MONTENEGRO

Highlights

- **The Covid-19 pandemic is weighing strongly on growth in 2020.** The economy relies heavily on tourism, and foreign tourist arrivals declined by over 80 per cent year-on-year in the first half of 2020, contributing to a sharp fall in GDP.
- **The government adopted three packages of economic support measures as a response to the coronavirus crisis.** The packages are worth over €1.5 billion (more than 30 per cent of GDP) and aim to maintain the liquidity of companies, saving jobs and supporting vulnerable groups.
- **The country is progressing on greening energy generation.** The decarbonisation agenda of the state electricity company (EPCG) relies on an extensive renewable investment plan.

Key priorities for 2021

- **Fiscal adjustment should be resumed as soon as Covid-19 concerns recede.** Besides maintaining a primary surplus over the medium term, further strengthening of budgeting procedures, public investment management and public and tax administration is needed. Construction of further sections of the major cross-country highway should be preceded by a careful cost-benefit analysis.
- **Informality needs to be tackled through further measures.** Unfair competition from the informal sector weighs primarily on local micro, small and medium-sized enterprises. Government measures should be focused on underlying causes such as the regulatory burden, weak enforcement capacity and corruption, and simplifying tax legislation and reducing para-fiscal charges would also be beneficial.
- **The bank asset quality review should be completed.** This would help give a clear picture of the underlying strengths and weaknesses of the banking sector. In addition, the central bank should closely monitor financial stability and issues arising from the Covid-19 crisis.

Main macroeconomic indicators %

	2016	2017	2018	2019	2020 proj.
GDP growth	2.9	4.7	5.1	4.1	-9.0
Inflation (average)	-0.3	2.4	2.6	0.4	-0.1
Government balance/GDP	-6.2	-6.9	-6.2	-2.4	-10.0
Current account balance/GDP	-16.2	-16.1	-17.0	-15.2	-14.0
Net FDI/GDP [neg. sign = inflows]	-9.4	-11.3	-6.9	-7.0	-5.0
External debt/GDP	162.6	160.6	164.7	170.2	n.a.
Gross reserves/GDP	18.1	20.8	21.9	27.9	n.a.
Credit to private sector/GDP	48.8	48.7	49.6	49.4	n.a.

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Covid-19: macroeconomic implications

The economy has entered a strong recession in 2020. GDP growth slowed to 3.6 per cent in 2019, primarily due to large investment projects approaching completion (the Bar-Boljare highway) or being completed (power link to Italy), although the tourist season was the strongest on record. In Montenegro, around one-fifth of GDP normally comes from tourism, and most tourists visit the country in the summer months. In June 2020, the government announced that the Covid-19 virus had been eliminated on the territory, but in mid-July the government acknowledged that new cases had emerged throughout the country. In the first half of 2020 GDP contracted by 10.3 per cent year-on-year, while foreign tourist arrivals declined by over 80 per cent year-on-year. Exports recorded a fall of 35.5 per cent. The economy also entered deflation in the second quarter, with year-on-year inflation averaging -0.7 per cent in April to June 2020.

Public debt will likely reach a record high level in 2020. As in other countries, economic support measures (described below) aimed at mitigating the negative effects of the coronavirus pandemic, combined with falling revenues, will lead to an increased budget deficit in 2020. According to the government, the deficit will be 7.3 per cent of projected GDP in 2020, but other estimates suggest it could be as high as 10 per cent of GDP. Besides coronavirus-related measures, the previous government announced a pension hike (raising minimum pensions by around 13 per cent retroactively from 1 January 2020) ahead of the parliamentary elections at the end of August.

The current account deficit declined only marginally in the first half of 2020. Montenegro has run high current account deficits for many years, reaching 15 per cent of GDP in 2019. In the first half of 2020, it declined by only one percentage point, as the fall in goods imported was more than compensated for by the decline in tourism exports.

A sharp recession in 2020 is expected to be followed by a recovery in 2021. GDP is forecast to fall by 9.0 per cent in 2020 as the tourist season was significantly affected by the crisis. Provided the pandemic loses its power both locally and globally in the second half of 2021, the economy should return to growth in 2021, which is projected at 5.0 per cent. The downside risks are associated with potentially longer duration and stronger impact of the pandemic on the economy than envisaged, and further deterioration of the fiscal position.

Policy response to Covid-19

The government adopted three packages of economic measures between mid-March and August 2020. The overall aims were to maintain the liquidity of companies and citizens, save jobs and support the vulnerable. While the government spent around €320 million on the first two packages, the third is far larger, estimated at €1.2 billion, and will span over four years. Fiscal measures ranged from deferral of wage taxes and social contribution payments, to wage subsidies for employees in troubled sectors (such as tourism, hospitality and transport) and for new employment, to assistance to the agricultural and fisheries sectors. The government provided farmers with access to soft loans worth up to €20,000 and announced it would purchase and store surplus agricultural products as well as assist producers to transport those products to public institutions. Measures also included shorter value-added tax (VAT) refund deadlines, financial aid to pensioners and the unemployed, power subsidies for vulnerable groups, and higher wages for healthcare workers and police officers. Among the latest actions was a one-year reduction of VAT for catering activities (from 21 to 7 per cent), additional support for the tourism sector as well as incentives for the agriculture, fisheries and information technology sectors.

