR 500,000 has been approved by WBIF for the requirements of preparation of the Technical study of options for the implementation of highway project and the Environmental Impact Assessment under the European standards. In the meantime, the Ministry of Transport and Maritime Affairs, with the support from EIB, has published Invitation for interest expression for a consultant who would develop the mentioned documents. The invitation for interest expression was closed on 28 October 2011 and a list of 6 companies who received tender documents was formed. Following the timeframe prescribed by the procedure, the deadline for the submission of offers for the preparation of the Technical study of options for the implementation of highway project and the Environmental Impact Assessment was 30 December 2011, after which the offers will be evaluated. The time foreseen for the preparation of the Technical study of options for the implementation of highway project and the Environmental Impact Assessment under European standards is 5 months. After that the Government will consider options for launching the tender for the highway.

Air transport

Implementation and deviation from implementation of measures and reasons for the deviation. The Government has adopted the Master Plan for the development of the public company Airports of Montenegro, defining the strategy of infrastructure development for the airports in Podgorica and Tivat for the period 2011-2030, and aimed at improving the capacity and quality of services appropriate for the forecast volume of traffic.

Montenegro Airlines has not been privatized due to lack of interest from strategic partners.

Current and future economic policy programme and measures. The Government of Montenegro has approved the Proposed Law on Air Transport, and intends to intensify multilateral activities on the ratification of new international conventions as well as bilateral activities with other states in the coming period.

A new tender for the sale of Montenegro Airlines is foreseen.

Railway transport

Implementation and deviation from implementation of measures and reasons for the deviation. Measures foreseen by the last year's EFP and relating to the reconstruction and maintenance of the railway system and finalization of legal framework have been carried out.

The process of restructuring of the railway system in Montenegro continued during 2011 and has been carried out in accordance with the principles and objectives from the Strategy for the Restructuring of Montenegrin Railways Company adopted in 2007. A disintegration restructuring model was used, whereby infrastructure management has been completely separated from the transport of passengers and cargo. The restructuring process is now, in line with the restructuring action plan, neat the end of Phase 2, which requires further segmentation of newly formed joint-stock companies in the following way: (i) the Maintenance of railway infrastructure and railway station and adjacent land will split from the infrastructure managing company - Željeznička Infrastruktura Crne Gore AD – Podgorica (72.35% state-owned) and (ii) the Maintenance of railway vehicles split from the passenger operator company – Željeznički Prevoz Crne Gore AD – Podgorica (85.45% state-owned) in January 2011. The companies formed in this way will be privatized through the sale of the state-owned package of shares.

Investment projects that are completed or under implementation are financed from the loans and grants from the following financial institutions: (i) EBRD for EUR 18,350,000, (ii) EIB for EUR 14,800,000, (iii) the Czech Export Bank for EUR 57,000,000 and (iv) IPA 2009 for EUR 5,000,000.

Current and future economic policy programmes and measures. The process of restructuring Montenegrin railway system will be finalized upon the implementation of the last phase of restructuring, i.e. the privatization of individual parts of the railway system. The companies dealing with transport of passengers and maintenance of railway vehicles are planned to be privatized through joint venture with a strategic partner or the sale of the state-owned package of shares. Precondition for the commencement of that process is the financial stabilization of both companies and the definition of level of fees for public transport obligation by the state. The company managing infrastructure and regulating the traffic is majority state-owned, and such share will be increased through recapitalization. The sale of state-owned shares is planned for the company that will maintain railway infrastructure, and attractive railway stations and adjacent land, now managed by Željeznička Infrastruktura AD will be offered for concession or lease.

In the next period it is planned to:

- finalize the legislative framework treating railway transport issues, by adopting appropriate laws and subsidiary legislation,
- further strengthen administrative capacities of the responsible ministry and the Directorate for Railways and start the operation of new bodies, both in the Directorate (safety body and regulatory body) and in the responsible ministry (railway accidents and incidents investigation body),
- initiate the process of mutual recognition of licences and certificates, primarily with the Republic of Serbia, and then with other countries in Southeast Europe.

The planned implementation of investment projects in railways transport in the coming period will be financed by: (i) IPA 2010 – in the amount of EUR 5,000,000 and (ii) EIB, for the period 2011-2012, in the amount of EUR 14,000,000.

Shipping industry

Implementation and deviation from implementation of measures and reasons for the deviation. The Government of Montenegro is still committed to the privatization of the Port of Bar. To that end, certain measures have already been implemented (2 companies have been formed: AD Kontejnerski Terminal i Generalni Tereti and AD Luka Bar). Activities for the privatization of the Container Terminal and General Cargo Company have started in 2011 and the consultant has been chosen.

Current and future economic policy programmes and measures. Activities in the shipping industry will be mostly related to the privatization of the Port of Bar and the Container Terminal and General Cargo Company. Delivery of 2 vessels is expected during 2012 in accordance with relevant contracts signed.

The concession contract between the Government of Montenegro and Jadransko Brodogradilište AD Bijela (Adriatic Shipyard Bijela) has been made for 30 years. Annual fixed fee for the utilization of the concession area until 31 December 2021 will amount to EUR 36,000 + VAT, to be re-considered upon the expiry of that term.

On 22 October 2010, the concession contract was signed between the Government of Montenegro and DOO Pomorski Poslovi (Maritime Affairs Company) for the period of 30 years Annual fixed fee for the utilization of the concession area amounts to EUR 27,500. Annual variable fee is paid every 3 months in advance and is equal to 1% or 1.5% of the company's income.

Table 30. Budgetary effects of programmes and measures

	2011	2012	2013	2014
Programme of reconstruction of crossroads on state roads in Montenegro				
Net budgetary effect	-2.000.444,11	-1.500.000		
Direct effect on budget revenues				
Direct effect on budget expenditures	2,000,444.11	1,500,000		
Programme of elimination of bottlenecks in the traffic network in Montenegro				
Net budgetary effect	-11,500,000	-12,800,000		
Direct effect on budget revenues				
Direct effect on budget expenditures	11,500,000	12,800,000		
Regular maintenance of roads 2010-2014				
Net budgetary effect	-10,000,000	-10,000,000	-10,000,000	-10,000,000
Direct effect on budget revenues				
Direct effect on budget expenditures	10,000,000	10,000,000	10,000,000	10,000,000
Adriatic-Ionic highway				
Net budgetary effect	-450,000	-500,000		
Direct effect on budget revenues				
Direct effect on budget expenditures	450,000	500,000		
Programme of reconstruction and rehabilitation of critical points on state roads in Montenegro				
Net budgetary effect		-1,500,000		
Direct effect on budget revenues				
Direct effect on budget expenditures		1,500,000		
Land expropriation for the construction of Bar-Boljare highway				
Net budgetary effect		-2,500,000		
Direct effect on budget revenues				
Direct effect on budget expenditures		2,500,000		
Concession contract between the Government of Montenegro and Adriatic Shipyard in Bijela for 30 years				
Net budgetary effect	36,000 + VAT	36,000 + VAT	36,000 + VAT	36,000 + VAT
Direct effect on budget revenues	36,000 + VAT	36,000 + VAT	36,000 + VAT	36,000 + VAT
Direct effect on budget expenditures				

4.1.4.3. Telecommunications

Electronic communications

Implementation and deviation from implementation of measures and reasons for the deviation. Legal framework in electronic communications has been completed and conditions have been created for the implementation of the Law on Electronic Communications. Activities for the adoption of regulations on RTT and EMC equipment are at the final stage and are expected to be adopted in the first quarter of 2012.

The Government of Montenegro adopted on 27 January 2012 the Decree on Organization and method of Operation of State Administration, under which responsibility for the telecommunications sector has been transferred to the Ministry for Information Society. The Agency for Electronic Communications and Postal Services successfully completed the tender for the selection of universal service operators for access to fixed network. Pursuant to the tendering procedure, operators have been selected for the period of 5 years.

Current and future economic policy programmes and measures. It is planned to adopt a new Law on Electronic Communications in 2012 following changes in the EU framework in this field.

Broadcasting

Implementation and deviation from implementation of measures and reasons for the deviation. The Law on Digital Broadcasting was adopted. However the project for the support to the digitalisation of Montenegro has not progressed at the foreseen speed. The tender procedure for the supply of transmitters and gap fillers, funded by the State of Montenegro, has not been launched because of delays in the delivery of equipment from the supplier selected by the European Commission. It is not possible to carry out tendering procedure for the end user without prior installation and commissioning of the equipment funded by the EC. The tendering procedure will therefore be carried out in 2012.

Postal services

Implementation and deviation from implementation of measures and reasons for the deviation. In accordance with the last year's EFP, all foreseen activities related to the drafting of the new Law on Postal Services were completed and the Law was adopted in 2011. In line with EU directives and provisions of this Law, full opening of postal market is envisaged starting from 1 January 2013.

Tender procedure for implementation of the model for JPP Pošta Crne Gore (Montenegro Post) has not been completed. Delays have been caused by changes in the organization and method of operation of state administration, so that new tender committee has been set up. The procedure is expected to be finished by the end of 2012.

Current and future economic policy programmes and measures. The restructuring of Montenegro Post from limited liability company into a joint-stock company has been finalised. Preparation is underway for the tender procedure for the selection of legal entity that will be the consultant in the process of selection of a partner, through the PPP model. During 2012, the tender for public-private partnership with Montenegro Post will be launched.

Table 31. Budgetary effects of programmes and measures

	2011	2012	2013	2014
Digitalization programme				
Net budgetary effect[15]	-400,000			
Direct effect on budget revenues				
Direct effect on budget expenditures	400,000			

4.2. FINANCIAL SECTOR

Against the backdrop of the global financial market developments, the macroeconomic environment in Montenegro, the banking system developments, and the situation in the capital and insurance markets, the financial system stability is assessed to exhibit moderate risk.

Joint activities of the regulators involved the preparation of the *Contingency Plan* for acting in case of market disturbances induced by a crisis, which is the obligation prescribed under the Financial Stability Council Law. After drafting individual contingency plans, the common *Contingency Plan* at the national level will be prepared in 2012.

Amendments to the Law on the Prevention of Money Laundering and Terrorist Financings have also been prepared.

[15] EUR 900,000 from 2011 + EUR 600,000 for electricity RDC

Amendments to the Law on the Prevention of Money Laundering and Terrorist Financings have also been prepared.

4.2.1. ***Banking sector***

The Central Bank faced all challenges from past years in 2011 too, although some to a higher extent than the others. The problems accumulated during the credit boom, primarily due to the poor credit risk management in banks, have amplified owing to the crisis and they are being tackled gradually, but this requires time. The banking system is still burdened with non-performing assets and loans and reduced credit potential. The system liquidity is satisfactory, as is its solvency. Banks have sufficient liquid funds and capitalization to cover operational risks, but the financial result is negative in more than half of the banks. On the other hand, companies face debts, social issues, reorganisations and restructurings. Regardless of the moderate growth outlook, macroeconomic risks are growing, making the regulators even more alert.

Total assets and liabilities of banks as of 30 September 2011 amounted to EUR 2,900,000,000, being 0.6% lower than in the same period in 2010. The most important item in the aggregate balance sheet of banks is loans, EUR 1,900,000,000, and they recorded the year-on-year decline of 13.5%. A decline in the loan portfolio is due to the growing risk aversion of banks, but also the transfer and sale of credit portfolios of some banks with a view to repairing their balance sheets. The level of non-performing assets and loans in the system is high (18.1% and 24.2%, respectively). The percentage of 30-day default loans amounts to 23.1%, almost at the same level as in September 2010 (23.6%). The majority of past due loans refer to private companies and natural persons (61.5% and 30%, respectively).

Total deposits at the system level amount to EUR 1,800,000,000, showing the year-on-year increase of EUR 95,300,000 or 5.34%. Their ongoing growth, in particular of deposits by households, which has been evident as of mid-2009, is an encouraging fact.

Capital of banks amounts to EUR 291,000,000 and it declined by 2% over the one-year period. At end-June 2011, the capital adequacy ratio at the aggregate level was above the prescribed minimum of 10%, amounting to 15.26%. Loss at the system level was recorded in six banks (of EUR 22,600,000).

Regulatory activities

Implementation and deviation from implementation of measures and reasons for the deviation. In line with the last year's EFP and the Action Plan, and initiatives to strengthen the Central Bank capacity and supervisory function in the period 2010-2014, the Central Bank activities in 2011 were aimed at further strengthening of its capacity and the improving and strengthening of its supervisory function, with a view to implementing the new regulatory framework and the harmonisation of primary and secondary legislation with the relevant EU legislation.

Considering the growing internal and external risks in 2011 and with a view to strengthening the banking system resilience, the supervision of banks and micro-credit institutions was intensified through more frequent on-site and diagnostic supervisory inspections. Some of them were imposed Central Bank measures in order to remove identified irregularities and poor business practices. Home-host supervision aimed at parent banks and their subsidiaries in Montenegro was further strengthened. The regulatory base was additionally improved and harmonised with positive European practices and guidelines. Options for further relaxing of banks were also considered in order to improve the situation in banks and create conditions for further credit and economic growth. It is planned to further bolster the banks` resilience to stress through stress testing.

