MINISTRY OF FINANCE OF MONTENEGRO

MONTENEGRO

ECONOMIC AND FISCAL PROGRAMME

2010 – 2013

Podgorica, January 2011

CONTENTS

FOREWORD

2010-2013 Economic and Fiscal Programme (hereinafter: EFP) is a step forward in economic and political communication of the Government of Montenegro with the European Commission. While preparing this year's EFP our goal was, among other things, to respond to comments and remarks of the European Commission to the last year's 2009-2012 EFP as well as to anticipate the requests that Montenegro, as a candidate country, will receive next year in preparation of PEP. Comparing to the last year's EFP, breakthroughs effected include the following

- Preparation of this EFP was for the first time included in regular preparation of national fiscal documents, mid-term fiscal framework and the annual budget. Preparation of EFP i.e. future Pre-accession Economic Programme (hereinafter PEP) is therefore integrated into preparation of the most significant national fiscal documents.
- For the first time, EFP includes the Government's output gap assessment as well as the assessment of structural surplus/deficit.
- In preparation of this year's EFP, special attention has been paid to enhancement of the quality of the text relating to structural reforms. Text is now shorter and more concise and we find the detailed assessment of budgetary effects of measures and policies related to structural reforms to be the special quality of the document.

1. FRAMEWORK AND GOALS OF THE ECONOMIC POLICY

1.1. General framework of economic policy

As the outturn of 2009 implied the lower level of economic activity and evident real decrease of GDP amounting to 5.7%, in 2010 Montenegrin economy faced the transferred effects of economic and financial crisis, especially in the first semester. Economic environment and its basic trends were conditioned by the illiquidity problem and difficulties in maintaining the reproduction process. It is however evident that the strong influence of anti-crisis measures of economic policy relaxed the unfavourable effects and weakened the influence of the crisis. In circumstances implying the consolidation of the banking sector, support to SMSs and initiation of production in large industrial sectors, in third quarter of 2010, the economy recorded upturn (industry, agriculture, tourism) and available indicators show the real growth and expectations to reach the projected growth of 0.5% by the end of 2010.

Favourable external effects and developments in national economy will certainly form more prospective general environment in 2011. At the same time, estimates on stability and foundation of economic activity upturn trends will be of crucial importance for validity and reality of development projections. Stabilisation of the banking sector with the capital increase process, along with slight recovery of credit activity of banks and favourable effects of Eurobonds project and other credit arrangements to public finances will represent the framework for strengthening entrepreneurship and investment activity. Improvement of business environment with enhanced conditions for doing business and systematic solutions focused on fostering of private entrepreneurship initiative will generate the creative force and role of new business. Structural reforms in education, health, social protection and state administration as a basis for long-term systemic adjustment will contribute to ensuring sustainability of public finances and possible new investments to energy, tourism, road and utility infrastructure should initiate the expected multiplicative effects. However, necessary precaution should be a part of general image of economic environment in 2011 considering still vulnerable economy in conditions of reduced availability of fresh capital and budgetary restrictions with savings measures and rationalisation.

Economic policy and strategic development goals; Strategic development framework is dependent on EU accession process and Euro-atlantic integration. The new phase has begun by entry into force of the Stabilisation and Association Agreement and acquisition of the candidate status, phase of qualitatively more substantial relations with the EU based on EU accession negotiations. In this respect, economic policy counts on favourable position of international community on efforts to form and direct the development process upon the basis of European standards and norms. At the same time, long-term development vision, contained in document „Montenegro in XXI century – competitiveness era”, enables the articulation of global challenges of time and to establish development directions, commitments and goals of Montenegrin society in all of its segments. Furthermore, commitment to build openness of Montenegrin economy, strengthen economic freedoms with more stimulating environment for fostering the entrepreneurship initiative and reinforcing the element of system market orientation along with the efforts to improve competitiveness on basis of own natural, economic and human resources and newly-acquired knowledge will represent the basis for long-term development goals. At the same time, new conditions of institutional and systemic support to the policy of balanced regional development of the country have been defined in accordance with the Strategy of regional development of Montenegro to 2014, making the additional preconditions for dynamisation of overall economic growth.

