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MINISTRY OF FINANCE
Department for Economic Policy and Development

MONTENEGRO PRE-ACCESSION ECONOMIC PROGRAMME
2012-2015

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I ECONOMIC FRAMEWORK

Political and economic seriousness and credibility of Montenegro, democratic values as well as the willingness to integrate the European values and standards aimed at improving the quality of life of citizens have been the key elements of a stable process of approximation of the country to Euro-Atlantic integration in previous years. In 2012, with the beginning of the EU membership negotiations, a new extremely significant step was made in this process. It is realistic to expect that the negotiations will take several years, but their commencement nevertheless points out clearly that the country has entered the final and the most demanding phase of the process that will be completed with the full membership of the country in the EU.

There is something else that the beginning of the EU accession negotiations makes increasingly obvious. Euro-Atlantic integration process as the basic political orientation of the country is becoming also the key economic framework within which Montenegro is to achieve its objectives on the road to renewed economic growth and development of the country as a whole. However, experiences that Montenegro gained in the previous years, starting from the strong economic growth in the period from 2006 to 2008, through recession in 2009, and to economic recovery thereafter clearly confirm that such European integration framework requires economic policies of a good quality and that depends primarily on economic policy makers within the country itself.

In the context of debt crisis in the Euro area and taking into consideration that the fiscal policy is the only macroeconomic policy instrument in the Euroised Montenegrin economy, the Pre-Accession Economic Programme has confirmed its significance of being one of the basic economic programming documents in Montenegro. PEP 2012 has been produced under specific circumstances given the fact that in the mid of October 2012 Parliamentary elections took place. This had two types of effects on the document preparation. In technical terms, there were some delays with respect to the adoption of the budget by the Government, which is understandable given the fact that the new Government was established only at the beginning of December 2012. Still, due to major efforts of both, the new Government and the Parliament, the 2013 budget was adopted on time, i.e. before the end of 2012. In substance terms, it is realistic to expect that based on the programme of the new Government there will be some adjustments or changes in economic policies, but given the short term since the establishment of the Government, they have been included in this year's PEP only to a limited extent.

In relation to the last year's PEP, this year special attention was paid to detailed analysis of the potential economic growth. Thus, in addition to HP filter methodology, this year for the time, potential economic growth has also been calculated based on the *Cobb-Dougllass* production function. In contrast to the pre-crisis period when the growth was based primarily on the high share of fixed capital accompanied with rather minor shares of other factors of growth, in the forthcoming period larger contribution to economic growth will have to originate from other growth generators, primarily from technological progress (TFP-total factor productivity), and the share of fixed capital will be relatively lower. Such a form of economic development is expected to result in an increase of export and therefore in reduction of external imbalances.

After the recovery in 2011, when Montenegro registered one of the higher economic growth rates in Europe amounting to 3.2%, the year 2012 can be considered as one of the hardest years in economic terms in the period after the independence. Many trends were caused by reasons outside the scope of economic policy of Montenegro. Snow and droughts, recession and stagnation in the most

influential economies of the Euro area, oil price leaps and fall of the aluminium price in the world market were the factors that we could only adapt to and only partially mitigate, but not eliminate. Internal weaknesses of Montenegrin economic system that are reflected through its non-diversification, "industrial" heritage and dependence of economic trends on weather conditions (tourism and production from hydro-energy sources) contributed to further deterioration of adverse effects spilled over from abroad. Although in a small and open economy, extremely dependent on regional and international trends, recession under such conditions would be almost certain, Montenegro succeeded to avoid it. Due to introduced economic policy measures, focused strongly on fiscal instruments, the country succeeded to avoid recession in the first half of the year what was not the case for the Euro area. Montenegro succeeded to retain or even improve its position in ratings published by various international agencies, and continued with implementation of structural reforms in the area of public finances, administration, labour market, business environment. Montenegro succeeded not to be another in a row of European countries that increased tax rates for the purpose of addressing the problem of deficit and debt, but improved fiscal performance indicators through mechanisms that affect the threatened social layers to the lowest extent.

Already in the first quarter, it became clear that the base scenario, according to which economy was to increase by 2% in 2012, was not realistic. Extremely bad weather conditions in the country, they required introduction of the state of emergency, paralysed the economy and affected adversely the finances of private and public sectors. The crisis in the Euro area turned out to be even more complex and difficult to resolve, so the reduction of consumption in the Euro area affected Montenegrin economy as well. External shocks accompanied with calling upon the sovereign guarantees for KAP and structural weaknesses of economy resulted in lower than forecasted budget revenues and in higher than forecasted expenditures. According to the budget revision in April 2012, the public finance plan was adjusted to the low-growth scenario. Weaker collection of revenues initiated the revision of excise on heating oil and gas and introduction of new duties (€1 per a SIM card and an electricity meter) as well as the measures in the direction of better collection of revenues and suppression of grey economy. A more restrictive policy related to public sector salaries was applied on the side of the budget expenditures. Developments in the second quarter indicated the recovery of economy through preparations for the summer tourist season and its good start, as well as through growth of agricultural production. On the other hand, with respect to industrial production, the second quarter brought the fall in the production of electrical power caused by regular overhaul of the Thermal Power Plant Pljevlja and the fall in the production of aluminium. The third quarter, with its high share of 32% in formation of GDP of Montenegro, was characterised by good tourist season, growth of electricity production after the overhaul of the TPPP and better collection of government revenues. However, one of the longest droughts of the last decades in Montenegro and a large part of Euro-Asian continent, as well as the growth of fuel price, contributed to the fall of agriculture production and to the increase of food prices, while the KAP crisis continued to adversely affect foreign trade balance.

For the first time the Statistical Office (MONSTAT) published preliminary estimates of quarterly GDP growth in Montenegro already at the end of the third quarter. Thus, the first quarter resulted in the fall of 2.4%, while the second quarter brought a slight recovery of 0.3%. The analysis of macroeconomic trends in the first nine months of 2012 points to the economic growth estimation of 0.5% for 2012 as a whole.

The priority goal of economic policy in 2013 is stabilisation and consolidation of public finances accompanied by creation of conditions for growth of foreign and domestic investments and by continuation of the financial sector stabilisation process. According to the budget for 2013, restrictive government spending policy is continued and basic tax rates are maintained on "one digit" level. The continuation of implementation of the existing and preparation/implementation of

new structural reforms will mark the year of 2013. The requirements for fiscal consolidation and increase of competitiveness of economy have been instrumental for, *first*, the introduction of fiscal rules and for creation of an institutional framework for their consistent application, and, *second*, the amendments to the general collective agreement in the direction of improvement of labour market flexibility and mobility, and of facilitation of requirements for issuance of construction permits in line with the recommendations of international “rating” reports. The fiscal policy continues to prioritise the maintenance of the bank sector stability and liquidity, as well as the contribution to creation of the conditions for increase of lending activity of banks.

In the forthcoming years the economic growth will accelerate. Economic growth projections, in the mid-term period, are based on rather conservative estimates of investment activities. GDP real growth in the mid term is projected at the level of 2.5% in 2013, 3.0% in 2014 and 3.5% in 2015. Macroeconomic low-growth scenario is based on the assumption of deepened adverse trends in the Euro area: recession, reduction of lending activity and increase of unemployment. Such scenario in the Euro area, with structural weaknesses of Montenegrin economy, would result in lower expenditures, which would directly affect export, FDI and tourism. According to this scenario, the following GDP real growth rates are projected in Montenegro: 1.0% in 2013, 1.5% in 2014 and 2% in 2015. In line with the base macroeconomic projections and based on the draft fiscal rules, public finance deficit is projected to have a declining trend in the midterm reaching 0.7% of GDP in 2015. According to the low-growth scenario, the deficit of public finances is expected to go down more slowly reaching an equivalent of 2.3% of GDP in 2015. In line with the projected deficit calculated on the base macroeconomic scenario, government debt will remain at approximately the same level in 2013 and 2014 before declining to 51.7% of GDP in 2015.

Table 1 *Macroeconomic and fiscal framework*

Macroeconomic and fiscal framework (in % GDP)		Outturn	Estimate	Base scenario			Low-growth scenario		
		2011	2012	2013	2014	2015	2013	2014	2015
Macroeconomic indicators	GDP nominal growth	4.2	2.8	5.1	5.6	6.1	3.0	3.5	4.0
	GDP real growth	3.2	0.5	2.5	3.0	3.5	1.0	1.5	2.0
	Deflator	1.0	2.3	2.5	2.5	2.5	2.0	2.0	2.0
	Inflation	3.1	4.0	2.7	2.5	2.5	2.4	2.2	2.2
	Employment	0.8	1.5	1.0	1.5	1.5	0.0	-0.5	0.5
	Current account deficit	-19.6	-20.0	-21.0	-20.4	-19.7	-19.8	-18.2	-18.3
Fiscal indicators	Primary source public revenues	39.7	38.0	37.0	36.0	35.6	37.0	36.0	35.3
	Public spending	41.0	41.8	39.4	37.7	36.3	39.5	38.5	37.7
	Deficit/Surplus	-5.4	-3.7	-2.3	-1.7	-0.7	-2.5	-2.5	-2.3
	Interest	1.5	1.8	2.1	2.4	2.6	2.2	2.5	2.8
	Primary deficit/surplus	-4.0	-1.9	-0.2	0.7	1.9	-0.3	-0.1	0.5
	Government debt	46.0	52.1	54.5	54.3	51.7	55.7	57.2	56.9

Euro-Atlantic integration process on one side, and global economic crisis effects on the other, demand a serious approach to structural reforms that Montenegro has recognised as a condition for overcoming the crisis effects and in the long run for creating a competitive system that will ensure a sustainable economic growth and development. Systemic changes are implemented in all areas of economic system. Enhancement of business environment and reforms in labour legislation remain the priority. The agendas of all sector policies include the harmonisation with European regulations. Administrative reform is moving in the direction of achieving better efficiency and productivity of state administration. Chapter 4 details the implemented and planned reforms, i.e. completed and planned activities within individual areas of structural reforms.

II MACROECONOMIC DEVELOPMENTS

2.1. Macroeconomic Developments in the Period 2011-2012

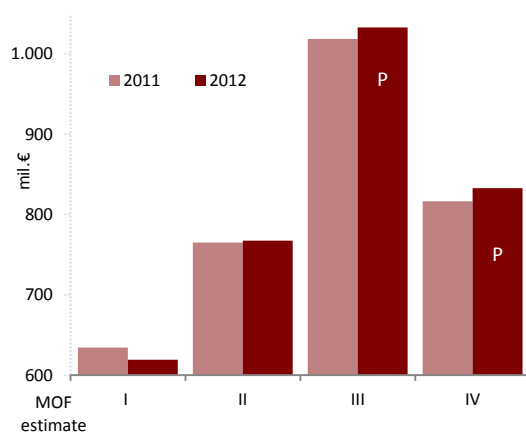
The world economy is still recovering from economic crisis effects but the recovery is slow. The achieved GDP growth rate for 2011 amounted to 3.8%, while for 2012¹ it is estimated to 3.3%. The growth estimate is based on the growth of developed economies of 1.3% (USA 2.2%, Euro area - 0.4%, Japan 2.2, Great Britain – 0.4%), the growth of newly growing economies and developing economies of 5.3% (China 7.8%, India 4.9%, Central and Eastern European countries 2.0%). IMF lowered almost all growth forecasts in October projections in relation to the projections from April 2012, which shows that the world economy position deteriorated in the period between the 2 projections. It is the fiscal consolidation and weak financial system that reduce the growth rates in many countries. It has turned out that fiscal consolidation has much stronger adverse effects on economic growth than it was forecasted (fiscal multiplier is significantly higher at times of crisis). The situation is particularly unstable in the European Union and Euro area, where such effects are particularly expressed. The latest forecast of the European Commission envisages the fall of GDP growth rate by 0.4% in 2012 and stagnation in 2013 (growth rate of 0.1%).

High exposure and tight economic connectivity of the Balkans and Montenegro² with the broader environment of the European Union make this region very sensitive to adverse developments in the environment. All the risks that our country and the region were exposed to have been, to a greater or lesser extent, materialised through: export in the Euro area, conditions of external borrowings, foreign direct investments, lending activity, budgetary balance and public debt. Unfavourable trends and prospects of Western Balkans economies are a limiting factor for Montenegrin economy growth, given that they are its significant economic partners.

2.1.1. GDP

Montenegrin economy generated GDP real growth of 3.2% in 2011 and it is higher than estimated. The growth is the result of growth in agriculture, processing industry, retail, tourism and construction, and the fall in the generation of electrical power had an adverse impact. Expenditure

Figure 1 Quarterly GDP - Q12/Q11



side of GDP shows that the highest share in GDP growth was related to household consumption (3.3%) and export of goods and services (4.6%), while adverse contribution was caused by the fall in gross investments (2.1%) and reduced government expenditures (0.6%).

Montenegrin economy generated GDP fall of 0.9% in the first half 2012. This fall resulted from extreme weather conditions in the first quarter 2012, adverse effects caused by the crisis in the environment and internal structural weaknesses. Economic activity downturn was more expressed in *the first quarter* and it amounted to 2.4% on annual level. There has been fall in agriculture (-5%), generation of electricity (-35%), transport (-3,5%),

¹ World economic outlook - October 2012

² Montenegro generates 75% trade with European countries, Banking sector is under the ownership of banks from the region (90% ownership), majority of investments inflow of is from European countries, the tourists from Europe make 95% of foreign guests²

as well as on the position of taxes-subsidies on products (-7%). Estimated effect of bad weather conditions on economic growth amounts to 1.3%. In the *second quarter*, there was slight recovery and real growth of economy of 0.3%, supported by the growth in agriculture and processing industry.

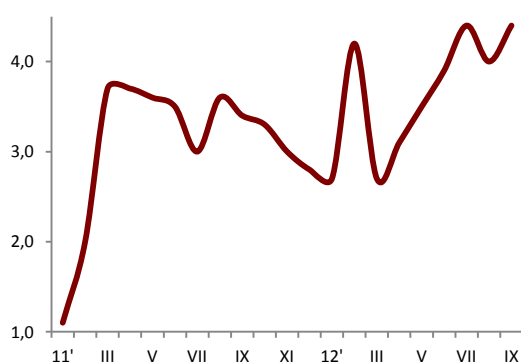
Slight recovery of Montenegrin economy initiated in the second quarter continued in the third quarter as well. Supported by the growth in the sectors of tourism, agriculture and generation of electrical power, Montenegrin economy generated growth³ of 1.5-2% in the third quarter. Preliminary results for the first three quarters show that Montenegrin economy compensated the minus from the first quarter. Although indicators for the fourth quarter are not available, it is possible to make approximate estimate of GDP trends until the end of 2012. As to achieve the projected GDP annual growth rate of 0.5%, real growth in the fourth quarter should be around 2% on annual level.

Although the data on expenditure side of GDP are not available for 2012, it is certain that adverse contribution to GDP will result from the fall in export of goods (aluminium), mitigated by the growth of export of services (tourism). For the first three quarters, the export of goods went down by 16%, while the revenues from services went up by 5%. Weak growth of import will be a neutral item (1.5% in nominal amount, real fall of 0.2%). Available indicators of household consumption, as the most significant GDP item, show that it is difficult to expect significant growth of this position, since real salaries for ten months of this year are lower by 3.2%, while the number of employees increased by 1.9%. Average pension is really lower by 2.8%. The need for fiscal consolidation will also reduce the share of government spending in GDP formation.

2.1.2. Inflation

Annual inflation rate, measured by consumer price index, in 2012 had a growing trend and ranged from 3.1% in January to 5.2% in October. Natural disasters in Montenegro, effects of economic crisis in Euro area and turbulent upheavals on the world

Figure 2 - CPI- Consumer price index



economic stage significantly affected the level of prices of goods and services included in the consumer basket of Montenegrin citizens. The inflation growth in 2012 was mostly affected by a) the growth of electrical power prices (in January 6.1%, July 3.1% and August 6.5%), b) the growth of fuel prices, due to changes of oil prices in the world market that Montenegro, as an importer of oil derivatives, cannot influence on, c) the growth of food prices as a result of reduced supply of domestic food products, caused by snow

conditions, d) the growth of duties and excise, which led to the growth of prices of goods that are subject to application of new regulations (tobacco, alcohol beverages, fizzy drinks and coffee). Annual inflation rate, measured by the consumer price index in October 2012 amounted to 5.2%, which is higher by 1.3 p.p. in relation to the end of the second quarter. The greatest effect on the measured inflation rate was dominantly determined by the growth of food prices (6.8%), electrical power (17.6%), tobacco (16.5%), fuel and lubricants (6.3%) and clothes (6.3%). In the period January – October, in relation to the same period last year, production prices went up by 1.2%, import prices by 1.9%, while export ones went down by 6.7%, as a result of reduction of prices of base metals (-9.4%). Although macroeconomic projections from October forecasted inflation of 4.0% at the end of

³ Estimate of the Ministry of Finance

2012, it is certain that it will be higher due to sharp leap of prices in October. According to the latest forecasts of the Central Bank (November 2012), it is expected that inflation will increase in relation to the previous year, so it is envisaged that it will range from 4.7% to 6.0% during this year. The increase of this range was affected by the growth of prices at the beginning of the fourth quarter.

2.1.3. Labour Market and Salaries

Slight recovery of Montenegrin economy in 2011 affected the growth of employment in relation to 2010 by 0.8%, while real salaries went down by 2%.

In 2012, the trend of increasing employment and decreasing unemployment continues, as well as the decreasing of real salaries. Number of employed persons in October 2012 amounted to 168,701, while the number of unemployed persons was 29,540, and it decreased by 2.1% in relation to October 2011. In the period January-October 2012, the number of employed persons went up by 1.9% in relation to the comparative period 2011, while the number of unemployed persons in the same period went down by 2.9%. Unemployment rate reduced in October 2012 in comparison to October 2011 from 13.0% to 12.7%. The number of advertised vacancies in the period January-October 2012 amounted to 20,948, which is by 1.0% higher than in the comparative period 2011, and at the same time 17,921 work permits were issued to foreigners, which is higher by 5.6%. The number of new job seekers also increases, so in October 2012 their number was by 5.5% higher than in October 2011. Average salary in October 2012 amounted to €717, which is by 0.8% higher than in October 2011. Average salary excluding taxes and contributions amounted to €480 in October 2012, which is by 0.6% higher than in October 2011, and really, it went down by 3.2% in the period January-October 2012 in relation to the same period 2011.

2.1.4. External Sector

Current transaction deficit in 2011 amounted to €634 mill (19.6% GDP), which is by 17.0% less than in the previous year, and it resulted from the growth of net revenues from services, current transfers and factor income, while the merchandise trade balance slightly deteriorated.

Current account deficit, which is increasing due to the growth of foreign trade deficit in the first three quarters 2012, amounted to € 330.9 mill or 10% of estimated GDP, which is by 6% higher in comparison to the previous year. Fall of exports by 15.7%, primarily resulting from the fall of export of aluminium by 24.4% and iron and steel by 29.2%, with import increased by 1.5% led to the increase of merchandise trade deficit by 7.6%. Such trend is expected to continue by the end 2012. On the other side, standard good export of services, headed by the record revenues from tourism, and surpluses generated on accounts of factor income and current transfers cover 69% of foreign trade deficit. Surplus has been generated on account of services, which for the first nine months amounted to € 610.8 mill or 18% of estimated GDP for 2012.

Net foreign direct investment inflow in 2011 amounted to €389.1 mill or 30% less in relation to 2010.

In the first three quarters 2012, net foreign direct investment inflow amounted to €302.6 mill, or 11.6% more in comparison to the same period last year, which resulted from the growth of investments into real estate (36.7%) and investments in the form of inter-company debt (17.7%). Based on the previous trends it is realistic to expect that in 2012 net direct investments will exceed the last year's level. In the FDI inflow, investments in enterprises and banks make 22.5% of the total inflow (of which a third related to recapitalisation of banks), inter-company debt 26%, while 43.8% investments related to real estate.

The value of net errors and omissions in the period from 2009 to 2011 amounted on average to 12% GDP. This trend also continued in 2012, when in the first half of the year the value of net errors and omissions amounted to 14.7% GDP (GDP is a quarterly estimate of MONSTAT). The position of net errors and omissions shows that some transactions have not been included (errors) at all or have been valued in an inadequate fashion (omissions). It does not show directly where discrepancies occur. In case of Montenegro, due to use of euro as a tender currency and significant payments in cash, particularly in the area of tourism, it is not simple to account for all transactions since there is no possibility to make distinction between domestic and euro of foreign origin. Therefore, it is possible to underestimate some payment balance positions such as revenues from tourism, remittances from abroad, retail deposits whose source is the transactions with non-residents and the like. On the other hand, reasons can also be sought in the potential overestimation of some positions (e.g. positions of import of goods). Extremely high merchandise trade deficit, which ranged from 40% GDP to even 65% GDP in the previous years, arouses suspicion of its reasonableness, because in international practice, such high deficits are very rare and it is very difficult to find economic justification for them from the aspect of possibility of their financing. In addition, high differences in data that were found by comparing the data of domestic statistics to the statistics of individual foreign trade partner countries (mirror statistics) impose a dilemma if the deficit is actually that high.

Table 2: Foreign direct investments by sectors, in mill €

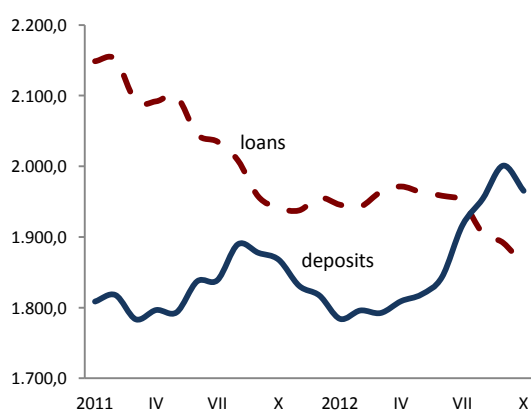
	2011				2012		
	IQ	IIQ	IIIQ	IVQ	IQ	IIQ	IIIQ
Investments in domestic enterprises and banks	53.8	32.4	40.8	30.7	20.7	22.4	46.0
Inter-company debt	34.1	25.5	27.9	45.3	20.4	38.7	43.8
Real estate sale in Montenegro	31.3	42.1	53.5	57.4	43.0	63.5	67.0
Other	8.2	4.3	0.3	7.3	0.1	2.9	27.9
Total inflow	127.3	104.3	122.5	140.7	84.2	127.5	184.6
Total outflow	11.2	36.8	34.8	22.8	29.7	41.4	22.7
Net FDI	116.1	67.5	87.6	117.9	54.5	86.1	161.9

Source: Central Bank of Montenegro

2.1.5. Banking Sector

Economic activity slowdown, deterioration of creditworthiness of legal entities and increase in the number of illiquid companies had a significant adverse impact on the banking sector in 2011. Impact of economic developments was particularly expressed in the first half of the year, and it reflected on the increase of the share of non-performing loans and default loans in the total loans, and also in the growth of written-off loans. In the second half of the year, some banks "cleaned" their balances (sale or transfer of a part of the credit portfolio to factoring companies or mother banks), so the year finished with significantly improved quality of credit portfolio of banks, i.e. reduced level of non-performing assets. This, further, resulted in the increase of solvency ratio. In addition, business activities of banks in 2011 were characterised by satisfactory liquidity and also continuation of the restrictive lending policy. Expressed maturity mismatch of sources of funds and placements still represents an adverse factor. In 2011, banks were recapitalised in the total amount of €20 mill

Figure 3 Total loans and deposits (mil.€)



performing assets. This, further, resulted in the increase of solvency ratio. In addition, business activities of banks in 2011 were characterised by satisfactory liquidity and also continuation of the restrictive lending policy. Expressed maturity mismatch of sources of funds and placements still represents an adverse factor. In 2011, banks were recapitalised in the total amount of €20 mill

In 2012, banking sector was stable with growing tendency of deposit potential, which exceeds their placements. Although the banks consolidated after the first wave of the crisis, they are still

implementing a restrictive and prudent policy of approving new loans; therefore there was a fall in the lending activity. Financial result of banks for nine months is negative. Banks are burdened with high level of non-performing loans and slow collection of previously approved loan placements. Although the total deposits in October 2012 went down by 1.8% on monthly level, their amount in the last three months ranges above the total loans level. On annual level, total deposits went up by 5.2%. Viewed from sector aspect, retail deposits amounting to €1,114.7 mill have the greatest share in the total deposits of 56.7%, and it is by 9.0% higher in relation to the same month last year. The value of total loans amounted to € 1,859.3 million, which is by 1.7% lower in relation to the previous month and 4.2% on annual level. Debt in respect of loans of economy sector amounted to € 891.8 mill and it went down by 1.9% on monthly level, while retail loans went down by 2.4% on annual basis. Lending interest rates on loans amounted to 9.5%, which is slightly lower in relation to September (9.53%), while deposit interest rates went up and amounted to 3.24%. Due to the present growing trend of interest rates on newly approved loans (11.32% in October), as well as extremely high interest rates on individual loan placements, CBM passed the *Decision on interim measures for limiting bank interest rates*, which limited interest rates on retail loans to 15% p.a., and 14% for legal entities. One of the risks for financial stability is default loans which amounted to € 473.4 mill and went up by 7.6% on monthly basis, while they went down by 7.9% on annual level. Also, non-performing loans went down by 5.7% on monthly basis, so their share decreased from 18.5% in September to 17.7 % in October. Economy liquidity is still unfavourable, so there are 11,964 legal entities under blockade or 23.1% of the total number of registered companies, which is by 0.5% higher on monthly basis. The value of debt amounted to €398.5 mill, which is by 2.3 % higher in comparison to the previous month and 5.5% in relation to the end of the previous year.

2.2. Base Macro-economic Scenario for the Period 2013-2015

Macro-economic projections for the period 2013-2015 envisage real GDP growth rates of 2.5% in 2013, 3.0% in 2014, and 3.5% in 2015. Montenegrin economy will be under negative impact of the Euro area crisis even in 2013, which will primarily reflect on availability of financial resources and investments. GDP growth rate of 2.5% in 2013 is based on the assumption that natural (climate) conditions will be within normal parameters. In 2014 and 2015, growth of the Montenegrin economy will accelerate by engaging domestic potentials, primarily tourism and energy, and by moderate increase in lending activity and exports. In years covered by the projection, inflation will be stable and somewhat higher than the Euro area one.

The following external environment assumptions were taken into account in projections:⁴

- Crude oil price in 2013 will be 109 \$/bbl, with a downward trend in 2014 (103 \$/bbl);
- Euro exchange rate will be 1.29 USD/EUR during the entire period;
- Inflation will be 1.8% in 2013 and 1.6% in 2014; and
- Food prices in 2013 will be at the same level as in 2012, which is a continued effect of extreme drought.

Macro-economic scenario for 2013-2015 uses the following assumptions:

- In the period 2013-2015, foreign direct investments will maintain the stable share of 10% of GDP;
- Banks will stop “exporting liquidity”. Deposits will be stable;
- Banking loans will start to grow, but somewhat more slowly than the nominal GDP growth, so that their share in GDP will decline;

⁴ External assumptions were taken from October projections of the European Commission.

- Following the drop in export in 2013, the share of export in the total growth (2014-2015) will be around 2.7%;
- As a consequence of decline of export (2.1%) and growth of import (1.7%), the current account deficit will increase in 2013 to around -21% of GDP, as to gradually decrease by 2015;
- Low base caused by adverse climate events in 2012 will determine the growth of 1.3%;
- Deflator is projected to around 2.5% during the entire period, which is in line with the Euro area projections;
- Employment will record a gradual growth over the entire period, resulting from gradual growth of economy, adjusted in accordance with the need to increase competitiveness and required structural reforms. Employment growth is projected to 1.0%, 1.5%, and 1.5%;
- Inflation projections forecast a reduced rate, if compared to 2012, as a consequence of weak demand, stable or lower energy prices and stable food prices. In the period 2013-2015, the inflation rates will be 2.7%, 2.5%, and 2.5%.