A set of secondary legislation necessary for the enforcement of the Central Bank of Montenegro Law was adopted in 2011, the most important being: Statute of the Central Bank of Montenegro, Decision on Open

Market Operations, Decision on Detailed Conditions for Granting Liquidity Loans to Banks, Decision on Granting Last-Resort Financial Assistance, Decision on International Reserves Management, Decision on the Investment Committee Establishment, Decision on Bank Reserve Requirements to be Held with the Central Bank of Montenegro, Decision on Supplying Banks with Banknotes and Coins, and Decision on Credit Registry. The Central Bank also adopted the Capital Adequacy Decision and Decision on Mandatory Elements of the Payer Transfer Order.

Current and future economic policy programme and measures. The plan by March 2012 is to adopt a Decision on Calculating Bank Exposures, whereas the following regulations were adopted in 2011: Decision on Public Disclosure of Information and Data by Banks, Decision amending the Decision on Bank Reporting to the Central Bank pursuant to the Banking Law, and Guidelines for granting approval to use credit ratings assigned by external institutions.

The Central Bank has started preparatory actions for the implementation of the International Accounting Standards. This primarily involves IAS 39 and this will require amending regulations – the Chart of Accounts of Banks and the Decision on Credit Risk Management in Banks. The amendments will result in changed classification of balance sheet and off-balance sheet assets and uniform reporting to bank shareholders and the Central Bank.

To that end, until March 2012, the Central Bank will work on defining and applying clear specification of acceptable ratios in all economic sectors with a view to developing methodologies for applying models of assessing financial capacity of borrowers. This involves incorporating IAS rules in the assessment of a borrower's financial capacity, thus eliminating risks of individual assessments based on the current criteria and applying already standardised and accepted IAS principles.

As for amendments to the Decision on Minimum Standards of Bank Investments in Property and Fixed Assets, the Central Bank takes into account the reasons and need for the commercial banks` initiative to extend the time limits within which investments are not considered property acquisitions.

The Supervision Department fulfilled its plan of supervisory activities in 2011, thus rounding off the cycle of on-site bank inspections planned for 2011. In Q1 2012, stress testing of systemic banks, to be conducted with the assistance of the selected consultant, will provide for the assessment of potential additional capital requirements of banks in 2012.

Budgetary effects of programmes and measures
There are no budgetary effects of the planned programmes.

4.2.2. Non-banking sector

4.2.2.1. Insurance

The Montenegrin insurance market has been recording positive rates of growth and development over the past years, but its structure and level of premiums still lag behind the European averages by far. Invoiced gross premium in the insurance market amounted to EUR 49,672,000 at end-Q3 2011, recording the year-on-year growth of 4.47%. The slowdown in economic growth of Montenegro also reflected on results in the insurance industry, so the reduced purchasing power of economic entities and citizens were the key limiting factors in the setting up of the amount of gross insurance premium in 2011. The year-on-year data show that there were no significant changes in the structure of the invoiced gross premium in the first nine months of 2011. Non-life insurance still accounted for the main share in total market portfolio, staying at the level of 87.53%, whereby the main share was of compulsory insurance, in particular motor vehicle liability insurance. At the same time, life insurance recorded a slight upward trend and accounted for 12.47% of the invoiced gross premium.

Implementation and deviation from implementation of measures and reasons for the deviation. Actions aimed at further development of the insurance regulatory framework in 2011 primarily involved the harmonisation of both primary and secondary legislation with the relevant EU *Acquis.* The most important activities involved the drafting of proposals for amending the Insurance Law and the Law on Compulsory Transport Insurance. In addition, a new System of tariffs and requirements for the insurance of owners of motor vehicles and trailers against liability for damage caused to third parties was adopted.

Planned activities on drafting a Proposal for amendments to the Law on Bankruptcy and Liquidation of Insurance Companies to provide its harmonisation with the EU *Acquis* were not implemented in 2011 due to redefining dynamics of activities in the creation of the insurance regulatory framework. In line with the predefined priorities, activities were intensified to finalise the proposals for amendments to the Insurance Law and the Law on Compulsory Transport Insurance the adoption of which will provide for the necessary prerequisites for drafting a Proposal for amendments to the Law on Bankruptcy and Liquidation of Insurance Companies. It is planned to carry out activities on amending this law in 2012.

Current and future economic policy programmes and measures. Activities of the Insurance Supervision Agency in the upcoming period will be directed towards amending the insurance regulations and developing administrative capacity with a view to improving the insurance supervision quality. As for the improvement of the regulatory framework, activities will be continued to provide for the passing of secondary legislation based on the amendments to the Insurance Law and the Law on Compulsory Transport Insurance.

Consistent implementation of amendments to the Insurance Law will involve the establishment of new norms to cover, inter alia, the following: the right to qualified participation in an insurance company, further defining of the legal framework for insurance representation and intermediation, implementation of the amended criteria for meeting the monitored performance criteria of insurance companies. The implementation of the amended Law on Compulsory Transport Insurance will involve the realisation of new obligations as regards the control of activities of the Guarantee Fund.

In the upcoming period, the Insurance Supervision Agency will intensify cooperation with international institutions with a view to further capacity development and bolstering long-term development of the insurance market in Montenegro. Future activities will be directed towards promotion and affirmation of the insurance business and education of citizens on key segments of insurance offer in the Montenegrin market, in particular on voluntary insurance. Activities on the regulation of education and licensing of actuary profession and the passing of the relevant regulation will be particularly addressed in the upcoming period.

Budgetary effects of programmes and measures
There are no budgetary effects of the planned programmes.

4.2.2.2. Capital market

Implementation and deviation from implementation of measures and reasons for the deviation. Negative tendencies on the capital market in 2010 continued in 2011. It concerns, primarily, poor liquidity of real sector, relatively high interest rates charged by banks, level of living standard of population that does not allow for the creation of new level of saving deposits that could encourage new investments. In such circumstances, in the first 9 months of 2011, relatively low turnover was recorded – EUR 41,000,000 (it was EUR 42,000,000 for the first 9 months in 2010); stock exchange indices have fallen (MONEX20: -21%; MONEXPIF: -25%), and market capitalization has also dropped, to a slight extent, thus amounting to EUR 2,950,000,000 at end-September 2011 (in early 2011: EUR 3,150,000,000).

The measures foreseen by the last year's EFP and implemented in 2011 include: 1) adoption of the Law on Takeover of Joint-Stock Companies, 2) adoption of the Law on Investment Funds, which, as a novelty on

Montenegrin market, regulates the operation of UCITS structures, 3) as a result of restructuring carried out in 2010, Montenegroberza a.d. merged with former NEX Montenegroberza, so that since early 2011 one stock exchange operates on the Montenegrin capital market. The Central Depository Agency is implementing an IT system improvement project intended primarily for higher data security and better operational efficiency.

The Securities Commission has prepared, as part of its current activities at the end of 2011, the working draft of the Law on Securities that is planned to be adopted during 2012. Amendments were adopted to the Rules on the conduct of operations of participants in the securities market, governing the so-called securities operations on the margin. Expanding further its cooperation with regulators in surrounding countries, the Securities Commission signed memoranda of cooperation with the Commissions of the Republic of Srpska and of Bulgaria in 2011. Cooperation has been initiated in the field of development and regulatory harmonisation of capital markets in the region and a memorandum of understanding has been proposed.

Current and future economic policy programmes and measures. The activities to be implemented in the coming period include: 1) harmonisation with relevant EU legislation, 2) drafting and adoption of enabling regulations deriving from the Law on Investment Funds, 3) fulfilment of obligations in the procedures of transformation of existing Mutual Investment Funds, 4) adoption of the Law on Securities and related regulations, 5) improvement of information system of the Securities Commission, 6) continuation of international cooperation (IOSCO, OECD, IPA, IFC, Toronto Centre), 7) continuation of staff training and education and 8) education of participants in the capital market and general public.

Budgetary effects of programmes and measures
There are no budgetary effects of the planned programmes.

4.3. LABOUR MARKET

Implementation and deviation from implementation of measures and reasons for the deviation. In the first ten months of 2011, the labour market in Montenegro recorded positive trends. The unemployment rate, as per the Labour Force Survey, declined by 1.3 pp in Q2 2011, in comparison with Q1, but a further decline in unemployment is expected in Q3 owing to the seasonal effect. According to Montenegro's Employment Agency data, the registered unemployment rate was on a downward trend as of March 2011, staying at 11.09% at the beginning of October 2011, which is 1 pp decline, whereas the year-on-year decrease amounted to 0.6 pp. In addition, the number of announced job vacancies amounted to 36,312 at the beginning of October 2011, which is an increase of 18% in comparison with the same period in the previous year. According to MONSTAT data (Labour Market Survey), the rate of activity rose by 2.4 pp in Q2 2011 in relation to Q1, reaching the level of 49.5%, while the quarter-on-quarter increase of the employment rate amounted to 2.5 pp, rising from 37.1% in Q1 to 39.6% in Q2 2011. The number of issued work permits to foreign citizens amounted to 15,785 at the beginning of October 2011, which is the year-on-year increase of 43.5%.

The labour market activities planned under the 2010-2013 EFP and aimed at further improvement of the legal framework with a view to increasing the labour market flexibility were implemented. In December 2011, the Parliament of Montenegro adopted the Law on Amendments to the Labour Law, which is harmonised with the European Social Charter and the relevant EU *Acquis Communautaire*. The amended Labour Law regulates the work of temporary employment agencies, limits fixed-term contracts to no more than 24 months, and simplifies the procedure of individual dismissals. Additional improvements of the labour market legislation covered the Law on Amendments to the Law on Employment and Work of Foreigners, the Law on Amendments to the Law on Professional Rehabilitation and Employment of Disabled Persons, and the Law on the National Qualifications Framework.

The 2012-2015 National Employment and Human Resources Development Strategy was adopted in December 2011 and it represents a balanced framework for further development of the employment policy, modelled after the Europe 2020 Strategy recommendations.

The measures of active labour market policy and harmonisation of the educational system with the economy needs in order to reduce the labour market imbalances (training, qualification and additional qualification programmes) gave limited results. The structural imbalances are primarily reflected in a high share of long-term unemployed persons in total unemployment, as well as in growing unemployment among young population. The limited effects of the measures were primarily due to the low rate of economic growth, which also resulted in insufficient increase in new job creation.

The Labour Fund is still weighed down by mismatch between financial needs and possibilities.

Current and future economic policy programmes and measures. The following economic policy activities involving the labour market are planned for 2012:

- further improvement of the labour legislation through the adoption of the General Collective Bargaining Agreement and the implementation of the amended Labour Law, in particular with regard to the temporary employment provisions, which will largely contribute to the meeting of employers` needs more effectively and a faster employment of unemployed persons,
- continuation of activities on the harmonisation of the labour market legislation with the relevant EU legislation,
- setting up the labour market database within the Ministry of Labour and Social Welfare,
- establishment of a local partnership employment model in four underdeveloped municipalities in the north of Montenegro,
- establishment of the career counselling system.

It is planned to reduce funds for active employment policy measures from EUR 8,000,000 in 2011 to EUR 3,575,000 in 2012. In addition to the need for fiscal consolidation and the Employment Agency's budget excessively burdened with passive measures, one of the reasons for reducing expenditure for the active employment policy is also the lack of a proper system for monitoring and evaluation of the active policy measures. The reduced available funds will require careful planning and focusing of the active policy measures on the most important issues and the most efficient measures (long-term unemployment and youth unemployment)).

Table 32. Budgetary effects of programmes and measures

	2011	2012	2013	2014
Active employment policy				
Net budgetary effect	-4.790.000	-2.390.000	-2.390.000	-2.390.000
Direct effect on budget revenues	3.210.000	1.610.000	1.610.000	1.610.000
Direct effect on budget expenditures	8.000.000	4.000.000	4.000.000	4.000.000
Social security for unemployed persons				
Net budgetary effect	-11.670.000	-12.470.000	-12.970.000	-13.480.000
Direct effect on budget revenues	2.830.000	3.030.000	3.150.000	3.280.000
Direct effect on budget expenditures	14.500.000	15.500.000	16.120.000	16.760.000
Legislation – Labour Law				
Net budgetary effect	+160.000	+820.000	+250.000	+250.000
Direct effect on budget revenues	160.000	820.000	250.000	250.000
Direct effect on budget expenditures	-	-	-	-
Labour Fund				
Net budgetary effect	-350.000	-350.000	-350.000	-350.000

	2011	2012	2013	2014
Direct effect on budget revenues	2.000.000	2.000.000	2.000.000	2.000.000
Direct effect on budget expenditures	2.350.000	2.350.000	2.350.000	2.350.000
Agency for amicable resolution of labour disputes[16]				
Net budgetary effect	-290.000	-290.000	-290.000	-290.000
Direct effect on budget revenues				
Direct effect on budget expenditures	290.000	290.000	290.000	290.000

4.4. AGRICULTURAL SECTOR

In the previous period, obstacles to the market based development of agriculture in Montenegro have been removed. Montenegrin agriculture is now undergoing an intensive process of changes, reforms and preparations for the adoption of demanding European legislation in this field.

In order to increase agricultural competitiveness and achieve EU membership, Montenegrin Government is working on the application of agricultural policy measures that will enable improved functioning of market and upgraded public services.

"Montenegrin agriculture and EU – Strategy of development of food production and rural areas" and "National programme of food production and development of rural areas 2009-2013" are the documents adopted in the past period.