Financial measures ranged from loan payment holidays to soft loans. In March 2020, a 90-day moratorium on the repayment of bank loans for citizens and companies was announced. In May 2020, the central bank of Montenegro (CBCG) allowed a new 90-day moratorium for troubled borrowers and doubled its repurchase agreement line with the Bank for International Settlements to €100 million. In order to support banks' liquidity and lending potential, the CBCG reduced reserve requirement rates for banks by two percentage points (to 5.5 per cent for deposits with a maturity of less than one year and to a 4.5 per cent for deposits with a maturity longer than one year). In order to strengthen the capitalisation of banks, in April 2020 the central bank temporarily prohibited

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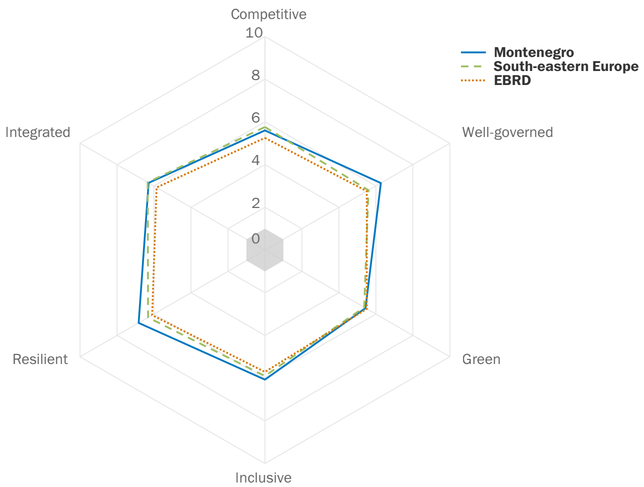
commercial banks from paying dividends to shareholders. In addition, the CBCG allowed banks to raise their exposure to a single entity beyond the regulatory limit of 25 per cent of the bank's own funds, under certain conditions. Lastly, a credit line has been opened by the state-run Investment-Development Fund, offering help to affected companies with soft loans of up to €3 million per beneficiary (two-year grace period, 1.5 per cent interest rate).

Assessment of transition qualities (1-10)



Structural reform developments

Government measures have been financed by the previous Eurobond issuance and external borrowing. The €500 million Eurobond issuance from September 2019 has helped the government secure a part of the budgetary funding need for 2020. The rest of the financing mainly comes from external borrowers. Among the rest, the government secured a €250 million syndicated loan from commercial banks with an €80 million World Bank guarantee in May 2020. In addition, the International Monetary Fund provided a €74 million loan under the Rapid Financing Instrument, the European Commission approved €60 million in macro-financial assistance, and further loans have been granted by other international financial institutions.

Montenegro opened the last negotiating chapter with the European Union (EU). The year 2020 saw the opening of the last remaining chapter of the EU accession negotiating framework, bringing the number of opened chapters to 33 in total. The focus will now be on closing the chapters — only three chapters have been provisionally closed since the opening of accession negotiations in June 2012. According to the council and European Commission (EC), further progress in negotiations will depend on meeting the interim benchmarks set in the rule-of-law chapters (23 and 24).

The government has provided support to some troubled state-owned enterprises. In December 2019 *a lex specialis* on Montenegro Airlines was adopted, allowing the government to provide support to the national air carrier so that it could pay its debt. The Agency for the Protection of Competition was not able to assess the compliance of the law with state aid rules. According to the EC, this may have long-lasting negative effects on the perception of the regulatory environment and unfairness of the state as a regulator. As a consequence of Covid-19, Montenegro Airlines has accumulated losses worth several million euros since halting its operations in mid-March 2020.

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In May 2020, the government approved €0.5 million support to the company. In addition, in March 2020, it was announced that the government will take over debt worth €5.5 million from the state railway infrastructure operator ZICG and the railway transport operator ZPCG.

Works on transport infrastructure continue, with some delays. Due to Covid-19-related factors, the deadline for completing the first section of the Bar-Boljare highway has been changed from the end of September 2020 to June 2021. The construction of the 41-kilometre long first section is estimated to cost €895 million (or around 18 per cent of 2019 GDP).

Energy linkages and renewables are advancing. In November 2019, the 455-kilometre power link between Montenegro and Italy was launched, marking the completion of one of the largest investment projects in recent years. In August 2020 the state electricity company (EPCG) started a one-month overhaul of one of two main hydropower plants (the 307 MW Perucica). The works are part of EPCG's investments aiming to improve the safety and efficiency of its power plants and ensure the stable functioning of the power system in the country. In June 2020, EPCG signed a €54 million deal for the ecological revamp of the Pljevlja thermal power plant, which will allow it to keep operating in line with the Paris Agreement and the Green Deal. In December 2019, the government completed the acquisition of the Italian A2A company's shares in EPCG, raising its stake in EPCG to 88.6 per cent, and in February 2020, it launched the first CO_2 emissions trading scheme in the Western Balkans. Its decarbonisation agenda includes an extensive renewable investment plan for EPCG. In August 2020, the government signed a contract worth over €100 million for the construction of a 70 MW wind farm. The farm will be located in the coastal area and will produce 220 GWh of electricity per year.