Table 3 Montenegro: Macroeconomic projections 2013-15 Base Scenario

Montenegro: Macro-economic projections, 2013-15 Base Scenario			
	2013	2014	2015
Nominal GDP in million €	3,493	3,687	3,912
Real growth	2.5	3.0	3.5
Deflator – growth	2.5	2.5	2.5
Inflation (HIPC)	2.7	2.5	2.5
Employment	1.0	1.5	1.5
Core items:			
Current account deficit	-21.0	-20.4	-19.7
Export	35.7	36.3	37.0
Import	-60.7	-60.2	-59.7
Other	4.0	3.5	3.0
Private deposits	50.0	50.0	50.0
Bank loans – domestic	57.1	55.6	55.4
Household consumption	85.4	84.6	82.5
Gross fixed capital formation	18.9	18.9	19.9
Current government spending	21.4	21.1	21.0
Nominal GDP growth	5.1	5.6	6.1
Household consumption	4.4	3.9	2.9
Gross fixed capital formation	1.8	1.0	2.2
Current government spending	0.8	0.9	1.2
Net export	-1.8	-0.3	-0.3
Export	-0.8	2.6	2.9
Import	-1.1	-2.8	-3.1
Core assumptions			
FDI (as % of GDP)	10.0	10.0	10.0
Net foreign assets (as % of GDP)	-0.6	-0.2	0.3
Bank loans	2.2	2.7	5.7
Export growth	-2.1	7.3	8.1
Import growth	1.7	4.7	5.2

Comparison of the Base macro-economic projections from the last year's and this year's PEP, shows significant differences, which result from external impacts and problems in the real sector of economy:

- Real GDP growth for 2012 is lower by 1.5%, which is caused by the fact that adverse climate conditions in the first quarter and decline in production which consequently implies decline in export have caused a significant economic activity downturn. The Budget revision of April

2012 acknowledged this reality and took the low-growth scenario from the PEP for 2012-2014 as the base scenario, which envisaged the growth of 0.5% as a consequence of activation of the risks stated in the document;

- Inflation rate for 2012 (5.2% in October) will be considerably higher than the one projected in the previous PEP (2%), which is a consequence of growth in administrative prices, prices of oil products on the global market and higher prices of food resulting from extreme drought in grain-growing regions of Americas and Europe;
- Projections of export for 2013 and 2014 are also significantly lower, caused by production downward trend, and consequently of aluminium export;
- A pronounced difference was the one in projections for the growth of banking activities (8% on average in the period 2012-2014). Banking sector is reducing assets, which is a consequence of more difficult accessibility to financing, need for consolidation, as well as the risk assessments arising from the high level of default loans in the internal market; and
- Projections of foreign direct investments are much lower (2.3% on average in the period 2012-2014) which is a consequence of investors' caution which postponed implementation of some of important projects.

As already mentioned, the Budget revision from April of this year reduced these differences by using the low-growth scenario.

2.2.1. Real Sector

Determining and measuring the position of the Montenegrin economy in a business cycle is made difficult and maybe even prevented by frequent and significant changes in the transition economy, short time-series or lack of data, thus the results of this analysis need to be taken with reservations. This-year's calculations of the business cycle position also include the estimate of potential GDP using the CD⁵ production function, in addition to the calculation of potential GDP with HP⁶-filter. Even though calculated based on use of many estimated base assumptions (value of the fixed capital), it reflects and estimates impact of all growth factors, therefore the text to follow will address results obtained from the function. With projected growth rates, Montenegrin economy will, in the period 2013-2015, slowly approximate the potential GDP, after a sharp retraction in 2009 and moderate growth rates in 2010 and 2011. One of the risks that may arise on this path is also the activation of negative impact of contracted economic activity in the Euro area, recession in the neighbouring countries, and inherited structural weaknesses and the need for fiscal adjustments.

The business cycle commenced in 2005 and had sharp oscillations, which is shown by the top-down range, which amounted to around 10% of GDP. After the boom in 2007 and 2008, there was a sudden adjustment in 2009, followed by certain stabilisation in 2010 and 2011. In 2012, a deferred effect of the crisis is present, marked by stagnation of economic activities. The growth of the economy in line with projected rates will approximate generated GDP to its potential level at the end of this cycle (2016). During the entire cycle, the potential growth rate was around 3.2%. Only by unleashing the potential that our economy has, primarily through implemented structural reforms (reform of the pension system and reform of the labour legislation) and those to follow, it is possible to raise the potential rate to the higher level.

⁵ Cobb-Douglas

⁶ Hodrick Prescott

Figure 2

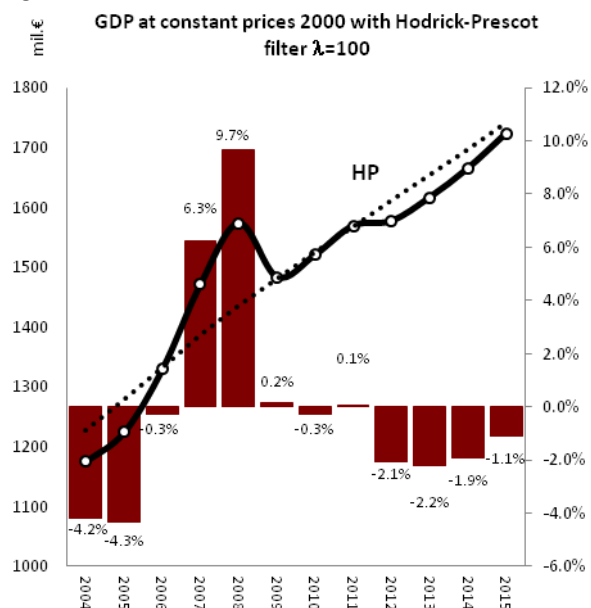


Figure 5

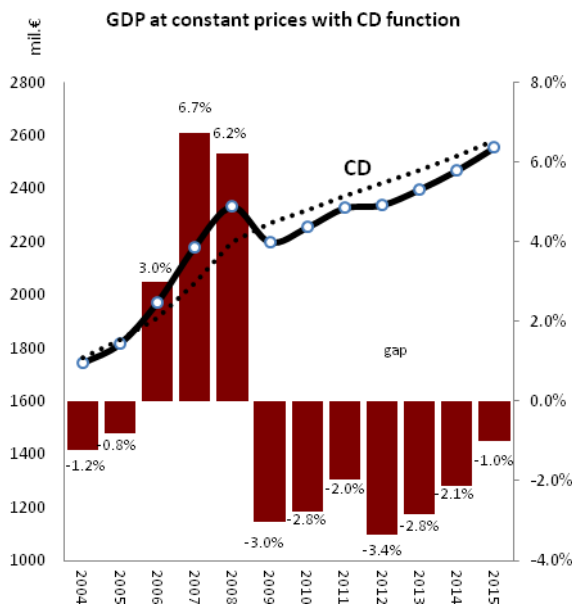


Table 4: Potential GDP and gap (using the CD function calculations)

	GDP	Potential GDP	GDP Gap	GDP growth rate	Potential GDP – growth rate	GDP Gap – as % of potential
	1	2	3	4	5	6=5-4
2004	1,742.2	1,764.0	-21.8	4.4	3.7	-1.2
2005	1,815.0	1,829.7	-14.7	4.2	3.7	-0.8
2006	1,970.5	1,913.2	57.3	8.6	4.6	3.0
2007	2,180.5	2,043.1	137.4	10.7	6.8	6.7
2008	2,331.4	2,195.5	136.0	6.9	7.5	6.2
2009	2,199.5	2,268.7	-69.2	-5.7	3.3	-3.0
2010	2,253.7	2,318.3	-64.5	2.5	2.2	-2.8
2011	2,326.5	2,373.4	-46.9	3.2	2.4	-2.0
2012	2,338.1	2,419.3	-81.2	0.5	1.9	-3.4
2013	2,396.6	2,466.7	-70.2	2.5	2.0	-2.8
2014	2,468.5	2,522.4	-53.9	3.0	2.3	-2.1
2015	2,554.9	2,581.0	-26.1	3.5	2.3	-1.0

Even with reservations, the results obtained by applying the CD production function indicate that in the years of boom the share of fixed capital is the main growth factor (2007-2008), with negligible share of other factors. The results of the CD function indicate that the growth envisaged by medium-term projections for 2013-2015 will be stimulated by technological progress (TFP – total factor productivity) and growth of fixed capital, with insignificant share of labour force.

Table 5: Breakdown of GDP growth based on the CD function

	Potential GDP in % year-to-year	TFP	Labour force	Capital
		Share in growth %		
2004	3.7	1.3	1.2	1.0
2005	3.7	1.2	1.2	1.3
2006	4.6	1.1	1.2	2.2
2007	6.8	0.9	1.3	4.5
2008	7.5	0.8	1.1	5.5
2009	3.3	0.8	0.0	2.5
2010	2.2	0.8	-0.1	1.5
2011	2.4	0.9	0.4	1.0
2012	1.9	1.0	0.0	0.9
2013	2.0	1.1	0.0	0.9
2014	2.3	1.1	0.2	0.9
2015	2.3	1.2	0.2	0.9

The Base macro-economic scenario for 2013-2015 is based on the projection of growth of production factors, primarily in: agriculture sector (low base in 2012 due to adverse climate conditions); retail sector; tourism sector, transport sector, information and communication sector, and financial sector. Negative contribution is expected in construction sector and public administration sector in the first year, while the years to follow would result in stagnation. Negative contribution of public sector is the consequence of projected fiscal adjustments required to regain macro-economic stability and investors' confidence.

2.2.2. Inflation

Inflation projections in the base macro-economic scenario are based on external assumptions, precisely on gradual drop in oil prices; stagnation of the food prices in 2013, with slight decline in the forthcoming period and stable euro exchange rate (1.29 USD/EUR).

Inflationary expectations are product of depressed demand affecting the inflation decrease and expected fiscal measures which are impacting the inflation rise over a medium term (administrative sources driven inflation). Uncertainties concerning the expected set of fiscal measures (decrease of expenditures, increase of revenues) affect the uncertainty of these projections, thus the inflation over the medium term is projected to be somewhat higher than the one of the European Commission projections (around 1%). Since Montenegro uses euro, the impact of the Central Bank of Montenegro on inflation developments via monetary policy is limited.

2.2.3. External Sector and its Medium-term Sustainability

The Base macro-economic scenario for 2013-2015 envisages the deterioration of the balance of payment position in 2012, so that the estimated deficit would be around 20% of GDP, resulting from decline in export of goods, but alleviated by growth in revenues from services and growth of the net current transfers. In 2013, the further deterioration of the balance of payment position is envisaged, due to the assumption on further drop of exports of 2.1% because of deteriorated situation in the processing industry and further decline in exports, as well as because of the slow growth in imports, which was the consequence of reduced export (high percentage of imports is for the metals industry needs). The current account deficit would reach 21% of GDP. In the period 2014-2015, a gradual reduction of the deficit is envisaged, which is a required prerequisite for further growth because of to low level of the domestic economy competitiveness. The current account deficit would drop to 19.7% of GDP in 2015. The base macro-economic scenario envisages a gradual decline of share the current transfers and revenues balance and reduction of their share from 4.5% of GDP to 3% in 2015.

The crisis in the Euro area underlined the vulnerability of its peripheral economies through worsening of competitiveness. This has deteriorated the balance of payment position of those countries, since the increase of competitiveness cannot be achieved by the currency devaluation (use of the common currency). Necessary adjustments must be achieved through a slow process of internal devaluation via reduction of wages and structural reforms.

The balance of payments position of Montenegro certainly shows that it is necessary, as soon as possible, to address these challenges. Export makes only 11% of the total foreign trade exchange, and if the aluminium is excluded it makes 6% (2011). High share of adjusting items of the balance of payments, pertaining to net errors and omissions (10.6% of GDP in 2011), makes the analysis of the balance payment position more difficult.

Overview of assessments, published by the World Economic Forum, shows that despite implemented reforms Montenegro has lower rating in the competitiveness report for 2012-2013 if compared to the previous report. The Table 6 presents the rating overview for individual competitiveness factors.

Table 6:

	2011-2012	2012-2013	difference
Global competitiveness index (score 1-7)	4.3	4.1	-0.2
Basic requirements (40%)	4.7	4.5	-0.2
Institutions	4.5	4.4	-0.1
Infrastructure	4.0	4.1	0.1
Macro-economic environment	4.5	3.8	-0.7
Healthcare and primary education	5.8	5.7	-0.1
Efficiency enhancers (40%)	4.1	4.0	-0.1
Higher education and training	4.6	4.6	0.0
Goods market efficiency	4.5	4.4	-0.1
Labour market efficiency	4.6	4.1	-0.5
Financial market development	4.6	4.5	-0.1
Technological readiness	4.0	4.1	0.1
Market size	2.0	2.1	0.1
Innovation and sophistication factors (10%)	3.6	3.6	0.0
Business sophistication	3.8	3.8	0.0
Innovation	3.4	3.3	-0.1

Source: the World Economic Forum Report 2012-2013 and 2011- 2012

The table indicates main causes of the reduction of the ratings, primarily substantially lower rating of macroeconomic environment, which is understandable considering the risks our economy will be exposed to in the forthcoming period. Second important factor is the reduction of the labour market efficiency. The labour market which is still rigid and structural mismatch of supply and demand, are the main factors for this deterioration.

Simplified analysis of the unit labour costs (ULC) shows that Montenegrin economy is in the phase of internal devaluation in form of real decline in wages, resulting in reduction of the unit labour costs.

Table 7

	Average number of employees - MONSTAT	Average number of employees (labour market survey) ⁷	Average gross wage + contributions attributed to the employer	Nominal GDP in mill €	ULC ratio	Rate of change
2010	161,742	202,195	796.1	3103.9	0.62	..
2011	163,082	196,000	804.4	3234.1	0.58	-6.0%
2012 ⁸	165,528	198,940	806.9	3324.0	0.58	-0.9%
2013 ⁹	168,011	201,924	806.9	3492.6	0.56	-3.4%
2014	169,691	203,943	827.1	3687.3	0.55	-1.9%
2015	172,237	207,002	849.4	3911.8	0.54	-1.7%

It is to be expected that the positive impulses for the improvement of the situation will not come either from the environment or over the short-term, as the improvement of the balance of payment positions in the EU countries will not be without significant medium-term changes in policies and structural reforms. The situation is further complicated by the fact, which became evident during the previous crisis, that the present instabilities are spilling over not only through financial channels but also via trade in goods (both among countries and within borders of a country). It is evident that the

⁷ The difference occurs because the number of employees is a difference between the number of unemployed from the Survey and the level of active labour force

⁸ Data for 2012 are estimates of the Ministry of Finance

⁹ Data for 2013-2015 are projections of the Ministry of Finance

balance of payments situation of Montenegro is far from desirable one over the next medium-term period. This could be achieved by implementing adequate structural reforms that could aim to increase the competitive ability of the Montenegrin economy, which entails faster implementation of reforms pertaining to improvement of the investment climate, further reform of the labour market and education and further integration in the global commerce trends. Particular attention is due also to the reforms of the social welfare system, which needs to take into account assumptions on demographic trends and expected level of the economic growth. Experiences from other countries (IMF, Pilot External Sector Report, 2012) show that limited social allowances have positive impact on increase of household savings, and therefore on national savings as well. However, no reforms without further efforts concerning strict fiscal consolidation and future borrowing will improve significantly the foreign trade balance position of Montenegro.

Box 1: Balance of Payments – revised data

Final data on the Balance of Payments for 2011 (CBOM) and revised data for the period 2005-2010, which were published after the adoption of macro-economic projections which make an integral part of this document, have significantly corrected some items. Corrections are caused by changes in the current account of the balance of payments in the item revenues from tourism, while in financial accounts the item of fixed investments was changed by increasing the item of cash and deposits and offsetting between assets and liabilities.

	2005	2006	2007	2008	2009	2010	2011
A. CURRENT ACCOUNT (1+2+3+4)	0.0	0.0	0.0	25.4	51.0	54.0	61.1
2. Services	0.0	0.0	0.0	25.4	51.0	54.0	61.1
B. CAPITAL AND FINANCIAL ACCOUNT	119.1	71.3	166.8	140.5	112.3	141.1	135.0
B2. Financial account	119.1	71.3	166.8	140.5	112.3	141.1	135.0
3. Other investments	119.1	71.3	166.8	140.5	112.3	141.1	135.0
3.1. Assets	119.1	71.3	166.8	140.5	112.3	141.1	104.3
3.2. Liabilities	0.0	0.0	0.0	0.0	0.0	0.0	30.7
C. NET ERRORS AND OMISSIONS	-119.1	-71.3	-166.8	-165.9	-163.3	-195.2	-196.1

This change is causing a need for the GDP data to be reviewed by changing the item of revenues from export of services, which will in case the revision is done increase the nominal GDP amount. Estimates of the Ministry of Finance show that these changes will also cause the decrease of the current account deficit, both due to reduction of the current account deficit and due to increase of nominal GDP.

% of GDP	2008	2009	2010	2011
Current account deficit	-49.3	-27.4	-22.5	-17.4
Net errors and omissions	2.2	6.3	6.3	4.8

The current account deficit is lower by 2.2 p.p. if compared to the one resulting from previous data, and net errors and omissions are down to 4.8% of GDP and were reduced by 6.1 p.p. In spite of this adjustment, the current account deficit remains high, and up to now was primarily financed by high inflow of foreign direct investments. Adjustment of such high deficit is a priority due to high risks of the balance of payments crisis resulting from reduction of high inflow of foreign direct investments and to certain extent by reduction of inflow from transfers from abroad.

In case of Montenegro, due to use of euro as a tender currency and significant payments in cash, particularly in the area of tourism (grey economy), it is not simple to account for all transactions since there is no possibility to make distinction between domestic and euro of foreign origin*. Therefore, it is possible to underestimate some payment balance positions such as revenues from tourism, remittances from abroad, retail deposits whose source is the transactions with non-residents.

*This is the case with majority of countries using euro (Germany, Austria, France and like), because the starting assumption of the methodology in use is that each country has its own currency. In case of countries where this is not the case, it is more difficult to account for all balance of payments flows and thus resulting in sizeable net errors and omissions.

2.2.4. Financial Sector

The Base macro-economic scenario for 2013-2015 forecasts a constant growth in deposits and moderate growth of lending activity (somewhat lower than the growth of nominal GDP). The growth of lending activity is a necessary prerequisite for the real sector growth. Stable share of private deposits (natural persons and non-financial organisations) of 50% of GDP is projected over the entire period – average growth of 5.6% during the period. This projection takes into account the growth of deposits in the previous period, which is an indicator of confidence in the financial system. A decline of share of loans is envisaged from 57.1% of GDP to 55.4% at the end of 2015, due to lower growth rate if compared to the nominal GDP growth.

2.2.5. Medium-term Risks

Small Montenegrin economy is facing the retraction of foreign demand caused by the crisis and is inevitably suffering consequences which are reflected on all sectors of the economy. Macro-economic and fiscal risks (deteriorations), which can materialise by the end of the year and over the forthcoming medium-term period, are:

1. Certain spill-over of recession processes from the immediate and broader Euro area environment and reduction in demand and available income in these countries can have negative retroactive effect on the Montenegrin economy through reduction of demand for our export products, including tourism as well;
2. Further decline of lending activity, caused by reduced available lending assets (crisis of the banking sector in countries of origin of parent banks – Italy, Slovenia, Austria, Hungary) and reduced demand for loans due to lower economic activity. In the latest World Economic Outlook (WEO), IMF warns of withdrawal of capital from banking systems of the threatened Euro area countries to the countries of the EC centre (Germany, Austria, and the Netherlands). This withdrawal reduces the lending activity, undermines the growth and increases the already high unemployment rate;
3. Lower inflow of foreign direct investments caused by the decline of investments in the EU, resulting from investors' uncertainty. This risk is effected through the drop in aggregate demand, import and budget revenues, negative impacts on liquidity and increase of unemployment;
4. Worsening of conditions on financial markets would make future borrowings expensive and unsustainable;
5. Further deepening of the crisis in KAP, through further reduction of production, would influence further decrease in export and reduction of budget revenues or increase of expenditures for further subsidies of the electricity price. Analysts do not foresee growth in the aluminium prices over the medium term, due to high supply and inventories on the LME¹⁰ of -10 million tonnes. Producers are reducing production and closing smelters (-2.1% of decline in the period January – August 2012);
6. Additional fiscal obligations could occur due to calling upon the guarantees, which would put in question the sustainability of the budget and achieving the set fiscal objectives;
7. A need for reducing public expenditure deficit, causing the economic activity downturn. Average fiscal multiplier is 0.5, which means that 1% of reduction of deficit is resulting in reduction of 0.5% of GDP. IMF experts (WEO) estimate that this coefficient is considerably higher, 0.9-1.7, in particular during recession times;
8. Further growth of oil products prices, which are currently at the level of 110 \$/T, puts a negative pressure on the growth of prices of broad assortment of products and economic activity downturn through inflationary pressures and reduced demand; and

¹⁰ London Metal Exchange

9. Continuation of negative trend in collection of budget revenues would additionally sharpen the question of fiscal adjustments, because it would require either further reduction of expenditures or increase of taxes. Need to restructure sovereign debt or to repay it in 2015 makes these adjustments urgent because of the confidence of possible investors.

Macro-economic and fiscal risks – probability of positive deviations – refer to activation of some of the delayed investments which would stimulate the growth of economy above the projected rates, since a relatively small investment in European terms (100-200 million euro) would have positive and multiplying effects on the growth of economic activities.

2.3. Low-growth Macro-economic Scenario for the Period 2013-2015

The Low-growth macro-economic scenario is based on the assumption of deepening of negative trends in the Euro area: recession, slowing of lending activity and increase of unemployment. Such scenario in the Euro area would impact the Montenegrin economy in the form of lower spending, which would have direct impact on export, FDI, and tourism. High probability of internal weaknesses and risks materialising and worsening would provide an additional impulse for the economic activity downturn. Under this scenario, the following Montenegro GDP growth rates are projected: 1.0% in 2013, 1.5% in 2014, and 2% in 2015.

The Low-growth scenario is based on the following assumptions:

- In the period 2013-2015, FDI is lower and amounts to 9% of GDP, banks continue to downsize the assets, and deposits are smaller;
- Lending activity is slowing down and its share in GDP is decreasing, at the average annual rate of 2.4% until 2015;
- Following the drop in exports in 2013, imports are growing at somewhat lower rate than in the Base scenario;
- Imports have a sharp decline in 2013 and drop until 2015, reducing the current account deficit to 18% of GDP;
- In spite of the GDP growth resulting from the low base in 2012, the growth rate is 1% and continues with the weak growth over the entire period;
- In this scenario, the deflator is lower (2%), due to deflationary developments caused by a weaker aggregate demand;
- Employment stagnates or decreases during the entire period, resulting from weak growth of economy, the need to increase the competitiveness and necessary structural reforms. Projected growth rates for employment are: 0.0%; -0.5%; and 0.5%;
- Inflation projections forecast reduced rates if compared to 2012, as a consequence of weak demand and low growth of economy, stable or lower energy prices and stable food prices. In the period 2013-2015, inflation rates are: 2.4%; 2.2%; and 2.2%.

Table 8

Montenegro: Macro-economic projections, 2013-15, *Low-growth Scenario*

	<u>2013</u>	<u>2014</u>	<u>2015</u>
Nominal GDP in million €	3,425	3,546	3,689
<i>Real growth</i>	1.0	1.5	2.0
<i>Deflator – growth</i>	2.0	2.0	2.0
<i>Inflation (HIPC)</i>	2.4	2.2	2.2
<i>Employment</i>	0.0	-0.5	0.5
Core items:			
Current account deficit	-19.8	-18.2	-18.3
Export	35.8	36.7	37.0
Import	-59.6	-58.4	-58.3
Other	4.0	3.5	3.0
Private deposits	48.4	48.5	49.0
Bank loans – domestic	55.1	52.3	51.7
Household consumption	87.0	86.5	85.8
Gross fixed capital formation	15.9	14.4	14.8
Current governments spending	21.6	21.5	21.5
Nominal GDP growth	3.0	3.5	4.0
Household consumption	4.3	2.6	2.8
Gross fixed capital formation	-1.7	-0.9	0.9
Current governments spending	0.6	0.7	0.9
Net export	0.0	1.2	-0.5
Export	-1.4	2.1	1.8
Import	1.3	-0.9	-2.3
Core assumptions			
FDI (as % of GDP)	9.0	9.0	9.0
Net foreign assets (as % of GDP)	-2.8	-3.0	-1.4
Bank loans	-3.3	-1.7	2.9
Export growth	-3.7	6.0	5.0
Import growth	-2.1	1.5	4.0

Constant downward trend in lending activity in 2012 and fiscal and macroeconomics risks are increasing probability for the Low-growth scenario to be realised or for adjustments to the Base scenario to take place. The Low-growth scenario does not cover drastic worsening of economic situation (activation of several stated risks simultaneously), conditioned by external or internal factors.

III Public Finance

3.1. Strategy and Fiscal Policy Mid-Term Goals

This Chapter provides an analysis of public finance basic trends in the period after the previous PEP (2011-2012), as well as mid-term fiscal projections that are presented through two fiscal scenarios: “base fiscal scenario” and “low-growth fiscal scenario”. Both scenarios have been developed in line with relevant macroeconomic scenarios that are presented in Chapter II. “Base fiscal scenario” is defined by the Budget Law 2013 and covers the period from 2013 to 2015. Relevant scenarios for public debt trends: “Base scenario for public debt” and “Low-growth scenario for public debt” have been further developed based on them.

Fiscal and financial stability make the basic prerequisite for the growth of Montenegrin economy. Montenegro is undertaking significant measures to overcome the crisis effects, and the effects of such measures are already visible, but more significant positive results are yet to be visible in the years to come. Pursuing a firm fiscal and economic position in Montenegro is supported by all relevant reports of international financial institutions. Although significant positive changes have been implemented in the previous period, the greatest challenge is ahead of us, i.e. ensuring sustainable long-term growth of economy. The year of 2012 is one of the hardest years in economic terms, particularly for public finance. This is supported by the fact that 2012 was characterised by numerous factors (extreme snow and droughts) which were beyond the influence of economic policy measures, and they could only be adapted to. Therefore, after the first quarter, the budget for 2012 was reviewed, in accordance with the scenario of low-growth economy of 0.5%.

In spite of deterioration of the basic fiscal performance, the basic directions of the fiscal policy have not been changed in relation to previous years. Competitive tax rates have been retained, with introduction of measures that are to lead to improved collection of revenues and reduction of grey economy. Additionally, temporary duties have been introduced that are to be applied until the end 2013, the financial effect of which is estimated to around €20 mill for the period August 2012 – December 2013. On the expenditure side, the reduction of public expenditure initiated in 2009 when it amounted to 50% GDP has continued. The greatest fall of public expenditure occurred exactly in 2012, whose level is estimated to 41.8% GDP, after which additional reduction is planned in 2013 to 39.4% GDP.

For the mid-term period, the amendments to the organic budget law¹¹ are under procedure, which is a step further in ensuring long-term stability, and also increase of credibility of financial plans. The law envisages introduction of budget ceilings, which will lead to ensuring public finance stability in the long term, through reduction of expenditures and level of deficit, and shifting to surplus.¹² Novelties that are introduced by this law are related to defining of fiscal rules (golden rule, budget revision rules and other), introduction of legally binding mid-term budgeting, as well as the system of multi-year expenditure control, which will substantially contribute to improvement in achieving fiscal goals. Although this law will be applied to preparation of the budget 2014, budget ceilings were also applied in 2013 on experimental basis.

The adoption of such fiscal rules and their rigid implementation will ensure sustainability and stability of public finance, which is a precondition for achieving the basic economic goal – acceleration of long-term economic growth. Relevant research and empirical experiences of other

¹¹ Previous organic budget law will be renamed to the Law on Budget and Fiscal Responsibility. Draft law is in the phase of public consultations until 31 January 2012. More detailed provisions of this law will be presented in section 3.3. Public Finance Quality.

¹² Application of this law will begin in 2014.

countries show that fiscal consolidation that would reduce the government debt level, while creating conditions for increase of capital investments, brings about a more favourable environment for private investments in the long run, opening of new jobs and finally more dynamic economic growth which has a feedback impact on lower relative share of government debt.

Fiscal policy instruments, in addition to direct impact on public finance, indirectly affect the conditions for economy business. Given the absence of a set of monetary policy measures, special attention is paid to creation of equal conditions for all market participants, through suppression of grey economy, retaining competitive tax rates, maintaining investments on stable level and creating a favourable investment and business environment.

Public finance trends in medium term are determined by:

- Macroeconomic projections for the period 2013-2015;
- Fiscal trends in the previous period and
- Fiscal rules defined in the Draft Organic Law on Budget and Fiscal Responsibility.

Montenegro Budget Law 2013 defines new goals that are to ensure stability in public finance in the medium term. In relation to the goals from the last year's PEP, downward adjustments were made given that economic situation drastically changed. In comparison to the previous programme, economic situation deteriorated not only in the EU and neighbouring countries but also in Montenegro. With deteriorated external situation in the previous period, internal weaknesses of Montenegro were additionally highlighted. Bad weather conditions, strengthened crisis effects in Euro area, growth of fuel prices are elements that strongly affected public finance of Montenegro in 2012 primarily through weaker collection of government revenues and calling upon state guarantees for the loan of "Kombinat Alumijuma" Podgorica. Lower level of revenues affected higher deficit, and also higher need for borrowings in the previous period, which consequently affected the growth of government debt. For the mentioned reasons, the stated base fiscal performance deteriorated in relation to the previous programme. However, stabilisation and consolidation of public finance remains the Montenegrin fiscal policy priority in the medium term.

New goals related to establishing of a sustainable public finance system, through definition of fiscal goals and rules in the period 2013-2015 are as follows (given by priority):

- Growth of public revenues through reduction of grey economy, intensifying collection of tax receivables and implementation of initiated and planned foreign direct investments.
- Reduction of public expenditures to 36.3% GDP in 2015;
- Reduction of public sector deficit in 2013 to 2.3% GDP with decreasing tendency to 0.7% GDP in 2015;
- Maintenance of the level of capital budget, in the medium term, to around 3% GDP;
- Abolishing of issue of guarantees except for development projects and
- Establishment of a decreasing trend of government debt, as to achieve the level of 51.7% GDP in 2015.