Consistent strategic framework which serves as a basis for economic policy of Montenegro for 2011 encompasses: 2010-2013 Economic and Fiscal Programme for Montenegro, Innovated Programme for Integration of Montenegro into the EU 2011-2015, Spatial Plan of Montenegro to 2020, National Strategy of Sustainable Development, Strategy of Information Society Development to 2013, sectoral development strategies. This is the basis for establishment of National Development Plan which will enable the implementation of defined strategic development goals. In defining the economic policy of Montenegro for 2011 the starting premises are the following:

- Results achieved in 2010. Consideration of economic and financial crisis effects to basic reproductive potentials of economy. Foundation of positive effects of anti-crisis measures in difficulties in the recovery of economy ;
- Preserved transformation processes in line with EU norms and standards;
- Maintained interest of potential investors in capital infrastructure projects and high level of foreign direct investments;
- Preserved macro-economic stability and high level of trust of foreign creditors in security of arrangements in macro-economic support projects;
- Enhancing the sustainability of public finance system in conditions of structural reforms and use of funds from Eurobonds project and possible credit arrangements;
- Enhancing the regional development component in conditions of defining institutional and systemic support to the policy of balanced regional development;
- Strengthening the role of know-how and application of the latest communication technologies and IT achievements as factors of development;

Limitations and development prospects; The effect of economic and financial crisis has significantly conditioned the general environment and level of economic activity in 2009 and 2010 and, apart from evident results of economic policy measures aimed at mitigation of these effects, has generated certain dilemmas, reserves and limits in terms of objective consideration of the development possibilities in 2011. This basically relates to:

- To which extent shall the stabilisation of general conditions in economy and still uncertain process of economic activity recovery be sufficiently reliable indicator in assessment of development possibilities in the following year;
- In which development performances the objective development possibilities shall be positioned.

Real development scenario relies on certain vigilance in respect of definition of basic measures, parameters and development goals in 2011. In this respect, the limitations are:

- Vulnerability of economy after economic and financial crisis;
- Illiquidity in real sector and established circle of debtor-creditor relation;
- Insufficient credit activity and support of banks to credit sector;
- Costs and accompanying effects of necessary structural reforms;
- Capital necessary for fostering economic activity through new development projects and new investments;
- Unstable international environment and fiscal crisis in states of economic and monetary zone.

Positive expectations are based on cases of the system's good reaction to global flows of world economy recovery. In this respect, the following is relied upon:

- Benefits related to acquired candidate status for the membership in the EU in respect of improved availability of pre-accession funds and other facilities;
- More favourable external effects from global economy setting the growth trend, after stabilisation and restoration of production, on the increase of activities in countries in the region and the EU member states (according to IMF assessment the expected growth of GDP in 2011 in Albania of 3,2%, Macedonia 3,0%, Bosnia and Herzegovina 3,0%, Serbia 3,0%, Croatia 1,6%, Slovenia 2,4%, Hungry 2,0%, Poland 3,7%, Estonia 3,5%, Germany 2,0%, France 1,6%, Italy 1,0% etc);
- High level of trust in macro-economic stability and interest of potential investors in capital infrastructure projects which may have long-term multiplicative effect to overall development;
- Rehabilitation of tourist demand in conditions of strengthening the tendencies for travel in growing economy.

Framework of development concept; Estimates that Montenegrin economy is recovering, that the outturn of 2010 will imply the real growth and that the economic activity will be stronger and will be developing at the level higher than in 2010 will dominantly influence the 2011 economic policy profile. Furthermore, development model implies the limitations that i.e. difficulties caused by illiquidity of the real sector and problems in provision of credit support to development projects.

Necessary restrictions in budgetary framework and the need to strengthen the sustainability of public finances system will form the environment of macro-economic stability and alignment of expenditure with the objective strength of the system in terms of creating the new value. This implies the measures for rationalisation and public expenditure cuts and structural changes in education, social protection and state administration which are aimed at establishment of sustainable system in these areas. Project Eurobonds and possible credit arrangements will contribute to creation of conditions for accomplishing budgetary balance in the following years and maintenance of macro-economic stability.