"Montenegrin agriculture and EU – Strategy of development of food production and rural areas" promotes the conception of "sustainable agriculture", which underlines a multifunctional role of agriculture in its economic, environmental, spatial and social dimension and puts agriculture in a much broader context than indicated by its contribution to GDP. The Strategy defines the following objectives of development:

- Sustainable resource management,
- Stable and affordable supply of safe food,
- Provision of adequate living standard for rural population,
- Raising competitiveness of food producers.

"National programme of food production and development of rural areas 2009-2013" defines the following principles as basic ones: introduction of Common Agricultural Policy (CAP) measures or CAP-like measures, observance of WTO principles and observance of conditions and specificities of Montenegro for the efficient implementation of the measures.

These two important documents have served as the basis for the preparation of annual plans of budgetary incentives – Agro-budget, as well as for the Law on Agriculture and Rural Development from 2009, which is the primary legal document for agricultural policy in Montenegro.

Ownership and restitution, land privatization, including sales, concessions

According to the 2010 agricultural census, total area of available land in Montenegro is 309.240.7 ha, of which 95.2% belongs to family agricultural households, and only 4.8% to legal entities. Average agricultural household possesses 3.5 ha of land. Total area of rented lend, including common public areas, amounts to 132,989.4 ha, so that average area of exploited agricultural land per farm amounts to 4.6 ha.

Montenegro has 48,243 farms that use 96.12% of total agricultural land. The structure of used land shows that perennial meadows and pastures account for 94.98% of total used agricultural land, while other land

[16] The expenditures are operational expenses of the Agency for Amicable Resolution of Labour Disputes

categories (gardens, plough land, vineyards, orchards and nurseries) cover slightly more than 5.0%. Starting from the fact that Montenegro has abundant agricultural resources and a large number of small agricultural households that are individually exploiting their fragmented (own and rented) holdings, it is not in the national interest for agricultural measures to encourage mostly intensive production, but to make present rural population stay there and their individual success (business) in agriculture will have an impact on the speed of changes in ownership structure.

Planned economic policy programmes and measures. In the coming period, the measures will focus on:
- Further harmonisation of the Law and other regulations with European acquis, standards and practices,
- Adoption of the law on Agricultural Land in 2012,
- Update of basic national development documents.

Increased efficiency of agricultural products market
Current and future economic policy programmes and measures. The National programme of food production and development of rural areas 2009-2013 envisages market-pricing policy measures (about 27.0% of total incentives), stimulating stable food supply, increased competitiveness, improved income position of producers through direct payments, as well as creation of stable market conditions.

Administrative framework
Previous economic policy programmes and measures. Significant administrative capacity strengthening measures have been implemented in the previous period, by using the Agro-budget funds, international donations and loans, which resulted in: 1) the strengthening of extension and advisory services, 2) the strengthening of administrative and management capacities in the Ministry of Agriculture and Rural Development, 3) the establishment of Rural Development Unit and Payment Department as a transitional solution towards the future IPARD agency – Payment Agency for agriculture, 4) the completion of agricultural census, 5) the development of farm registry and related cadastre maps for wines, olives and fruit, 6) the creation of a modern food safety system, 7) the provision of equipment for a specialized veterinary laboratory and capacity development of National reference laboratories, 8) the improvement of phytosanitary and veterinary border stations in the Port of Bar, 9) the establishment of safety system for animal by-product inputs, and 10) the provision of equipment for the Institute of Marine Biology (Kotor).

Planned economic policy programmes and measures. In the coming period, the measures will focus on the improvement of:
- administrative capacities, in order to achieve full functionality and readiness for the administration of pre-accession funds,
- the work of agricultural inspection, by ensuring adequate number of inspectors, training, equipment and adjustment to EU practices and standards,
- legal framework, including the adoption of: the Law on Agricultural Land, Law on Veterinary Services, laws in the field of health safety of food, sanitary and phytosanitary measures and rural development, law on cooperatives, Law on Payment Agency in Agriculture etc.

Setting up IPARD system
Economic policy programmes and measures in 2011. Towards setting up IPARD system, the Decree on requirements, method and timing of implementation of agrarian policy measures for 2011 – Agro-budget was adopted, and the first three books with official results of the agricultural census from 2010. The Government also adopted the Rulebook on internal organisation and systematisation of Ministry of Agriculture and Rural Development, which will enable the establishment of the Rural Development Department as a transitional solution towards the future management body for IPARD programme and the Payment Department as a transitional solution towards the future IPARD agency – Payment Agency in Agriculture.

The World Bank funds available under the MIDAS project were used to: (i) launch, in April 2011, first public invitation to support on-farm investments, responded to by 780 applicants, so that over 350 contracts are expected to be signed; (ii) continue the strengthening of extension and advisory services and start activities of the development of farm registry and related cadastre maps for wine, olives and citrus fruits, and to start drafting the IT strategy for the Ministry with international consultants.

During 2011, three sectoral analyses were completed and adopted for the needs of IPAR programme: (1. Meat, 2. Milk, 3. Fruit, vegetable and wine) and a social and economic study for the same purpose.

Planned economic policy programmes and measures. The first draft of IPARD programme for Montenegro was sent to the European Commission in April 2011. This programme refers to the period 2007-2013 and is a basis for the use of pre-accession funds from IPA Component V for rural development. The second draft was prepared following the suggestions from DG Agri and was sent in end November, and its adoption is expected during the first quarter of 2012.

On the basis of the adopted Rulebook on internal organisation and systematisation of the Ministry of Agriculture and Rural Development, the Rural Development Department and Payment Departments were formed in the Ministry, as operational structure for accreditation and use of EU funds for rural development. During 201, the Ministry recruited staff for these two departments, which will also continue in the following period, and a Twinning project is underway for the training of employees and preparation of accreditation package for IPARD.

In November 2010, the Government of Montenegro established the operational structure within the Ministry of Agriculture and Rural Development needed for IPA Component V, Rural Development Department as Managing Authority and Payment Department as IPARD Agency. The Action Plan until the accreditation of the operational structure which, in addition to the mentioned departments in the Ministry, includes National Fund in the Ministry of Finance and NAO – National Accreditation Officer, is in the final stage of preparation.

State aid in agriculture

Current and future economic policy programmes and measures. Agrarian incentive measures (Agro-budget) are and will remain primarily focused on increasing competitiveness in farming and food processing and will follow the need for strengthening economic and social position of rural areas.

Social transfers to rural population (allowances for the elderly) will be relocated from the Agro-budget, and incentives for the development of agriculture and rural areas will be increased for the same amount.

Development of rural areas

Current and future economic policy programmes and measures. With respect to strengthening the development of rural areas, the strongest agrarian support is achieved through the application of: 1) measures for strengthening competitiveness, 2) measures for sustainable management of natural resources, and 3) measures for improving quality of life and differentiating economic activities in rural areas. Favourable rural support practices will continue in 2012.

Fishing

Earnings from fishing sector come from the sale and production in several sub-sectors: (i) catch of saltwater fish (large-scale and small-scale commercial fishing), (ii) catch in freshwater fishing (mostly in Skadar Lake), (iii) aquaculture (trout farming), (iv) mariculture (farming of shells, oysters, sea bass and gilthead). Total annual sales from these subs-sectors are approx. EUR 5,000,000.

Economic policy programmes and measures in 2011. In the previous year, the programmes and measures focused on the following activities:

- Nine enabling regulations were adopted, on the basis of the Law on Marine Fishing and Mariculture.
- Efforts were made to increase capacities in the Ministry of Agriculture and Rural Development in resource management, aquaculture and inspection supervision with the assistance from Border Police.
- Development of Fishing Information System.
- Institute of Marine Biology in Kotor continued studies of demersal and pelagic fish resources at the Montenegrin coast, which was used as a basis for decision making on quotas and number of licences that may be issued for commercial fishing in 2011.
- Purification centre for shellfish in Tivat is under development. It is a common activity of the Ministry and Mariculture Association, and the national study of the fishing sector, which will enable access to IPARD funds, is at the final stage of preparation.

Planned economic policy programmes and measures. For the next period, it is planned to carry out measures for supporting the improvement of professional fishing fleet and to continue supporting associations of professional fishermen. All planned activities are aimed at protecting the saltwater fish catch sub-sector in a sustainable way, to prevent overfishing and possible problems with fish stocks.

Montenegro's priority is to develop an efficient fishing sector for all interested entities, which will be based on a long-term integrated management plan for these resources. To pursue this policy, support instruments will be used such as IPA 2009 Sustainable Management of Marine Fishing and the World Bank MIDAS Project.

Parallel to that, implementation of the following activities will continue:

- Capacity development in the Ministry of Agriculture and Rural Development in resource management, aquaculture and inspection supervision,
- Further development of Fishing Information System through the introduction of satellite-based Vessel Monitoring System (VMS) for fishing vessels exceeding 12m in length, establishment of the Centre for monitoring, control and surveillance, and introduction of electronic logbook,
- Finalisation of construction works on the Purification centre for shellfish in Tivat,
- Completion of national study of fishing sector that will enable access to IPARD funds.

Table 33. Budgetary effects of programmes and measures

	2011	2012	2013	2014
Agro-budget				
Net budgetary effect	-20,751,000	-25,679,000	-28,614,000	-35,283,000
Direct effect on budget revenues				
Direct effect on budget expenditures	20,751,000	25,679,000	28,614,000	35,283,000
Fishing				
Net budgetary effect	-171,000	-900,000	-1,100,000	-1,250,000
Direct effect on budget revenues				
Direct effect on budget expenditures	171,000	900,000	1,100,000	1,250,000

4.5. ADMINISTRATIVE REFORMS

Implementation and deviation from implementation of measures and reasons for the deviation. The basic guidelines of administrative reform of Montenegro are defined in the Public Administration Reform Strategy 2011-2016 adopted in 2011. The basic goal of the Strategy is efficient, professional and service-oriented public administration aimed to serve citizens and other social and economic subjects.

In 2011, the Parliament of Montenegro adopted: (i) the Law on Amendments to the Law on State Administration, which provides the basis for rationalisation of the system, (ii) the Law on Senior-grade and Lower-grade Civil Servants, which introduces the strengthening of the merit principle; higher level of personnel mobility; etc., and (iii) the Law on Amendments to the Law on General Administrative Procedure, which introduces the positive fiction in case of "silence of administration", shortens the timeframes for actions to be taken, introduces a single contact point. In December 2011, the Parliament of Montenegro adopted the Law on Amendments to the Law on Inspection Supervision, which will lead to functional reorganisation of inspections and finally to efficient and cost-effective conduct of inspection supervision. Proposal Law on Wages of Senior-grade and Lower-grade Civil Servants has been prepared and adopted, which envisages wage classes for new categorisation of work places and new titles, and it will improve the wage system in public administration that is gradually to lead to the reduction of the wage fund.

Economic and Fiscal Programme for 2011 envisaged the adoption of the Law on Licensing Centre, taking into account the perception of the regulator that the system of business licensing in Montenegro is complicated, non-transparent and expensive, requiring the establishment of a Licensing Centre. However, the focus groups established that the perception of the business community was different. After the analysis of the effects of possible solutions had been completed, it was identified that the establishment of an e-Register of licenses and application of other measures for simplification and rationalisation of licensing were the most optimal option.

In 2011, an e-administration portal was developed and it represents the access point to various information and public services under the responsibility of state authorities, aimed to enable electronic communication between the citizens and legal entities and the state administration, as well as within the state administration itself. In case of establishing the system of electronic document management in the public administration authorities, it is expected that the implementation of phase I related to ministries and Secretariat General of the Government will be completed in the forthcoming period. Activities continued with regard to introduction of RIA (*Regulatory Impact Assessment*) in the regulatory system of Montenegro as well as the implementation of regulatory "guillotine".

On 23 June 2011, the Government adopted the Strategy for inter-municipal coordination development in Montenegro 2011-2016 including the Implementation Action Plan 2011-2013, primarily aimed at achievement of a balanced socio-economic development of Montenegro. The procedure for election of members of the councils for development and protection of local self-government is in process, and such councils will be established in all local self-government units in Montenegro.

Current and future economic policy programmes and measures. In the forthcoming period the key activity of the Government in the area of administrative reforms will relate to the reduction of the number of state administration bodies and reduction of the number of employees of the state administration bodies, with the purpose of reducing the labour costs and better concentration of personnel, financial-material and technical resources.

The following activities will be carried out in the area of regulatory framework:

- Twelve secondary legislative pieces need to be adopted by the beginning of implementation of the new Law on Senior-grade and Lower-grade Civil Servants (1 January 2013) in order for the normative framework to be fully completed.
- Amendments to the Law on General Administrative Procedure from 2011 represent a transitional solution until the new Law on General Administrative Procedure is adopted, and its preparation has already commenced.
- The preparation of the Draft Law on Wages in the Public Sector is planned, and it is to incorporate: state bodies, local self-government bodies, agencies, institutes, public enterprises and other legal entities financed from the government budget or local self-government budgets.
- The adoption of the framework Law on Business Licensing is planned for 2012, and the adoption of the Law on Public Services and Funds and the Law on Public Agencies is planned for 2013.