Like in the previous programme, this year there are two fiscal scenarios - "base fiscal scenario" and "low-growth fiscal scenario"- developed based on the two macroeconomic scenarios. Also, two growth scenarios for government debt have been prepared. Section 3.3 details both fiscal scenarios. The following table provides basic characteristics of both macroeconomic and fiscal scenarios:

Table 9 Macroeconomic and fiscal framework according to base and low-growth scenarios

Macroeconomic and fiscal framework (in % GDP)		Outturn	Estimate	Base scenario			Low-growth scenario		
		2011	2012	2013	2014	2015	2013	2014	2015
Macroeconomic indicators	GDP nominal growth	4.2	2.8	5.1	5.6	6.1	3.0	3.5	4.0
	GDP real growth	3.2	0.5	2.5	3.0	3.5	1.0	1.5	2.0
	Deflator	1.0	2.3	2.5	2.5	2.5	2.0	2.0	2.0
	Inflation	3.1	4.0	2.7	2.5	2.5	2.4	2.2	2.2
	Employment	0.8	1.5	1.0	1.5	1.5	0.0	-0.5	0.5
	Current account deficit	-19.6	-20.0	-	-	-	-	-	-
			21.0	20.4	19.7	19.8	18.2	18.3	
Fiscal indicators	Current public revenues	39.7	38.0	37.0	36.0	35.6	37.0	36.0	35.3
	Public expenditure	41.0	41.8	39.4	37.7	36.3	39.5	38.5	37.7
	Deficit/Surplus	-5.4	-3.7	-2.3	-1.7	-0.7	-2.5	-2.5	-2.3
	Interest	1.5	1.8	2.1	2.4	2.6	2.2	2.5	2.8
	Primary deficit/surplus	-4.0	-1.9	-0.2	0.7	1.9	-0.3	-0.1	0.5
	Government debt	46.0	52.1	54.5	54.3	51.7	55.7	57.2	56.9

3.2. Public Finance in 2012

This part presents the development of basic fiscal indicators in relation to the last year's programme. Final data for 2011 show that there was negative divergence of revenues in relation to the estimate from the last year's PEP by only 0.26%, while expenditures were higher by 4.8%, making the public finance balance negative, amounting to 5.4% GDP.

The year 2011 is also characterised by the funds allocated to issued guarantees in the amount of 1.1% GDP, of which the largest part is related to the Steel Plant in Nikšić, for which in 2012 a reliable Turkish partner (*Tosyali Group*) was found and investment cycle was initiated. On the expenditure side, a significant methodological change took place that affected the mentioned divergence – starting from the Final Budget Account, guarantees have been included in the calculation of expenses, and thus they affect their increase as well as the increase of deficit, while previous guarantees were noted within the item called *debt repayment*. This change occurred after the suggestion of by relevant international institutions (IMF, European Commission), for the purpose of harmonising with international and regional practice.

In 2012, public finance is characterised by the continuation of fiscal adjustment, and insisting on the measures of rational budget spending, which is a priority in the domain and in maintaining fiscal policy in Europe. On the revenue side, significant decline in the first quarter resulted in development of the central budget revision, when projections of economic growth and budgetary revenues were reconciled.

Additional pressures marked the first quarter 2012, recognised by cyclically lower budgetary revenues. Unfavourable weather conditions that paralysed Montenegro in economic terms, conditioned significant reduction of revenues and created new commitments. It was the reason why macroeconomic aggregates were adjusted downwards. Due to the impossibility of automated fiscal stabilisation in the crisis period, and because of the collection of the guarantees by Deutsche Bank in respect of KAP debt amounting to €23.5 mill, expenditures increased, which resulted in the need for additional borrowings, and also for revision of the Budget.

In the course of budget revision preparation it was taken into account in both revenue and expenditure side not to threaten the standard of living of citizens or the conditions for business development. Thus, on the expenditure side non-productive expenses were reduced, while the development component of the budget did not significantly decrease. On the revenue side, a set of measures for their increase was introduced – duties on SIM cards, smoking areas, electricity meters and cable television, and as a part of planned harmonisation with European standards excise tax on alcohol, tobacco and heating oil was increased, and the list of excise goods was expanded too (coffee and fizzy drinks). Through introduction of these forms of budget revenue inflow, without increasing taxes, a competitive tax system is maintained and tax policy implementation is continued, which implies one-digit tax rates and the same taxes for everybody, irrespective of the amount of income (flat rate). Theoretically, maintaining this concept is good, since it is creating a competitive and reliable investment environment, which attracts new investments that generate revenues, open new jobs and finally make new revenues for the Central Government Budget in respect of higher collection of taxes.

Taxation policy in 2012 presented a continuity of activities in this area, and was directed to creation of business environment that is favourable to the greatest extent possible for development of entrepreneurship, attraction of investments and generating revenues required for financing public functions. Also, some tax policy measures were directed to mitigation of financial crisis effects and illiquidity overcoming, including application of the institute of rescheduling of tax and non-tax debt, payment of profit tax in instalments, as well as deferred payment of customs debt. Special emphasis is given to activities related to harmonisation of tax and customs legislation with the *Acquis*. Tax and customs legislation of Montenegro, particularly in part related to customs tariff and indirect taxes (excise and VAT), is mostly harmonised with the *Acquis communautaire*.

Box 2 Grey Economy Suppression

In view of intensifying and better coordinating of activities on suppression of grey economy and systemic resolving of this issue, the Government of Montenegro passed the *Brief on Grey Economy Suppression Measures 2012*. Pursuant to the mentioned Brief, the Ministry of Finance has established a Coordination Team for monitoring the implementation of grey economy suppression measures, which defined the Operational Plan for Grey Economy Suppression 2012. The mentioned Operational Plan envisages intensifying of activities in four areas that have been recognised as the highest risk from the aspect of grey economy, as follows: (1) control of trade in excise goods, (2) recording of retail trade, (3) labour market and (4) non-registered legal entities and natural persons. For each activity the Operational Plan defines competent institutions and responsible persons from such institutions that are assigned to monitor implementation of the same, deadlines for commencement and completion of activities, as well as the status and outcome for each individual activity. Also, the application of more rigid penalty policy, which is reflected through imposing rigorous penalty measures, such as closure of facilities and prohibitory injunction from business activities affected improvement of fiscal discipline of taxpayers. Inter alia, the mentioned measures contributed to overall revenues of the Budget of Montenegro in the third quarter 2012 to be by 5.34% higher in relation to the same period 2011. The Coordination Team for monitoring the implementation of grey economy suppression measures will at the beginning 2013 prepare a proposal of new measures for grey economy suppression, including the measures required for strengthening HR and institutional capacities of competent institutions.

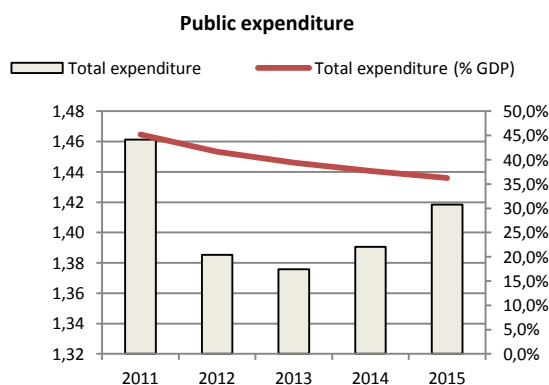
The preparation of the Budget Law 2013 included the development of the estimate of basic fiscal indicators by 2012. Public finance estimate for 2012 was based on the outturn of the central government budget and local budgets for 9 months and the expectations by the end of the year. Below follows a comment on basic public indicators for 2012 according to the estimate, while tabular overview presents 2011, as well as the plan pursuant to the budget revision and estimated outturn for 2012.

Current public revenues are estimated to amount to €1,263.5 mill or 38% GDP, while it is estimated that public expenditure will amount to €1,388.0 mill, or 41.8 % GDP. On the revenue side, the greatest negative divergences in relation to the plan for this year occurred in the items of value

added tax (€18.5 mill, 5.1%), excise (€14.2 mill; 9.5%) and customs (€16.8 mill; 55.3%). Also, €9.7 mill revenues in respect of duties are lower than planned due to the reduction of administrative and other duties, aimed at business environment improvement, and postponement of application of the solution to introduce new duties by 2 months, in relation to the plan.

Public Expenditure

Figure 7 Public expenditure as % of GDP and in mill €



Public expenditure in 2011 amounted to €1,461 mill, or 45.2% GDP. On the expenditure side, in relation to the plan, the following increased: subsidies (€5.3 mill; 19.9%), transfers for social care (€6.7 mill; 1.4%) and item of transfers to institutions, individuals, NGO and public sector (€5.3 mill; 9.2%). For the period 2012-2015, it is projected that there will be fall of public expenditure in relation to GDP, which in 2013 is planned at the level of 39.4% GDP, as to amount to 36.3% GDP in 2015.

The following Figure presents public expenditure by functional classification.¹³

Figure 8 Public expenditure by functions 2011-2015

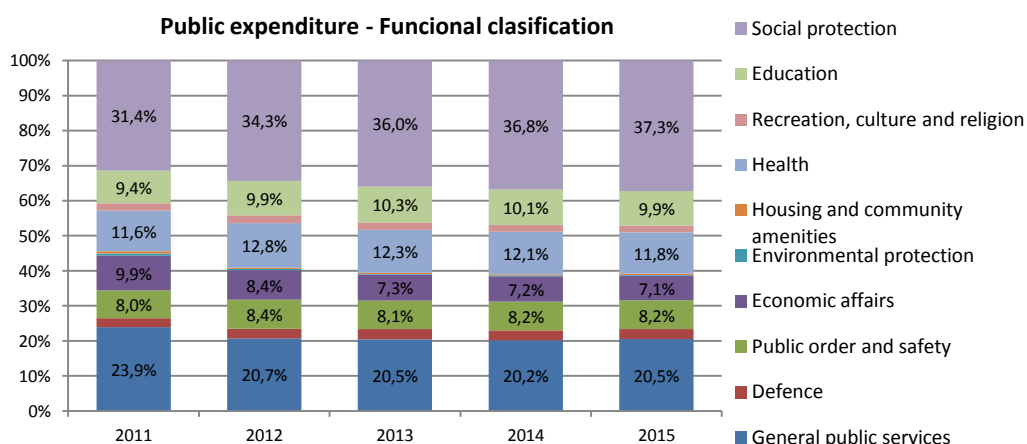


Figure 8 shows that social care represents the most significant expense in the overall expenditures, ranging from 31.4% in 2011 to projected 37.3% in 2015. Growing trend of social expenses is caused by constant growth of expenses for pension and disability insurance, which are the most important item within the expenses for social care.

Also, a significant share in the total expenditures is related to expenses for common public services. It is important to mention that these expenses, like in the previous period, include the expenditures of local governments which are the most important item of expenses for common public services. Expenses for these purposes have a stable share in the total expenditures, which ranges from 20.7% in 2012 to 29.5% in 2015. The exception is the year of 2011 when they were higher due to increased expenses of local governments.

Health-related expenses also have a significant and stable share in the total expenditures, with slight fluctuations in the period 2011-2015, and they on average amount to 12.1%. Education-related

¹³ Table is included in Annex no.3.

expenses are on the average level of 9.9%, and expenses for public order and safety are 8.2%. Expenses related to economic affairs recorded a slight fall of their share in the overall expenditures of 9.9% in 2011, 8.4% in 2012, all the way to 7.1% in 2015. In 2011, increased expenses for these purposes are primarily reflected through significant expenses for electricity, as well as increased expenses in the area of tourism and for the need of multi-year development projects.

Expenses related to defence on average make 2.7% of the overall expenditures, and expenses for sports, culture and religion 2%, housing and community amenities are 0.4% on average, while expenses for environmental protection go down in the overall share from 0.61% in 2011, 0.35% in 2012, to 0.23% in 2013 and keep this level until 2015.

Public sector deficit for 2012 is estimated to amount to €124.5 mill or 3.7 % GDP. It is estimated that shortfall will amount to €342.7 mill, of which €218.2 mill is related to debt repayment, while the remaining amount will cover the public sector deficit. It is estimated that public sector, at the end of the year, will have increased deposits in the amount of nearly €24 mill, which will serve as fiscal reserve for 2013.

Table 10 Public Finance 2011-2012

Public expenditure	2011		Budget revision 2012		Estimate 2012	
	mill €	% GDP	mill €	% GDP	mill €	% GDP
Current revenues	1285.07	39.74	1282.23	38.58	1263.53	38.01
Taxes, of which:	794.52	24.57	803.91	24.19	767.68	23.09
Corporate profit tax	36.10	1.12	46.87	1.41	65.21	1.96
Value added tax	392.24	12.13	381.22	11.47	362.69	10.91
Excise	143.38	4.43	163.06	4.91	148.88	4.48
Tax on international trade and transactions	45.33	1.40	47.34	1.42	30.49	0.92
Contributions	353.58	10.93	351.99	10.59	367.73	11.06
Duties	21.98	0.68	33.02	0.99	23.33	0.70
Fees	72.57	2.24	51.39	1.55	51.71	1.56
Other revenues	37.41	1.16	37.75	1.14	48.53	1.46
Receipts in respect of repayment of loans	5.01	0.15	4.17	0.13	4.54	0.14
Public expenditure	1461.25	45.18	1385.36	41.68	1388.03	41.76
Current public expenditure	1325.66	40.99	1271.72	38.26	1295.39	38.97
Current expenses, of which:	680.54	21.04	702.69	21.14	702.98	21.15
Gross salaries and contributions at expense of employers	403.94	12.49	410.27	12.34	403.18	12.13
Expenses for material and services	119.84	3.71	153.90	4.63	156.41	4.71
Interest	47.60	1.47	58.41	1.76	60.64	1.82
Subsidies	46.35	1.43	21.42	0.64	26.73	0.80
Transfers for social care	455.52	14.09	478.55	14.40	485.24	14.60
Transfers to institutions, individuals, NGO and public sector	112.82	3.49	52.73	1.59	58.05	1.75
Capital expenses	135.60	4.19	113.65	3.42	92.65	2.79
Borrowings and loans	4.23	0.13	3.47	0.10	3.69	0.11
Reserves	14.09	0.44	10.85	0.33	22.00	0.66
Repayment of guarantees	34.11	1.05	23.43	0.70	23.43	0.70
Net increase of liabilities	24.34	0.75	0.00	0.00	0.00	0.00
Surplus/deficit	-176.18	-5.45	-103.13	-3.10	-124.51	-3.75
Primary deficit	-128.57	-3.98	-44.72	-1.35	-63.87	-1.92
Debt repayment	182.47	5.64	181.12	5.45	218.17	6.56
Repayment of principal to residents	39.56	1.22	52.85	1.59	84.10	2.53
Repayment of principal to non-residents	60.32	1.87	57.46	1.73	58.68	1.77
Repayment of arrears	82.59	2.55	70.81	2.13	75.39	2.27
Shortfall/financing needs	-358.65	-11.09	-284.25	-8.55	-342.68	-10.31
Financing	358.65	11.09	284.25	8.55	342.68	10.31
Borrowings and loans from domestic sources	66.35	2.05	22.44	0.68	51.87	1.56
Borrowings and loans from foreign sources	189.72	5.87	291.80	8.78	296.10	8.91
Donations	8.26	0.26	2.00	0.06	6.04	0.18
Revenues from privatisation and sale of property	14.98	0.46	18.00	0.54	12.56	0.38
Use of government deposits	79.34	2.45	-50.00	-1.50	-23.90	-0.72

Source: Ministry of Finance of Montenegro

3.3. Public Finance in the Period 2013-2015

This section presents two fiscal scenarios, “base fiscal scenario”, and “low-growth fiscal scenario”, which are based on two relevant macroeconomic scenarios, presented in the previous chapter. The base fiscal scenario is adopted within the Montenegro Budget Law 2013 and makes the central scenario that will serve for implementation of fiscal and budget policy of the Government of MNE in the following mid-term framework. Low-growth fiscal scenario shows implementation of fiscal and budget policy measures in case economic growth from macroeconomic low-growth scenario is realised.

Pursue of fiscal policy in the following period will mean further fiscal consolidation, which implies reduction of government and public expenditures and increase of tax revenues, through implementation of measures for grey economy suppression, reduction of tax receivables and expanding of tax base. Negative trends in the development of world economy in the previous period, primarily, in Euro area and the region inevitably reflected on mid-term projections as well. Given the characteristics of Montenegro as a small and open economy, subject to external shocks, the new crisis wave overflowed to Montenegrin economy and fiscal performance deteriorated.

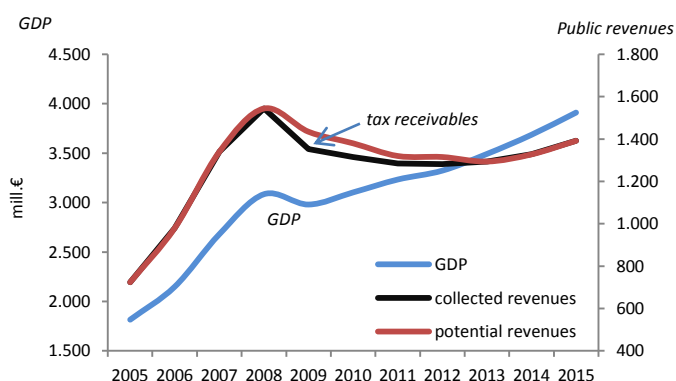
Under the conditions of deteriorated fiscal performance indicators, mid-term period will be the years of a great challenge having in mind the sustainability of public finance, economy competitiveness, new jobs and standard of living of citizens will depend on the implementation of these measures. Although in the conditions of deteriorated economic indicators all the neighbouring countries resorted to increase of tax rates, particularly VAT, fiscal policy in the coming period will keep the current tax system with the lowest tax rates in the region, which makes our economy one of the most competitive in Europe.

Base Fiscal Scenario

Current public revenues growth projection for the period 2013 – 2015 has been developed according to “bottom-up” principle, for each category of revenues individually taking into account the projected economy growth rate, inflation trends in the mentioned period and fiscal policy measures.

Due to illiquidity in economy, tax receivables of the state increase, which along with grey economy additionally make projections difficult and uncertain.

Figure 9 GDP and revenue trends 2005-2015



Based on the previous experience it can be concluded that GDP nominal growth trend does not correlate with revenue growth trends. In the period of strong economic growth, revenues went up above the GDP growth rate, while in the crisis period revenue growth rates were below GDP growth. The Figure 9 shows that the fall of public revenues in 2009 was sharper in relation to GDP fall.

Due to illiquidity in economy, state tax receivables went up, so in Figure no. 9 the red line represents potential revenues that the public sector should have generated in the mentioned period if there had not been problems in collection of revenues. Therefore, revenue projection was developed in a conservative way that does not imply growth equalling to nominal growth of economy of 5.1% in 2013, but due to the mentioned reasons is on the lower level of 2.4%.

In addition to current revenues for 2013 privatisation receipts are planned in the total amount of €19 mill, of which €8 mill is expected from the privatisation of the Steel Plant Nikšić. The Law on Duties has been introduced as a temporary measure for improvement of revenue collection and will be valid until the end of 2013, after which other duties will decrease. Pursuant to the plan of harmonising the excise law with the EU provisions, in the medium term there will be gradual increase of excise rates on alcohol, tobacco goods and mineral oils, and there will be increase of revenues in this respect.

Figure 10 Current public revenues 2012-2015

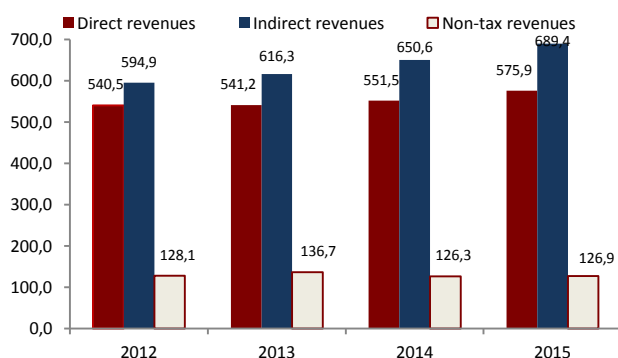


Figure no. 10 shows that the highest share in current public revenues is related to indirect revenues of which the most important are VAT, excise and customs. Gradual growth of indirect revenues is planned for the mid-term period, which will mostly depend on economic activity, and also on application of higher excise rates on tobacco and alcohol. Direct revenues (contributions, income and profit tax) will be stable, with the growth in the medium term resulting from the employment growth. Non-tax revenues, of

which the most significant fees and duties, in 2013 will slightly increase, and after that in 2014-15 will slightly decrease since the provisions of the law on duties on SIM cards, smoking areas, electricity meters and cable television will be rescinded.

On revenue side, in the medium term, slight recovery of collection of revenues is expected which will lead to the growth of collection in absolute amounts (average growth 3.3%), while in relation to GDP their gradual decline from 37% GDP to 35.6% GDP is expected. In the years of economic crisis 2009-2012, revenues went down on annual level due to weaker economic activity and evident problem of illiquidity. It is expected that current public revenues will stabilise in the mid-term period. As regards tax receivables, it was assumed that creation of new receivables will be discontinued.

For the purpose of creating a stable and sustainable public finance system in the mid-term period, it is planned that **public expenditure** will go down from 39.4 % GDP in 2013, to 36.3 % GDP in 2015.

Figure 11 Public expenditure 2012-2015



In the medium term, it is planned that pension expenses will increase, primarily due to expected increase in the number of beneficiaries of pension and disability insurance. It is expected that expenses for pension and disability insurance will increase by around 3.5-4% p.a. until 2015. With application of restrictive employment policy and payment of severance allowances to redundant employees, it is expected that by 2015 the number of

employed persons will additionally decrease. All other costs within the current spending in 2013 are planned on a lower level in relation to 2012 and this trend will continue until 2015. Figure no. 11 clearly shows that in the medium term the highest share in public expenditures is related to

expenses for gross salaries and expenses related to pensions. It is encouraging that all types of expenses have a decreasing trend as regards their share in GDP.

In the mid-term period, it is estimated that public sector will generate **deficit** of 2.3 % GDP in 2013, after which it will go down to 1.7% GDP in 2014 and 0.7 % GDP in 2015. Due to the planned deficit in all years and growing level of debt repayment by years, the need for borrowings in the mentioned period will also increase. For the year 2015 the repayment is planned in the amount of € 365 mill, of which € 200 mill is related to repayment of liabilities in respect of issued Eurobonds in 2010. With conservatively projected revenues from privatisation in the medium term, and uncertain level of donations, the basic source of financing in the coming period will be from borrowings and loans from foreign sources.

Figure 12: Public expenditure, revenues and deficit 2012-2015

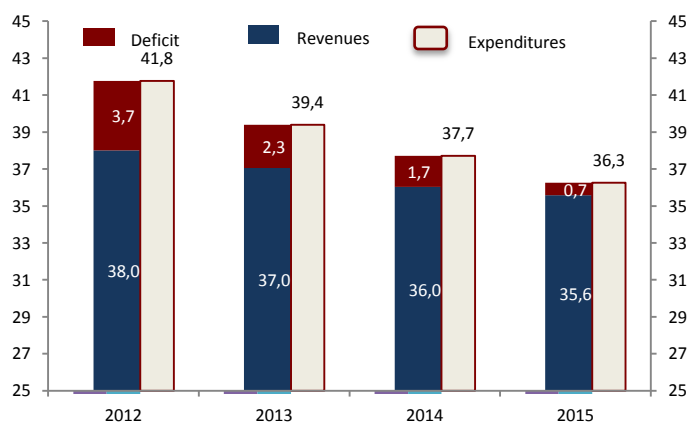


Figure no. 12 shows that in spite of significant savings in the medium term, public expenditures will exceed the level of public revenues, therefore public sector will generate deficit in all the years. It is encouraging that reduction of public expenditures will also continue in the medium term, and thus public deficit will decrease to below 1% GDP in 2015 as well. Pursuant to the provisions of organic budget law, preliminary projections for mid-term period plan are that deficit is to have a decreasing trend both as a GDP

percentage and an absolute amount.

The following Table presents projections of basic fiscal indicators for the period 2012-2015:

Table 11 Public Finance 2012-2015 - Base scenario¹⁴

Public expenditure	Budget revision 2012		Estimate 2012		2013		2014		2015	
	mill €	% GDP	mill €	% GDP	mill €	% GDP	mill €	% GDP	mill €	% GDP
Current revenues	1282.23	38.58	1263.53	38.01	1294.10	37.05	1328.39	36.03	1392.16	35.59
Taxes, of which:	803.91	24.19	767.68	23.09	773.23	22.14	809.41	21.95	855.06	21.86
Personal income tax	111.24	3.35	107.60	3.24	115.04	3.29	115.43	3.13	120.53	3.08
Corporate profit tax	46.87	1.41	65.21	1.96	41.93	1.20	43.40	1.18	45.14	1.15
Value added tax	381.22	11.47	362.69	10.91	373.05	10.68	393.09	10.66	416.15	10.64
Excise	163.06	4.91	148.88	4.48	157.45	4.51	166.30	4.51	175.74	4.49
Tax on international trade and transactions	47.34	1.42	30.49	0.92	31.19	0.89	32.94	0.89	33.74	0.86
Local taxes	37.55	1.13	33.92	1.02	34.94	1.00	38.08	1.03	43.03	1.10
Contributions	351.99	10.59	367.73	11.06	384.22	11.00	392.69	10.65	410.23	10.49
Duties	33.02	0.99	23.33	0.70	35.62	1.02	22.33	0.61	22.00	0.56
Fees	51.39	1.55	51.71	1.56	54.16	1.55	56.84	1.54	58.20	1.49
Other revenues	37.75	1.14	48.53	1.46	42.07	1.20	42.08	1.14	41.56	1.06
Receipts in respect of repayment of loans	4.17	0.13	4.54	0.14	4.81	0.14	5.04	0.14	5.11	0.13
Public expenditure	1385.36	41.68	1388.03	41.76	1375.77	39.39	1390.61	37.72	1418.54	36.26
Current public expenditure	1271.72	38.26	1295.39	38.97	1271.11	36.39	1283.26	34.80	1304.00	33.33
Current expenses, of which:	702.69	21.14	702.98	21.15	693.59	19.86	692.32	18.78	696.92	17.81
Gross salaries and contributions at expense of employers	410.27	12.34	403.18	12.13	397.37	11.38	396.54	10.76	396.92	10.15
Expenses for material and services	153.90	4.63	156.41	4.71	150.65	4.31	141.10	3.83	132.73	3.39
Interest	58.41	1.76	60.64	1.82	74.32	2.13	87.78	2.38	101.61	2.60
Transfers for social care, of which:	478.55	14.40	485.24	14.60	498.26	14.26	518.02	14.05	533.29	13.63
Social care benefits	60.15	1.81	66.58	2.00	61.40	1.76	62.28	1.69	63.30	1.62
Funds for redundant labour	18.92	0.57	18.18	0.55	15.36	0.44	15.36	0.42	15.36	0.39
Pension and disability insurance benefits	378.08	11.37	379.08	11.40	400.90	11.48	419.30	11.37	433.55	11.08
Transfers to institutions, individuals, NGO and public sector	52.73	1.59	58.05	1.75	63.96	1.83	57.51	1.56	58.19	1.49
Capital expenses	113.65	3.42	92.65	2.79	104.65	3.00	107.35	2.91	114.54	2.93
Repayment of guarantees	23.43	0.70	23.43	0.70	0.00	0.00	0.00	0.00	0.00	0.00
Net increase of liabilities	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Surplus/deficit	-103.13	-3.10	-124.51	-3.75	-81.67	-2.34	-62.22	-1.69	-26.39	-0.67
Primary deficit	-44.72	-1.35	-63.87	-1.92	-7.35	-0.21	25.56	0.69	75.22	1.92
Debt repayment	181.12	5.45	218.17	6.56	160.68	4.60	175.50	4.76	375.00	9.59
Repayment of principal to residents	52.85	1.59	84.10	2.53	27.80	0.80	28.60	0.78	32.60	0.83
Repayment of principal to non-residents	57.46	1.73	58.68	1.77	66.70	1.91	99.00	2.69	299.90	7.67
Repayment of arrears	70.81	2.13	75.39	2.27	66.18	1.89	47.90	1.30	42.50	1.09
Shortfall/financing needs	-284.25	-8.55	-342.68	-10.31	-242.35	-6.94	-237.72	-6.45	-401.39	-10.26
Financing	284.25	8.55	342.68	10.31	242.35	6.94	237.72	6.45	401.39	10.26
Borrowings and loans from domestic sources	22.44	0.68	51.87	1.56	8.00	0.23	6.00	0.16	6.00	0.15
Borrowings and loans from foreign sources	291.80	8.78	296.10	8.91	205.99	5.90	199.85	5.42	365.43	9.34
Donations	2.00	0.06	6.04	0.18	2.00	0.06	2.00	0.05	2.00	0.05
Revenues from privatisation and sale of property	18.00	0.54	12.56	0.38	19.00	0.54	22.00	0.60	19.00	0.49
Use of government deposits	-50.00	-1.50	-23.90	-0.72	7.35	0.21	7.87	0.21	8.96	0.23

Source: Ministry of Finance of Montenegro

New Government, which was constituted at the beginning of December, adopted a range of new measures aimed at improvement of the fiscal situation, i.e. public finance consolidation and such measures are to be implemented only in 2013:

- introduction of the "crisis interim tax" of 15% on gross salaries exceeding €720, i.e. increase of personal income tax on salaries above average net salaries in Montenegro

¹⁴ Tabular overview of basic fiscal indicators according to the base scenario is included in section 3.1 (Table 1), while detailed tables of the Budget of Montenegro and Public Expenditures are given in the Annex.

which is 480 €. Tax rate of 15% should be paid only on part of salaries which is above the limit of 720 € monthly gross salaries;

- freezing of growth of pensions, i.e. interim discontinuance of adjustments of pensions and their freezing on the current level;
- the Government proposed to the Parliament to reduce the salaries of Parliament members by 7%, i.e. equalisation of salaries of the Parliament members and salaries of ministers that have been reduced pursuant to the budget revision in April 2012 by 7%;
- it is envisaged that salaries should be reduced for the management members of regulatory agencies and enterprises under majority ownership of the state (for board chairpersons one average salary in the country, for board members 50% of an average salary, and for executive directors two average salaries).