In circumstances of aligning the macro-economic framework with post-crisis conditions, the economic policy is primarily focused on economic activity strengthening processes. The undertaken supporting measures for production and optimisation of number of employees in large industrial system are expected to enable, along with recovery of stock exchange indexes, the increase in production and more objective consideration of the conditions of their operating. Improvement of business environment in line with action plans for 2011 and improved credit activity of banks in circumstances of strengthening the developing economy performances, along with the activities of Investment Development Fund will provide for stabilisation of reproductive flows and creation of conditions for dynamisation of economic activity and economic growth in 2011. In compliance with the process of economy recovery, strengthening of market-oriented system will be maintained as well as the improvement of competitiveness on basis of own, economic, natural and human resources, import substitution, permanent export orientation and use of knowledge potentials.

Favourable circumstances related to the high level of investors' interest should affect the realisation (activities relating to rationalisation) of the capital infrastructure projects. Creation of conditions for realisation of construction projects of hydro-power plants and motorway Bar-Boljare, construction of resort in Luštica and other hotel capacities in tourism and communal infrastructure should contribute to activating domestic capacities, induce new employment and have significant effect to strengthening the liquidity and level of aggregate demand. This is related to expectations from activating civil engineering activity and restoration of housing construction.

Strengthening of foreign tourist demand will reinforce the effect of tourist activity to overall development and effect of inter-sectoral coordination in the function of widening the scope and quality of tourist demand.

Defining the conditions of institutional and systemic support to the policy of balanced regional development created the conditions for dynamisation of general economic growth in this respect.

The economic activity recovery and envisaged measures should enable the economy growth with gross domestic product really increased by 2.5%, inflation growth by 2.2%, employment growth by 1.3% with unemployment rate of 11.3%.

Economy policy goals; Consideration of general implications of economic crisis to strategic development goals, development possibilities and economy recovery flows in 2011, assessment of possibility to form enhanced entrepreneurship environment and realisation of activities in capital infrastructure projects refer to the basic economic policy goal in 2011: ***Dynamisation of economic growth with the priority to strengthen liquidity and competitiveness of the economy***.

System of individual goals is aimed at realising the basic goal of economic policy and it is focused on activating all the potentials that may contribute to dynamisation of economic activity and to growth of the economy. In this respect, creation of conditions in which SMS sector, as basic holder of development concept may develop its objective capacities and conditions for implementation of long-term oriented measures for creation of stable macro-economic framework and sustainable system of public finances, makes the basis for consistent economy policy goals system. Individual goals of economic policy are focused on:

- Implementation of structural reforms which contribute to sustainability of public finances system;
- Improvement of environment distinguished by doing business ;
- Defining alternative market solutions for supporting projects of small and medium size enterprises;
- Implementation of systemic solutions for support to regional development policy;
- Realisation of new Greenfield investments.

1.2. Structure and main focuses of EFP 2010-2013 EFP

Economic trends and projections; Economic trends in 2009-2010 were compliant with the 2009 Economic and Fiscal Programme. Decline of real GDP in 2009 was slightly higher than projected in the Programme whereas the return to slow growth projected for 2010 was maintained in present version. Three macro-economic scenarios have been elaborated for 2011 and mid-term period 2011-2013: one baseline and two alternative scenarios. Unlike the last year's programme, two alternative scenarios have been prepared this year of which one is macro-economic scenario of lower growth. Also, in accordance with macro-economic scenarios, base fiscal scenario has been prepared which represents the basis for 2011 Budget Law as well as two fiscal alternative scenarios.