Other activities in the area of administrative reform will include:

- Continuation of the reform of the inspection supervision system, which will enable gradual unification of inspections and their separation from ministries and administrative bodies, while the introducing of electronic management of documents will be completed in the ministries and General Secretariat of the Government.
- As of 1 January 2012, regulatory impact assessment (RIA) will be introduced in the legislative system of Montenegro, as a quality control system for adoption and application of public policies. The regulatory “guillotine” will continue, in order to repeal or amend regulations that have become obsolete and/or harmful for economy.
- Special attention will be paid to improvement of the system of concessions and development of the public-private partnership model.

As regards the local self-government area, mid-term activities will be focused on: continuation of gradual functional decentralisation; creation of a sustainable system of local public finances; strengthening legality of work of local government authorities; facilitating a balanced economic development; establishment of a quality system for HR development and personnel policy management; transparent work of the bodies of local self-government units; higher level of cooperation among the local self-government units, and among the local government authorities and public services founded by the state; etc.

Budgetary effects of programmes and measures.
The Public Administration Reform Strategy envisages that the implementation of measures in the period 2011-2016 will have a direct impact on budget expenditures in the amount of around EUR 19,000,000. It is estimated that the reduction of regulatory and administrative burden for citizens and economy will result in the reduction of revenues amounting to EUR 60,000,000.

On the other side, it is estimated that suppression of grey economy and illegal work will increase the budget revenues by around EUR 100,000,000 by 2015. Also, the reduction in the number of employees is expected to result in the reduction of the wage fund share in the consolidated budget by around EUR 40,000,000.

4.6. OTHER REFORM AREAS

4.6.1. Knowledge society development

4.6.1.1. Education

Implementation and deviations from implementation of measures and reasons for the deviation. In 2011, the Parliament of Montenegro adopted the Amendments to the Law on Higher Education and the Law on Sports. In 2011, the Government passed the following: Higher Education Development and Financing

Strategy, Decree on norms and standards for funding higher education institutions and funding of students of private higher education institutions, Public-private partnership models for improvement of pupil and student dormitories in Montenegro, Model for licensing and re-licensing of preschool teachers, school teachers, associates and heads of educational institutions, National Strategy for Life-Long Career Orientation for the period 2011-2015 and Adult Education Plan for 2011.

National Education Council has been established. The Parliament has adopted the Law on Recognition of Foreign Educational Certificates and Qualifications Equalisation. The Government has passed the Primary Education Strategy.
Regarding the measures planned by the last year's EFP, the activities related to optimisation of primary school network, inclusion of local self-governments in the financing of education and application of per-student financing failed to be implemented. The reason is bad financial situation in most of the local self-governments, which are largely affected by the global financial crisis and whose recovery is slow, as well as due to the fact that optimisation of primary schools should be planned carefully from the aspect of financial impact and the aspect of ensuring accessibility of primary education.

Current and future economic policy programmes and measures. The activities in the forthcoming period will be focused on: 1) preparation of the University of Montenegro Enrolment Policy Strategy, 2) development of an in-depth study on application of Bologna Declaration principles in Montenegro, 3) development of the Study on the labour market needs in the area of higher education, 4) preparation of the Analysis of various models for higher education financing in line with actual per-student costs, labour market needs and quality of study programmes, 5) implementation of external graduation and vocational exams for all pupils at the end of high school, 6) continuation of work on ensuring education quality at all levels, 7) increase in the level of mobility of Montenegrin students, 8) gathering data and preparation of Action Plan for optimisation of the current primary school network, 9) inclusion of local self-governments in education financing and commencement of application of the per-student financing model for institutions, 10) strengthening of connections between the labour market and education.

Table 34. Budgetary effects of programmes and measures

	2011	2012	2013	2014
Implementation of activities and measures in line with the Higher Education Development and Financing Strategy				
Net budgetary effect	-20,000	-1,450,000	-980,000	-980,000
Direct effect on budget revenues [17]				
Direct effect on budget expenditures	20,000	1,450,000	980,000	980,000
Implementation of external graduation and vocational exams				
Net budgetary effect	-200,000	-200,000	-200,000	-200,000
Direct effect on budget revenues[18]				
Direct effect on budget expenditures	200,000	200,000	200,000	200,000
Strengthening of the connection between the labour market and education				
Net budgetary effect	-14,000	-950,000	-500,000	-250,000
Direct effect on budget revenues[19]				
Direct effect on budget expenditures	14,000	950,000	500,000	250,000
Ensuring education quality at all levels (external and internal quality assessment)				
Net budgetary effect	-250,000	-500,000	-200,000	-200,000
Direct effect on budget revenues[20]				
Direct effect on budget expenditures	250,000	500,000	200,000	200,000
Action Plan for optimisation of the current primary school network				
Net budgetary effect		-10,000		
Direct effect on budget revenues				
Direct effect on budget expenditures		10,000		
Inclusion of local self-governments in financing				
Net budgetary effect	-10,000			
Direct effect on budget revenues[21]				
Direct effect on budget expenditures	10,000			

4.6.1.2. Research and development

4.6.1.2. Research and development

Implementation and deviation from implementation of measures and reasons for the deviation. The establishment of the Ministry of Science and adoption of the Law on Scientific-Research Activities at the end of 2010 contributed to creation of the environment for further enhancement of this area. In 2011, the Government of Montenegro adopted the Feasibility Study for establishment of centres of excellence in Montenegro and Feasibility Study for establishment of a science and technology park in Montenegro.

Current and future economic policy programmes and measures. The implementation of the following measures is planned for the coming period:

- Participation of Montenegro in FP7 Programme (2007-2013),
- Implementation of the Action Plan for mobility of researchers for the period 2011-2012,
- Implementation of projects within bilateral scientific cooperation,

[17] The goal of the Strategy is to increase the quality of higher education, which indirectly contributes to development of economy
[18] Implementation of Graduation and Vocational exams will not directly affect the revenues, but they will affect the overall quality of education, and thus further economic growth, providing incentives for development of labour force required by the labour market
[19] Alignment of education with the labour market needs will contribute to acquisition of qualifications at all levels of education that keep pace with rapid changes in the labour market, and in this way will contribute to economic growth.
[20] The application of the model for ensuring quality will not have a direct effect on revenues, but it will affect the overall quality of education
[21] Inclusion of local self-governments in financing of education and commencement of application of institution per-student financing

- Implementation of the Action Plan for participation of Montenegro in EUREKA Programme,
- Establishment of the Centre of Excellence, funded by the World Bank loan,
- Review of the Research Activity Strategy and
- Implementation of the plan for joining the ICGB (International Centre for Genetic Engineering and Biotechnology).

Table 35. Budgetary effects of programmes and measures

	2011	2012	2013	2014
Fee for participation of Montenegro in FP7 Programme				
Net budgetary effect	-385,912	-496,000	-620,000	
Direct effect on budget revenues[22]				
Direct effect on budget expenditures	385,912	496,000	620,000	
Action Plan for mobility of researchers for period 2011-2012				
Net budgetary effect	-300,000	-500,000		
Direct effect on budget revenues				
Direct effect on budget expenditures	300,000	500,000		
Linking of science and economy through establishment of the Centre of Excellence, Science and Technology Park, inclusion in EUREKA programme and financing of scientific-research projects				
Net budgetary effect	-844,508	-4,850,000	-4,600,000	-4,850,000
Direct effect on budget revenues[23]				
Direct effect on budget expenditures	844,508	4,850,000	4,600,000	4,850,000

4.6.2. Pension system reform

Implementation and deviation from implementation of measures and reasons for the deviation. Parameter reform of the pension system in 2010 established the foundations for long-term financial sustainability of the public pension system in Montenegro. The basic elements of the reform are the increase of the retiring age from 65 to 67 years of age for men, equalisation of the retirement age for men and women and change of the formula for pension adjustments (instead of semi-annual adjustment to the average wage growth rate and consumer price index, pensions are adjusted once a year to 25% average wage growth and 75% consumer index price growth). Particularly important aspect of the reform is the introduction of bonuses for overtime work and penalties for earlier retirement.

Analysis of the reform effects and long-term projections show that the reform significantly mitigated the pressure of pension expenditures on the central budget. According to the projections, if there had been no reform, the pension expenditures by 2050 would increase to 13.3% GDP, while with reform it is anticipated that expenditures will decrease to 9.3% GDP. The reform effects especially gain importance if the aging of population and projected growth of elderly dependency ratio from 20.4% in 2010 to 38.0% in 2050 are taken into consideration.

In 2011, the Parliament of Montenegro adopted the Supplements to the Law on Pension and Disability Insurance, which envisage more favourable retirement conditions for persons having jobs with accelerated years of service contributing to pension by the end of 2011.

[22] It will be possible to quantify revenues after the implementation of projects funded or to be funded in the next two years from the funds of FP7 programme and it will be possible to express them in the total amount of funds spent by Montenegrin institutions during their participation in these projects.

[23] Centres of Excellence and Science and Technology Parks are aimed at increase of scientific productivity, international cooperation and significant cooperation with economy. Inclusion in the EUREKA programme will initiate funding of scientific-research activities by business sector. Increase in the quality of scientific-research work will contribute to the overall economic growth.

Pension expenditures in 2011 exceeded the planned expenditures for the first 10 months and it is expected that by the end of the year the pension expenditures will be higher by approximately 5% in relation to the plan, while the amendments to the Law on the Pension and Disability Insurance from 2011 will result in additional increase of pension expenditures in 2012 by 2-3% of the total expenditures.

Current and future economic policy programmes and measures. In the forthcoming period the activities of the pension system reform will be focused on monitoring of the implementation of the law, the effects of the law and defining of the direction of further reform of the pension and disability insurance in Montenegro.

Table 36. Budgetary effects of programmes and measures

	2011	2012	2013	2014
Pension system budgetary effects				
Net budgetary effect	-137,650,000	-124,100,000	-107,500,000	-87,060,000
Direct effect on budget revenues[24]	218,350,000	240,000,000	263,880,000	289,890,000
Direct effect on budget expenditures	356,000,000	364,100,000	371,380,000	376,950,000

4.6.3. Healthcare

Implementation and deviation from implementation of measures and reasons for the deviation. The activities envisaged by the last year's EFP in the area of healthcare related to continuation of systemic changes and undertaking investment activities in the area of health infrastructure have been completed. The activities continued in the area of fight against HIV and cancer. The Government adopted the Draft Law on Health Insurance which defines the model of supplemental voluntary health insurance. Another structural reform in the area of health is the abolishing of the option for health workers to be employed in both private and public sector, with the possibility of outside employment in public sector in accordance with market principles, and this is in progress. The Strategy for optimisation of secondary and tertiary healthcare level including the Action Plan for implementation has been accepted.

So far, the contracts have been signed for implementation of two projects: 1) PET/CT and 2) Medical waste. Implementation of the project PET/SC is in delay because of the request of the investor for extension of the deadline due to economic crisis, while the Medical Waste Project will commence to be implemented in line with the provisions of the Contract.

So far, no state health institutions have been privatised.

Current and future economic policy programmes and measures. In the coming period, the activities related to the reform of the healthcare secondary and tertiary level will continue as well as defining and undertaking of a range of activities of regulatory, organisational and technical nature, for which the World Bank loan is provided in the amount of EUR 5,100,000.

In 2012:
- Activities will intensify on implementation of all decisions passed, and particularly the Strategy for Prevention and Control of Chronic and Non-communicable Diseases, i.e. programmes included in the Strategy and the National Strategic Document for fight against HIV.
- Investments in the health infrastructure will continue.
- Action Plan for Food and Food Safety of Montenegro will be carried out.

[24] It will be possible to quantify revenues after the implementation of projects funded or to be funded in the next two years from the funds of FP7 programme and it will be possible to express them in the total amount of funds spent by Montenegrin institutions during their participation in these projects

- The Strategy for Healthcare Quality Improvement and Control will be prepared,
- The Strategy for Suppression of Alcohol Use will be prepared.

In addition, in the forthcoming period the work will be done on implementing the activities defined in:
- Strategy for optimisation of healthcare secondary and tertiary level,
- National Programme for early detection of colorectal cancer for the period 2012-2016,
- National Programme for early detection of cervical cancer for the period 2012-2016,
- Action Plan for protection and improvement of health of children through enhancement of the quality of the environment in Montenegro,
- Implementation of the model of payment for services on the secondary and tertiary level of healthcare based on diagnostically related groups (DRG system).