Under the proposed settlement for the taxation of personal income, on higher wages should be paid higher taxes, while the wages to the level of the average wage in Montenegro maintain the existing level (9%). Gross wages in excess of € 720 a month, part of 720 € is taxed at a rate of 9%, while the share of the income that exceed the limit of 720 € is taxed at a rate of 15%. The fiscal effect of increasing the income tax rate to 15% will result in a net increase of budgetary revenues by approximately € 7-9 million.

The Government will protect the most threatened categories of citizens through subsidies. It is planned that pensioners with lowest income should be allocated one-off monetary assistance, and assistance will be provided for resolving housing issues.

In view of increasing budgetary revenues, additional measures have been proposed for narrowing grey economy zone and more efficient collection of public revenues. With regard to this, the Government will undertake measures to strengthen capacities of all institutions competent for establishment, control and collection of public revenues.

The Government recommended that remuneration for skill shortages in regulatory institutions should be regulated by a special act, as to maintain the HR capacity of such institutions, and to transfer surplus revenues over expenditures to the government budget through amendments of relevant regulations.

The mentioned measures represent an additional effort for ensuring a stronger public expenditure consolidation, implementation of more restrictive fiscal policy, in accordance with macroeconomic environment, both internal and external.

Legislative framework will be amended in an accelerated procedure as to ensure smooth implementation of the planned measures.

Low-Growth Fiscal Scenario¹⁵

Like in the previous programme, low-growth fiscal scenario has been produced, which is based on low-growth macroeconomic fiscal scenario. The basic difference in relation to the base fiscal scenario is the decline of current public revenues, resulting from lower level of economic activities, the fall of aggregate demand and fall of consumption, which has the growth of the need for borrowings as a direct consequence. Due to lower economic activities, current public revenues would be adjusted, and would be on a significantly lower level in relation to the base scenario, in the medium term.

In case of reduced economic activity, indirect revenues would go down, primarily VAT, excise and customs in relation to the base scenario. Additionally, lower economic activity, accompanied by stagnation and negative employment growth rates, would affect lower collection of taxes and contributions on salaries, in relation to the base fiscal scenario. In case of low-growth scenario, illiquidity would go up, and additionally it would bring about the pressure by grey economy. Revenues viewed as a GDP percentage are insignificantly lower than the ones from the central scenario, while in nominal amount significant fall is estimated, with average nominal growth of only 1.1%, in the medium term.

In case low-growth of economy is realised, due to lower revenues, specific categories of expenditures would also be adjusted. In case of deterioration of macroeconomic developments, further adjustment of spending would be continued, primarily through reduction of discretionary spending in all respects, with increase of expenses for interest due to increased borrowings.

Draft Law on Budget and Fiscal Responsibility envisages the possibility of generating budget deficit of maximum 1%, only in the case of adverse macroeconomic developments. Also, exceptionally from this provision, transitional provisions are established which limit the budget deficit in 2014 to the level of 2% GDP, and to the level of 1% in 2015. For the purpose of implementing the mentioned provisions, this law considered additional measures for reduction of budget expenditures, which would primarily relate to mandatory expenditures.

As a result of lower revenues and higher expenditures, public sector deficit is estimated to a significantly higher level, and it would amount to 2.5% GDP in 2013 and 2014, while in 2015 it would decrease to 2.3%. In case such scenario is realised, reduction of expenditures would be primarily commenced, while as final measure new solutions within fiscal policy would be considered.

¹⁵ Table 1 section 3.1. provides for basic macroeconomic and fiscal indicators according to low-growth scenario.

Table 12 *Public finance 2012-2015 – Low-growth scenario*

Public expenditure	Budget revision 2012		Estimate 2012		2013		2014		2015	
	mill €	% GDP	mill €	% GDP	mill €	% GDP	mill €	% GDP	mill €	% GDP
Current revenues	1282.23	38.58	1263.53	38.01	1267.18	37.00	1275.75	35.98	1303.82	35.34
Taxes	803.91	24.19	767.68	23.09	760.58	22.21	775.32	21.86	793.42	21.51
Contributions	351.99	10.59	367.73	11.06	376.92	11.01	383.71	10.82	391.38	10.61
Duties	33.02	0.99	23.33	0.70	35.33	1.03	20.70	0.58	21.04	0.57
Fees	51.39	1.55	51.71	1.56	52.38	1.53	53.37	1.50	54.55	1.48
Other revenues	37.75	1.14	48.53	1.46	37.33	1.09	37.96	1.07	38.65	1.05
Receipts in respect of repayment of loans	4.17	0.13	4.54	0.14	4.63	0.14	4.70	0.13	4.77	0.13
Public expenditure	1385.36	41.68	1388.03	41.76	1353.39	39.52	1365.66	38.51	1389.86	37.68
Current public expenditure	1271.72	38.26	1295.39	38.97	1263.74	36.90	1276.30	35.99	1297.40	35.17
Current expenses, of which:	702.69	21.14	702.98	21.15	686.15	20.03	687.13	19.38	693.50	18.80
Expenses for material and services	153.90	4.63	156.41	4.71	144.62	4.22	137.28	3.87	130.07	3.53
Current maintenance	27.16	0.82	26.95	0.81	25.87	0.76	25.04	0.71	24.03	0.65
Interest	58.41	1.76	60.64	1.82	74.32	2.17	88.02	2.48	103.77	2.81
Transfers for social care	478.55	14.40	485.24	14.60	498.26	14.55	516.85	14.58	531.12	14.40
Social care benefits	60.15	1.81	66.58	2.00	61.40	1.79	61.59	1.74	61.61	1.67
Funds for redundant labour	18.92	0.57	18.18	0.55	15.36	0.45	15.36	0.43	15.36	0.42
Pension and disability insurance benefits	378.08	11.37	379.08	11.40	400.90	11.71	419.30	11.82	433.55	11.75
Other health care benefits	14.13	0.43	14.13	0.43	13.60	0.40	13.60	0.38	13.60	0.37
Other benefits from the area of health insurance	7.28	0.22	7.28	0.22	7.00	0.20	7.00	0.20	7.00	0.19
Transfers to institutions, individuals, NGO and public sector	52.73	1.59	58.05	1.75	63.96	1.87	56.91	1.61	57.17	1.55
Capital expenses	113.65	3.42	92.65	2.79	89.65	2.62	89.35	2.52	92.46	2.51
Borrowings and loans	3.47	0.10	3.69	0.11	3.73	0.11	3.56	0.10	3.61	0.10
Reserves	10.85	0.33	22.00	0.66	11.64	0.34	11.85	0.33	12.00	0.33
Repayment of guarantees	23.43	0.70	23.43	0.70	0.00	0.00	0.00	0.00	0.00	0.00
Net increase of liabilities	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Surplus/deficit	-103.13	-3.10	-124.51	-3.75	-86.21	-2.52	-89.91	-2.54	-86.04	-2.33
Primary deficit	-44.72	-1.35	-63.87	-1.92	-11.89	-0.35	-1.88	-0.05	17.72	0.48
Debt repayment	181.12	5.45	263.65	7.93	160.68	4.69	175.50	4.95	375.00	10.17
Repayment of principal to residents	52.85	1.59	77.39	2.33	27.80	0.81	28.60	0.81	32.60	0.88
Repayment of principal to non-residents	57.46	1.73	110.86	3.34	66.70	1.95	99.00	2.79	299.90	8.13
Repayment of arrears	70.81	2.13	75.39	2.27	66.18	1.93	47.90	1.35	42.50	1.15
Shortfall/financing needs	-284.25	-8.55	-388.15	-11.68	-246.89	-7.21	-265.41	-7.48	-461.04	-12.50
Financing	284.25	8.55	388.15	11.68	246.89	7.21	265.41	7.48	461.04	12.50
Borrowings and loans from domestic sources	22.44	0.68	51.87	1.56	8.00	0.23	6.00	0.17	6.00	0.16
Borrowings and loans from foreign sources	291.80	8.78	309.00	9.30	208.74	6.09	223.05	6.29	416.19	11.28
Donations	2.00	0.06	6.04	0.18	2.00	0.06	2.00	0.06	2.00	0.05
Revenues from privatisation and sale of property	18.00	0.54	12.56	0.38	19.00	0.55	22.00	0.62	19.00	0.52
Use of government deposits	-50.00	-1.50	8.68	0.26	9.15	0.27	12.35	0.35	17.85	0.48

Source: Ministry of Finance of Montenegro

Given the decision to continue the low tax policy, aimed at preservation of a favourable environment for foreign direct investments, as well as limited options for further reduction of expenditures, without threatening developmental and social components, low-growth fiscal scenario envisages that the fall in revenues will be offset by additional borrowings. In this case, there would be no decrease in aggregate demand or additional economy contraction, but government debt would additionally increase, as well as interest in the coming years, which would adversely affect the public finance sustainability. Additional borrowings would be provided from foreign banks or international financial institutions.

3.4. Structural Balance

Calculation and reasoning of cyclical budget components are based on the results obtained through the use of CD function, with the reservation that starting assumptions are based on estimates of fixed capital obtained based on the comparison with European countries (fixed capital/GDP ratio). The calculation of cyclical component of the budget balance also includes the expenditure side, through transfers to citizens, which is considered to be a budget component through which the

position of an economy in a business cycle is manifested, since by rule these transfers increase at times of crisis (automated fiscal stabilisers).

Developments of budgetary revenues are determined by GDP trends and its components. The growth of budgetary revenues is faster than the growth of potential GDP in the boom period and slower in the periods when it is lower. At the time of economic activity downturn, budget revenues are lower than their mid-term potential level. Therefore potential level of revenues must be taken as a base for planning expenditures in the medium term. Higher budget revenues at time of boom should be annulled by lower revenues on lower levels of the cycle with adjustment by growth rates, while structural trend is in correlation with potential GDP.

Figure 13 Government budget (% GDP)

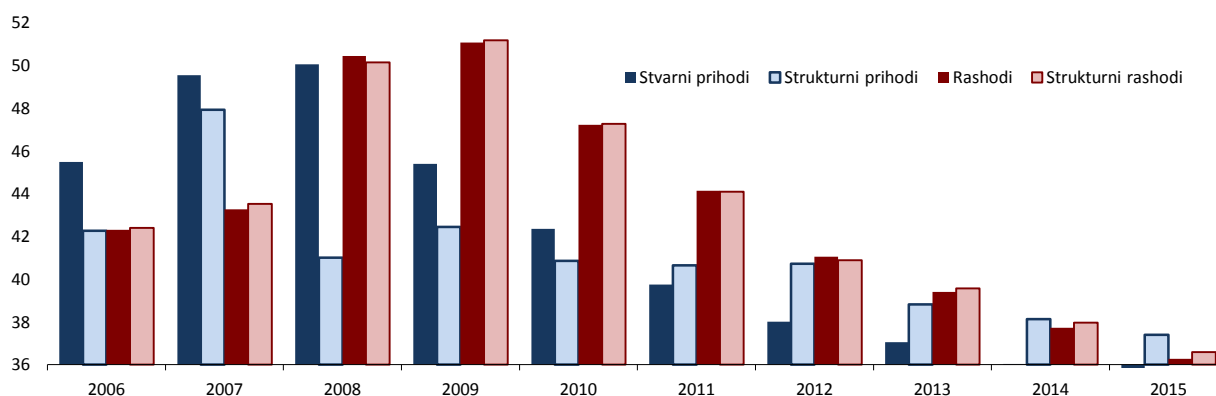
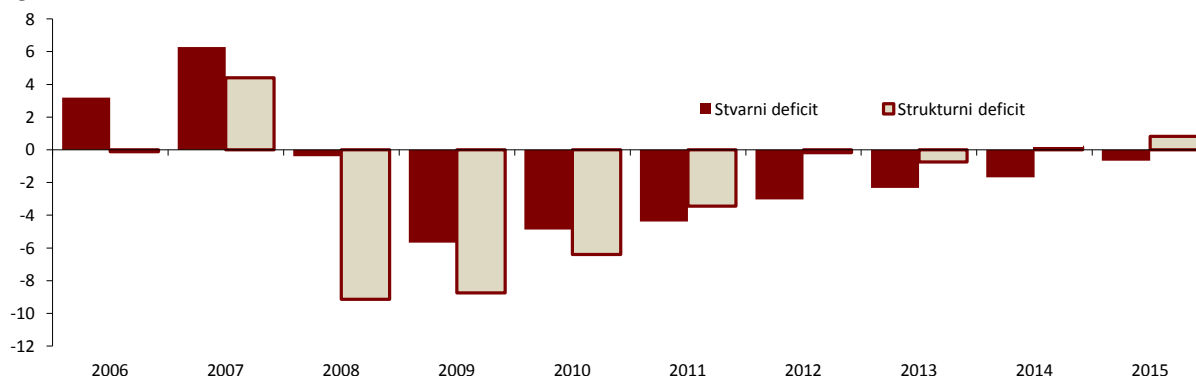


Figure 14 Structural balance 2006-2014



Source: Ministry of Finance

The above figures show decline in revenues after the boom 2007-2008 and required fiscal adjustments followed.

Public finance in the period of boom was not in such a good position as showed by resulting balance. This is particularly expressed in 2008 when the difference between the achieved and structural balance of the budget amounted to around 9% GDP. Since 2009 it can be seen that budgetary balance has been slowly returning to the balanced level stimulated by budget consolidation measures, as to reach it in 2014 when structural surplus will be 0.2% GDP. Although all the results obtained based on these calculations should be taken conditionally because of the fact that due to the mentioned restrictions they reflect fiscal adjustments. Although these adjustments have a strong pro-cyclical component they are required for achievement of budgetary balance.

3.5. Government Debt 2012-2015

The situation in the EU public finances is featured by public debt crisis of 88.2% in the Euro area, as well as by high budget deficits. Neighbouring countries are in the similar situation, where over-indebtedness is their main feature, which along with the openness of economies and vulnerability to external impacts is additionally slowing down the economic growth.

BOX 3 – Evolution of the Montenegrin Government Debt

Development of the government debt of Montenegro over the last ten years can be divided into two phases. *The first phase* – period of reduction of the government debt – from 2002, when the debt was 1.149 billion euro or 88.3% of GDP until 2008, when the debt was 894 million euro or 26.8% of GDP. During this period there was a nominal reduction of debt resulting from the successful debt rescheduling with the Paris Club of Creditors and prepayment of debt during the budget surplus from 2006 to 2008 (prepayment of the part of the debt to the World Bank and liabilities arising from the restitution). In 2008, the level and breakdown of the government debt (stated at average maturity, interest rate, currency structure, and similar parameters) have classified Montenegro in the group of European countries with very favourable indebtedness level and possibility to service debt. As a result of improvement of macro-economic performances, in particular the level and structure of public debt, Montenegro improved its credit rating, which reached the level of one notch below the investment credit rating, which is a success having in mind the size of the country, the structure of economy and relatively young government institutions. *The second phase* – period of fast increase of government debt – commenced in 2008, precisely with the first strike of the financial crisis and is still going on. At the beginning of October 2012, the debt reached 1.707 billion euro, or 51.3% of GDP. The debt increase is primarily a consequence of relatively high budget deficit in the years of the economic crisis, which was financed predominantly from borrowings. The deficit is a result of constant growth of mandatory expenditures and reduction of budget revenues in the “crisis” years. Increased need to borrow and the growth of government debt during the crisis period were inevitable, since for example only expenditures for pensions and social benefits in the period 2008-2012 were increased by around 150 million euro, while the current government revenues, over the same period, lowered by around 150 million euro due to contraction of economic activity, reduction of imports and liquidity problems.

Montenegrin government debt grew sharply in the last three years, predominantly due to the crisis outburst, increased need to finance budget in the crisis years and unfavourable conditions on international financial market. The priority objective of the fiscal policy over the coming period is ensuring further stability of public finances, with special focus on reducing the need for financing, and thus reducing the public debt level in years to come. Even though there was a sharp increase of government debt, it is still lower than the one in the neighbouring countries and in majority of the EU countries¹⁶.

Fiscal consolidation affects the reduction of deficit, and consequently creates conditions for reduction of the public debt over the medium term (see Figure 15). A strong debt crisis characterised the year of 2012, which had important impact on the economic condition and (in)ability to borrow additionally. In order to ensure financial stability and undisturbed functioning of all government institutions, the estimate is that Montenegrin public debt will reach the level of 52.1% of GDP at the end of 2012.

Pursuant to Article 64 of the Law on Financing of Local Self-governments, municipalities are independent in managing records on the level of debt and adopting borrowing decisions¹⁷, which was the reason why the Ministry of Finance is not engaged in planning of borrowing for that segment of public administration, thus this section addresses borrowings only for the Budget needs.

¹⁶ As a matter of comparison, at the end of the second quarter of 2012, Government debt of Montenegro was 47.9% of GDP, while average debt of the European Union countries was 90 percent of GDP. Highest debt, at the end of the second quarter of 2012, is recorded in Greece (150.3%), Italy (126.1%), Portugal (117.5%) and Ireland (111.5%), while the lowest is recorded in Estonia (7.3%), Bulgaria (16.5%) and Luxemburg (20.9%). Out of the EU-27, at the end of the second quarter, 17 countries had higher debt than Government debt of Montenegro. Highest debt at the end of the second quarter in the region was recorded in Albania (59%), Serbia (55%) and Croatia (50%), while Macedonia had the lowest debt (30% of GDP).

¹⁷ Local self-governments can have long-term borrowings only for capital projects and such borrowings cannot exceed 10% of revenues generated in the previous year, with prior consent of the Government, while the Ministry of Finance is the one to stipulate detailed conditions for their borrowings.

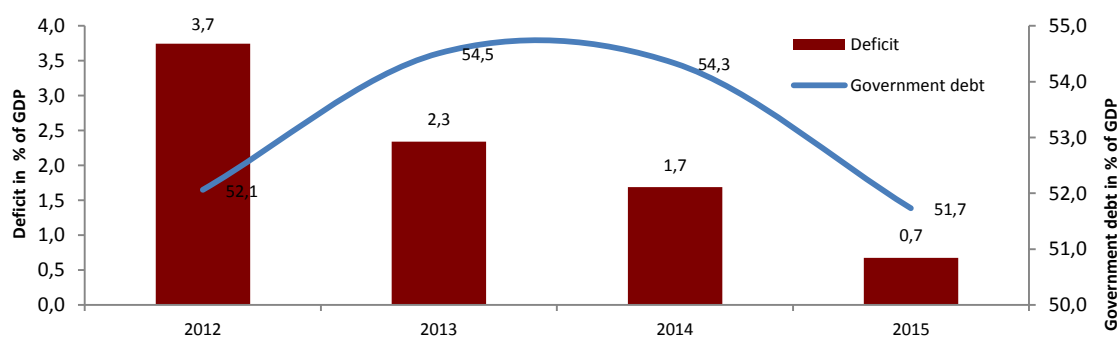
Base Scenario for the Government Debt 2013-2015

Problems with liquidity and unavailability of loans for the economy are directly affecting the revenues collection, thus the new borrowing will be required in 2013 for financing of the entire government system and repayment of previous debts, which will have impact on the increase of the government debt. Planned government debt level for 2013 was 1,904 million euro or 54.5% of estimated GDP. In 2013, the increase in debt of some 174 million euro if compared to 2012, or 2.45 p.p. of GDP is envisaged. Major drivers of the debt increase during 2013 will be additional borrowing for financing the budget deficit, servicing of obligations, and creation of the fiscal reserve of 250 million euro¹⁸. Internal debt will be reduced by some 43 million euro at the end of 2013. During 2013, disbursement of around 30 million euro is also envisaged from funds for financing infrastructural and other projects, while funds of close to 119 million euro are planned for the repayment of principle, domestic and foreign debt.

Table 13: Base Scenario

GOVERNMENT DEBT	30-Sep-2012	2012	2013	2014	2015
GDP u million €	3,324	3,324	3,493	3,687	3,912
Foreign debt	1,307.6	1,330.7	1,548.1	1,682.6	1,738.1
As % of GDP	39.3	40.03	44.32	45.64	44.43
Domestic debt	399.6	399.7	355.9	320.6	285.5
As % of GDP	12.0	12.02	10.19	8.70	7.30
Government debt	1,707.2	1,730.4	1,904	2,003.2	2,023.6
As % of GDP	51.3	52.06	54.51	54.33	51.73

Figure 15: Government debt and deficit over the medium term



On account of the permanent deficit during the crisis period, there was a sharp growth of the government debt, which is expected to continue until 2013. Figure 15 shows the growth trend of government debt in the period 2012-2014, and a decline afterwards, in line with the deficit reduction in 2015.

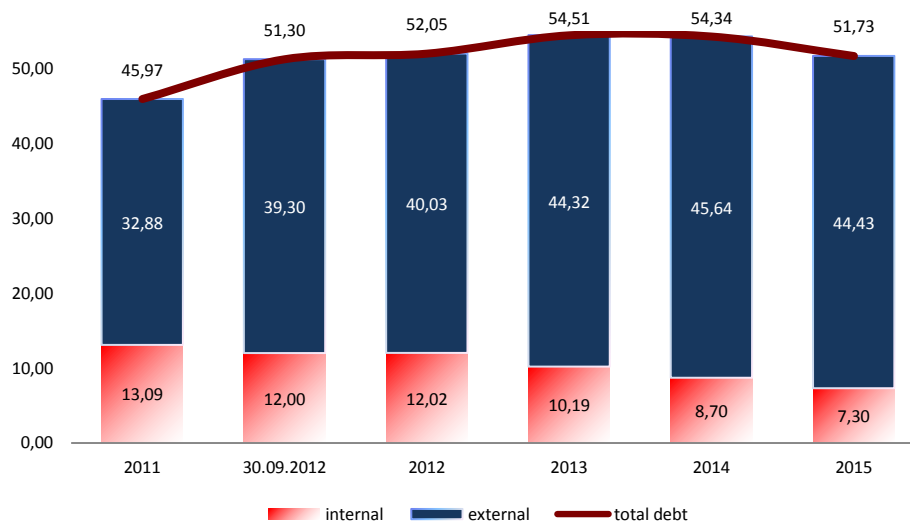
In the period 2013-2015 a slight increase of debt is expected to 54.5% of GDP, and will remain approximately at the same level in 2014 (54.3% of GDP), as to amount to 2,023 million euro or 51.7% of GDP at the end of 2015. Forecasted funds for borrowings to finance the budget will have major impact on the debt increase during this period. For 2013, a disbursement of close to 206 million euro is planned for financing the budget expenditures, while in the case that there is a need to create a fiscal reserve or for additional financing, the Law on Budget for 2013 envisages the possibility for borrowing of up to 250 million euro. For 2015, the amount of 200 million euro is envisaged for refinancing of the Eurobonds issued in 2010. At the same time, a disbursement of

¹⁸ As defined by Article 11 of the Law on Budget for 2013.

funds from other financial facilities (infrastructure-related and other projects) is also planned during the stated period, which will amount to around 30 million euro annually.

Following Figure 16 presents an overview of the government debt developments during the period 2011-2015, as well as the share of internal and external debt in the total government debt (as % of GDP):

Figure 16: Government debt, 2011-2015, as a percentage of GDP



Government debt trends in the period 2012-2015 – the Low-growth Scenario

As already stated, in case of the Low-growth scenario a downturn of economic activity would take place, as well as the decline in revenues, which would result in an increased need for borrowing and consequently in increase of the Public debt. Table 14 presents the debt trend in the period 2012-2015 under the Low-growth Scenario. In case of the lower growth, an increase of the total debt is expected over the medium-term horizon of 2013-2015, thus the public debt will be 55.68% of GDP at the end of 2013, 57.24% of GDP in 2014, while it is expected to decrease in 2015 to 56.94%. Foreign debt will increase over the medium-term period, to 45.28% of GDP in 2013; 48.2% of GDP in 2014; and to 49.21% of GDP at the end of 2015.

Table 14: Government debt trends in the period 2012-2015 – the Low-growth Scenario¹⁹

GOVERNMENT DEBT	2012	2013	2014	2015
GDP in million €	3,324	3,425	3,546	3,689
Foreign debt	1,330.7	1,551	1,709	1,815.2
As % of GDP	40.03	45.28	48.20	49.21
Domestic debt	399.7	355.9	320.6	285.5
As % of GDP	12.02	10.39	9.04	7.74
Government debt	1,730.4	1,906.9	2,029.6	2,100.7
As % of GDP	52.06	55.68	57.24	56.94

During 2013, an increase of debt of some 178 million euro is envisaged, meaning that the total debt will amount to around 1,907.0 million euro or 55.7% of GDP. The major drivers of debt increase in

¹⁹ Assumption is that the entire amount for borrowing of 250 million euro will be disbursed in 2013.

2013 will be the growth of the foreign government debt, of around 220 million euro, whereby its main driver will be the borrowing to finance the Budget of 253 million euro. It should be mentioned, that from the stated amount 40 million euro are planned for increase of the stock of deposits in 2014. At the same time, disbursement of around 30 million euro is also planned during 2013, from funds for financing infrastructure-related and other projects. Planned amount for foreign debt principle repayment during 2013 is around 63 million euro.

In 2014, it is expected for the foreign debt to grow as well, by about 158 million euro, if compared to 2013, mostly for the budget financing, and the budget for this year envisages borrowing of around 223.5 million euro plus additional 30 million euro required for implementation of infrastructural projects. During 2014, foreign debt repayment will amount to 95 million euro.

Foreign debt will also increase in 2015, by 106 million euro, where it will be required to borrow additional 416.2 million euro for the budget financing, along with additional 30 million euro for implementation of projects in Montenegro. At the same time, 295 million euro will be repaid in 2015.

Whilst, if observing the internal debt trends for the period 2012-2015, it is expected for domestic debt to record a sizeable decline, from 12% of GDP in 2012 to 7.74% of GDP at the end of 2015. Sizeable reduction of the domestic debt, which will take place in the next 3 years i.e. until 2015, will amount to around 144 million euro, as a result of both scheduled repayments on one hand and forecasted specific obligations to arise in the coming period on the other hand.

When analysing the Low-growth and the Base scenario, we can conclude that the nominal increase of debt will be around 77 million euro; whilst as percentage of GDP it will grow by 5.2%. The major reason for debt increase, as it could be noted, will not be the very amount of the increase of borrowing, but the decline of economic activity or GDP level.

Under the Low-growth Scenario, while public debt will increase by around 3 million euro, during 2013, due to GDP retraction, as far as the percentage increase is concerned the debt will increase by some 1.2% and will make 55.7% of GDP. As far as this segment is concerned, the estimate taken into account is that the foreign debt will grow, by the abovementioned amount, since funds will be most likely borrowed from foreign sources. Depending on the market conditions, a possibility of issuing Eurobonds will be also considered over a medium term, or securing funds from international institutions loans.

As far as the debt trends are concerned in the period of 2014 and 2015, debt will undergo somewhat greater change. Thus, in 2014, resulting from reduction of revenue, needs for additional borrowings will also increase by some 24 million euro in addition to the amount in the Base Scenario. This increase, along with the debt increase for 2013, will result in an increase of debt at the end of 2014, by some 27 million euro or 2.91% if compared to the projected estimate in the Base Scenario. Furthermore, as far as 2015 is concerned, the debt increase will amount to around 77 million euro or 5.21% more if compared to the Base Scenario. As already mentioned, this debt increase expressed as a share of GDP does not represent a portrait of real debt increase in actual funds, but the stated amount of increase is directly linked with the sharp GDP retraction.

The Government Guarantees Stock

As of 30 September 2012, the government guarantees amounted to 372.6²⁰ million euro or 11.2% of GDP or 21.8% of the government debt. Foreign guarantees of Montenegro were 340.8 million euro or 10.2% of GDP or 19.9% of the government debt, while the level of domestic guarantees was 31.8 million euro or 0.95% of GDP i.e. 1.86% of the government debt.