Apart from the standard description of economic developments by sectors, sectors were considered in more details according to production and consumption side of GDP for all three scenarios. Methodology that we used in projection of GDP trends for 2010 and the following period, in baseline i.e. budgetary scenario and two alternative scenarios was therefore presented in details. Also, short review was provided of the output gap of Montenegrin economy and of the structural balance, themes that will be further elaborated in the Ministry of Finance and that may improve mid-term planning as well as the review of basic economic indicators trends on basis of which projections of economic trends in 2010 have mostly already been prepared. Main economic indicators are: past value trends as well as the future projections which significantly affect the mentioned projections of macro-economic trends. Matrix or economic risk and potentials map has been elaborated. It provides summery overview on how certain economic factors reflect in all three scenarios.

This year's EFP provides more details on economic trends in the last two years whereas projections and alternative scenarios specially address the area of liquidity and banking sector trends, foreign direct investments and employment and how changes in these areas may affect the economy growth rate.

Public finances; Effect of the economic crisis greatly affected the area of public finances. On one hand, temporary direct revenues decreased significantly due to overheating of the economy. This primarily implies the indirect taxation (VAT and customs) while on the other hand significant adjustments have been made of expenditure side, both of the central Government's budget and of the budgets of local self-government units. Basic goals defined in previous EFP, including reduction of public expenditure deficit and maintaining the public debt at the limit at around 40% of GDP have been largely achieved. These indicators have been additionally corrected by adopted 2011 Budget so main categories of revenues and expenditures in the period of three years have not been significantly changed if compared to the last year-s EFP.

Fiscal policy for the following mid-term period is to the greatest possible extent compliant with fiscal anchors defined in previous EFP, namely: reduction of current expenditure and public debt, balanced budget in 2012 and budgetary surplus in 2013, limitation in growth of wage fund, reduction of subsidies and reduction of issued guarantees. Law on Amendments to the Law on Pension and Disability Insurance has been adopted. The Law will additionally increase the sustainability of both pension and disability insurance system and overall public finances.

Apart from the mentioned scenarios, as a novelty, fiscal part provides more detailed information on public finances trends and the amount of fiscal adjustment in the last two years, review of costs by functional classification and the review of consolidated public expenditure. At the end, summary assessment of fiscal effects of structural project is provided.

Structural reforms; Accession of Montenegro to the EU, experiences and results of economic boom 2006-2008 and of the recession the consequences of which, in spite of slight recovery in 2010, still reflect to all aspects of economy have led to requested and spontaneous changes in Montenegrin economic system. These changes require new institutional framework. Montenegro sees structural reforms as response to negative influence of financial and economic crisis but at the same time as a need to face structural imbalances and to timely adjust to new market conditions thus creating a competitive system for long-term and sustainable economic growth and development. .

All measures of economic policy are focused on adjustment to the EU standards and directives as well as on administrative capacities building with a view to more efficient application. The previous period in all areas was characterized by adjustment of the national with the EU regulations. Some of the structural changes were implemented through IPA programmes. Although legislation amendment and training of staff for its application requires short-term costs, creation of single rules reduces risks and opens the door for investors.

Since there is a lack in monetary instruments, Montenegro employs fiscal policy measures for restoring aggregate demand in short term but manner in which the measures are used in order to create new basis for investment cycle may affect mid-term and long-term productivity of the economy. In its fiscal policy, Montenegro decided to invest in capital instead of public expenditure and induced households' consumption.

In may be noted that systemic measures are implemented in almost every area of Montenegrin economic system with a view to increasing aggregate demand and fostering economic activity in short term and to maintaining growth in long-term.