Table 37. Budgetary effects of programmes and measures

	2011	2012	2013	2014
Construction of the Policlinic of General Hospital Berane, Medication Agency, Institute for Blood Transfusion and reconstruction of some healthcare institutions in municipalities, Neurology Clinic, Psychiatry Clinic and Gynaecology Clinic within the Clinic Centre of Montenegro (CCMNE)				
Net budgetary effect	-400,000	-4,800,000	-3,200,000	-6,000,000
Direct effect on budget revenues[25]				
Direct effect on budget expenditures	400,000	4,800,000	3,200,000	6,000,000
Strategy for optimisation of secondary and tertiary level of healthcare				
Net budgetary effect	-	-	-1,500,000	-
Direct effect on budget revenues[26]				
Direct effect on budget expenditures	-	-	1,500,000	-
Action Plan for Food and Food Safety of Montenegro				
Net budgetary effect	-425,000	-616,000	-563,000	-570,000
Direct effect on budget revenues				
Direct effect on budget expenditures	425,000	616,000	563,000	570,000
Action Plan for implementation of the National Strategic Response to HIV/AIDS in Montenegro				
Net budgetary effect[27]	-968,520	-1,149,920	-3,340,400	-1,425,680
Direct effect on budget revenues				
Direct effect on budget expenditures	968,520	1,149,920	3,340,400	1,425,680
National Programme for early detection of colorectal cancer for the period 2012-2016				
Net budgetary effect	-	-531,307	-255,000	-355,000
Direct effect on budget revenues				
Direct effect on budget expenditures	-	531,307	255,000	355,000
National Programme for early detection of cervical cancer for the period 2012-2016				
Net budgetary effect	-	-349,307	-100,000	-100,000
Direct effect on budget revenues				
Direct effect on budget expenditures	-	349,307	100,000	100,000
Action Plan for protection and improvement of child health through improvement of the quality of the environment in Montenegro				
Net budgetary effect	-	-	-442,500	-516,500
Direct effect on budget revenues				
Direct effect on budget expenditures	-	-	442,500	516,500

[25] The construction of Clinics, Policlinic, Institute and specific healthcare institutions will not directly affect the budget revenues, but will affect the improvement of the quality of healthcare services
[26] There is no direct effect on the budget revenues, but it will affect the improvement of the quality of healthcare and control of quality, availability of healthcare and reduction of costs.
[27] The funds are provided from the Global Fund for AIDS, tuberculosis and malaria

4.6.4. Social care

Implementation and deviation from implementation of measures and reasons for the deviation. Analysis that is to serve as the base for adoption of the Law on Social Security and Child Protection is prepared, while the preparations are in progress for the Law that is aimed at ensuring higher social inclusion, improvement of the area of social care, particularly long-term care, better channelling of social care benefits and elimination of non-activity incentives.

The Social Map Project hasn't been implemented, and its goals and manner of implementation are in the process of reviewing. The project team with the support of UNDP prepared an analysis of the current project for introduction of the social map, and gave a range of recommendations. In 2012, it is expected that the decision regarding the implementation of the reviewed concept of the social map will be made.

Strategic document for permanent resolution of the issue of refugees and resettled persons has been passed, and it envisages the resolution of the issue of a person's status, issues of access to the social care system and education system.

Current and future economic policy programmes and measures
In 2012, the activities in this area will be focused on:
- Adoption of the new Law on Social Security and Child Protection,
- Designing of an innovated concept of the Social Map,
- Work out of the transformation of social care institutions and improvement of availability of social services.

Table 38. Budgetary effects of programmes and measures

	2011	2012	2013	2014
Implementation of the Law on social security and child protection				
Net budgetary effect	-58,690,000	-64,560,000	-67,780,000	-70,100,000
Direct effect on budget revenues				
Direct effect on budget expenditures	58,690,000	64,560,000	67,780,000	70,100,000
Social Map				
Net budgetary effect	-0.00	-500,000.00[28]		
Direct effect on budget revenues				
Direct effect on budget expenditures	0.00	500,000.00		

4.6.5. Environment

Previous economic policy programmes and measures. In the previous period, Montenegro made efforts to enhance the institutional and legislative framework in the area of the environment. The country takes part in the work of the *Regional Environmental Network for Accession-RENA*, and the Twinning Project "*Support to Environment Management"*, between the Ministry of Sustainable Development and Tourism and the Italian Ministry for the Environment, Land and Sea through intermediation of the EU Delegation in Montenegro, under IPA 2008 commenced in March 2011. In addition, the Ministry of Sustainable Development and Tourism applied under IPA 2012-2013 for two projects: *National Approximation Strategy* (EUR 440,000) and *NATURA 2000* (EUR 2,750,000).

[28] The funds for potential implementation of the Social Map in the mentioned amount are envisaged in the current budgetary reserve, while their outturn depends on the decision regarding the manner of implementation and concept of the project.

The progress in harmonisation with the *Environmental Information Directive (2003/4/EC)* was made in 2009 through adoption of the *Convention on Access to Information, Public Participation in Decision-making and Access to Justice in Environmental Matters (Aarhus Convention)* and opening two Aarhus centres in April and November 2011.

In 2011, the Parliament of Montenegro adopted the Bill on Amendments to the Law on Strategic Environmental Assessment, which contributed to full transposition of the *SEA Directive 2001/42/EC*.

Planned economic policy programmes and measures. Such approach will continue in the coming period, where:

- the preparation of the Law on Amendments to the Law on Environmental Impact Assessment is planned for 2012,
- the preparation of the new Law on Environment is planned for 2013,
- the development of the National Programme for Environmental Protection that is to be based on the *Sixth Community Environment Action Program* is planned for 2014.

Air quality and climate change

Previous economic policy programmes and measures. In the area of air quality Montenegro achieved a significant progress in transposing the new *Directive 2008/50/EC on ambient air quality and cleaner air for Europe* through adoption of the Law on Air Quality. The zones for monitoring of the quality of air have been determined, locations defined, as well as the number and allocation of measurement stations for monitoring of air quality. The network for monitoring of air quality has been partially established.

Since 1 January 2011, the use of leaded fuel has been banned. The programme of monitoring of the fuel quality takes place in two periods (summer and winter).

The share of Montenegro in the global market of GHG emissions is significantly limited. Namely, in Montenegro, the Kyoto Protocol is enforced through the Clean Development Mechanism (CDM) that enables industrially developed countries to invest in the projects that contribute to sustainable development, and concurrently lead to the reduction of emissions of greenhouse gases in the developing countries. Also, Montenegro is not allowed to take part in the European Emissions Trading System, since this right is reserved for EU member countries.

Under the implementation of the Montreal Protocol on Substances that Deplete Ozone Layer, Montenegro observed the deadlines for final phase-out of CFC substances that deplete ozone layer so the consumption, i.e. import of the same has not been allowed since January 2010. In October 2010, the Government passed the Plan for Phasing out the HCFC substances that deplete the ozone layer, which will be implemented in the area of cooling and air-conditioning device servicing. In the first phase of the plan, HCFC substances will be phased out to 10% by 2015 and to 35% by 2020, while in the second phase from 2020 to 2040 they will be phased out 100%.

Planned economic policy programmes and measures in the area of air quality and climate change will be focused on the following:

- Improvement of the Network for air quality monitoring for the period 2012-2014. The amount of EUR 300,000 will be allocated for maintenance of the Network and monitoring in this period.
- Development of the National Air Quality Management Strategy in 2012 and establishment of an information system in the area of the environment.
- Implementation of the Plan for phasing out of HCFC substances that deplete the ozone layer in the area of cooling and air-conditioning device servicing.
- Continuation of implementation of the project under the Clean Development Mechanism (CDM),
- Adoption of the Law on Emissions Trading in 2014 aimed at establishment of the framework for ETS system.

Waste management

Previous economic policy programmes and measures. Waste Management Strategic Master Plan (from December 2004) envisages that by 2014 the amount of around EUR 110,000,000 will be invested in: the construction of 8 regional sanitary landfills for the needs of all municipalities, rehabilitation of the existing waste dump sites, the procurement of equipment, etc. Given that the dynamics in implementation of Waste Management Strategic Master Plan is evidently unsatisfying (only one landfill in Podgorica), the Ministry of Sustainable Development and Tourism initiated the development of the Study on Assessment of the Need for Review of the Waste Management Strategic Master Plan in Montenegro and the recommendation for organisation of waste management affairs in the period by 2030.

Planned economic policy programmes and measures. For the period 2011-2014 significant investments in the infrastructure are planned, primarily in the areas of:

- waste waters and waste (19 priority projects have closed financial structures),
- procurement of equipment required for work of utility companies (in the value of EUR 4,000,000),
- strengthening institutional capacities for development of the national waste management plan 2013–2018 and subsequently several local plans based on the same (for which the amount of EUR 800 000 will be allocated),
- construction of the waste water purification plant and sewage network in Pljevlja (in the value of EUR 3,500,000).

Water Management

Current and future economic policy programmes and measures. The implementation of the project "Lake Skadar Integrated Ecosystem Management" is in progress, and its beneficiaries are the Governments of Montenegro and the Republic of Albania, while the implementing agency is the World Bank, and this project will continue in 2012. In addition, the project of "Sustainable use of the Dinaric karst aquifer system (DIKTAS)" is implemented, in the value of US$ 5,813,570, of which the donation of GEF is US$ 2,160,000 while the reminder is co-financed by: Albania, Bosnia and Herzegovina, Croatia and Montenegro.

Nature protection

Economic policy programmes and measures in 2011. In 2011, the Government of Montenegro adopted the Proposal Law on Amendments to the Law on Nature Protection, which will contribute to harmonisation of the national legislation with the: Habitats Directive, Birds Directive and partly the *Regulation on protection of species of wild fauna and flora by regulating trade therein*.

Planned economic policy programmes and measures in the area of nature protection will be focused on the following:

- Implementation of activities defined by the National Biodiversity Strategy including Action Plan for the period 2010-2015,
- Work on creating the assumptions for establishing of ecological network of protected areas *NATURA 2000,*
- Implementation of the Coastal Area Management Programme in Montenegro–CAMP Montenegro in 2012,
- Implementation of the Coastal Area Integrated Management Protocol in 2012.

Industrial pollution and chemicals

Economic policy programmes and measures in 2011. Establishment, maintenance and improvement of a single system for chemicals management are incorporated in the new Law on Chemicals adopted by the Government of Montenegro in December 2011.

Current and future economic policy programmes and measures. In the area of industrial pollution control, the *IPPC Directive* is almost fully transposed in the Law on Integrated Pollution Prevention and Control. For 2012, it is planned that the Programme for compliance of individual economic branches with the Law on Integrated Pollution Prevention and Control will be adopted. The new licensing system that is planned to be established in 2015 should ensure that all ecologically relevant installation issues are taken into account in an integrated fashion. In cooperation with the World Bank, the preparation phase for the project "Industrial Waste Management and Cleaning" is implemented, and its objective is to rehabilitate 5 hot spots where the landfills of hazard industrial waste are located: KAP, Steel Mill Nikšić, Shipyard Bijela, Gradac Pljevlja and TPP Pljevlja, as well as to designate a single location as the national hazard waste landfill. It is planned that at the end of 2012 a tender will be advertised for selection of a company to rehabilitate the mentioned areas based on the Feasibility Studies that will be developed for each location individually in the earliest stage. The World Bank will provide a loan in the value of around US$ 60,000,000 for implementation of the project.

Ionising and non-ionising radiation and noise

Current and future economic policy programmes and measures. The Law on Protection against Environmental Noise was adopted in May 2011. In line with the provisions of the *Directive 2002/49/EC*, it is necessary to develop a strategic noise map for an agglomeration with population over 100,000 (Podgorica) and 2 regional roads with the traffic of 3 million automobiles a year. The state railway and 2 airports don't have high traffic frequency which would require strategic noise maps to be developed. Development of action plans will commence 2 years after the adoption of relevant strategic noise maps. Action plans will be reviewed every five years, and maybe sooner in case of significant changes in the level of environmental noise. The Law envisages that strategic noise maps should be completed by 2017 and relevant action plans in the area of noise by 2019.

In the area of protection against ionising and non-ionising radiation, activities will be undertaken on implementation of the Law on Protection against Ionising Radiation and Radiation Safety and the Strategy on Protection against Ionising Radiation, Radiation Safety and Radioactive Waste Management, which was adopted by the Government in September 2011. In the area of protection against non-ionising radiation which has not been legally regulated yet, it is planned that the Law on Protection against Non-ionising Radiation will be developed in 2012. During the period 2012-2013 national and regional projects from this area will be implemented with support of the European Commission and International Atomic Energy Agency.

Table 39. Budgetary effects of programmes and measures

	2011	2012	2013	2014
Horizontal legislation				
Net budgetary effect	411,450	486,272	700,000	715,000
Direct effect on budget revenues	611,450	751,272	1,000,000	1,000,000
Direct effect on budget expenditures	200,000	265,000	300,000	285,000
Waste and waste water management				
Net budgetary effect	-380,000	-530,000	-1,770,000	-2,100,000
Direct effect on budget revenues				
Direct effect on budget expenditures	380,000	530,000	1,770,000	2,100,000
Management of waters and the sea and marine area				
Net budgetary effect	-330,000	-190,000	-930,000	-1,395,000
Direct effect on budget revenues				
Direct effect on budget expenditures	330,000	190,000	930,000	1,395,000
Nature protection				
Net budgetary effect	-193,280	-123,800	-343,500	-493,000
Direct effect on budget revenues	6,720	6,200	6,500	7,000
Direct effect on budget expenditures	200,000	130,000	350,000	500,000

	2011	2012	2013	2014
Protection of air and climate change				
Net budgetary effect	-150,000	-386,000	-250,000	-250,000
Direct effect on budget revenues				
Direct effect on budget expenditures	150,000	386,000	250,000	250,000
Industrial pollution and chemicals management				
Net budgetary effect	-79,450	-128,650	-112,000	-104,000
Direct effect on budget revenues	550	7,350	8,000	8,000
Direct effect on budget expenditures	80,000	136,000	120,000	112,000
Ionising and non-ionising radiation				
Net budgetary effect	-29,550	-184,840	-187,000	-187,000
Direct effect on budget revenues	10,450	7,160	10,000	10,000
Direct effect on budget expenditures	40,000	192,000	197,000	197,000
Protection against noise				
Net budgetary effect	-17,000	-17,000	-17,000	-17,000
Direct effect on budget revenues				
Direct effect on budget expenditures	17,000	17,000	17,000	17,000

Source: Own calculations (Ministry of sustainable development and tourism)

4.6.6. Regional development

Unbalanced development of Montenegro has been a multiyear development problem. Although the regional dimension of development was present in all development policies of the State, there has been no reduction in the differences of development levels of municipalities, i.e. regions, but their deepening.