At the end of 2012, the total amount of guarantees will be 380.7 million euro, whereby the amount of total guarantees at the end of the third quarter was reduced by some 8 million euro. When discussing the foreign guarantees stock, it is important to mention that in 2012 one of the issued guarantees for the loan facility of KAP was paid out, in the amount of 22 million euro, upon demand of the Deutsche Bank. Payment of this guarantee reduced liabilities of KAP towards creditors, as well as the liabilities of the state for issued guarantees. The Government of Montenegro still holds issued guarantees for the facility between KAP and OTP Bank of 42.2 million euro, as well as for the facility with VTB Bank of 60 million euro.

Having in mind that the situation in KAP has not improved substantially, nor have the aluminium market prices trends, a justifiable risk still exists pertaining to ability of KAP to ensure sufficient funds to cover general operating expenses and liabilities under concluded loan facilities. At this time, the Government of Montenegro is able to defer the debt collection, i.e. the guarantees issued to OTP Bank, and is looking into possibilities with all parties to the facility on how to overcome this situation. Furthermore, one of the advantages of the loan facility with VTB Bank is that commencement of repayment of the loan is planned for 2014, which leaves additional time for this problem to be solved. In order to surpass the present situation, the Government of Montenegro has also tried to contact investors in order to find a new buyer for KAP, which would also ensure certain funds for possible investments as well as increase in production, and thus the possibility to settle all obligations.

New foreign guarantees are planned to be issued in 2013, in the amount of 66.8 million euro, out of which the amount of 40 million euro is planned for the loan facility between the Chinese Exim Bank and *Barska Plovdiba* for the project of procurement of cargo ships, the amount of 25 million euro for loan facility for *Cronogorski Elektroprenos* for the project of transmission cable Tivat – Pljevlja, while the amount of 1.2 million euro is envisaged for support to *Montenegro Airlines*.

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 infrastructural 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, as for two projects above-mentioned, as well as for those where the evaluation is that there are no risks that they will be called on.

In the period 2010-2011 arrears grew, whereby the net increase of arrears makes around 2.7 p.p. of GDP in that period. We have to mention that out of that amount 2 p.p. of GDP are related to December pensions which are as a rule paid in January.

²⁰ Annex – Tables 4.2 and 4.3.

3.6. Budget Implications of Structural Reforms

Table 8 presents an overview of quantified fiscal effects of those structural programmes and measures presented in more details in the Chapter 4. In terms of its methodology, Table 8 is compiled based on inputs from some segments of structural reforms contained in some sections of Chapter 4²¹.

Structural reforms affect both the public finances expenditure and revenue side. As far as the fiscal expenditures are concerned, implementation of structural reforms is commonly paired with certain increases in expenditures caused by design and implementation of those reforms. As it could be seen from Table 8, total volume of quantified fiscal expenditures resulting from structural reforms is estimated to be 108.9 million euro in 2012. Over the next three years, initiated or planned structural reforms will result in further increase of fiscal expenditures, which are estimated to be 118.8 million euro in 2013 and 112.4 million euro in 2014. In 2015, this amount is estimated at 105.1 million euro.

Structural reforms also affect the revenue side of public finances, predominantly in the form of revenue increase. While the positive effects of public finances on the revenue side in 2012 are estimated to 42.6 million euro, in the next three years the estimate is that they will range between 12.0 and 18.0 million euro.

Based on envisaged effects that the structural reforms have on public expenditure or revenue side of public finances, the net effect of such reforms is also estimated. In 2012 their effect is estimated to be -66.4 million, and around -100 million euro in the next two years, while it is estimated to be -92.7 million in 2015²².

Table 15 Budget effects of quantified programmes and measures: Summary based on analysis presented in Chapter 4

	2012	2013	2014	2015
Competition				
Implementation of the new Law and activities of the Competition Protection Agency				
Net Budget effects	-213,439.01	-222,939.01	-269,487.99	-281,137.71
Direct effect on Budget revenues				
Direct effect on Budget expenditures	213,439.01	222,939.01	269,487.99	281,137.71
State Aid				
Called upon guarantees issued to KAP				
Net Budget effects	-23,400,000.00			
Direct effect on Budget revenues				
Direct effect on Budget expenditures	23,400,000.00			
Improvement of Business Environment				
Council for regulatory reform and improvement of business environment				
Net Budget effects				
Direct effect on Budget revenues	130,000.00	130,000.00	130,000.00	130,000.00
Direct effect on Budget expenditures	-130,000.00	-130,000.00	-130,000.00	-130,000.00
Tax policy				
Law on supplements of the Law on Excise Taxes				
Net Budget effects	2,500,000.00 ²³	3,000,000.00		
Direct effect on Budget revenues	2,500,000.00	3,000,000.00		

²¹ Annex to this document contains an overview of all structural reforms identified as having or that will have fiscal effects, however the size of the effect is not quantified. Tables in the Annex also state years in which these structural reforms have or will have effect on public finances.

²² Fiscal effects of structural reforms in this-year's PEP in terms of their scope are sizably lower than those quantified in the last-year's PEP, only because of one important change in methodology. The last-year's PEP in the segment of fiscal effects of structural reforms covered in the category "pension reform" on the side of revenues a complete inflow into the pension system from the heading 'contributions' and on the side of expenditures entire scope of paid pension benefits. Since these are regular revenues and expenditures for pensions, and not revenues and expenditure resulting from structural reforms in this area, this-year's PEP does not include them in quantification of structural reforms.

²³ Law on Supplements to the Law on Excise Taxes is in application from 21 June 2012

	2012	2013	2014	2015
Direct effect on Budget expenditures				
Law on fees for access to certain services of general interest and for use of tobacco products and electronic and acoustic devices				
Net Budget effects	6,000,000.00 ²⁴	6,000,000.00		
Direct effect on Budget revenues	6,000,000.00	6,000,000.00		
Direct effect on Budget expenditures				
Law on Amendments and Supplements to the Law on Compulsory Social Insurance				
Net Budget effects	ca. 3,000,000			
Direct effect on Budget revenues	ca. 3,000,000			
Direct effect on Budget expenditures				
Education				
Implementation of activities and measures under the Strategy of development and financing of higher education				
Net Budget effects	-1,450,000.00	-980,000.00	-980,000.00	
Direct effect on Budget revenues				
Direct effect on Budget expenditures	1,450,000.00	980,000.00	980,000.00	
Delivery of external graduation exam and professional exam				
Net Budget effects	-200,000.00	-200,000.00	-200,000.00	-200,000.00
Direct effect on Budget revenues ²⁵				
Direct effect on Budget expenditures	200,000.00	200,000.00	200,000.00	200,000.00
Strengthening links between the labour market and education				
Net Budget effects	-950,000.00	-500,000.00	-250,000.00	
Direct effect on Budget revenues				
Direct effect on Budget expenditures	950,000.00	500,000.00	250,000.00	
Quality assurance in education for all levels (external and internal quality assessment)				
Net Budget effects	-500,000.00	-200,000.00	-200,000.00	
Direct effect on Budget revenues				
Direct effect on Budget expenditures	500,000.00	200,000.00	200,000.00	
Action plan for optimisation of the existing school network				
Net Budget effects	-10,000.00			
Direct effect on Budget revenues				
Direct effect on Budget expenditures	10,000.00			
Research and Development				
Participation fee for Montenegro in the FP7 Programme				
Net Budget effects	-496,000.00	-620,000.00		
Direct effect on Budget revenues				
Direct effect on Budget expenditures	496,000.00	620,000.00		
Action Plan for mobility of researches for the period 2011-2012				
Net Budget effects	-500,000.00			
Direct effect on Budget revenues				
Direct effect on Budget expenditures	500,000.00			
Linking science and economy by establishing the Centre of Excellence, Scientific-technological park, participation in the EUREKA programme and financing of scientific and research projects				
Net Budget effects	-4,850,000.00	-4,600,000.00	-4,850,000.00	
Direct effect on Budget revenues				
Direct effect on Budget expenditures	4,850,000.00	4,600,000.00	4,850,000.00	
Energy				
Subsidies to electricity consumers				
Net Budget effects	-15,832,408.00	-1,200,000.00		
Direct effect on Budget revenues				
Direct effect on Budget expenditures	15,832,408.00	-1,200,000.00		
Energy efficiency measures of public sector reconstructions (+ energy savings in public institutions; - loan repayment)				
Net Budget effects	-500,000.00	-300,000.00	200,000.00	-500,000.00
Direct effect on Budget revenues	500,000.00	1,500,000.00	2,200,000.00	2,500,000.00
Direct effect on Budget expenditures	-1,000,000.00	-1,800,000.00	-2,000,000.00	-3,000,000.00
Transport				
Programme of reconstruction of intersections on the state roads				
Net Budget effects	-1,200,000.00	-1,000,000.00		

²⁴ Law on fees is in application since 6 July 2012

²⁵ Delivery of graduation exam and professional exam will not have direct effect on revenues, but will influence the overall quality of education and by doing so the further economic growth by giving incentives to development of the labour force needed for the labour market.

	2012	2013	2014	2015
Direct effect on Budget revenues				
Direct effect on Budget expenditures	1,200,000.00	1,000,000.00		
Programme of resolving bottle-necks in the transportation network of Montenegro				
Net Budget effects	-14,500,000.00	-8,250,000.00		
Direct effect on Budget revenues				
Direct effect on Budget expenditures	14,500,000.00	8,250,000.00		
Regular maintenance of roads				
Net Budget effects	-10,000,000.00	-10,000,000.00		
Direct effect on Budget revenues				
Direct effect on Budget expenditures	10,000,000.00	10,000,000.00		
Adriatic- Ionian Highway				
Net Budget effects	-50,000.00	0.00		
Direct effect on Budget revenues				
Direct effect on Budget expenditures	50,000.00	0.00		
Programme of reconstruction and rehabilitation of critical spots on state roads of Montenegro				
Net Budget effects	-1,500,000.00	-2,300,000.00		
Direct effect on Budget revenues				
Direct effect on Budget expenditures	1,500,000.00	2,300,000.00		
Land expropriation for construction of the Bar- Boljare highway				
Net Budget effects	-250,000.00	-100,000.00		
Direct effect on Budget revenues				
Direct effect on Budget expenditures	250,000.00	100,000.00		
Construction of the Tifran tunnel				
Net Budget effects	-2,000,000.00	-1,000,000.00		
Direct effect on Budget revenues				
Direct effect on Budget expenditures	2,000,000.00	-1,000,000.00		
Programme of elimination of flood consequences on arterial and regional roads				
Net Budget effects	-500,000.00	-2,000,000.00		
Direct effect on Budget revenues				
Direct effect on Budget expenditures	500,000.00	2,000,000.00		
Concession Contract between the Government of Montenegro and „Jadranskog brodogradilišta“, AD Bijela on 30 years				
Net Budget effects	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				
Telecommunications				
Implementation of the Law on Electronic Communications				
Net Budget effects		-29,000.00		
Direct effect on Budget revenues				
Direct effect on Budget expenditures		29,000.00		
Implementation of the Law on Postal Services				
Net Budget effects		-6,000.00		
Direct effect on Budget revenues				
Direct effect on Budget expenditures		6,000.00		
Implementation of the programme „Support of digitalisation of the Public Broadcasting Service of Montenegro – equipment procurement“				
Net Budget effects			-500,000.00	
Direct effect on Budget revenues				
Direct effect on Budget expenditures			500,000.00	
Labour Market				
Active labour policy				
Net Budget effects	-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
Ensuring social safety for unemployed persons				
Net Budget effects	-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
Programme of professional development university students				
Net Budget effects	0.00	0.00	-7,280,000.00	-7,280,000.00
Direct effect on Budget revenues	0.00	0.00	2,720,000.00 ²⁶	2,720,000.00

²⁶ Includes revenues from healthcare insurance and VAT revenues

	2012	2013	2014	2015
Direct effect on Budget expenditures	0.00	0.00	10,000,000.00	10,000,000.00
Legislation – Labour Law				
Net Budget effects	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 Budget effects	-350,000	-350,000	-350,000	-350,000
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 Peaceful Settlement of Labour Disputes				
Net Budget effects	-290,000.00	-290,000.00	-290,000.00	-290,000.00
Direct effect on Budget revenues				
Direct effect on Budget expenditures	290,000.00	290,000.00	290,000.00	290,000.00
Healthcare Protection				
Construction of the Polyclinic of the General Hospital Berane, Drugs Agency, Institute for Blood Transfusion, and reconstruction of some healthcare institutions in municipalities, Neurology Clinic, Psychiatric Clinic, and Gynecology Clinic in the Clinical Centre of Montenegro				
Net Budget effects	-4,800,000.00	-3,200,000.00	-6,000,000.00	-4,835,000.00
Direct effect on Budget revenues				
Direct effect on Budget expenditures	4,800,000.00	3,200,000.00	6,000,000.00	4,835,000.00
Strategy for optimisation of the secondary and tertiary healthcare level				
Net Budget effects		-1,500,000.00		
Direct effect on Budget revenues				
Direct effect on Budget expenditures		1,500,000.00		
Action Plan for Nutrition and Food Safety of Montenegro				
Net Budget effects	-616,000.00	-563,000.00	-570,000.00	
Direct effect on Budget revenues				
Direct effect on Budget expenditures	616,000.00	563,000.00	570,000.00	
Action Plan for implementation of the national strategic response to HIV/AIDS in Montenegro				
Net Budget effects	-1,149,920.00	-3,340,400.00	-1,425,680.00	
Direct effect on Budget revenues				
Direct effect on Budget expenditures	1,149,920.00	3,340,400.00	1,425,680.00	
National Programme of Early Detection of Colorectal Cancer for the period 2012-2016				
Net Budget effects	-531,307.00	-255,000.00	-355,000.00	-190,000.00
Direct effect on Budget revenues				
Direct effect on Budget expenditures	531,307.00	255,000.00	355,000.00	190,000.00
National Programme of Early Detection of Cervical Cancer for the period 2012-2016				
Net Budget effects	-349,307.00	-100,000.00	-100,000.00	-220,000.00
Direct effect on Budget revenues				
Direct effect on Budget expenditures	349,307.00	100,000.00	100,000.00	220,000.00
Action Plan for protection and improvement of children health by improving the environment quality in Montenegro				
Net Budget effects		-442,500.00	-516,500.00	-338,500.00
Direct effect on Budget revenues				
Direct effect on Budget expenditures		442,500.00	516,500.00	338,500.00
National Strategy for improvement of healthcare protection equality and safety of patients				
Net Budget effects		-57,300.00	-38,500.00	-55,300.00
Direct effect on Budget revenues				
Direct effect on Budget expenditures		57,300.00	38,500.00	55,300.00
National Strategy of healthcare of persons with diabetes 2012 to 2016				
Net Budget effects		-5,000.00		-10,000.00
Direct effect on Budget revenues				
Direct effect on Budget expenditures		5,000.00		10,000.00
National Strategy for control of antibiotic-resistant bacteria for the period from 2012 to 2016, with the Action Plan for 2012/2016				
Net Budget effects		-13,000.00	-10,000.00	-10,000.00
Direct effect on Budget revenues				
Direct effect on Budget expenditures		13,000.00	10,000.00	10,000.00
National Strategy of prevention of harmful use of alcohol and alcohol-induced disturbances in Montenegro 2013-2020, with the Action Plan for 2013/2014,				
Net Budget effects		-6,200.00	-21,800.00	
Direct effect on Budget revenues				
Direct effect on Budget expenditures		6,200.00	21,800.00	
Social Protection				
Allocations in line with the Law on Social and Child Protection				
Net Budget effects	-64,560,000.00	-60,755,000.00	-61,350,000.00	-62,560,000.00

	2012	2013	2014	2015
Direct effect on Budget revenues				
Direct effect on Budget expenditures	64,560,000.00	60,755,000.00	61,350,000.00	62,560,000.00
Social Card (Social Welfare Records)				
Net Budget effects	-500,000.00, ²⁷	-651,981.00	0.00	0.00
Direct effect on Budget revenues				
Direct effect on Budget expenditures	500,000.00	-651,981.00	0.00	0.00
Administrative Reforms				
Law on Wages of Civil Servants and State Employees and the Law on Civil Servants and State Employees				
Net Budget effects		-750,000.00		
Direct effect on Budget revenues				
Direct effect on Budget expenditures		750,000.00		
TOTAL NET BUDGET EFFECTS:	-66,372,381.01	-100,801,320.01	-100,430,967.99	-92,703,937.71
Direct effect on Budget revenues	42,576,000.00	17,996,000.00	11,966,000.00	12,396,000.00
Direct effect on Budget expenditures	108,948,381.01	118,797,320.01	112,396,967.99	105,099,937.71

3.7. Sensitivity Analysis and Comparability with the Last-year's Programme

In the case that any of the stated risks would materialise, it would have adverse effect on sustainability of public finances, precisely on the level of deficit and government debt.

Fiscal risks over the medium-term are:

1. Calling upon of guarantees for KAP would have direct impact on public finances sustainability over the medium term. In addition to the possibility for guarantees to be called upon, numerous risks are coupled with this business entity. As a matter of reminder, in the previous period the Government of Montenegro guaranteed to additional loans of The Aluminium Plant Podgorica (KAP), with the Hungarian OTP Bank and Russian VTB Bank for a total of 118 million euro with interests, which make ca. 3.5% of GDP. Additional risks exist also concerning the ownership of this company, as well as in terms of its going concern over the coming period. In the case of liquidation, a need for subsidies issued by the state for electricity to EPCG would cease to exist, while on the other hand pressure would rise on social welfare benefits due to increased number of unemployed persons. Furthermore, aluminium exports would drop which would result in decline in revenues.
2. Further growth of tax liabilities and/or the gray economy growth would have negative impact on the general government budget liquidity over the medium term, as well as on creation of additional need for borrowing, which would on the other hand result in additional growth of the general government deficit, and ultimately endanger the stability and sustainability of public debt.
3. Further growth of arrears would additionally threaten the sustainability of the government debt.
4. Borrowing possibility and borrowing conditions on the international market would have negative impact on the rise in interest rates and level of the debt repayment in the years to follow, having as its direct consequence the government debt growth.
5. Realisation of any of the stated risks could lead to a risk of credit rating downgrade issued by the credit rating agencies.

The following Table²⁸ presents projections of core macro-economic and fiscal indicators as stated in the last-year's PEP and latest projections presented in this-year's PEP:

²⁷ Funds for possible implementation of the project "Social Card" (Social Welfare Records) in the set amount are planned in the current budgetary reserve.

²⁸ Indicators are stated as a percentage of GDP

Table 16: Difference from the last-year's PEP

COMPARISON PEP 2011/PEP 2012	2011			2012			2013			2014		
	PEP 2011	PEP 2012	Differen ce	PEP 2011	PEP 2012	Differen ce	PEP 2011	PEP 2012	Differen ce	PEP 2011	PEP 2012	Differen ce
Real GDP growth	2.5	3.2	0.7	2.0	0.5	-1.5	3.5	2.5	-1.0	4.0	3.0	-1.0
Public revenues	39.4	39.7	0.4	39.4	38.0	-1.4	39.2	37.1	-2.2	39.0	36.0	-3.0
Public expenditure	42.6	45.2	2.6	40.5	41.8	1.3	39.1	39.4	0.3	38.0	37.7	-0.3
Deficit/Surplus	-3.3	-5.5	-2.2	-1.1	-3.8	-2.7	0.1	-2.3	-2.5	1.0	-1.7	-2.7
Primary deficit/surplus	-1.9	-4.0	-2.1	0.7	-1.9	-2.7	1.9	-0.2	-2.1	2.8	0.7	-2.1
Government debt	43.8	46.0	2.2	46.9	52.1	5.1	45.4	54.5	9.1	42.9	54.3	11.4

According to the final data of the Statistical Office – MONSTAT, the real growth rate was generated in 2011, which was higher than the one projected by PEP²⁹. However, due to large uncertainties in the Euro area, pronounced sensitivity of Montenegro to external shocks, supported by internal weaknesses, the projections of the GDP growth over a medium term are conservative.

Due to lower GDP growth rates, and considering conservative projection of revenues, they are also at considerably lower level if compared to the previous programme. Moreover, developments in the period following the preparation of the previous programme have also influenced the level of projected revenues over the medium term. Hereby the Budget revision in 2012 is primarily implied, according to which the planned revenues are to be lower by 60 million euro, while the projection for 2012 was adjusted by additional 14 million euro.

As explained earlier, the 2011 deficit is sizeably higher due to fact that calculation of deficit included called upon state guarantees and net increase of liabilities (difference between arrears at the beginning and end of the period).

If compared to the previous programme, the public spending is noticeably reduced, so that the projections for 2014 are envisaging even lower level than the one in the previous programme. Budget expenditures are mostly reduced, whereby the growth is envisaged only for pensions and interests, while the capital budget is projected on the stable level.

As expected, with lower level revenues the need to borrow also grows, and consequently the level of the government debt as well.

²⁹ Explained in details in Chapter 2

3.8. Public Finance Quality

Fiscal policy, in the financial crisis period, is designed and aimed at reduction of macro-economic and fiscal risks, as well as at continued public finances alignment with the legislation and practice in the EU. During 2012, reforms in the area of public finances management and budgeting have continued, as well as the pursuit of the fiscal policy aimed at strengthening the fiscal stability (improvement of budget discipline and strengthening internal financial control, suppression of the grey economy).

To that end, at the end of 2012 a new Draft Law on Budget and Fiscal Responsibility was prepared, supported by the public consultations lasting until 31 January 2013. This Draft Law defines the following fiscal rules:

1. **General Government Deficit** up to maximum 1% of GDP may be planned only in the case when a projected real GDP growth rate is less than 1.5% and/or the sovereign credit rating is equivalent to a higher middle rating on the relevant list of the relevant organisation engaged in a sovereign credit rating assessment (equivalent the Standard&Poor's A rating). Exceptionally, the budget deficit for 2014 must not exceed 2% of GDP, or exceed 1% of GDP in 2015. If the real GDP growth rate exceeds 5%, the surplus of at least 1.5% of GDP is planned and generated excess will be used for debt repayment.
2. **Government Debt**, over a long-term, must be reduced to the level below 30% of GDP (a transitional period of 11 years is established for reaching this objective precisely the maximum level of debt up to 60% of GDP until the end of 2015; up to 45% of GDP until the end of 2019 and reduction of debt to the level of up to 30% of GDP until the end of 2024);
3. **Medium-term budget** is introduced, which sets the mandatory spending level for two following years and indicative spending level for third year. Furthermore, the budget spending reserve/margin is established, which creates space for possible increase of spending when planning the budget for the next year;
4. Current expenditures must be lower than the current revenues, and the net borrowing can be accepted only for capital budget financing;
5. Total cumulative scope of **guarantees** issued by the state is limited to 10% of GDP, except in cases of implementation of projects having strategic importance for Montenegro;
6. A **corrective procedure** is defined in case of divergence from fiscal rules and medium-term budget, or a package of measures that the Government proposes to the Parliament in order to ensure compliance with provisions of the Law. A package of measures, depending on the reached debt level, covers reduction of multi-year expenditures, as follows: gross wages, other personal earnings, expenditures for pension insurance and other social protection expenditures, monetary benefits paid by the Employment Office;
7. Projected/planned revenues growth rate is restricted with the projected GDP growth rate, i.e. the revenues growth rate cannot exceed projected nominal GDP growth rate;
8. **Penalty provisions** are a new element introduced under this Law, envisaging pecuniary fines for responsible persons in such situations when in breach of provisions of this Law.

In 2012, stable revenues were provided from core tax forms. Budget discipline was improved with application of savings measures and rationalisation.

Amendments to tax legislation (Law on Personal Income Tax, Law on Compulsory Social Insurance Contributions and Law on Corporate Profit Tax) have improved the tax system and generated major tax revenues, which were priorities of the Ministry of Finance in 2012. Amendments to these laws: have introduced a maximum base for compulsory social insurance contributions, making the tax system additionally attractive for new taxpayers; and have increased the threshold for calculation of contributions from 43,000 to 50,000 euro, broadening the tax base; have extended the deadline for use of the tax relief for legal entities in underdeveloped municipalities. Namely, legal entities that

have engaged in production activity in underdeveloped municipalities have a tax holiday for the corporate profit and personal income tax for the first eight years of operation (previously the tax holiday was applicable for the first 3 years of operation); electronic filing of tax returns is enabled (for corporate profit tax, VAT, excise taxes, and personal income tax). In the period 2013-2015, further harmonisation of the VAT Law with the Directive 2006/112/EC is planned. The objective of these legislative amendments will be to clarify and supplement existing legal provisions. Also, amendments to the Law on Excise Taxes are planned pertaining to harmonisation of the level of excise tax for cigarettes and other tobacco products, alcohol and alcoholic beverages, as well as for mineral oils, products and substitutes thereof, in order to ensure additional harmonisation with the relevant EU directives (2011/64/EU and 92/84/EEC and 2003/96/EC), and the Rulebook on Application of the Law on Excise Taxes will be also amended.

Measures to **suppress grey economy** in 2012: One of the priorities of the Ministry of Finance in 2012 was to suppress grey economy in order to increase the tax base and generate higher tax revenues. The most efficient model for suppression of grey economy is through preventive measures, precisely to design and implement relevant tax policies to eliminate room for irregular operation, along with application of a strict penalty policy. To that end, the Ministry of Finance has established a Coordination Team for monitoring the implementation of grey economy suppression measures, headed by the Minister of Finance, whereby its members are representatives of the Ministry of Finance, Ministry of Labour and Social Welfare, Tax Administration, Customs Administration, Police Administration and Administration for Inspection Affairs. Control measures are increased, in particular in the segment of trade in excisable goods, labour market and employment of non-residents, issuing of fiscal receipts, and registration of legal entities and natural persons engaged in economic activities. Better exchange of information was achieved, and more intensive and efficient inspection controls have influenced improvement of the taxpayers' fiscal discipline. Within legislative measures aimed to reduce grey economy, the Law on Excise Taxes was amended, improving the existing solutions concerning the use of gas oils and liquid petroleum gas used for heating for users of public interest (e.g. schools, hospital, etc) and introducing the system for the excise tax payment and refund in order to introduce a more efficient control and narrow down a room for misuse. The Coordination Team for monitoring the implementation of grey economy suppression measures will prepare a new proposal of measures for suppression of grey economy at the beginning of 2013; such measures are also to include the measures required to strengthen human resources and institutional capacities of the competent institutions.

In the first half of 2012, due to extremely adverse climate conditions, as well as due to the fact that a part of the guarantees for loans of KAP was called upon, additional budget pressures were created and budget revenues have decreased sizeably and new liabilities were created, so that in mid 2012 the **Budget Revision** was prepared and a **set of fiscal measures adopted** aimed at the budget consolidation. Non-productive expenditures, high wages, pensions, remunerations and per-diems were reduced. On the budget revenue side, new duties were introduced on SIM cards, cable TV connections, electricity meters and hospitality industry facilities where in tobacco products can be consumed. However, it should be emphasized that core tax rates were not increased, and wages, pensions or social welfare benefits were not reduced.

Raising funds to finance budget needs: Due to unstable situation on financial markets and currently high interest rates, issuing bonds is not a first option for the government borrowing, so that alternative methods for borrowing were used on domestic and foreign market. To that end, the Government of Montenegro entered into a Contract on Loan Facility with Credit Suisse and the World Bank for 100 million euro, out of which 60% will be covered by the World Bank guarantee (the Policy Based Guarantee, PBG). The loan repayment period is 7 years, with effective interest rate of 5.5%. Those terms and conditions are more favourable than the lending terms and conditions

obtained by the issue of Eurobonds in 2010 and 2011, when the repayment period was 5 years and interest rate 7.85% and 7.25% respectively. These funds will be used to finance the current budget expenditures, capital investments, repayment of unfavourable loans and for the fiscal reserve.

Amount planned for **the Capital Budget** for 2013 is 65 million euro, or 1.86% of GDP, which is at the level of real outturn of previous years. If we take into account capital expenditures within the current budget, as well as the capital expenditures of local self-governments, total capital expenditures for 2013 are planned to amount to around 103 million euro or around 3% of GDP.

3.9. Long-term Sustainability of the Public Finances System

In order to ensure a long-term sustainability of the public finances system, reforms were implemented in the previous period (2010) which will give results in the long run. One of the most important reforms implemented in Montenegro is the parameters reforms of the state pay-as-you-go pension system. Longevity, low population growth rates, as well as the low labour force activity rate, have conditioned a need for the retirement age limit to be gradually moved to 67 years of age. Moreover, the formula for pension adjustments was also changed. A growing number of pensioners was threatening to put in serious jeopardy sustainability of public finances of Montenegro. Thus, the last-year's PEP presented the analysis of the pension reform impact on the public finances. No new analysis was prepared for this year, but facts show that a number of pensioners has increased and along with a growing inflation rate, has led to growth of costs for pension benefits. Since the inflation rate in 2012 was estimated to over 5%, the estimate for 2013 is that expenditures for pensions will increase by ca. 4%. In the long term, it is expected that costs for pensions will reduce as we approach 2040, the year when it is expected for the retirement age to reach 67 years for men and women, as envisaged by the reform.