- Large infrastructure projects in net industries and privatization projects and public private partnerships should affect the increase of investment, aggregate demand and employment is short-term. Their positive influence in mid and long term is expected in balancing current balance, employment and productivity growth. Quality of infrastructure represents a basis for supporting business, which positively affects the economic growth in long term.
- Stimulating tax policy, attractive business environment and support to SMSs increases the available revenues in short term, stimulates creation of new products and businesses, increases employment which at the end positively affects the demand. In long term, stronger competition will increase productivity and living standard. Montenegro has already been recognized as competitive economic system, which arouses the expectations for FDI growth and in mid and long term affects the economic growth.
- Financing, banking and non-banking sector was significantly affected by the negative consequences of recession, at first through loss of trust in banking sector and decline of the banks' potential. However, financial support of the state and regulatory measures recovered the trust in banking sector and maintained its stability and liquidity. Low credit activity caused by the increased risk imposed by economy illiquidity still represents an obstacle for investments in real sector. On the other hand, regulation reforms provide for deeper integration of financial sector into the EU market, which will in mid-term affect the growth of investments and in the long-term the economic growth.
- Structural reforms in the areas of labour market, education and social insurance create the possibility for provision of public services to private sector through private-partnership model. In short-term, these measures affect the growth of investments and aggregate demand on one part and the other the improvement of quality of public services. Systemic changes that will affect the higher level of adjustment of labour legislation with circumstances in the market and of the education system to labour market requests affect the reduction of structural imbalances and growth of

employment and productivity in long term. In short term, policies regulating preparations and trainings for labour market enables an individual to find job easier. Systematic changes in Montenegrin education system are designed to increase productivity mostly through effects achieved in long term. .

- By implementing the administrative reforms the state recognizes its clear and real role in public service provision that cannot be performed by private sector and aims at increasing efficiency and reduction of administrative barriers and transaction costs. This is another contribution to competitiveness of economic system and business environment that in short term may influence the reduction of fiscal burdens of the economy and the improvement of public service quality while in long term it may foster investments and economic growth.

Lack of the system's structural adaptation with market conditions is most evident in uneven regional development and imbalances in the labour market. The difference occurred due to accelerated development of the south and central region on one part and decades-long stagnation of the north region on the other part. The difference caused migrations from the north and consequently the lower productive use of its natural resources. Through economic policy fostering road infrastructure projects, investments in energy potential of the north (thermo and hydro) and incentives and fiscal support to entrepreneurship and SMSs, the state may foster the growth of employment and earned incomes as well as the aggregate demand. The measures employed in the areas of labour and education will affect the improvement of knowledge and qualifications in short term and in the long term these will affect better quality of cadre offer and overall economic productivity.

2. ECONOMIC FRAMEWORK

After economic downturn in 2009 and negative trends in the first half of 2010, particularly in the first quarter, aggregate demand growth was recorded in mid-2010, primarily as a consequence of good tourist season. According to the economic activity indicators, economic growth in the third quarter could lead to minor real GDP growth in 2010, provided that the economic growth continues in the fourth quarter of this year as well. The last quarter of 2009 was higher than in 2008. Positive trends could be observed in two most important momentums in the previous period – banking sector and foreign direct investments (hereinafter referred as FDIs), even though crediting remains low, while investments are stable[1] though more in the form of intercompany debt. Continuation of such trends could lead to moderate real growth in 2011, although economic recovery will not proceed at relatively high rates, habitual after recession, and it will depend on further consolidation of banks' balances and inflow of foreign direct investments in the energy and tourism sectors.

Apart from base macroeconomic scenario for 2011-2013, the Government of Montenegro has also prepared two alternative macroeconomic scenarios. The base scenario was used as a basis for the adopted 2011 Budget of Montenegro, and it envisages economic growth of 2.5% in 2011, the first alternative scenario foresees growth rate up to 4.5% while the second scenario envisages growth up to 0.5%. Detailed elaboration of mentioned macroeconomic scenarios is given in the following chapters.

2.1. ANALYSIS OF CURRENT MACROECONOMIC TRENDS IN THE PERIOD 2009-2010

As a small and very open economy still facing the challenges and possibilities implied by switchover to the market system, Montenegro was especially vulnerable to the economic crisis, the effects of which had appeared in the fourth quarter of 2008. In the period of six up to nine months, i.e. by mid-2008, the main problem was disbelief in the banking sector, resulting in withdrawal of 30% of private sector deposits, suspension of credit activity, decline in retail trade for more than 10%, as well as decline in production and export of goods for almost 40%. At the same time, foreign direct investments remained at the same level as prior to the crisis (not including the partial privatisation of the Electric Power Company of Montenegro), which

[1] Investments in 2010 remained at the same level as in 2009, not including revenues from recapitalisation and partial privatisation of the Electric Power Company of Montenegro. Recapitalisation of the Electric Power Company of Montenegro totalled 41% of the overall FDIs in 2009.

significantly mitigated economic downturn in 2009, while employment growth in the services sector absorbed the majority of labour force laid off from the industrial production sector. Owing to deposits accumulated during the surplus years, the Government has provided support to the banking system, with the view to improving its liquidity. Economy reached its lowest point in the second half of 2009, while the moderate recovery was recorded in the second and third quarters of 2010[2].