Viewed from the territorial aspect, Montenegro consists of 19 municipalities, the Administrative Capital and Historical Capital. According to EUROSTAT criteria for division of a country into territorial units for statistics purposes, Montenegro represents a single region (NUTS2). For the needs of the national policy for regional development, the region of Montenegro is geographically classified into the north, central and coastal region, given the fact that based on the development index of local self-government units it is established that there are significant differences in the level of development of municipalities, and broader areas they belong to.

Insufficient capture of value from significant natural, economic and human potentials of municipalities, primarily in the north region, conditioned unfavourable demographic processes, which reflect in the migration from rural to urban areas and deserting of under-developed municipalities, which is confirmed by the data of population censuses from 2003 and 2011. Namely, the population in the north region decreased by 13,662 in 2011 in relation to 2003, and their share in the total population of Montenegro went down from 31.42% in 2003 to 28.98% in 2011. In the observed period, out of under-developed municipalities, only in the municipalities of Rožaje and Berane the population increased by 2.7% and 1.1% respectively.

According to Article 113 of the Stabilisation and Association Agreement between Montenegro and EU, the contracting parties are bound to strengthen cooperation in the area of regional and local development, with the view of overall economic development and reduction of regional disbalances.

Previous economic policy programmes and measures. In order to create assumptions for balanced development of Montenegro, under the coordination of the Ministry of Economy there are significant activities implemented for strengthening the regional competitiveness, based on own development potentials and comparative advantages within the national framework and in relation to similar regions in the surroundings. In these terms, a clear strategic and institutional framework of regional policy has been defined.

In 2010, the Regional Development Strategy of Montenegro 2010-2014 was adopted with the purpose of achieving a balanced socio-economic development of the State, in line with the sustainable development principles. The Strategy defines three strategic goals, as follows: 1) more balanced development of all local self-government units and regions, 2) accelerated development of under-developed local self-government units and regions and 3) regional development and environmental protection.

In 2011, activities intensified on implementation of the regional development policy.

- The Law on Regional Development was adopted, which created the legal grounds for leading the policy of regional development, and a range of secondary legislation pieces were prepared as to ensure consistency of interests of local communities with general development framework. In line with the Decree on the manner of calculating the index of development of local self-government units, the level of their development was established,
- The “Resource Map of Montenegro” was prepared, which is the base for development of planning documents, aimed at defining of the starting assumption for resource management, the analysis of competitiveness of the region from the aspect of available resources and development potentials, and attraction of potential investors,
- In order to ensure transparency and include all stakeholders in creation and implementation of the policy of regional development, the Partnership Council for Regional Development was established,
- In view of building local capacities required for improvement of the situation and enhancement of the quality of life of the local population, strategic development plans for the period to seven years are under preparation, where all stakeholders from the local level are involved in identifying the key problems of the community and the basic development directions.

Planned economic policy programmes and measures. In the forthcoming period, intensive activities for mitigation of regional disparities will continue, which will be financed by donor support funds. In this respect:

- Action Plan for implementation of the Regional Development Strategy 2012-2014 will be adopted,
- Electronic base of development projects will be established, which will provide for efficient planning and monitoring of implementation of the regional development policy,
- Strategy for sustainable economic growth of Montenegro will be adopted through introduction of clusters by 2016.

A range of competitive investment and other projects that directly or indirectly encourage the regional development will be completed in 2012:

- Implementation of initiated activities will continue and activities will commence on new development projects, based primarily on the resources of under-developed areas. For financing of these projects, inter alia, envisaged are the funds of Capital Budget of local self-government units (LSGU) for 2012 that are estimated in the amount of EUR15,000,000 (around 40% of the total Capital budget of LSGU for 2012),
- The Capital Budget of Montenegro for 2012, which is to be implemented through the Directorate for Transport for projects of construction, reconstruction and investment maintenance of the road infrastructure of the North Region envisages investments in the amount of EUR 13,750,000,
- Through the Directorate of Public Works, in the area of the North Region, the projects from the following areas will be implemented: (i) improvement and preservation of the environment (EUR 390,000), (ii) construction and reconstruction of local infrastructure (EUR 4,174,000) and (iii) construction and reconstruction of facilities from the area of culture, sports, healthcare and education (EUR 2,580,000).

The Law on Budget does not explicitly define the funds for implementation of the regional development policy, but a range of instruments and measures aimed at encouragement of development of under-developed municipalities and regions are established, such as: Equalisation Fund, conditional subsidies, state aid, Agro-budget, credit support to development of small and medium enterprises and employment, co-financing of IPA projects, advancement of business environment, etc. Based on the five-year trend regarding the amount of allocations for development projects and incentive measures to be implemented in under-developed areas, it is projected that in the observed period around 40% of the total funds from the mentioned funding sources will be allocated for projects and incentive measures in this region.

Table 40. Budgetary effects of economic policy programmes and measures.

	2011	2012	2013	2014
Implementation of initiated and activities on new development projects funded from the Government Budget and budgets of local self-government units				
Local self-government capital budget				
Net budgetary effect		-15,000,000	-15,000,000	-15,000,000
Direct effect on budget revenues				
Direct effect on budget expenditures		15,000,000	15,000,000	15,000,000
Projects through Transport Directorate				
Net budgetary effect		-13,750,000	-22,550,000	-9,850,000
Direct effect on budget revenues				
Direct effect on budget expenditures		13,750,000	22,550,000	9,850,000
Programmes through Directorate of Public Works				
Net budgetary effect		-7,144,000	-8,750,000	-9,400,000
Direct effect on budget revenues				
Direct effect on budget expenditures		7,144,000	8,750,000	9,400,000

Budget revenues in respect of implementation of envisaged measures, activities and projects under the regional development policy are not possible to be quantified. This is primarily the case because such activities and projects require a longer time period for total effectuation. At the same time, significant indirect impact produced by the implementation of these measures, activities and projects is multiple, given that it has a multiplicative effect, which is also impossible or very difficult to be quantified.

A N N E X

ANNEX 1

MODEL STRUCTURE
FOR THE
PRE-ACCESSION ECONOMIC PROGRAMME

ANNEX 2: TABLES TO BE CONTAINED IN THE PRE-ACCESSION ECONOMIC PROGRAMMES AND THEIR UPDATES[29]

Table 1a: Macroeconomic prospects

Percentages unless otherwise indicated	ESA Code	Year 2010	Year 2010	Year 2011	Year 2012	Year 2013	Year 2014
		Level (bn EUR)	**Rate of change**				
1. Real GDP at market prices	B1*g	2911.1	2.5	2.4	2.0	3.5	4.0
2. Current GDP at market prices	B1*g	2981.0	4.1	5.5	4.0	5.6	6.1
Components of real GDP							
3. Private consumption expenditure	P3	2450.6	2.0	4.7	2.0	3.5	4.0
4. Government consumption expenditure	P3	703.3	-0.3	2.0	0.3	2.1	2.6
5. Gross fixed capital formation	P51	824.6	-18.5	-9.1	-1.4	0.9	-1.9
6. Changes in inventories and net acquisition of valuables (% of GDP)	P52+P53	10.0	375.0	-100.0	0.0	0.0	0.0
7. Exports of goods and services	P6	945.9	7.5	8.7	4.1	4.9	6.5
8. Imports of goods and services	P7	2023.3	-3.1	2.1	1.6	3.1	3.3
Contribution to real GDP growth							
9. Final domestic demand		3978.5	-3.4	2.4	1.5	3.6	3.6
10. Change in inventories and net acquisition of valuables	P52+P53	10.0	1.4	-1.7	0.0	0.0	0.0
11. External balance of goods/services	B11	-1077.4	4.5	1.7	0.5	-0.1	0.4

Table 1b: Price developments

Percentage changes, annual averages	ESA Code	Year 2010	Year 2011	Year 2012	Year 2013	Year 2014
1. GDP deflator		1.6	3.0	2.0	2.0	2.0
2. Private consumption deflator		-0.1	3.0	2.0	2.0	2.0
3. HICP[30]						
4. National CPI change		-0.8	2.8	-1.4	0.0	0.0
5. Public consumption deflator		10.3	3.0	2.0	2.0	2.0
6. Investment deflator		0.8	3.0	2.0	2.0	2.0
7. Export price deflator (goods & services)		4.7	3.0	2.0	2.0	2.0
8. Import price deflator (goods & services)		3.7	3.0	2.0	2.0	2.0

[29] Please replace in the tables the placeholders (Year X+/-n) indicating the programme period with the concrete years, with the year X being the year of the submission deadline.

[30] Pilot project starting from 2011

Table 1c: Labour markets developments

	ESA Code	Year 2010	Year 2010	Year 2011	Year 2012	Year 2013	Year 2014
		Level	Level/Rate of change				
1. Population (thousands)				620.0	621.3	622.5	623.8
2. Population (growth rate in %)					0.20	0.20	0.20
3. Working-age population (persons)				421.7	422.5	423.4	424.2
4. Participation rate							
5. Employment, persons [2]		161.7	161.7				
6. Employment, hours worked[3]							
7. Employment (growth rate in %)							
8. Public sector employment (persons)			50.2				
13. Compensation of employees	D1						

Table 1d: Sectoral balances

Percentages of GDP	ESA code	Year 2010	Year 2011	Year 2012	Year 2013	Year 2014
1. Net lending/borrowing vis-à-vis the rest of the world	B.9	-24.6	-22.8	-21.7	-20.8	-19.7
of which:						
- *Balance of goods and services*		-27.6	-26.0	-24.7	-23.9	-22.7
- *Balance of primary incomes and transfers*		3.0	3.1	3.0	3.0	3.0
- *Capital account*		0.0	0.0	0.0	0.0	0.0
2. Net lending/borrowing of the private sector	B.9/ EDP B.9					
3. Net lending/borrowing of general government		-4.9	-3.2	-1.0	0.1	1.0
4. Statistical discrepancy						

Table 1e: GDP, investment and gross value added

	ESA Code	Year 2010	Year 2011	Year 2012	Year 2013	Year 2014
GDP and investment						
GDP *level* at *current* market prices (in domestic currency)	B1g	3103.9	3273.2	3405.4	3595.1	3813.7
Investment ratio (% of GDP)		21.1	18.7	18.1	17.7	16.7
Growth of Gross Value Added, percentage changes at constant prices						
1. Agriculture		-1.3	2.8	1.9	2.9	3.9
2. Industry (excluding construction)		13.1	2.1	2.0	3.5	4.0
3. Construction		-7.4	-3.9	-7.8	2.0	2.9
4. Services		1.8	2.4	2.0	3.5	4.0

Table 1f: External sector developments

		Year 2010	Year 2011	Year 2012	Year 2013	Year 2014
1. Current account balance (% of GDP)	% of GDP	-25.3	-22.8	-21.7	-20.8	-19.7
2. Export of goods	NCU or EUR	356.6	421.4	460.0	507.0	564.0
3. Import of goods	NCU or EUR	1623.8	1760.0	1850.0	1940.1	2063.1
4. Trade balance	NCU or EUR	-1267.2	-1338.6	-1390.0	-1433.1	-1499.1
5. Export of services	NCU or EUR	410.3	488.8	548.5	575.2	633.2
6. Import of services	NCU or EUR	336.8	316.5	310.1	324.9	328.1
7. Service balance	NCU or EUR	410.3	488.8	548.5	575.2	633.2
8. Net interest payments from abroad	NCU or EUR	-97.9	-103.3	-116.9	-118.6	-123.2
9. Other net factor income from abroad	NCU or EUR	76.2	85.0	90.0	93.0	96.6
10. Current transfers	NCU or EUR	114.4	121.4	129.7	135.1	139.7
11. Of which from EU	NCU or EUR					
12. Current account balance	NCU or EUR	-764.2	-746.8	-738.6	-748.3	-752.9
13. Capital and financial account	NCU or EUR	370.9	441.9	521.1	545.0	695.0
14. Foreign direct investment	NCU or EUR	552.1	404.1	410.5	483.0	592.0
15. Foreign reserves	NCU or EUR	229.9	194.1	212.6	241.3	261.1
16. Foreign debt	NCU or EUR					
17. Of which: public	NCU or EUR	917,7	1061,5	1259,1	1324,8	1360,5
18. O/w: foreign currency denominated	NCU or EUR					
19.O/w: repayments due	NCU or EUR					
20. Exchange rate vis-à-vis EUR (end-year)	NCU/EUR	1.00	1.00	1.00	1.00	1.00
21. Exchange rate vis-à-vis EUR (annual average)	NCU/EUR	1.00	1.00	1.00	1.00	1.00
22. Net foreign saving	% of GDP					
23. Domestic private saving	% of GDP	43.4	44.1	44.8	45.8	46.9
24. Domestic private investment	% of GDP					
25. Domestic public saving	% of GDP	5.9	5.4	5.4	6.4	6.9
26. Domestic public investment	% of GDP					