Long-term impact on public finances will come from adopted policy in the Labour Law, which reduces the costs of firing and simplifies employment, which will affect the labour market flexibility in the future. Amendments to the *Law on Social Insurance* were also adopted, which introduce a voluntary additional insurance at the level of 20% of the base insurance, and if not paid this amount will have to be paid at the time the public healthcare services are used. Negotiations about the amendments to the Law on Child Protection are underway, which would limit maternity allowance to the level of average wage in the country, and not to the average wage in a company as it is the case now, and introduce a new limit for duration of maternity leave to 9 months after the delivery. In addition to the abovementioned, development of the project Social Card (Social Welfare Records) is underway, which would improve the system of distribution of social welfare benefits and introduce the system where only those in actual need would receive the benefits.

3.10. Institutional Framework of Public Finances

In 2012, the Department for Economic Policy and Development, within the Ministry of Finance, has implemented planned activities and commenced with regular development of the spring and autumn analysis, wherein the analysis of macro-economic trends for the previous period are presented as well as macro-economic and fiscal projections for the following three-year period. They represent an analytical framework in the budget planning process, as well as for the next-year's budget preparation, and for preparation of other medium-term documents (PEP). Montenegro joined the General Data Dissemination System (GDSD) within the International Monetary Fund (IMF), and this Department publishes on regular basis (monthly, quarterly) GDSD tables with fiscal data and public debt data. This has improved the data quality and data being up-to-date.

The Ministry of Finance worked to develop a legal framework in the previous period, as well as to develop necessary documents and procedures for efficient use of IPA funds, in line with the European Commission requirements. The **Law on Audit of the European Union Funds** was adopted at the beginning of 2012, which creates an independent Auditing Body responsible for audit of the EU funds (IPA funds, structural funds after the accession of Montenegro to the European Union and other EU funds). Required structures were created, which will after they receive approval of the European Commission carry out independently activities pertaining to programming and implementation of the EU pre-accession funds. Following the positive Report by KPMG and awarding of the national accreditation to structures established for the future independent programming and implementation of IPA components I and IIb, the Ministry of Finance submitted the documents to the Directorate-General for Enlargement, which created conditions for auditors of the European Commission to come and assess established system of financial control and management of the EU pre-accession funds. Following the insight and review of the documentation, the European Commission will send an auditor from the Directorate-General for Enlargement, who will audit on the spot and assess established institutional and legal framework, i.e. adopt a decision on transferring responsibility from the European Commission to Montenegrin institutions taking part in programming and implementing of the EU funds.

Improvement of the fiscal responsibility and strengthening functions and capacities of the public internal financial control: **Amendments and supplements to the Law on the Public Internal Financial Control System** were produced to achieve that, introducing submission of annual reports on implementation of planned activities of financial management and control and audit, as well as the quality assessment of the system of financial management and control and internal audit. This has improved the efficiency of the public internal financial control system.

Adoption of the **National Development Plan for Montenegro 2013-2016**: Montenegro, being a country with the EU membership candidate status, has obligation to set a national framework of socio-economic priorities. The Plan encompasses a detailed analysis of all existing strategies and projects in order to define strategic priorities, time schedule for their implementation, as well as their fiscal impacts. The structure of the National Development Plan (its drafting started in 2011) is aligned with the structure of the Europe 2020 growth strategy (smart growth, sustainable growth, inclusive growth) and contains relevant policy and sub-policy areas identified in the process of assessing strategic development documents.

In the segment of **regulatory reform and improvement of the business environment**, in 2012 the Government adopted the Decree on Register of Licenses for Carrying-out Economic Activities, which established an **e-register of licenses** to be kept on a website, a portal for licences registry. The process of business licensing reform in Montenegro started in 2011, while the main objective of establishment of an e-register of licenses is to increase transparency and reduce regulatory risks for business entities. This will be achieved by having all information on business licensing and documents required to be submitted when applying for a license available in an on-line format. Establishment of the e-register will enable simpler, cheaper and shorter procedures, aimed at ensuring a favourable environment for efficient doing business and creating confidence in public administration. In addition, amendments to the Law on National Payment Operations enabled publication of the **list of legal entities and entrepreneurs with blocked accounts**. This provides for a higher level of information and protection of creditors, reduction of costs for obtaining information, timeliness in initiating bankruptcy proceedings, as well as creation of incentives for regular settlement of due obligations, all aimed to surpass problems of illiquidity and insolvency of business entities, thus achieving the improvement of the business environment.

IV Structural Reforms

Euro-Atlantic integration process on one hand, and global economic crisis effects on the other, demand a serious approach to structural reforms that Montenegro has recognised as a condition for overcoming effects of the crisis and, in the long run, for creating a competitive environment that will enable a sustainable economic growth and development of the country.

Corporate and Financial Markets. Reduced investment activity in international environment had an adverse impact on corporate and financial markets in Montenegro. Systemic changes are by and large aimed at strengthening competitiveness of the country and at its harmonisation with the EU legislation. Within this framework, public resources will be directed towards establishment of long-term competitiveness, i.e. so called "good" state aid. **Business environment enhancement**, as one of priorities of the Government of Montenegro is implemented through activities directed to provision of additional incentives for business development, while tax policy is characterised by preservation of the current level of basic tax rates and by temporary measures for overcoming adverse crisis effects that will represent minimum threat for business environment and socially vulnerable groups. **Financial sector.** Banking sector is stable and controlled on a continuous basis by the regulator. Basic characteristics of the banking sector are: high level of non-performing assets, deposit potentials grow, lending activity goes down, while liquidity and solvency are on the satisfactory level. Regulatory framework has been improved, where attention was paid to its harmonisation with relevant EU directives. This process will continue, including new directives concerning regulation of banking sector operations. Legal framework has been completed for the purpose of full implementation of the law on investment funds. **Labour market.** Inconsistent and inadequate statistical base for analyses have been identified, which has been reflected primarily through unsatisfactory quality of data on labour market, both from survey and administrative sources. Labour market is still characterised by high long-term unemployment and high youth unemployment rates. Taking into consideration the mismatch between the education system and labour market needs, the Law on Professional Development of persons with acquired high education has been adopted, based on which the implementation of the Programme for employment of persons with acquired high education has commenced. In view of increasing flexibility of labour market and decreasing labour costs, negotiations are in process concerning the General Collective Agreement, whose adoption is expected at the beginning of 2013. **Administrative reforms.** In 2012, the Government paid special attention to the issue of state administration reform, through legal framework which will ensure optimisation of the number and structure of state bodies and number of employees. The reform of the inspection supervision reform has been completed, through establishment of the Administration for Inspection Affairs, as a single inspection authority. Regulatory impact analysis (RIA) has been introduced as a quality control system of adopting and implementing public policies.

4.1. Corporate and Financial Markets

4.1.1. Privatisation

Implementation and Divergences: Privatisation process in 2012 was carried out in line with the Privatisation Plan for 2012 (OGM 15/12, 24/12 and 41/12). Only three procedures have been completed by conclusion of a contract: Concession Contract between the Government of Montenegro and "Jadransko Brodogradilište" AD Bijela (for the period of 30 years), Contract on Long-term Lease of Military Camp Location "Orjenski Bataljon" – Kumbor (for the period of 90 years)

and Contract on Sale of Shares AD "Zora" Berane. Only the facility "Plava Školjka" under the ownership of the Hotel Group "Budvanska Rivijera" AD - Budva was privatised through auction sale of shares and property at the initial price of €778,000, which are not a part of the Budget revenues.

Current and Future Economic Policy Programmes and Measures: In 2013, the privatisation process will be directed to completion of failed privatisation processes from previous years and projects for which public invitations were not published. Pursuant to the Work Programme of the Government of Montenegro, the Privatisation Plan 2013 will be adopted at the beginning of the year, which will identify the list of enterprises to enter privatisation process. Announcing and implementing of projects will depend primarily on the interest of potential investors, which is uncertain under the crisis conditions. The policy of the Government of Montenegro in the previous period was directed to preservation of the largest business entities. In view of finding a sustainable solution for KAP, the interest of foreign companies to take over this significant business entity is under survey. Steel Plant Nikšić has been sold to the Turkish company Toscelik through bankruptcy procedure with Commercial Court for €15.1 mill and production has already started. Commercialisation of touristic sites, included in the Privatisation Plan 2012, is expected after the adoption of spatial-planning documents for these areas.

Budgetary Effects of Programmes and Measures: Privatisation Plan for enterprises and property for the period 2013-2015 does not exist while the plan for 2013 is under preparation. Therefore, the amount of budgetary revenues to be generated through privatisations may not be quantified at this moment.

4.1.2. Competition, State Aid and Public Procurement

Competition

Implementation and Divergences: The new Law on Competition Protection that came into force in 2012 brought about the harmonisation of the domestic legislation with European legislation in the area of competition protection.

Current and Future Economic Policy Programmes and Measures: The establishment of the Agency for Competition Protection (Statute is under preparation) is under way, and it is to take over fixed assets, current documentation and employees of the Administration for Competition Protection. Pursuant to the Law on Competition Protection, the Agency is obligated to adopt 6 secondary legislations by the end of the first quarter 2013. Legally envisaged model of organisation and performance of operations of the Agency implies its functional and financial independence, as well as possibility of financing from fees for activities under the scope of its competence, which will be defined by a Tariff Book.

Budgetary Effects of Programmes and Measures are presented in Table no. 15.

State Aid

Implementation and Divergences: All the measures and activities from the last year's Pre-Accession Economic Programme within this area have been fully implemented. In view of measuring performance, i.e. efficiency of granted state aid, the Ministry of Finance amended the *Rulebook on the content of the granted state aid annual report*. Also, the *Decree on the manner and procedure of filing the state aid return* has been harmonised. In line with the obligations from the Stabilisation and Association Agreement, the *Decision on regional aid map* has been passed.

In 2011, state aid was granted in the total amount of 66,441,062.09 EUR, (7.62% less than in 2010) in Montenegro. The share of state aid in GDP went down from 2.32% in 2010 to 2.03% in 2011. The amount of state guarantees including the aid element in 2011 was lower by 80.09% in relation to 2010. Although the data from the Granted State Aid Annual Report for 2011 show a positive trend in terms of decreased so called “unhealthy” state aids, the aid forms granted for rehabilitation and restructuring are still dominant in Montenegro. One of the reasons is the failure in implementation of the Restructuring Plan for the Steel Plant Nikšić, which brought about the calling upon the guarantee, which significantly affected the level of granted state aid in 2011.

Current and Future Economic Policy Programmes and Measures: The problems in implementation of the Restructuring Plan for the Aluminium Plant Podgorica (KAP) conditioned calling upon of the Deutsche Bank guarantee in the first half 2012. With regard to this and in view of avoiding calling upon the remaining guarantees given to KAP, the Government of Montenegro is intensively working on finding the solution for rescheduling of the same.

In view of consolidating public finance and bringing fiscal risks to acceptable level, in 2012 the Government of Montenegro significantly reduced the amount of issued guarantees (€10 mill). The guarantees were issued with the context of financing the reconstruction of the railway infrastructure.

Therefore, the intention of the state aid policy in the coming period will be to strengthen and implement the state aid rules, particularly in the area of state aid sensitive sectors. Also, it is expected that public resources will be directed to establishment of long-term competitiveness to a greater extent, i.e. so called “good” state aids (aid for research, development and innovations, aid for professional development, efficient use of energy, investment in environmental protection, aid to small and medium enterprises, etc.) will be granted.

In the coming period, the project “Strengthening of institutional capacities of Montenegrin authorities in managing and applying the EU state aid policy” will be implemented within IPA 2011 as support to the EU state aid policy.

Budgetary Effects of Planned Programmes and Measures: Payment of guarantees to Deutsche Bank, in the amount of 23.4 million EUR produced a direct negative effect on the Budget, given that the liability was serviced from its funds.

Public Procurement

Implementation and Divergences: The Public Procurement Law (OGM 42/11) was adopted, which has been applied since 1 January 2012, as well as supporting secondary legislation acts: the Rulebook on the forms in public procurement procedure (OGM 62/2011), the Rulebook on the methodology of presenting sub-criteria into relevant number of points, manner of evaluation and comparing bids (OGM 63/2011), the Rulebook on the manner of keeping and content of records on breach of anti-corruption rules (OGM 63/2011), the Rulebook on records of public procurement procedures (OGM 63/2011).

Current and Future Economic Policy Programmes and Measures: In line with the above mentioned Law, the new act on internal organisation and systematisation of the technical service of the State Commission is under way, which will significantly increase the number of higher and lower-grade civil servants. Activities are undertaken on enhancing awareness of significance of the control of public procurement procedure with all entities which are directly or indirectly related to the public

procurement procedure. A new software solution will be established as the base for introduction of an electronic public procurement system, i.e. new electronic register.

There are no budgetary effects of planned programmes and measures.

4.1.3. Business Environment and Tax Policy, from the Aspect of Business Sector

Business Environment Improvement

Implementation and Divergences: Business environment enhancement is one of the key priorities of the Government of Montenegro. At the same time, in 2012, significant activities were also implemented by local self-governments. In 2012, the Council for Regulatory Reform and Business Environment Enhancement (Council) and the Ministry of Finance coordinated reforms, primarily through the following activities and measures:

- electronic filing of application for registration of new business entities in Montenegro, through the e-Administration Portal;
- implementation of a set of regulations on local level, which related to establishment of “One Stop Shop” for issuance of minimum-technical requirements and construction permits;
- reduction of notary fees, particularly in the segment of establishment of lower costs for registration of real estate with the cadastre;
- further simplification of the procedure for employment of foreigners;
- Action Plan for doing business reform for 2012, which defined short-term and mid-term priorities for improvement of the situation in the areas treated by “Doing Business” Report;
- implementation of RIA (Regulatory Impact Assessment) on legislation and secondary legislation acts, as well as the preparation of opinions of the Ministry of Finance regarding the validity of RIA, as well as the impact of the same on business environment, and
- adoption of the Action Plan for implementation of “Regulatory Guillotine” recommendations.

Efforts made in implementation of these reforms were recognized by various institutions including by the World Bank through its Doing Business Report 2013. In this report, Montenegro advanced by 5 places in relation to the last year, and was rated as 51st in the global rating.

Current and Future Economic Policy Programmes and Measures: The following is planned for the coming period:

- implementation of accepted “Regulatory Guillotine” recommendations for 2013 and 2014;
- implementation of new legal solutions for the procedure of issuing construction permits on the local level;
- preparation of the Action Plan for elimination of business barriers on the local level, and
- reform of the system of duties and fees on the local level.

Budgetary Effects of Programmes and Measures are presented in Table no. 15.

Sector of Small and Medium-sized Enterprises

Implementation and Divergences: Action Plan 2012 for implementation of the SME Development Strategy, Action Plan for the Strategy of Competition Promotion on the Macro Level for 2012 and the Strategy for Sustainable Economic Growth through introduction of clusters 2012-2016 have been passed. IDF lending policy in 2012 resulted in 130 approved loans directed towards the SME sector, entrepreneurs and agriculture in the amount of €11.8 mill, 12 new contracts were concluded and

credit limits were approved in the amount of €5.8 mill for factoring, and €7.05 mill receivables were redeemed. Agreement was signed between EIB and IDF, which defines a loan facility in the amount of €50 mill. Employment Agency approved 83 loans in the value of €0.50 mill, which enabled opening of 63 new jobs.

In view of encouraging not only entrepreneurship, but also more balanced development of the State, significant loan support, under favourable conditions, is directed to the north of Montenegro. With regard to this, IDF placed 36.15 % total loan funds to this area, which supported 47 projects, while the Employment Agency, within the self-employment programme, supported the implementation of 43 projects in the value of €250,000, in which respect 50 persons were employed.

The most important implemented activities from the area of SME development in 2012 are as follows:

- Feasibility Study for establishment of the Regional Business Centre has been produced;
- Public Invitation for the project "Voucher schemes for innovative small and medium size enterprises" has been announced;
- National Partnership for Entrepreneurial Learning has been established;
- Activities of the SEECCEL (South East European Centre for Entrepreneurial Learning) project related to introduction of the key competence of entrepreneurship in primary education have been completed; and
- Guidelines for development of national qualifications have been produced and 10 sector commissions for qualifications have been established.

The 2011 Report presents the analysis of realisation and implementation of the small and medium enterprises policy in line with the principles of the Small Business Act.

Current and Future Economic Policy Programmes and Measures: In the coming period the implementation of the measures for financial and institutional support, strengthening of competitiveness and stimulation of export orientation, business knowledge enhancement, promotion of European values and support to business beginners will continue.

Budgetary effect of envisaged programmes and measures are not quantified.

Tax Policy

Implementation and Divergences: Amendments to the Law on Contributions for Compulsory Social Insurance establish the amount of the highest annual base for payment of all contributions for compulsory social insurance, which has been applied since 2012, and clearly define the base for payment of contributions for persons generating income from self-employment activities. The Law on Duties for access to specific services of general interest and for use of tobacco goods and electro-acoustic and acoustic devices³⁰, introducing an obligation of payment of special duties, has been adopted. The Law on Amendments to the Excise Law improved the current solutions related to the use of gas oils and liquid oil gas used for heating, as well as the establishment of the system of exercising the right to lower excise, through the model of payment and refund of a part of paid excise, as to introduce a more efficient control and reduce the space for misuse.

³⁰The mentioned law prescribes the obligation of payment of special duties on the following: mobile telephony cards, electricity meters, cable electronic communication network connections for distribution of radio and TV programmes, for use of tobacco goods and electro-acoustic and acoustic devices in hospitality facilities, and its temporary character for the period from the day of coming into force to 1 January 2014.

Current and Future Economic Policy Programmes and Measures: In the coming period, taxation policy will be in line with basic principles of tax policy in Montenegro, aimed at further improvement of tax system competitiveness, which implies attractive and unique tax rates, efficient administration and procedures, and good tax culture of taxpayers. In the coming period, activities will continue to be undertaken with regard to harmonisation of the tax and customs regulations with the EU legislation and practice, as well as the activities related to signing of contracts on double taxation avoidance, which will create more favourable environment for attraction of foreign investments and further stimulation of economic-financial relations of the contracting countries.

At the same time, in view of creating a more stimulating investment environment and increasing budgetary revenues of local self-governments, various modalities of support to development of under-developed areas are and will continue to be applied. Incentives are implemented primarily through stimulating tax policy, Equalisation Fund resources, conditional subsidies, state aid and the like.

Budgetary Effects of Programmes and Measures are presented in Table no. 15.

4.1.4. Knowledge Society Development

Education

Implementation and Divergences: Within the measures planned by the last year's PEP, activities were not implemented with regard to optimisation of the primary schools network, inclusion of local self-governments in financing of education and application of the principle of per student financing. The reason for these divergences should be sought in the bad financial situation of most local self-governments, which are largely affected by the global financial crisis and whose recovery is slower, as well as the fact that optimisation of primary schools network should be carefully planned, both from the aspect of financial impact and from the position of ensuring primary education accessibility.

Current and Future Economic Policy Programmes and Measures: In the coming period the activities will be directed to: 1) the preparation of the Strategy for enrolment policy at the University of Montenegro, 2) the development of a thorough study on application of the Bologna Declaration principles in Montenegro, 3) the development of the study on the labour market needs in the area of high education, 4) the preparation of the Analysis of various models for high education financing, in line with actual per student costs, labour market needs and quality of study programmes, 6) the continuation of the work on ensuring education quality on all levels, 7) the increase of the level of mobility of Montenegrin students, 8) the collection of data and preparation of the Action Plan for optimisation of the current primary schools network, 9) the inclusion of local governments in education financing and commencement of application of per student financing of institutions, 10) the strengthening of links between the labour market and education.

Budgetary Effects of Programmes and Measures are presented in Table no. 15.

Research and Development

Implementation and Divergences from implementation of measures and divergence reasons: All the activities planned by the last year's PEP have been implemented.

Current and Future Economic Policy Programmes and Measures: The following is planned for the coming period:

- implementation of measures specified by the Feasibility Study for establishment of centres of excellence in Montenegro, through implementation of the HERIC³¹ Project, financed by the World Bank loan for the period 2012-2017;
- implementation of measures specified by the Feasibility Study for establishment of a science-technology park in Montenegro,
- 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;
- implementation of the Action Plan for participation of Montenegro in EUREKA Programme;
- implementation of the plan of including Montenegro in ICGEB (International Centre for Genetic Engineering and Biotechnology) and
- review of the Strategy for Scientific Research Activity.

Budgetary Effects of Programmes and Measures are presented in Table no. 15.

4.1.5. Network Industries

Energy

Implementation and Divergences: The activities from the concession contract for exploitation of watercourses for construction of small hydropower plants are implemented with some delay resulting partly from the lack of spatial-planning documentation. The project of the construction of the submarine interconnection power cable between the electric power systems of Montenegro and Italy is carried out in accordance with the envisaged schedule (Detailed Spatial Plan for the 400 kV power line corridor with optical cable from the Montenegrin coast to Pljevlja and submarine 500kV cable with optical cable Italy-Montenegro has been produced, urban-technical requirements have been obtained, activities related to expropriation and procurement of a part of equipment are under way). Implementation of the District Heating Project for the Pljevlja Municipality has not started yet, due to the problems in business operations of the company that is designated to be responsible for implementation of this project.

The basic obstacle for completion of the projects envisaged for the energy sector are the difficulties related to raising funds, i.e. reduced interest of companies to invest, under the conditions of economic and financial crisis. In spite of the existing difficulties, the trend of energy sector development and reforms is followed, and therefore activities are undertaken on fulfilling the commitments under the Treaty Establishing the Energy Community for the South-East Europe and application of relevant EU directives.

Current and Future Economic Policy Programmes and Measures: Implementation of initiated activities in the energy sector will continue in the coming period. Thus:

- *Montenegro Energy Development Strategy until 2030 and a four-year Action Plan for its implementation will be passed;*
- *The Programme for Development and Application of High Efficiency Cogeneration as well as local energy plans for the period of 10 years will be passed;*
- *A new Tender for construction of small hydro-power plants will be announced and implementation of activities under the concession contracts for exploitation of watercourses*

³¹ HERIC Project - Higher Education and Research for Innovation and Competitiveness

for construction of small hydro-power plants signed based on completed tender procedures will continue;

- *Projects related to construction of wind turbines on the locations of Krnovo and Možura will continue, as well as the Project of exploration of wind potentials and development of wind turbines on the Adriatic coast;*
- *The Programme for development and exploitation of renewable energy sources will be passed for 10-year period. The Programme is to specify the schedule and incentive measures for achieving the national goal in relation to the share of renewable energy sources in the total final energy consumption;*
- *Pursuant to the Second National Energy Efficiency Action Plan 2013-2015, which is to be passed in the second quarter 2013, activities will be completed that will mostly be directed to public sector and infrastructure measures, which are required to be implemented as to achieve savings of 3% of the final energy consumption by 2015;*
- *Decisions will be made as regards financing models for construction of hydro power plants on the Morača and HPP Komarnica, and preparatory activities for construction of the TPP Pljelja II and TPP Maoče will be implemented. (In 2012, possible options for implementation of these projects were considered, and interest of potential investors was surveyed);*
- *Activities will continue with regard to the project of construction of the Ionic-Adriatic gas pipeline, whose implementation is expected as early as 2014, and tender procedure will be carried out for award of the concession contract for production of hydrocarbons on the offshore of Montenegro (tender will be announced in the first half 2013);*
- *Implementation of the Project of construction of the submarine inter-connection direct current cable between the electric-power systems of Montenegro and Italy will continue.*

Taking into account that there have been certain divergences in implementation of the construction of small hydro-power plants and windmills in relation to the planned schedule, their fiscal effects in 2012 were insignificant. In the coming period they will depend on the dynamics of implementation and commencement of production. Activities related to the construction of the sub-marine inter-connection cable between the electric power systems of Montenegro and Italy and the project of HPP Komarnica imply no fiscal impact until 2014.

Preparation of strategic development documents and action plan, programme and tender documents is financed mostly by donations, thus there is no net budgetary impact produced.

Energy Regulatory Agency, which carries out public authorisations related to regulation of energy sector of Montenegro:

- *at the end 2011 passed methodologies for establishing regulatory revenue and prices for network activities (transmission and distribution), i.e. methodology for establishing regulatory revenues and tariffs for public supplier;*
- *in 2012, pursuant to such methodologies, the Agency established prices and tariffs for electricity for the following three-year period;*
- *at the end 2011, approved the Rules on cross-border capacity auctions, and in 2012 it approved the Market Rules, i.e. rules for operating a transmission and distribution electrical power system, which created the basic prerequisites for bringing a competitive electricity market into life in Montenegro.*

Due to the features of the electrical power sector of Montenegro (market size - number and structure of consumers, EPS size and ownership structure, insufficient production, general economic situation and other), it is still impossible to talk about the creation of a national market that would be liquid and fully sustainable.

For the mentioned reasons, in addition to activities related to organisation of the national market, Montenegro is clearly committed to creation of a regional energy market together with the neighbouring countries, pursuant to the Treaty Establishing the Energy Community. Therefore, initial activities related to establishing of a legal entity “Coordinated Auction Office for SE Europe” (CAO SEE) with registered office in Montenegro are implemented.

In the coming period, the Agency will implement activities in the field of renewable sources, i.e. establishing of the status of eligible producers, issuance of guarantees of origin and keeping a Register of eligible producers. At the same time, it will control the work and operations of energy entities, particularly in relation to implementation of investment plans, following of the conditions envisaged by licenses to operate; legal unbundling of an electricity system distribution operator from a vertically integrated entity; application of regulations on cross-border energy trade; application of market rules and operating of entities in the market.

Budgetary Effects of Programmes and Measures are presented in Table no. 15.

Transport

Road infrastructure and road traffic: Activities directed to improvement of the road infrastructure have been implemented in continuity. Therefore, in the coming period the following will be carried out: regular maintenance of state roads that is financed from the current budget funds; continuation of implementation of the programme for elimination of bottlenecks in the traffic network of Montenegro, the programme of reconstruction of intersections on state roads of Montenegro and the programme of reconstruction and rehabilitation of critical points on state roads of Montenegro. Land will be expropriated for the needs of construction of the dual carriageway/single carriageway section Podgorica - Mateševo, and activities required for implementation of the Adriatic-Ionic Highway project will be undertaken.

The following have been produced: Feasibility Study, Investment Plan for SEETO Road Route 4, as well as the social impact assessment and environmental impact assessment according to European standards. The findings of the Feasibility Study also include the Potential Capital Investment Programme of the dual carriageway/single carriageway section Podgorica – Mateševo:

Table 17 Indicative investment plan

	2014	2015	2016	2017	2018	Total costs (€ mill)
Smokovac-Mateševo 44km	145	112	115	115	15	502

Source: Extract from Economic Report URS Infrastructure and Environment UK Limited (Scott Wilson)

A formal request will be sent to international financial institutions, primarily EIB, for raising funds for construction of this road route. Activities are in process for preparatory activities for development of the Main Design, with supporting documents, as well as relevant Tender Documents (these activities are planned to be implemented in the period 2013-2014).

Air Transport: Pursuant to the Master Plan for development of the public enterprise »Aerodromi Crne Gore«, options are considered for raising financial resources for specific infrastructure projects and services, through cooperation with reputable world companies from the area of airport infrastructure, based on the model of private-public partnership and concessions.

Secondary legislation will be passed based on the Law on Air Transport (adopted in 2012). Activities will intensify with regard to ratification of new international conventions and bilateral agreements.

Railway Transport: The railway restructuring process has continued. The second phase is close to its finalisation, and it implies segmentation of already established joint stock companies, and it will be completed by the privatisation of some parts of the railway system.

In the coming period, the following is planned: completion of the regulatory framework treating railway transport issues; strengthening of administrative capacities of the line ministry and the Railway Directorate; commencement of the process of mutual recognition of licenses and certificates. Feasibility Study of the construction of and a conceptual design for the railway from Pljevlja via Bijelo Polje and Berani to the border with Kosovo have been produced.

It is planned that the remaining funds from the EBRD loan amounting to €10,000,000 and EIB loan amounting to €7,000,000 will be spent for the projects related to railway transport area (railway modernisation, rehabilitation of landslides, tunnels, road crossings, railway stations) in 2013. It is expected that the projects funded by IPA 2010 funds in the amount of €5,000,000 will be completed in the first quarter 2013. In the coming period, IPA III component funds for the period 2012-2016 will be used to finance two projects in the amount of €7,537,895.

Maritime Affairs: Activities related to renewal and expanding of the Montenegrin naval fleet are undertaken. In 2012, exploitation commenced of two ships »Kotor« and »21 Maj«, which sail under the Montenegrin flag. Negotiations are in process between the AD "Barska Plovidba" and Poly Group from Beijing for purchase of two green ships.

Liabilities under two concession contracts between the Government of Montenegro and »Jadransko Brodogradilište« AD Bijela and the Government of Montenegro and DOO »Pomorski Poslovi« are implemented in accordance with the foreseen schedule.

Budgetary Effects of Programmes and Measures are presented in Table no. 15.

Telecommunications

Electronic communications: In 2013, the Law on Electronic Communications will be adopted (Proposal of the Law is prepared and submitted to the Government for adoption), as well as enabling regulations for its implementation. Regulations on RTT and EMC equipment have been adopted.

The Agency for Electronic Communications and Postal Services has defined the fixed and mobile network termination rates in 2012. Electronic communication networks in Montenegro are interconnected, while each operator separately negotiates and implements the interconnection with foreign networks. Number portability service is operational. Quality parameters for services provided by operators have been published.

In accordance with the new Law on Electronic Communications, in addition to further legislative regulation of the area of electronic communications, the Agency will: analyse relevant markets of electronic communication services and monitor the implementation of established regulatory obligations; regulate retail prices of fixed telephony services (Telekom A.D. is designated as the operator with significant market power on the relevant retail market); develop and implement a model for accounting unbundling and cost accounting for operators of public electronic communication networks; develop a study on intended use of the frequency band 790-862 MHz; develop a study on establishment of the national internet exchange point (IXP) in Montenegro; install platforms for users to be able to measure internet access speed, as well as develop tools to enable users to compare prices of services and select the most favourable user packages.

Radio-broadcasting: Process of transition from analogue to digital broadcasting systems is not taking place in line with the planned time schedule. The tender procedure for procurement of transmitters and repeaters, as part of the 2nd phase of the digitalisation financed by the state of Montenegro has not commenced due to delays in realisation of the 1st phase, i.e. the delivery of equipment by the supplier selected by the European Commission. The EU Delegation to Montenegro hired an independent expert to verify compliance of the equipment with technical requirements set forth under the Contract. Findings of the expert will determine future steps in the Project (changes of equipment delivery dates or taking corrective measures).

In accordance with the Law on Amendments to the Law on Digital Broadcasting (adopted in 2012), the final deadline for completion of the digitalisation process is set (17 June 2015). Also, electronic broadcasters are enabled to obtain new approvals for broadcasting their television programmes using the analogue technology.

Postal services: In accordance with the Law on Postal Services, the market of postal services will be fully open starting from 1 January 2013.

Budgetary effects of programmes and measures are presented in Table No 15.

4.1.6. Financial sector

Banking Sector

Banking sector of Montenegro is stable and continuously controlled by the regulator. A deposit potential of banks, as well as the aggregate balance sheet sum increased in October 2012 if compared to the end of 2011. Deposits of banks are higher than their placements. The liquidity of banks is at a satisfactory level, as is its solvency. Banks are prudential and restrictive in approving new placements, which resulted in decline in lending activity in 2012. The banking system is still burdened with non-performing loans, specifically collection of previously approved placements. Interest rate spread is high and amounts to 6.26% (in October 2012 the average effective lending interest rate was 9.5%, while the average deposit interest rate was 3.24%). The financial result of banks was negative in the period January-October 2012.

At the end of October 2012, the aggregate balance sheet of banks in Montenegro amounted to EUR 2,838,077,000 that is by 1.0% higher than at the end of 2011. The most important item in the aggregate balance sheet of banks is loans of EUR 1,859,350,000, and they recorded the year-on-year decline of 4.2%. The level of non-performing assets in the total assets of banks was 13.38%, while the share of non-performing loans in the total loans was 17.77%. The percentage of default loans amounts to 25.46%, for the entire system.

Total deposits amount to EUR 1,965,523,000, showing the nominal increase of 8.2% (EUR 148,463,000). At the sector level, the deposits of natural persons are dominant in the structure of deposits (56.7%) with the growth of 7.9% if compared to the end of the last year.

Total capital of banks amounts to EUR 285,423,000 in October and it declined by 6.5% if compared to the end of 2011. The reason for decline of capital was the negative financial result of commercial banks (EUR -59,054,000) in the period January-October 2012. The solvency ratio of banks at the end of September 2012 at the aggregate level was 13.56%.

During 2012, the Central Bank of Montenegro (CBCG) carried out stress testing of all banks in the system under two stress scenarios (real and pessimistic), the objective being to establish the need for recapitalisation, in case of more significant impact of the economic crisis in the EU countries on Montenegro. The exogenous pessimistic scenario is based on the pronounced retraction of the real GDP, increase of interest rates, decline in the capital markets indices and real-estate prices. The test showed that three banks did not meet statutory minimum capital adequacy of 10% after the exogenous shock. Supervisory strategies, including projected capital needs, were sent to all banks. In the forthcoming period an increase of their capital is expected.

High level of non-performing loans is a big challenge for Montenegrin financial sector and economy. In that regard, CBCG and the Ministry of Finance, in cooperation with the World Bank, are implementing a project concerning preparation and implementation of a specific strategy for reduction of the non-performing loans level in the financial sector of Montenegro. This project is managed and financed by the Financial Sector Advisory Centre (FinSAC) from Vienna.

In 2012, supervision of banks and micro-finance institutions (MFIs) was intensified in the segment of monitoring the level of risks the financial institutions are facing in operations and strengthening the system tenacity. Twelve on-site targeted controls of banks and MFIs were carried out, and based on the results, supervisory measures were imposed for some of the banks in order for them to correct noted irregularities and bad practices in operations. Supervisors of CBCG were taking part in supervisory educations of parent banks having their subsidiaries in Montenegro, aimed at considering the overall risk profile of bank groups, business strategies and their impact on operation of banks in Montenegro.

Regulatory Activities

Implementation and divergences: In 2012, activities to improve the regulatory framework and its harmonisation with the relevant EU directives were undertaken.

The Decision on the Manner of Calculating Bank Exposures was adopted, completing the planned process of harmonisation of legislation with the Directive 2006/48/EC. The Decision on Minimum Standards for Credit Risk Management in Banks was also adopted, thus creating a legal basis for application of international accounting standards for valuation of financial assets when compiling financial statements of banks (balance sheet and income statement). At the same time, in line with the rules set forth under this Decision, the classification of assets and calculation of provisions for possible credit losses is carried out, for the Central Bank reporting purposes, aimed at observing the capital adequacy and other indicators of banks' operation. In the event the value of required provisions, as established by the asset classification, exceeds the amount of corrected value established by applying the international accounting standards, such difference is a deductible item for calculation of the regulatory capital, whereby so called "prudential filters" have been introduced ensuring additional protection of depositors and other banks' creditors.

Regulations pertaining to the IAS 39 application obligation were adopted (Decision on the Chart of Accounts for Banks, Decision on Reports Submitted to the Central Bank of Montenegro, Decision on Capital Adequacy of Banks), and their application will commence on 1 January 2013.

Obligations from the previous Pre-accession Economic Programme for the period 2011-2014, pertaining to the regulation of the banking sector, were met with completion of these activities.

Current and future economic policy programmes and measures: Activities aimed at improving the solutions, in particular those concerning the minimum standards for liquidity risk management, will

continue. Based on internationally accepted documents, guidelines for banks on the management of concentration risk and stress testing in banks will also be prepared.

Moreover, further alignment of enabling regulations with the relevant EU regulations will continue, including also new directives being adopted in the sphere of governing the banking sector operations.

There are no budgetary effects of planned programmes and measures.

Capital market

Implementation and divergences: The capital market in 2012 functioned under conditions not prone to investments on the secondary market, while the primary market and investments of new capital were at a substantial level. New capital invested in companies and banks, in first nine months was 87.5 million EUR, while the total turnover on the domestic capital market was 27.4 million EUR during the same period. Factors driving the reduction of the capital market's liquidity were primarily the transformation of investment funds (during the transformation process the funds were able to dispose with their portfolio only in exceptional circumstances) and the fact that banks own a sizeable part of most liquid securities, as collateral/pledge, meaning that those securities are practically not traded in.

Transparency in reporting in the capital market has increased. Following the implementation of the regulation on publication of financial reports, the discipline of market participants has increased and public information ledger was created that contains around 8,000 pages of financial reports which are updated on daily basis.

All supporting rules were adopted for implementation of the Law on Investment Funds. Cooperation with investment fund management companies and banks was established, aimed at clear and precise delivery of custody and depositary affairs.

New software applications were implemented for the control of operation of the voluntary pension funds, which will be introduced next year for investment funds as well.

The project for improvement of operations of CDA (Central Depository Agency), with focus on the IT system, in terms of data security and new services, was completed in April 2012.

Current and future economic policy programmes and measures: Over the coming period, the following activities will be implemented: 1) harmonisation of regulations with the EU legislation, 2) adoption of the Law on Capital Market and supporting enabling regulations, 3) improvement of the information system of the Securities Commission, 4) continuation of international cooperation (IOSCO, OECD, IPA, IFC, Toronto Centre), 5) continuation of staff training and advance education, and 6) delivery of education activities to the capital market participants, as well as to the general public.

Current Law on Securities will be replaced by the Law on Capital Market, which will contribute for the capital market to be more attractive for foreign investors. The Law on Capital Market will define, amongst other things, the securities issuing, secondary trading, stock market operations, CDA functioning, publication of financial data, as well as a ban on manipulative and other prohibited activities.

There are no budgetary effects of planned programmes and measures.

Insurance

Core feature of the Montenegrin insurance market is stability, with present upward trends. However, the structure and level of realised gross premiums are lagging behind the European averages by far. The state of the national economy has reflected, to a certain degree, on the results in the insurance sector, thus a moderate growth of the written premium value on the market in 2011 was generated. According to the preliminary data for 10-month period of 2012, the gross written premium on the insurance market was €56.5 million and generated growth of 4.2% if compared to the same period of 2011. Thus, there were no significant changes in the structure of the gross written insurance premium if compared to the previous period. Non-life insurance activities maintained an extremely high share in the overall market portfolio, and they are at the level of 87.3%, with continued dominant share of the mandatory insurance activities, in particular the automobile liability insurances. Life insurance activities had the share of 12.7% in the gross written premium over the same period.

Implementation and divergences: During 2012, activities in the insurance sector predominantly involved the harmonisation of legislation with the EU Directives. In that regard, the adoption of the Law on Amendments and Supplements to the Law on Insurance and the new Law on Compulsory Transport Insurance, has improved the framework regulating this area. Application of the said legal instruments will commence after enabling regulations have been adopted, which is planned for 2013, which are covering, amongst other things: conditions for obtaining operating licenses, including also conditions for acquisition of a qualifying holding in an insurance company and conditions for carrying out management functions in the insurance company; change in the criteria for calculation of core elements of an insurance company operation, including the solvency margin, capital adequacy, sufficiency, manner of depositing and investing technical reserves funds; manner of sale of insurance under specific conditions (bank insurance model) and similar. Whilst, the application of the Law on Amendments and Supplements to the Law on Compulsory Transport Insurance will govern in more details the supervision over the fulfilment of obligations of the Insurers Association, in particular in the segment concerning the functioning of the Guarantee Fund.

Regulatory Activities

The Insurance Supervision Agency was successful in implementing preparatory activities for education and licensing in the sphere of the actuary profession, with practical implementation scheduled to commence in the second half of 2013. Preparatory activities concerning the harmonisation of the Law on Bankruptcy and Liquidation of Insurance Companies with the EU *Acquis* have commenced. Its adoption is planned for 2013.

Current and future economic policy programmes and measures: Activities of the Insurance Supervision Agency will be directed to amendments of existing and adoption of new enabling regulations, resulting from amendments and supplements to the Law on Insurance and Law on Compulsory Transport Insurance and adoption of legislation pertaining to further harmonisation with the EU standards. One of the core priorities of the Agency in the coming period is the development of administrative capacities, with a view of improving the insurance supervision quality, as well as education of citizens, aimed at adequate information provision and protection of insurance users.

The Insurance Supervision Agency will intensify cooperation with international institutions, aimed at ensuring technical assistance, advisory and expert missions and training, necessary for capacity development and bolstering the quality in delivery of all its functions.

There are no budgetary effects of planned programmes and measures.

4.2. Labour market

4.2.1. Employment Policy

Implementation and divergences: Activities planned under the last-year's PEP were chiefly implemented, with the exception of the General Collective Bargaining Agreement, where its signing is expected at the beginning of 2013.

In the first ten months of 2012, the labour market recorded a mild recovery reflected through a decline of the unemployment rate, and an increase of the active population and employment. As per MONSTAT data (Labour Force Survey), the population activity rate increased from 48.6% in the first quarter to 52.0% in the third quarter of 2012, while the employment rate rose from 38.5% to 42.2%. If compared to the same quarter of the last year, the activity rate in the 3Q of 2012 was higher by 1.9 p.p., employment rose by 1.9 p.p., while the unemployment decreased by 0.7 p.p. Furthermore, total registered employment recorded a continuous increase from January to October (except for a reduction in June), while in October 2012 it was 168,701, which is 4.9% higher if compared to January. If observing the annual data, in the period January-October 2012 employment was higher by 1.9% if compared to the same period of the last year, whereby the highest growth was recorded in the energy sector (9.9%), professional, scientific, and technical activities (9.1%), and agriculture (7.7%), while the largest decline of employment was recorded in the processing industry (10.7%).

According to the Employment Office data, number of registered unemployed persons is experiencing a downward trend. In October 2012, a number of unemployed persons was 29,540 or 2.2% less than in October 2011, while in the same period, the registered unemployment rate was reduced from 13.0% to 12.6%. In the period January-October 2012, number of employed persons, via the Employment Office, was higher by 22.8% if compared to the same period of the last year, whereby the number of employed seasonal workers was 9,523, which is 10.0% more than in the same period of the last year. Number of advertised vacant jobs over the same period was 20,948 (1.0% more), while the number of issued work permits to foreigners, from January to the end of October 2012, (17,921) was higher by 5.6% if compared to the same period of 2011. In October 2012, the Government adopted the Decision on Determining the Number of Work Permits for Foreigners for 2013, which has sizeably reduced the quota.

Adverse climate conditions at the beginning of the year had a major effect on the labour market developments in this year, as well as the debt crisis, high interest rates, continued adverse lending support to business and grey economy. In addition to that, the labour market problems include an unaligned and inadequate statistical base for analysis, which result primarily in an unsatisfactory quality of the labour market data, both from survey-based and from administrative sources.

High long-term unemployment and high unemployment rate of young population of 17.6% continue to be features of the labour market. According to the data from the Labour Force Survey, unemployment rate of young population in the third quarter of 2012 was 44.6%. In the forthcoming period, status and trends on the labour market will continue to be driven by a broader economic context, primarily the economic crisis, scope and structure of foreign direct investments, and congruently the number of new jobs. Additionally, some companies and restructuring thereof continues to be a constant threat for the labour market, principally due to the labour force structure, which could possibly fall in the category of unemployed persons. At the same time, the need to reduce the public spending, need for savings, financial consolidation and restrictive budgetary envelope are limiting the employment opportunities in the public sector and possibility to direct more funds for implementation of measures incentivising employment. Also, lack of a

monitoring and evaluation system of active employment measures was limiting the optimum planning and directing of the limited budgetary funds for those measures being the most effective ones.

Having in mind the mismatch of the education system and the labour market needs, the Law on Professional Development of Persons with acquired University Education was adopted. In line with that, the programme that will provide persons with acquired university education and who are without experience and being registered with the Employment Office work experience and consequently an increased chance for employment is being implemented. The Budget for 2013 has allocated 10 million EUR for implementation of this programme.

Moreover, during 2012, social partners have negotiated about the General Collective Bargaining Agreement, and its adoption is expected at the beginning of the next year. The new General Collective Bargaining Agreement will contribute to the labour market flexibility and reduction of the costs of labour (by a three-year reduction of compensation for years of service to 0.5% for each year initiated, instead of present 0.5%, 0.75% and 1% depending on the number of years of service, as well as by limiting the maximum amount for increase hourly rate in case of overtime, night work and work during state holidays, to 150% of the hourly rate instead of present 230%).

Current and future economic policy programmes and measures: Assuming the above stated, the following activities are planned:

- further improvement of the labour market legal framework, in order to align it with the European legislation and to increase its flexibility;
- incentives for employment of young population through implementation of the Law on Professional Development of Persons with acquired University Education;
- implementation of active employment policy measures; and
- development of a local partnership in resolving the unemployment problem.

Expected effects of the labour market measures in the period to come will be conditioned by the overall economic environment, but will contribute, to a certain degree, to improvement in employment intermediation, alignment of the labour market needs and education, reduction of unemployment, and especially the structural unemployment.

If the overall economic environment ends up being in line with expected projections, reduction of the unemployment rate and reduction of the registered unemployment rate to the level of 11.5% could be expected. In such case the public finances crisis continues, the effects will be visible in the labour market as well, primarily through reduced activity, reduced employment and increase of unemployment.

Budgetary effects of programmes and measures are presented in Table No 15.

4.2.2. Reform of the Social Protection System

Pension System Reform

Implementation and divergences: Expenditures for pensions for the first 10 months of 2012 were higher than the planned; and will exceed the plan by approximately 4% by the end of the year.

Current and future economic policy programmes and measures: Activities pertaining to the pension system reform in the coming period will be directed towards application of laws, effects thereof and defining further directions of the pension and disability insurance reform in Montenegro.

Budgetary effects of programmes and measure: Positive effects of reforms in the pension system area could not be expected in 2012 and 2013. This is even more the case as there was an increase of pensioners and of disability insurance recipients in 2012 what consequently resulted in an increase of the expenditures for pensions. However, in the future period, prominent positive advancements are expected, precisely reduction of the Budget allocations for payment of pensions.

Health Care

Implementation and divergences: Activities planned under the last-year's PEP for the area of healthcare were implemented. Based on the Law on Health Care Insurance, additional offers for supplemental voluntary health care insurance and public-private partnership were introduced. Cancellation of the tender by the Directorate for Public Works concerning the construction of the Polyclinic of the General Hospital Berane delayed the commencement of works.

Current and future economic policy programmes and measures: Activities concerning the reform of the secondary and tertiary health care will continue, aimed at increasing the health quality of population. The secondary health care level needs to be aligned with international guidelines along with improvement of services of specialised out-patient facilities, acute and non-acute hospital-based care, transfer of activities into day-care hospitals with a transparent system of patient classification as base for the financing system, which needs to be ultimately linked with the system for improving quality and safety. The tertiary activity is of significant national importance, since it covers the most complex procedures, scientific and research work, thus the tertiary status needs to be verified periodically (every 5 years).

In the coming period:

- Activities will continue on implementation of strategic documents, in particular the Strategy for Optimisation of the Secondary and Tertiary Healthcare Level, as well as of the strategies adopted in 2012;
- Investments in the health care infrastructure will continue;
- Network of healthcare institutions will be rationalised, as well as the optimum spatial distribution of capacities in public healthcare institutions and concessionaires;
- Eight healthcare centres will be established; and
- Preventive programmes will be developed and implemented.

Budgetary effects of programmes and measures are presented in Table No. 15.

Social Protection

Implementation and divergences: Proposal of the Law on Social and Child Protection is adopted and submitted to the Parliamentary procedures, and its adoption is expected at the beginning of 2013. Core new elements introduced in the Law refer to the social benefits allocation improvement, engaging users of social benefits who are able to work and removing the inactivity trap, as well as to improvement of the social protection services area, in particular the long-term care.

Implementation of the project "Social Card (Social welfare records)" has commenced. The Ministry of Labour and Social Welfare and the UNDP office in Montenegro have signed the Agreement on the Project implementation, while the completion is planned for the third quarter of 2014.

Current and future economic policy programmes and measures: During 2013, activities in this area will be aimed at:

- Implementation of solutions from the new Law on Social and Child Protection;

- Realisation of the “Social Card (Social welfare records)”;
- Improvement of social services accessibility.

Budgetary effects of programmes and measures are presented in Table No 15.

4.3. Administrative Reforms

Implementation and divergences: In the process of the public sector optimisation, the Draft Plan for the Public Sector Reorganisation is adopted, which will establish a balance between the reduction of budgetary expenditure, on one hand, and servicing obligations arising from the EU accession process, on the other hand.

At the same time, the Decree on Organisation and the Manner of Work of Public Administration was adopted, and entered into force in January 2012, with the objective for activities to be carried out more efficiently and more cost-effectively, better and with improved quality in coordination of work and activities of authorities, to strengthen the supervision function over their work, and more focused concentration of resources. The Law on Wages of Civil Servants and State Employees was adopted, which was aligned with the Law on Civil Servants and State Employees. The Law on Civil Servants and State Employees expanded the application of the Law to employees in the state funds, Employment Office and Agency for Peaceful Settlement of Labour Disputes, so that the wages of employees of said institutions are made equal with wages of employees in other state administration authorities starting from 1 January 2013.

The Law on Amendments and Supplements to the Law on Inspection Supervision, which entered into force on 1 January 2012, established the Administration for Inspection Affairs. Establishment of a single inspectorate authority will result in better coordination in the work of various inspection services, improvement of the responsibility system, consolidation of resources into a single point, which should all together lead to a more efficient work of inspectorates in the field of suppressing the “grey economy” and increasing budget revenues.

The draft of the new Law on Administrative Proceedings is prepared, aimed at creating preconditions for higher-quality provision of services to citizens, entrepreneurs and other entities by public administration authorities (simplification and shortening of procedures, higher degree of legal protection of parties to the proceedings, introduction of e-government). Starting from 1 January 2012, the Regulatory Impact Assessment (RIA) was introduced in the legal system of Montenegro, as a quality control system in the process of adoption and application of public policies. Furthermore, in order to improve the participative democracy and quality of public policies, the Decree on Procedure and the Manner of Public Consultations Delivery in Preparation of Laws and the Decree on the Manner and Procedure for Cooperation of Public Administration Authorities and Non-governmental Organisation were adopted. In October 2012, the Government of Montenegro opened a portal for electronic petitions – “Citizens’ Voice”, with the objective to provide a possibility to citizens to influence the public policy creation through submission of petitions to the Government concerning the issues falling within its constitutional responsibility³². The project “Citizens’ Voice” is part of the multilateral initiative of the Open Government Partnership (OGP). The Strategy for Further Development of the Public Internal Financial Control System for the period 2013-2017 is adopted, intended to improve the quality of public sector services through financial management and control, to strengthen internal audit units and to strengthen capacities of the Central Harmonisation Unit.

³² All electronic petitions of citizens with at least 6,000 signatures via portal “Citizens’ Voice” will be translated into formal initiatives and considered at the session of the Government of Montenegro.

The Law on Amendments and Supplements to the Law on Local Self-Government is adopted, which improves the supervision over the legality of work of authorities and strengthens the role of the chief administrator. Most of the local self-government units have adopted agreements on cooperation of the municipal assembly with non-governmental organisations, decision on a Council for cooperation of local self-government and non-governmental organisations, decision on the manner and procedure for participation of local population in delivery of public services, decision on criteria, the manner and procedure for allocation of funds to non-governmental organisations.

Taking into account that uneconomical spending of public institutions and companies in majority state ownership, in particular in the segment of employees' wages was recognised as one of the problems in the process of implementation of austerity measures in all spending levels in the public sector, a ceiling on wages for management persons was introduced.

Current and future economic policy programmes and measures: In the next period, a key activity in the administrative reforms will deal with the reorganisation of the public administration authorities and optimisation of the number of employees therein, aimed at reducing costs of labour and better concentration of human resources, financial, material and technical resources. In order for the said objectives to be realised, it is necessary to carry out a comprehensive analysis of existing human resources capacities, so that based on those information and after reviewing the situation for the overall public sector, conditions would be created for a planned and systemic strengthening of priority sectors through human resources mobility or new employment, as well as for a comprehensive and transparent identification of jobs which became obsolete or which have more officers than what is needed for the tasks being performed. In this way a balance between the need for new employment and the need to preserve financial stability could be achieved.

Precise and comprehensive classification and categorisation of jobs into ranks in the public administration requires detailed measurements for defining tasks and their classification by complexity. This is also important in order to develop a clear picture of number of staff necessary to carry out certain categories of jobs, both for individual needs and from the aspect of managing human resources needs at the level of the overall public administration system, but also in terms of keeping a uniform, transparent and fair wage and remuneration policy. In order to ensure that wages and other earnings are in support of effective and efficient delivery of tasks by qualified and motivated human resource, further reforms and establishment of a uniform public sector wage and remuneration system, in line with a comparative European practice, need to be considered over the medium term, which will also consider the experiences in implementation of solutions which will enter into force on 1 January 2013.

Montenegro does not have a unique legal framework for the system of public services i.e. entities (except for the state authorities) empowered with public authorisations. Absence of a systemic law that governs the area of agencies and other organisations empowered with public authorisations results in extensive differences in their status and functioning, as well as in insufficient control of legality of work and purposefulness of their work. In the last decade, the number of these entities in the public sector has almost doubled. In spite of the need for certain number of institutions to be established in order to advance in the integration process and in order to regulate certain areas, an unjustified trend of creation of new authorities is present in the previous period, instead of integration of new tasks within already existing institutional framework. Result of such practice is sizeable increase of operating costs in the public sector. To that end, a scope of operation and status of public agencies and other regulatory bodies established by the Government needs to be revisited and legal framework for these institutional forms for delivery of public services created, in order to establish clear and uniform rules for their establishment, functions, responsibilities,

supervision of their work, employment, classification of jobs, status of employees and the manner of financing. The Framework Action Plan for implementation of the Strategy of the Public Administration Reform in Montenegro for the period 2011-2016 plans the adoption of the Proposal of the Law on Public Services and Funds and the Proposal of the Law on Public Agencies for 2013. Improvement of the legal framework for the area of public services and organisation with public authorisations will enable more clear defining of the status of public services, public agencies and funds in the overall system, as well as the strengthening of the responsibility in this public administration segment towards other administrative, legislative or judicial authorities, all with the objective to ensure rule of law and principle of legality. As part of measures for improvement of the legal framework for the area of public services and organisations with public authorisations, it is necessary to analyse national and comparative European practice and based on those results consider the need for further concentration of jobs within the ministries.

Budgetary effects of programmes and measures: Experience of countries which have undertaken the similar processes show that an adequate dimensioning or optimisation of the public sector can imply but not necessarily lead to a reduction of number of employees. Efficiency increase is achieved also by applying other measures such as improvement of the way the work processes are carried out, responsibility, expertise and other. Not only the total number of employees is important, but also their distribution in institutions, skills and knowledge they have.

Budgetary effects of programmes and measures are presented in Table No 15.