Table 2: General government budgetary prospects

	ESA code	Year 2010 Level (mil NCU)	Year 2010	Year 2011	Year 2012	Year 2013	Year 2014
			% of GDP				
Net lending (B9) by sub-sectors							
1. General government	S13	-151.1	-4.9	-3.2	-1.0	0.1	1.0
2. Central government	S1311	-112.2	-3.6	-3.5	-1.3	-0.1	0.9
3. State government	S1312	0.0	0.0	0.0	0.0	0.0	0.0
4. Local government	S1313	-38.8	-1.3	0.2	0.2	0.2	0.2
5. Social security funds	S1314	0.0	0.0	0.0	0.0	0.0	0.0
General government (S13)							
6. Total revenue	TR	1314.3	42.3	39.4	39.4	39.2	39.0
7. Total expenditure[1]	TE	1465.4	47.2	42.6	40.5	39.1	38.0
8. Net borrowing/lending	EDP.B9	-151.1	-4.9	-3.2	-1.0	0.1	1.0
9. Interest expenditure	EDP.D41 incl. FISIM	31.4	1.0	1.4	1.8	1.8	1.8
10. Primary balance[2]		-119.7	-3.9	-1.9	0.7	1.9	2.8
11. One-off and other temporary measures [3]		0.0	0.0	0.0	0.0	0.0	0.0
Components of revenues							
12. Total taxes (12 = 12a+12b+12c)		0.7	0.0	22.5	23.3	23.3	23.3
12a. Taxes on production and imports	D2	0.5	0.0	17.7	18.6	18.6	18.6
12b. Current taxes on income and wealth	D5	0.1	0.0	4.6	4.6	4.5	4.5
12c. Capital taxes	D91	0.0	0.0	0.2	0.2	0.1	0.1
13. Social contributions	D61	0.4	0.0	11.1	10.9	10.9	10.9
14. Property income	D4	0.0	0.0	0.4	0.4	0.4	0.4
15. Other (15 = 16-(12+13+14)) [4]		1313.2	42.3	5.3	4.8	4.7	4.5
16 = 6. Total revenue	TR	1314.3	42.3	39.4	39.4	39.2	39.0
p.m.: Tax burden (D2+D5+D61+D91-D995) [5]		1.1	0.0	33.7	34.2	34.2	34.2

Table 2 (continued)

17. Total social transfers	D62 + D63	423.6	13.6	13.9	14.0	14.1	13.9
17a. Social transfers in kind	P31 = D63	0.0	0.0	0.0	0.0	0.0	0.0
17b. Social transfers other than in kind	D62	423.6	13.6	13.9	14.0	14.1	13.9
18 = 9. Interest expenditure (incl. FISIM)	EDP.D41 + FISIM	31.4	1.0	1.4	1.8	1.8	1.8
19. Subsidies	D3	39.8	1.3	1.5	0.6	0.3	0.3
20. Gross fixed capital formation	P51	146.4	4.7	3.4	3.1	3.1	3.1
21. Other (21 = 22-(16+17+18+19+20) [6]		824.2	26.6	22.4	20.9	19.7	18.9
22. Total expenditures	TE [1]	1465.4	47.2	42.6	40.5	39.1	38.0
p.m. compensation of employees	D1	341.0	11.0	13.1	12.6	12.0	11.4

Table 3: General government expenditure by function

% of GDP	COFOG Code	Year 2010	Year 2011	Year 2012	Year 2013	Year 2014
1. General public services	1	11.6	8.5	8.2	0.0	0.0
2. Defence	2	1.2	1.1	1.1	0.0	0.0
3. Public order and safety	3	3.8	3.6	3.4	0.0	0.0
4. Economic affairs	4	4.6	4.4	3.4	0.0	0.0
5. Environmental protection	5	0.3	0.2	0.1	0.0	0.0
6. Housing and community amenities	6	0.3	0.2	0.1	0.0	0.0
7. Health	7	5.4	5.2	5.2	0.0	0.0
8. Recreation, culture and religion	8	0.9	1.0	0.9	0.0	0.0
9. Education	9	4.4	4.3	4.0	0.0	0.0
10. Social protection	10	14.7	14.0	14.0	0.0	0.0
11. Total expenditure (item 7 = 23 in Table 2)	TE	47.2	42.6	40.5	39.1	38.0

Table 4: General government debt developments

% of GDP	ESA code	Year 2010	Year 2011	Year 2012	Year 2013	Year 2014
1. Gross debt [1]		40.9	43.8	46.9	45.4	42.9
2. Change in gross debt ratio		40.9	2.9	3.1	-1.6	-2.4
Contributions to change in gross debt						
3. Primary balance [2]		3.9	1.9	-0.7	-1.9	-2.8
4. Interest expenditure [3]	EDP D.41	1.0	1.4	1.8	1.8	1.8
5. Stock-flow adjustment		36.1	-0.4	2.1	-1.4	-1.4
of which:						
- Privatisation proceeds		0.9	0.4	0.5	0.5	0.5
- Valuation effects and other [6]		0.0	0.0	0.0	0.0	0.0
p.m. implicit interest rate on debt [7]			3.5	4.3	4.0	4.1
Other relevant variables						
6. Liquid financial assets [8]		0.0	0.0	0.0	0.0	0.0
7. Nefinancial debt (7 = 1 - 6)		40.9	43.8	46.9	45.4	42.9

Table 4.1: Public Debt on 31. 09. 2011.

Foreign Debt		
Creditor	**Level of Debt**	**Nondisbursed Funds**
International Bank for Reconstruction and Development (IBRD)	174,0	31,8
International Financial Corporation (IFC)	4,2	
Paris Club Creditors	108,2	
International Develošment Agency (IDA)	61,1	5,3
European Investment Bank (EIB)	74,2	47,5
European Bank for Reconstruction and Development (EBRD)	23,4	10,4
Development Bank of European Council (CEB)	10,2	15,0
European Community	5,5	
KFW	11,6	48,5
Austrian Loan	10,1	
Hungarian Loan	13,1	0,5
Polish Loan	10,8	0,1
Societe Generale - Education IT	0,6	
Franch Loan	8,5	
EUROFIMA – Railway Debt	28,3	
Chech EXIM - Railway Debt	32,5	
Steiermarkische Bank und Sparkassen AG	20,9	
Erste Bank	22,5	

Credit Suisse Bank	59,9	
Spanish Loan for Solid Waste removal facility	5,0	
Exim Bank Hungary	3,0	1,0
EUROBOND	380,0	
TOTAL	**1.067,6**	**160,1**
Domestic Debt		
Old Foreign Frozen Curency Deposits	89,4	
Local Government Debt*	79,5	
Restitution	80,2	
Loans at Commercial Banks	32,2	
Loans at Nonfinancial Institutions	53,1	
Pensions**	2,3	
T - Bills	55,6	
TOTAL	**392,3**	
TOTAL DEBT	**1.459,9**	

Table 4.2: Issued Foreign State Guarantees on 30.09.2011.

Creditor	Purpose of Loan	Borrower	Year of issuance	Signed amount	Disbursed by 30.09.2011.	Level of Debt on 30.09.2011.
EIB	European Roads Project	Monteput	2004	24.000.000	24.000.000,00	24.000.000,00
EIB	Reconstruction of Eenergetic System	EPCG	2002	11.000.000	8.023.090,00	7.311.505,79
EIB	Modernization of Airports	JP Aerodromi CG	2004	12.000.000	11.000.000,00	10.333.333,33
EIB	SME credit lines through Commercial Banks	Commercial Banks	2009	91.000.000	75.645.000,00	75.192.934,67
EIB	Modernization of Railway Infrastructure	Željeznička infrastruktura CG	2010	7.000.000	0,00	0,00
EBRD	Modernization of Airports	JP Aerodromi CG	2003	11.000.000	10.235.127,00	6.393.215,82
EBRD	Regional Water supply – south (faze 1)	JP Regionalni vodovod	2007	8.000.000	8.000.000,00	7.333.333,33

EBRD	Regional Water supply – south (faze 2)	JP Regionalni vodovod	2008	7.000.000	7.000.000,00	6.708.333,33
EBRD	Regional Water supply – south (extension of faze 2)	JP Regionalni vodovod	2010	3.000.000,00	3.000.000,00	2.875.000,00
EBRD	Reconstruction of Railway infrastructure – faze III	JP Zeljeznice CG	2009	4.000.000	2.333.293,55	2.333.293,55
EBRD	Reconstruction of Railway infrastructure – faze II	Zeljeznicka infrastruktura AD Podgorica	2009	15.000.000	6.061.131,00	6.061.131,00
EBRD	Acquisition of electromotor supply and diagnostic equipment	Željeznički prevoz AD	2010	13.550.000	485.500,00	485.500,00
EBRD	Credit Line for Deposits Protection	Fund for Deposits Protection	2010	30.000.000	0,00	0,00
KfW	Perucica	EPCG	2003	3.580.000	3.564.135,21	1.473.831,97
KfW	Piva	EPCG	2007	16.000.000	2.883.264,84	2.883.264,84
KfW	Transformer station Ribarevine	EPCG	2007	5.400.000	3.943.943,09	3.943.943,09
KfW	Filtre replacement in TE Pljevlja and capacity increase of Transformer station Podgorica-Ribarevine	EPCG	2008	15.000.000	12.345.832,32	12.345.832,32
KfW	Erste bank	Erste bank	2009	15.000.000	15.000.000,00	13.636.363,64
KfW	NLB	NLB	2009	16.000.000	16.000.000,00	16.000.000,00
OTP	KAP	KAP	2009	49.680.000	49.680.000,00	48.994.444,45
EXIM China	Acquisition of Ships	Crnogorska plovidba	2010	47.396.000,00	14.334.502,00	14.334.502,00

WTE Wassertechnik	Waste Water Removal Project	Municipality of Budva	2010	29.250.000,00	0.00	
Abu Dabi DEvelopment Fund	Water supply Project	Regional Water supply	2010	18.977.884,37	873.821,83	873.821,83
Deutsche Bank	Support to KAP	KAP	2010	22.000.000,00	22.000.000,00	22.000.000,00
VTB	Support to KAP	KAP	2010	60.000.000,00	60.000.000,00	60.000.000,00
TOTAL on 30.09.2011.					**356.107.337,60**	**345.513.584,96**

Table 4.3: Issued Domestic State Guarantees on 30.09.2011.

CREDITOR	BOROWER	ISSUANCE DATE	EUR
NLB Montenegrobanka	Rudnici boksita a.d. Nikšič	09.06.2009.	5.000.000,00
Podgorička banka	Pobjeda a.d. Podgorica	10.07.2009.	2.970.000,00
Hipotekarna banka a.d.	Montenegro Airlines	31.12.2009.	2.700.000,00
NLB Montenegrobanka	Montenegro Airlines	25.02.2010.	1.800.000,00
Erste banka a.d. Podgorica	Fond za solidarnu izgradnju	23.02.2010.	0,00
Erste banka a.d. Podgorica	Željeznički prevoz Crne Gore	30.04.2010.	0,00
Erste banka a.d. Podgorica	Pobjeda a.d. Podgorica	01.07.2010.	3.500.000,00
Erste banka a.d. Podgorica	Regionalni vodovod	16.07.2010.	0,00
Hipotekarna banka a.d.	MI-RAI GROUP DOO NIKŠIĆ	27.07.2010.	800.000,00
NLB Montenegrobanka	Gradir Montenegro doo Nikšić	27.07.2010.	900.000,00
NLB Montenegrobanka	Gradir Montenegro doo Nikšić	27.07.2010.	700.000,00
NLB Montenegrobanka	Gradir Montenegro doo Nikšić	27.07.2010.	2.000.000,00
NLB Montenegrobanka	Melgonia-Primorka	22.12.2010.	4.000.000,00
Hipotekarna banka a.d.	Montenegro Airlines	06.05.2011.	2.000.000,00
Erste banka a.d. Podgorica	Fabrika elektroda "Piva" Plužine	27.07.2011.	1.500.000,00
Hipotekarna banka a.d.	MI-RAI GROUP DOO NIKŠIĆ	13.09.2011.	700.000,00
TOTAL on 30.09.2011			**28.570.000,00**

Table 5: Cyclical developments

% of GDP	ESA Code	Year 2010	Year 2011	Year 2012	Year 2013	Year 2014
1. Real GDP growth (%)	B1g	2.5	2.5	2.0	3.5	4.0
2. Net lending of general government	EDP.B.9	-4.9	-3.2	-1.0	0.1	1.0
3. Interest expenditure	EDP.D.41	1.0	1.4	1.8	1.8	1.8
4. One-off and other temporary measures [1]						
5. Potential GDP growth (%)		3.0	2.9	2.8	2.7	2.7
6. Output gap		-1.5	-2.0	-2.8	-2.2	-1.0
7. Cyclical budgetary component		1.5	-0.9	-0.5	-0.4	-0.4
8. Cyclically-adjusted balance (2-7)		-6.4	-2.4	-0.6	0.5	1.4
9. Cyclically-adjusted primary balance (8+3)		-5.3	-1.0	1.2	2.3	3.2
10. Structural balance (8-4)		-6.4	-2.4	-0.6	0.5	1.4