ANNEX

ANNEX 2:

Table 1a: Macroeconomic prospects

Percentages unless otherwise indicated	ESA code	Year 2011.	Year 2011.	Year 2012.	Year 2013.	Year 2014.	Year 2015.
		Level (bnl EUR)	Rate of change				
1. Real GDP at market prices	B1*g	3,052	3,2	0,5	2,5	3,0	3,5
2. Current GDP at market prices	B1*g	3,104	4,2	2,8	5,1	5,6	6,1
Components of real GDP							
3. Private consumption expenditure	P3	2,550	4,2	1,7	2,5	2,0	0,9
4. Government consumption expenditure	P3	0,650	-1,6	-1,4	1,1	1,6	3,0
5. Gross fixed capital formation	P51	0,660	-10,3	-1,3	7,0	3,0	9,0
6. Changes in inventories and net acquisition of valuables (% of GDP)	P52+P53	0,052	-34,6	-100,0	0,0	0,0	0,0
7. Exports of goods and services	P6	1,030	14,1	-6,1	-4,5	4,7	5,5
8. Imports of goods and services	P7	1,890	3,1	-4,8	-0,8	2,1	2,7
Contribution to real GDP growth							
9. Final domestic demand		3,9	0,9	0,9	3,7	2,6	3,1
10. Change in inventories and net acquisition of valuables	P52+P53	0,1	-0,6	-1,1	0,0	0,0	0,0
11. External balance of goods/services	B11	-0,9	2,9	0,7	-1,2	0,4	0,4

Table 1b: Price developments

Percentage changes, annual averages	ESA code	Year 2011.	Year 2012.	Year 2013.	Year 2014.	Year 2015.
1. GDP deflator		0,9	2,3	2,5	2,5	2,5
2. Private consumption deflator		2,7	2,3	2,5	2,5	2,5
3. HICP		3,3	1,5	-2,0	-0,2	0,0
4. National CPI change		2,6	0,9	-1,3	-0,2	0,0
5. Public consumption deflator		-0,1	2,3	2,5	2,5	2,5
6. Investment deflator		1,5	2,3	2,5	2,5	2,5
7. Export price deflator (goods & services)		5,7	2,3	2,5	2,5	2,5
8. Import price deflator (goods & services)		5,9	2,3	2,5	2,5	2,5

Table 1c: Labour markets developments

	ESA code	Year 2011.	Year 2011.	Year 2012.	Year 2013.	Year 2014.	Year 2015.
		Level	Level/Rate of change				
1. Population (thousands)			620,1	621,3	622,5	623,8	625,0
2. Population (growth rate in %)			0,00	0,20	0,20	0,20	0,20
3. Working-age population (persons)[1]			421,0	421,8	421,7	422,5	423,4
4. Participation rate			58,0	60,6	60,6	60,6	60,6
5. Employment, persons [2]			196,0	197,6	201,4	203,4	206,4
7. Employment (growth rate in %)			-6,4	0,8	1,9	1,0	1,5
8. Public sector employment (persons)			52,1	49,6	49,6	49,6	49,6
9. Public sector employment (growth in %)			-0,6	-4,8	0,0	0,0	0,0
10. Unemployment rate [4]			19,7	22,7	21,2	20,6	19,6
11. Labour productivity, persons[5]			10,3	-0,4	0,6	2,0	2,0
13. Compensation of employees	D1		-5,5	1,2	1,9	1,0	1,5

Table 1d: Sektorski bilans

Percentages of GDP	ESA code	Year 2011.	Year 2012.	Year 2013.	Year 2014.	Year 2015.
1. Net lending/borrowing vis-à-vis the rest of the world	B.9	-27,6	-24,1	-24,4	-25,0	-23,9
<i>of which:</i>						
- <i>Balance of goods and services</i>		-27,6	-24,1	-24,4	-25,0	-23,9
- <i>Balance of primary incomes and transfers</i>		0,0	0,0	0,0	0,0	0,0
- <i>Capital account</i>		0,0	0,0	0,0	0,0	0,0
2. Net lending/borrowing of the private sector	B.9/ EDP B.9	-22,2	-21,0	-22,1	-23,3	-23,2
3. Net lending/borrowing of general government		-5,4	-3,1	-2,3	-1,7	-0,7
4. Statistical discrepancy		0,0	0,0	0,0	0,0	0,0

1e: GDP, investment and gross value added

	ESA code	Year 2011.	Year 2012.	Year 2013.	Year 2014.	Year 2015.
GDP and investment						
GDP level at current market prices (in domestic currency)	B1g	3,2	3,3	3,5	3,7	3,9
Investment ratio (% of GDP)		18,4	18,1	18,9	18,9	19,9
Growth of Gross Value Added, percentage changes at constant prices						
1. Agriculture		11,2	-3,0	5,5	2,2	3,0
2. Industry (excluding construction)		-6,7	-3,4	0,7	3,3	4,5
3. Construction		15,8	-7,0	3,6	3,7	2,5
4. Services		3,9	1,9	2,2	3,0	4,1

Table 1f: External sector developments

Billion Euro unless otherwise indicated		Year 2011.	Year 2012.	Year 2013.	Year 2014.	Year 2015.
1. Current account balance (% of GDP)	% BDP-a	-19,6	-20,0	-21,0	-20,4	-19,7
2. Export of goods	NCU or EUR	0,477	0,369	0,286	0,306	0,328
3. Import of goods	NCU or EUR	1,783	1,775	1,821	1,891	1,993
4. Trade balance	NCU or EUR	-1,306	-1,406	-1,535	-1,585	-1,666
5. Export of services	NCU or EUR	0,845	0,904	0,960	1,032	1,119
6. Import of services	NCU or EUR	0,317	0,310	0,299	0,328	0,342
7. Service balance	NCU or EUR	0,528	0,594	0,661	0,704	0,777
8. Net interest payments from abroad	NCU or EUR	0,000	0,000	0,000	0,000	0,000
9. Other net factor income from abroad	NCU or EUR	0,026	0,004	-0,006	-0,019	-0,026
10. Current transfers	NCU or EUR	0,117	0,145	0,145	0,147	0,145
11. <i>Of which</i> from EU	NCU or EUR	0,000	0,000	0,000	0,000	0,000
12. Current account balance	NCU or EUR	-0,634	-0,663	-0,734	-0,753	-0,770
13. Capital and financial account	NCU or EUR	0,634	0,663	0,734	0,753	0,770
14. Foreign direct investment	NCU or EUR	0,389	0,378	0,349	0,369	0,391
15. Foreign reserves	NCU or EUR	0,000	0,000	0,000	0,000	0,000
16. Foreign debt	NCU or EUR	0,000	0,000	0,000	0,000	0,000
17. <i>Of which</i> : public	NCU or EUR	1,064	1,331	1,548	1,683	1,738
18. <i>O/w</i> : foreign currency denominated	NCU or EUR	0,000	0,000	0,000	0,000	0,000
19. <i>O/w</i> : repayments due	NCU or EUR	0,000	0,000	0,000	0,000	0,000
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	% BDP-a	0,0	0,0	0,0	0,0	0,0
23. Domestic private saving	% BDP-a	0,0	0,0	0,0	0,0	0,0
24. Domestic private investment	% BDP-a	0,0	0,0	0,0	0,0	0,0
25. Domestic public saving	% BDP-a	0,0	0,0	0,0	0,0	0,0
26. Domestic public investment	% BDP-a	0,0	0,0	0,0	0,0	0,0

Table 2: General government budgetary prospects

	ESA code	Year	Year	Year	Year	Year	Year
		2011	2011	2012	2013	2014	2015
		Level (bn NCU)	% of GDP				
Net lending (B9) by sub-sectors							
1. General government	S13	-0.176	-5.4	-3.1	-2.3	-1.7	-0.7
2. Central government	S1311	-0.190	-5.9	-3.3	-2.7	-2.0	-0.9
3. State government	S1312	0.000	0.0	0.0	0.0	0.0	0.0
4. Local government	S1313	0.013	0.4	0.2	0.4	0.3	0.2
5. Social security funds	S1314	0.000	0.0	0.0	0.0	0.0	0.0
General government (S13)							
6. Total revenue	TR	1.285	39.7	38.6	37.1	36.0	35.6
7. Total expenditure[1]	TE	1.461	45.2	41.7	39.4	37.7	36.3
8. Net borrowing/lending	EDP.B9	-0.176	-5.4	-3.1	-2.3	-1.7	-0.7
9. Interest expenditure	EDP.D41 incl. FISIM	0.048	1.5	1.8	2.1	2.4	2.6
10. Primary balance[2]		-0.129	-4.0	-1.3	-0.2	0.7	1.9
11. One-off and other temporary measures [3]		0.000	0.0	0.0	0.0	0.0	0.0
Components of revenues							
12. Total taxes (12 = 12a+12b+12c)		0.736	22.7	22.7	20.8	20.6	20.4
12a. Taxes on production and imports	D2	0.581	18.0	17.8	16.1	16.1	16.0
12b. Current taxes on income and wealth	D5	0.149	4.6	4.8	4.5	4.3	4.2
12c. Capital taxes	D91	0.005	0.2	0.2	0.3	0.2	0.2
13. Social contributions	D61	0.354	10.9	10.6	11.0	10.7	10.5
14. Property income	D4	0.016	0.5	0.4	0.4	0.4	0.4
15. Other (15 = 16-(12+13+14)) [4]		0.180	5.6	4.9	4.8	4.4	4.3
16 = 6. Total revenue	TR	1.285	39.7	38.6	37.1	36.0	35.6
p.m.: Tax burden (D2+D5+D61+D91-D995) [5]		1.089	33.7	33.3	31.8	31.2	30.9

Continuation

		Level (bn NCU)	% of GDP				
		2011	2011	2012	2013	2014	2015
Selected components of expenditures							
16. Collective consumption	P32	0.000	0.0	0.0	0.0	0.0	0.0
17. Total social transfers	D62 + D63	0.456	14.1	14.4	14.3	14.0	13.6
17a. Social transfers in kind	P31 = D63	0.000	0.0	0.0	0.0	0.0	0.0
17b. Social transfers other than in kind	D62	0.456	14.1	14.4	14.3	14.0	13.6
18 = 9. Interest expenditure (incl. FISIM)	EDP.D41 + FISIM	0.048	1.5	1.8	2.1	2.4	2.6
19. Subsidies	D3	0.046	1.4	0.6	0.4	0.3	0.3
20. Gross fixed capital formation	P51	0.136	4.2	3.4	3.0	2.9	2.9
21. Other (21 = 22-(16+17+18+19+20) [6])		0.776	24.0	21.5	19.6	18.0	16.8
22. Total expenditures	TE [1]	1.461	45.2	41.7	39.4	37.7	36.3
p.m. compensation of employees	D1	0.4241208	13.1	12.8	11.8	11.1	10.4

Table 3: General government expenditure by function

% of GDP	COFOG Code	Year 2011	Year 2012	Year 2013	Year 2014	Year 2015
1. General public services	1	10.8	8.6	8.1	7.6	7.5
2. Defence	2	1.1	1.1	1.1	1.1	1.0
3. Public order and safety	3	3.6	3.5	3.2	3.1	3.0
4. Economic affairs	4	4.5	3.5	2.9	2.7	2.6
5. Environmental protection	5	0.3	0.1	0.1	0.1	0.1
6. Housing and community amenities	6	0.3	0.1	0.1	0.1	0.1
7. Health	7	5.2	5.3	4.8	4.6	4.3
8. Recreation, culture and religion	8	0.9	0.9	0.8	0.7	0.7
9. Education	9	4.2	4.1	4.0	3.8	3.6
10. Social protection	10	14.2	14.3	14.2	13.9	13.5
11. Total expenditure (item 7 = 23 in Table 2)	TE	45.2	41.7	39.4	37.7	36.3

Table 4: General government debt developments

% of GDP	ESA code	Year 2011	Year 2012	Year 2013	Year 2014	Year 2015
1. Gross debt [1]		44.4	52.1	54.5	54.3	51.7
2. Change in gross debt ratio		44.4	7.7	2.5	-0.2	-2.6
Contributions to change in gross debt						
3. Primary balance [2]		4.0	1.3	0.2	-0.7	-1.9
4. Interest expenditure [3]	EDP D.41	1.5	1.8	2.1	2.4	2.6
5. Stock-flow adjustment		38.9	4.6	0.1	-1.9	-3.3
<i>of which:</i>						
- Privatisation proceeds		0.0	0.0	0.0	0.0	0.0
- Valuation effects and other [6]		0.0	0.0	0.0	0.0	0.0
p.m. implicit interest rate on debt [7]			4.1	4.3	4.6	5.1
Other relevant variables						
6. Liquid financial assets [8]		0.0	0.0	0.0	0.0	0.0
7. Net financial debt (7 = 1 - 6)		44.4	52.1	54.5	54.3	51.7

Table 4.1: Public Debt Stock as of 30 September 2012

Foreign debt		
Creditor	Debt stock	Undisbursed funds
International Bank for Reconstruction and Development (IBRD)	238.5	30.2
International Finance Corporation (IFC)	2.5	
Member countries of the Paris Club of Creditors	105.5	
International Development Association (IDA)	66.9	1.9
European Investment Bank (EIB)	80.9	38.5
European Bank for Reconstruction and Development (EBRD)	22	9.7
Council of Europe Development Bank	9.1	
European Community	5.5	
German Development Bank – KfW	12.8	55.1
Hungarian loan	11.9	
Polish loan	10.1	
Societe Generale - Education IT	0.02	
French loan	8.5	
EUROFIMA – debt of the Railways company	24.8	
Czech EXIM - debt of the Railways company	27.4	
Steiermarkische Bank und Sparkassen AG	18.7	
Erste Bank	15	
Credit Suisse Bank	250	
Spanish loan for construction of a landfill	4.9	
Exim Bank Hungary	2.8	
Austrian loan	9.8	
EUROBOND	380	
TOTAL FOREIGN DEBT	1,307.62	135.4
Domestic debt		
Creditor	Debt stock	
Old foreign currency savings	83.0	
Debt of local self-governments	84.9	
Compensations-related liabilities	78.0	
Loans with commercial banks	41.6	
Loans of non-financial institutions	35.2	
Pension arrears	1.8	
Treasury bills	69.2	
The Labour Fund bonds	6.0	
TOTAL DOMESTIC DEBT	399.7	
TOTAL GOVERNMENT DEBT	1,707.32	

Table 4.2: Foreign Government Guarantees on 30 September 2012

Creditor	Loan	Borrower	Year of signing	Signed amount	Disbursed until 30-Sep-2012	Debt Stock as of 30-Sep-2012
EIB	European roads Project	Monteput	2004	24,000,000	24,000,000.00	23,480,014.16
EIB	Reconstruction of the Electricity System	EPCG	2002	11,000,000	8,023,090.00	6,776,633.13
EIB	Modernisation of Airports	JP Aerodromi CG	2004	12,000,000	11,000,000.00	9,600,000.00
EIB	Small and medium-sized enterprises credit line via commercial banks	Commercial banks	2009	91,000,000	81,845,000.00	79,757,103.31
EIB	Modernisation of the railways infrastructure	Željeznička infrastruktura CG	2010	7,000,000	0.00	0.00
EBRD	Modernisation of Airports	JP Aerodromi CG	2003	11,000,000	10,235,127.00	5,539,457.78
EBRD	Construction of the regional water-supply system Project – southern branch – Phase I	JP Regionalni vodovod	2007	8,000,000	8,000,000.00	6,666,666.70
EBRD	Construction of the regional water-supply system Project – southern branch – Phase II	JP Regionalni vodovod	2008	7,000,000	7,000,000.00	6,125,000.00
EBRD	Construction of the regional water-supply system Project – southern branch – Phase II Annex	JP Regionalni vodovod	2010	3,000,000	3,000,000	2,625,000.00
EBRD	Project of reconstruction of the railways infrastructure– Phase III	JP Zeljeznice CG	2009	4,000,000	3,146,345.80	3,146,345.80
EBRD	Project of urgent reconstruction of the railways infrastructure II	Zeljeznicka infrastruktura AD Podgorica	2009	15,000,000	7,772,301.90	7,772,301.90
EBRD	Project of acquisition of electric-railcars and diagnostic equipment	Željeznički prevoz AD	2010	13,550,000	3,098,372.46	3,098,372.46

EBRD	Credit line for deposit protection	Deposit Protection Fund	2010	30,000,000	0.00	0.00
KfW	Perucica	EPCG	2003	3,580,000	3,422,387.66	1,235,387.70
KfW	Piva	EPCG	2007	16,000,000	3,015,210.84	3,015,210.84
KfW	Sub-station Ribarevine	EPCG	2007	5,400,000	3,943,943.09	3,943,943.09
KfW	Replacement of filters in the TPP Pljevlja and expansion of the substations Podgorica-Ribarevine	EPCG	2008	15,000,000	12,446,953.00	12,446,953.00
KfW	Opportunity bank	Opportunity bank	2009	15,000,000	15,000,000.00	10,909,090.90
KfW	NLB	NLB	2009	16,000,000	16,000,000.00	13,454,545.54
OTP	KAP	KAP	2009	49,680,000	49,680,000.00	42,198,234.59
EXIM China³³	Acquisition and overhaul of ships	Montenegrin maritime transport company (<i>Crnogorska plovidba</i>)	2010	36,656,066.40	32,343,588.00	32,343,588.00
WTE Wassertechnik	Wastewater treatment Project	Municipality of Budva	2010	29,250,000.00	0.00	
Abu Dhabi Development Fund³⁴	Water-supply Project	Regionalni vodovod	2010	9,180,571.74	4,969,274.31	4,969,274.31
VTB	Support to KAP	KAP	2010	60,000,000.00	60,000,000.00	60,000,000.00
Czech Export bank	Completion of the Railroad Podgorica – Nikšić	ŽICG	2011	5,000,000.00	1,963,200.54	1,963,200.54
On 30 September 2012					369,904,794.60	340,897,573.75

³³ Loan of the Chinese Exim Bank for the Project "Acquisition and overhaul of ships" is signed for the amount of 47,396,000 USD. Contracted amount, amount of disbursed funds, as well as debt stock based on the issued guarantee were converted at the applicable exchange rate of the CBCG of 31 March 2012.

³⁴ Loan of the Abu Dhabi Development Fund for the Project "Water supply" was signed for 43,600,000 AED, were a fixed exchange rate of 1USD=3.673 AED was set. Contracted amount, amount of disbursed funds, as well as the debt stock based on the issued guarantee were converted at the applicable exchange rate of the CBCG of 31 March 2012.

Table 4.3: Domestic Guarantees Issued in 2009, 2010 and 2011

	Creditor	Borrower	Guarantee Issuance Data DATUM POTPISIVANJA GARANCIJE	Signed Amount (EUR)	Debt Stock as of 30-Sep-2012 (EUR)
1	NLB Montenegrobanka	Rudnici boksita a.d. Nikšič	09-Jun-2009	5,000,000.00	5,000,000.00
2	Podgorička banka	Pobjeda a.d. Podgorica	10-Jul-2009	2,970,000.00	2,290,724.85
3	Hipotekarna banka a.d.	Montenegro Airlines	31-Dec-2009	2,700,000.00	2,700,000.00
4	NLB Montenegrobanka	Montenegro Airlines	25-Feb-2010	1,800,000.00	1,800,000.00
5	Erste banka a.d. Podgorica	Pobjeda a.d. Podgorica	01-Jul-2010.	3,500,000.00	3,500,000.00
6	Hipotekarna banka a.d.	MI-RAI GROUP DOO NIKŠIĆ	27-Jul-2010	800,000.00	777,975.71
7	NLB Montenegrobanka	Melgonia- Primorka	22-Dec-2010	4,000,000.00	4,000,000.00
8	Hipotekarna banka a.d.	Montenegro Airlines	06.05.2011	2,000,000.00	2,000,000.00
9	Erste banka a.d. Podgorica	Fabrika elektroda "Piva" Plužine	27-Jul-2011	1,500,000.00	1,500,000.00
10	Hipotekarna banka a.d.	MI-RAI GROUP DOO NIKŠIĆ	13-Sep-2011	700,000.00	700,000.00
11	Erste banka a.d. Podgorica	Željeznički prevoz Crne Gore	13-Dec-2011	3,500,000.00	3,500,000.00
12	NLB Montenegrobanka	Montenegro Airlines	13-Dec-2011	2,400,000.00	1,130,000.00
13	Investiciono razvojni fond AD (Investment and Development Fund JSC)	Crnogorska plovdba a.d. Kotor	30-Dec-2011	1,500,000.00	1,500,000.00
14	Crnogorska komercijalna banka a.d. Podgorica	Jadransko brodogradilište a.d. Bijela	19-Jan-2012	1,050,000.00	916,894.80
15	Hypo Alpe Adria banka	Lenka a.d. Bijelo Polje	30-Dec-2011	525,000.00	525,000.00
	TOTAL			33,945,000.00	31,840,595.36

Table 5: Cyclical developments

% of GDP	ESA code	Year 2011.	Year 2012.	Year 2013.	Year 2014.	Year 2015.
1. Real GDP growth (%)	B1g	3,2	0,5	2,5	3,0	3,5
2. Net lending of general government	EDP.B.9	-5,4	-3,1	-2,3	-1,7	-0,7
3. Interest expenditure	EDP.D.41	1,5	1,8	2,1	2,4	2,6
4. One-off and other temporary measures [1]						
5. Potential GDP growth (%)		2,4	1,9	2,0	2,3	2,3
Contributions:						
- labour		0,4	0,0	0,0	0,2	0,2
- capital		1,0	0,9	0,9	0,9	0,9
- total factor productivity		0,9	1	1,1	1,1	1,2
6. Output gap		-2,0	-3,4	-2,8	-2,1	-1,0

Table 6: Divergence from previous programme

	Year 2011.	Year 2012.	Year 2013.	Year 2014.	Year 2015.
1. GDP growth (% , yoy)					
Previous update	2,5	2,0	3,5	4,0	3,5
Latest update	3,2	0,5	2,5	3,0	3,5
Difference (percentage points)	0,7	-1,5	-1,0	-1,0	0,0
2. General government net lending (% of GDP)					
Previous update	-3.2	-1.0	0.1	1.0	
Latest update	-5.4	-3.1	-2.3	-1.7	-0.7
Difference	-2.2	-2.1	-2.5	-2.7	-0.7
3. General government gross debt (% of GDP)					
Previous update	43.82	46.92	45.36	42.93	
Latest update	44.4	52.1	54.5	54.3	51.7
Difference	0.5	5.1	9.2	11.4	51.7

Table 8: Basic assumptions on the external economic environment underlying the PEP^{35 36}

VARIABLE (annual growth rates in %, unless otherwise stated)	IMPLEMENTATION AND ASSUMPTION FOR								COMMENT	
	2010	2011	2012	2013	2014	change*	change*	change*		change*
Interest rates (in % p.a., annual averages)										
- Short-term interest rates ³⁷ (annual average)										
- Long-term interest rates ³⁸ (annual average)	1.6	0.4	1.9							
Exchange rate (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							

*: changes vis-à-vis projections made for the previous PEP

** : please indicate type of calculation (number of currencies, type of price index for deflation)

³⁵ This table is from the last-year's Pre-accession Economic Programme 2011-2014

³⁶ This table should be included in the programme itself; if not, these assumptions should be transmitted to the Commission together with the Programme

³⁷ If necessary, purely technical assumption

³⁸ If necessary, purely technical assumption

Table 9: Agenda of Structural Reforms and Achievements

Measures from the 2011 EFP	Measure accepted (Yes/No)	Date of acceptance / envisaged acceptance	Comment
4.1.1. PRIVATISATION			
AD „Montecargo“, Podgorica	Not implemented	2012	Based on the experience from previous failed tenders and reduced investors' interest within the economic crisis context, public invitations for most companies were not announced in 2011. Their announcement and implementation in 2012 or later depend primarily on the interest of possible investors, which is uncertain under the present circumstances.
„Montenegro airlines“ AD, Podgorica	Not implemented	2012	
AD „Kontejnerski terminal i generalni tereti“, Bar	Not implemented	2012	
„Pošta Crne Gore“ AD, Podgorica	Not implemented	2012	
„Održavanje željezničkih vozniha sredstava“ AD, Podgorica	Not implemented	2012	
NIG „Pobjeda“ AD, Podgorica	Active	2012	
„Jadransko brodogradilište“ AD, Bijela	Not implemented	2012	
Institut „Dr Simo Milošević“ AD, Igalo	Not implemented	2012	
„Luka Bar“ AD, Bar	Not implemented	2012	
AD „Zora“, Berane	Not implemented	2012	
HG „Budvanska rivijera“ AD, Budva	Not implemented	2012	
HTP „Ulcinjaska rivijera“ AD, Ulcinj	Not implemented	2012	
„Institut crne metalurgije“ AD, Nikšić	Not implemented	2012	
Fabrika elektroda „Piva“ AD, Plužine	Not implemented	2012	
„Barska plovidba“ AD, Bar	Not implemented	2012	
Ada Bojana	Not implemented	2012	
Velika plaža	Not implemented	2012	
Bjelasica-Komovi	Not implemented	2012	
Utjeha	Not implemented	2012	
Njivice/Sutorina	Not implemented	2012	
Valdanos	Not implemented	2012	
Ostrvo cvijeća	Not implemented	2012	
Bigova –Trašte	Not implemented	2012	
Mediteran Žabljak	Not implemented	2012	
Orijenski bataljon - Kumbor	Active	2012	
Ostrvo Mamula	Active	2012	
4.1.2.1. COMPETITION			
Adoption of the new Law on Protection of Competition	No		Law is in the Parliamentary procedure
4.1.2.2. STATE AID			
Adjustment Programme	Yes		
IT system for recording the state aid is established	Yes		
Proposal of the Decision on the Regional Aid Map	Yes		
4.1.2.3. PUBLIC FINANCES			
Law on Public Procurement	Yes		
Secondary legislation	Yes		
Rulebook on internal organisation and systematisation of the Directorate for Public Procurement	Yes		
4.1.3.1. IMPROVING THE BUSINESS ENVIRONMENT			
Introducing 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 of Claims	Yes		
Simplification of employment of foreigners	Yes		
Expansion of the credit register coverage in line with the new Law on the Central Bank	Yes		

Measures from the 2011 EFP	Measure accepted (Yes/No)	Date of acceptance / envisaged acceptance	Comment
of Montenegro			
Action plan for the Doing Business Reform for 2011	Yes		
4.1.3.2. SECTOR OF SMALL AND MEDIUM-SIZED ENTERPRISES			
Adoption of new strategic documents	Yes		
Credit support to SMEs by the Investment and Development Fund (IDF)	Yes		
Strengthening institutional support to SMEs (new business centre model created, decision made on establishment of incubators in Berane, competition for feasibility study for technology parks launched, PPP dialogue initiated)	Yes		
Strengthening competitiveness and export (providing information, developing market research surveys, electronic database of exporters, survey on 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 entrepreneurial competencies", training needs analysis, national qualifications framework)	Yes		
Export development programme	No		Shortage of fund for implementation
4.1.3.3. TAX POLICY			
Amendments to the Law on Administrative Fees	Yes		
Project of unified registration and collection of the personal income tax and mandatory social insurance contributions	Yes		
4.1.4.1. ENERGY			
Adoption of the Energy Policy of Montenegro until 2030	Yes		
Publication of the third tender for construction of small hydropower plants	No	2012	
National Energy Efficiency Plan	Yes		
Activities on the project concerning the Adriatic-Ionic gas pipeline construction	Yes		
Tender for exploration of oil and gas	No	2012	
Tender for construction of the hydropower plan on the River Morača	No		Qualified bidders failed to submit the required documentation within the envisaged deadline
4.1.4.2. TRANSPORTATION			
Regular maintenance of state roads 2010-2014	Yes		
Implementation of the project Bar-Boljare Highway	No		In the coming period the Government will examine the options for final implementation of this project
Adriatic-Ionian Highway	Yes		
Implementation of the programme for elimination of bottlenecks in the network	Yes		

Measures from the 2011 EFP	Measure accepted (Yes/No)	Date of acceptance / envisaged acceptance	Comment
Implementation of the programme for reconstruction of intersections on state roads	Yes		
Privatisation programme of "Montenegroairlines"	No	2012	
Programme of the railway infrastructure reconstruction	Yes		
Programme of restructuring and privatisation of the AD Luka Bar (Port of Bar)	Yes		
4.1.4.3. TELECOMMUNICATIONS			
Project of transition from analogue to digital broadcasting	Yes		
Implementation of the Universal service in electronic communications	Yes		
Postal Services Development Strategy	Yes		
Adoption of the Law on Postal Services	Yes		
Privatisation of the Post of Montenegro, using the public-private partnership model	No		The delay was caused by the change in organisation and way of work of the state administration, so that a new Tender Committee was established
4.2.1. BANKING SECTOR			
Activities under the Action Plan of initiatives on strengthening the capacities of the Central Bank and supervisory function in the period 2010-2014	Yes		
Secondary legislation for implementation of the Law on the Central Bank	Yes		
4.2.2.1. INSURANCE			
Amendments and supplements to the Law on Insurance	No		Redefining the schedule of activities in creation of the regulatory framework in the insurance sector
Amendments and supplements to the Law on Compulsory Transportation Insurance	No		Redefining the schedule of activities in creation of the regulatory framework in the insurance sector
New system of tariffs and conditions for third party liability insurance of owners of motor vehicles and trailers thereof	Yes		
Amendments to the Law on Bankruptcy and Liquidation of Insurance Companies	No		Redefining the schedule of activities in creation of the regulatory framework in the insurance sector
Rulebook on the requirements for acquiring a title of an authorised actuary	No		Working draft of the Rulebook prepared
4.2.2.2. CAPITAL MARKETS			
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 trading system in the merged stock exchange	Yes		
Continued increased oversight and control of authorised participants and issuers	Yes		
4.3. LABOUR MARKET			
Law on Amendments and Supplements to the Labour Law	Yes		
Law on Amendments and Supplements to the Law on Employment and Work of	Yes		

Measures from the 2011 EFP	Measure accepted (Yes/No)	Date of acceptance / envisaged acceptance	Comment
Foreigners			
Law on Amendments and Supplements to the Law on Professional Rehabilitation and Employment of Persons with Disabilities	Yes		
Law on National Framework of Qualifications	Yes		
Measures for reduction of structural imbalances 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 and Supplements to the Law on General Administrative Procedure	Yes		
Law on Amendments and Supplements 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 the 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, wherein the model of supplemental voluntary insurance is defined	Yes		
Strategy for optimisation of the secondary and tertiary healthcare 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 additional work in the public sector under the market principles	Yes		
Model for implementation of the of public-private partnership mechanism	Yes		

Measures from the 2011 EFP	Measure accepted (Yes/No)	Date of acceptance / envisaged acceptance	Comment
Model for full or partial privatisation of specific state health institutions	No		Privatisation preconditions are not created
4.6.4. SOCIAL PROTECTION			
Social protection system analysis	Yes		
Law on Social and Child Protection	Yes		
“Social Card” (Social welfare records)	No		Project hasn't been implemented due to the need to review the concept, which is in underway

Table 10: Implementation overview of programmes and measures without quantification of fiscal effects

	2012	2013	2014	2015
Improvement of the business environment				
Implementation of accepted “Regulatory Guillotine” recommendations	X	X		
Implementation of new legal solutions for the procedure of issuing construction permits on the local level	X	X	X	
Preparation of the Action Plan for elimination of business barriers on the local level	X	X	X	
Reform of the system of duties and fees on the local level	X	X	X	
Tax Policy				
Law on supplements to the Law on Excise Taxes	X	X	X	X
Law on amendments and supplements to the Law on Contributions for Mandatory Social Insurance	X	X	X	X
Energy				
Subsidies to electricity consumers	X	X	X	X
Projects for construction of small hydropower plants	X	X	X	X
Projects for construction wind turbines	X	X	X	
Project of construction of the submarine interconnection power cable	X	X	X	X
Project of construction of the HPP Komarnica	X	X	X	X
Development of the <i>Montenegro Energy Development Strategy until 2030</i>	X	X		
Development of the Action Plan for implementation of the <i>Montenegro Energy Development Strategy until 2030</i>		X		
Development of the <i>Programme for Development and Use of High Efficiency Cogeneration</i>		X		
Development of local energy plans	X	X		
Exploring wind potential and development of coastal wind turbines	X	X	X	
Tender for award of a concession contract for production of hydrocarbons in the offshore Montenegro	X	X		
Transport				
Program of reconstruction of intersections in the state roads	X	X	X	