Table 6: Divergence from previous programme

	Year 2010	Year 2011	Year 2012	Year 2013	Year 2014
1. GDP growth (%, yoy)					
Previous update	0.5	2.5	3.5	4.0	
Latest update	2.5	2.4	2.0	3.5	4.0
Difference (percentage points)	2.0	-0.1	-1.5	-0.5	4.0
2. General government net lending (% of GDP)					
Previous update	-4.0	-2.4	-0.1	1.7	
Latest update	-4.9	-3.2	-1.0	0.1	1.0
Difference	-0.9	-0.8	-1.0	-1.5	1.0
3. General government gross debt (% of GDP)					
Previous update	41.8	42.9	40.9	37.5	
Latest update	40.9	43.8	46.9	45.4	42.9
Difference	-0.9	0.9	6.0	7.9	42.9

Table 7: Long-term sustainability of public finances

% of GDP	2007	2010	2020	2030	2040	2050	2060
Total expenditure	43,34	47.21					
of which:							
- Age-related expenditures							
- Pension expenditure	8,52	10.7	9,8	9,6	9,1	9,3	8,7
- Social security pension							
- Old-age and early pensions							
- Other pensions (disability, survivors)							
- Occupational pensions (if in general government)							
- Health care							
- Long-term care (this was earlier included in the health care)							
Education expenditure		4,4					
Other age-related expenditures							
Interest expenditure	1,04	1,01					
Total revenues	49,99	42,34					
of which: property income							
of which: from pensions contributions (or social contributions, if appropriate)	6,47	7,52					
Pension reserve fund assets							
of which: consolidated public pension fund assets (assets other than government liabilities)							
Assumptions							
Labour productivity growth							
Real GDP growth	10,7	2.5	3.0	3.0	3.0	3.0	
Participation rate males (aged 20-64)[31]		34.0	34.2	33.8	33.8	32.5	
Participation rates females (aged 20-64)		34.0	33.9	33.0	32.5	30.9	
Total participation rates (20-64)		68.0	68.1	66.8	66.4	63.4	
Unemployment rate							
Population aged 65+ over total population		12.8	15.3	18.4	20.5	24.4	

[3131] *Low fertility scenario: Low fertility, expected mortality, expected migration, available data for 15-63 group only. Projection are made by MoF staff according to " Demografic trends in Montenegro from 20th Century and prospects until 2050"- Author Mr. Goran Penev.

Table 8: Basic assumptions on the external economic environment underlying the PEP framework[32]

VARIABLE (annual growth rates in %, if not otherwise stated)	REALISATIONS AND ASSUMPTIONS FOR 2010		2011		2012		2013		2014	COMMENTS
		*change **		*change **		*change **		*change **		
Interest rates (in % p.a., annual averages)										
- Short-term interest rate[33] (annual average)										
- Long-term term interest rate[34] (annual average)	1,6		0,4		*1,9*					
Exchange rates (annual average "-": depreciation)										
Exchange rate vis-à-vis €										
USD / €										
Nominal effective exchange rate										
Real effective exchange rate **										
GDP (in real terms)										
- World, excluding EU	5,1		4,0		*4,0*					
- EU 25	1,8		1,6		*1,1*					
World trade (in real terms)										
Country export markets										
World imports										
International prices										
World import prices (goods, in €)										
Oil Prices (Brent – USD per barrel)	79		103		*100*					

*: change vis-à-vis assumptions made for last PEP
**: please indicate type of calculation (number of currencies, type of price index for deflation)

[32] This table should preferably be included in the programme itself; if not, these assumptions should be transmitted to the Commission together with the programme.
[33] If necessary, purely technical assumption
[34] If necessary, purely technical assumption

Table 9: Structural reform agenda and achievements

Measures from EFP 2011	Measure accepted (Yes/No)	Date of acceptance/ planned acceptance	Comment
4.1.1. PRIVATISATION			
AD "Montecargo", Podgorica	Not completed	2012	Based on the experience from previous failed tenders and reduced interest of investors under the conditions of economic crisis, public invitations for most companies in 2011 were not announced. Their advertisement and implementation in 2012 or later depend primarily on the interest of potential investors, which is uncertain under current circumstances.
"Montenegro airlines" AD, Podgorica	Not completed	2012	
AD "Kontejnerski terminal i generalni tereti", Bar	Not completed	2012	
"Pošta Crne Gore" AD, Podgorica	Not completed	2012	
"Održavanje željezničkih voznih sredstava" AD, Podgorica	Not completed	2012	
NIG "Pobjeda" AD, Podgorica	In progress	2012	
"Jadransko brodogradilište" AD, Bijela	Not completed	2012	
Institut "Dr Simo Milošević" AD, Igalo	Not completed	2012	
"Luka Bar" AD, Bar	Not completed	2012	
AD "Zora", Berane	Not completed	2012	
HG "Budvanska rivijera" AD, Budva	Not completed	2012	
HTP "Ulcinjska rivijera" AD, Ulcinj	Not completed	2012	
"Institut crne metalurgije" AD, Nikšić	Not completed	2012	
Fabrika elektroda "Piva" AD, Plužine	Not completed	2012	
"Barska plovidba" AD, Bar	Not completed	2012	
Ada Bojana	Not completed	2012	
Velika plaža	Not completed	2012	
Bjelasica-Komovi	Not completed	2012	
Utjeha	Not completed	2012	
Njivice/Sutorina	Not completed	2012	
Valdanos	Not completed	2012	
Ostrvo cvijeća	Not completed	2012	
Bigova –Trašte	Not completed	2012	
Mediteran Žabljak	Not completed	2012	
Orijenski bataljon - Kumbor	In progress	2012	
Ostrvo Mamula	In progress	2012	
4.1.2.1. COMPETITION			
Adoption of the New Law on Protection of Competition	No		The Law is in the Parliamentary procedure
4.1.2.2. STATE AID			
Adjustment Programme	Yes		
IT system for state aid records is established	Yes		
Proposal decision on the regional assistance map	Yes		
4.1.2.3. PUBLIC PROCUREMENT			
Public Procurement Law	Yes		
Secondary legislation	Yes		
Rulebook on internal organisation and systematisation of the Public Procurement Directorate	Yes		
4.1.3.1. BUSINESS ENVIRONMENT ADVANCEMENT			
Introduction of RIA	Yes		
Regulatory "Guillotine"	Yes		
"One stop shop" for registration of companies	Yes		
Reform of issuance of construction permits	Yes		
Law on enforcement and securing claims	Yes		
Simplification of employment of foreigners	Yes		
Expansion of credit register in line with the new Law on CBM	Yes		
Action Plan for Doing Business Reform for 2011	Yes		
4.1.3.2. SECTOR OF SMALL AND MEDIUM ENTERPRISES			
Adoption of new strategic documents	Yes		
Credit support to SME – Investment Development Fund (IDF)	Yes		
Strengthening of institutional support to SME (new business centre model created, decision made on establishment of incubators in Berane, competition for feasibility study for technology parks, initiated PPP dialogue)	Yes		

Measures from EFP 2011	Measure accepted (Yes/No)	Date of acceptance/ planned acceptance	Comment
Competitiveness and export strengthening (provision of information, development of market research surveys, electronic base of exporters, research of internal performance indicators of enterprises, presentation at fairs, feasibility study for "SME Voucher Scheme", preparatory activities for development of the Strategy for Sustainable Economic Growth of Montenegro through introduction of clusters by 2016)	Yes		
Enhancement of business knowledge through training programmes (project »Opportunity for young managers«, »Development of entrepreneurship competencies«, analysis of training needs, national qualification framework)	Yes		
Export development programme	No		Lack of funds for implementation
4.1.3.3. TAX POLICY			
Amendments to the Law on Administrative Fees	Yes		
Project of unified registration and collection of personal income tax and contributions for mandatory social insurance	Yes		
4.1.4.1. ENERGY			
Adoption of Energy Policy of Montenegro until 2030	Yes		
Publication of the third tender for construction of small hydro power plants	No	2012	
National Plan for Energy Efficiency	Yes		
Activities on the project of construction of Adriatic-Ionic gas pipeline	Yes		
Tender for exploration of oil and gas	No	2012	
Tender for construction of hydro power plant on the Morača River	No		Qualified tenderers failed to submit the required documentation within the envisaged timeframe
4.1.4.2. TRANSPORT			
Regular maintenance of state roads 2010-2014	Yes		
Implementation of the project Bar-Boljare High-way	No		In the coming period the Government will examine the options for final implementation of this project
Adriatic-Ionic high-way	Yes		
Implementation of the programme for elimination of bottlenecks in the network	Yes		
Implementation of the programme for reconstruction of intersections on state roads	Yes		
Privatisation programme for "Montenegroairlines"	No	2012	
Programme for reconstruction of railway infrastructure	Yes		
Programme for restructuring and privatisation of the joint stock company Luka Bar	Yes		
4.1.4.3. TELECOMMUNICATIONS			
Project for transition from analogue to digital radio broadcasting	Yes		
Implementation of Universal service in electronic communications	Yes		
Postal Activity Development Strategy	Yes		
Adoption of the Law on Postal Services	Yes		
Privatisation of the Post of Montenegro, according to the public-private partnership model	No		The delay was caused by the change of organisation and way of work of state administration, so new Tender Committee has been established
4.2.1. BANKING SECTOR			
Activities according to the Action Plan of initiatives on strengthening the capacities of the Central Bank and supervision function in the period 2010-2014.	Yes		
Secondary legislation for enforcement of the Law on Central Bank	Yes		
4.2.2.1. INSURANCE			
Amendments to the Law on Insurance	No		Redefining of the schedule of activities in creation of the regulatory framework in the sector of insurance
Amendments to the Law on Compulsory Transport Insurance	No		Redefining of the

Measures from EFP 2011	Measure accepted (Yes/No)	Date of acceptance/ planned acceptance	Comment
			schedule of activities in creation of the regulatory framework in the sector of insurance
New system of tariffs and conditions for third party liability insurance of owners of motor vehicles and trailers	Yes		
Amendments to the Law on Bankruptcy and Liquidation of Insurance Companies	No		Redefining of the schedule of activities in creation of the regulatory framework in the sector of insurance
Rulebook on the requirements for acquiring the title of an authorised actuary	No		Prepared working draft of the Rulebook
4.2.2.2. CAPITAL MARKET			
Law on Takeover of Joint Stock Companies	Yes		
Law on Investment Funds	Yes		
Preparation of Amendments to the Law on Securities	Yes		
Implementation of the new system of trading in the united stock exchange	Yes		
Continuation of strengthened oversight and control of authorised participants and issuers	Yes		
4.3. LABOUR MARKET			
Law on Amendments to the Labour Law	Yes		
Law on Amendments to the Law on Employment and Work of Foreigners	Yes		
Law on Amendments to the Law on Professional Rehabilitation and Employment of Disabled Persons	Yes		
Law on National Framework of Qualifications	Yes		
Measures for reduction of structural disbalances in the labour market	Yes		
4.5. ADMINISTRATIVE REFORM			
Public administration reform strategy 2011-2016	Yes		
Law on Senior-Grade and Lower-Grade Civil Servants	Yes		
Law on Amendments to the Law on General Administrative Procedure	Yes		
Law on Amendments to the Law on State Administration	Yes		
4.6.1.1. EDUCATION			
Higher Education Development and Financing Strategy	Yes		
Action Plan for Optimisation of the current primary school network	Yes		
External graduation and vocational exams	Yes		
Implementation of the model for ensuring education quality at all levels	Yes		
Increased level of mobility of Montenegrin students	Yes		
Inclusion of local self-governments in financing of education	No		The reason for failure in implementation is a bad financial situation in most of the local self-governments
4.6.1.2. RESEARCH AND DEVELOPMENT			
Increase in participation in European programmes of science, research and technology development	Yes		
4.6.2. PENSION SYSTEM REFORM			
Supplement to the Law on Pension and Disability Insurance	Yes		
4.6.3. HEALTHCARE			
Activities related to fight against HIV, through implementation of the National Strategic Document for fight against HIV	Yes		
National Plan for fight against cancer	Yes		
Draft Law on health insurance where the model of supplemental voluntary insurance is defined	Yes		
Strategy for optimisation of the health care secondary and tertiary level including the Action Plan for implementation	Yes		
Abolishing the option for medical workers to be employed in both private and public sector with the possibility of outside employment in the public sector under the market principles	Yes		
Model for implementation of the institute of public-private partnership	Yes		
Model for full or partial privatisation of specific state health institutions	No		Privatisation

Measures from EFP 2011	Measure accepted (Yes/No)	Date of acceptance/ planned acceptance	Comment
			preconditions are not created
4.6.4. SOCIAL SECURITY			
Social security system analysis	Yes		
Law on Social Security and Child Protection	Yes		
Social map	No		Project hasn't been implemented due to the need to review the concept, which is in progress

ANNEX 3

MATRIX OF POLICY COMITMENTS

Description of policy	Year 2011	Year 2012	Year 2013	Year 2014
1. Policy measure				
A. Implementation profile*				
B. Net direct budgetary impact (if any)	-324.62	-277.09	-247.17	-238.20
B.1 Direct impact on budgetary revenue	228.73	262.31	271.96	298.10
B.2 Direct impact on budgetary expenditure	553.35	539.40	519.12	536.30