In 2009, Montenegrin economy recorded a significant downturn. According to MONSTAT data for 2009, the real economic growth was -5.7%. The most affected sectors were construction and industry (including energy) with downturn rates of 15.3% and 12.4% respectively, whereas the services sector, as the most dominant economic sector, scored 0.2% of downturn. Analysis of trends of main economic indicators, monitored by the Ministry of Finance, has showed deceleration of the economic downturn, while significant growth in demand was recorded in the third quarter, which can, depending on trends in the fourth quarter, lead to modest economic growth of 0.5%. However, it is important to mention that MONSTAT does not publish data on quarterly GDP trends, and therefore projections of GDP trends should be taken with certain reserve.

Economic trends in 2009-2010 were compliant with the last year's Economic and Fiscal Programme. Real GDP decline in 2009 was slightly higher (5.7%) than the one projected by the Programme (5.3%), while the slow growth (0.5%) projected for 2010 was kept in this version as well (Table 1). Current account deficit was significantly reduced, as expected, but it will be somewhat modified in 2010. Furthermore, as projected, credit activity remained low, since foreign banks have withdrawn the capital supporting the banking sector in 2008.

Table 1: Main macroeconomic trends and prospects

	2008	2009	2010[3]
GDP (in million EUR)	3.086	2.981	3.025
Real growth	6.9	-5.7	0.5
Deflator (growth)	7.7	2.4	1.0

[2] This is an estimation made by the Ministry of Finance, not official data produced by MONSTAT, since this institution still does not publish quarterly data on GDP realisation.

[3] Estimations for 2010, given in the table, are made by the Ministry of Finance.

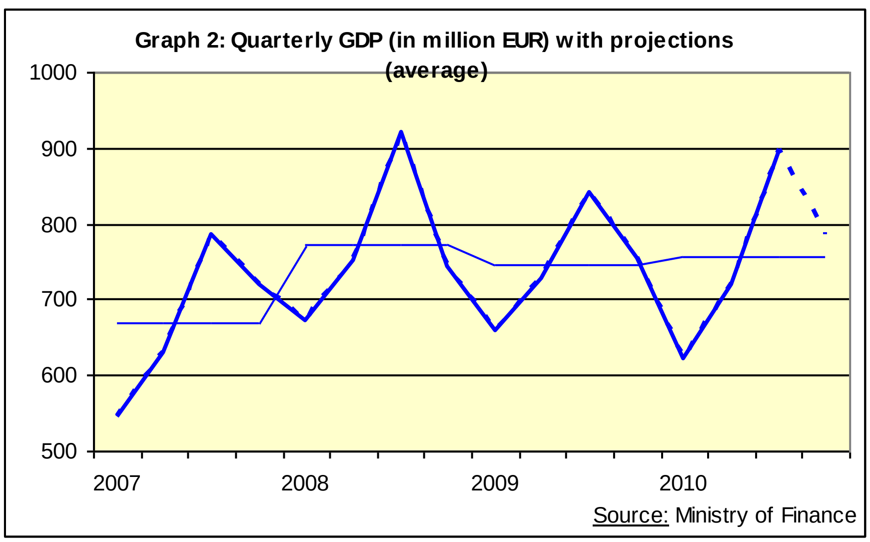
Inflation	7.7	3.4	0.7
	in %		
Share in GDP growth 1)	6.9	-5.7	0.5
Household consumption	9.1	-12.0	0.4
Investments	9.7	-15.1	-4.1
Public sector	4.1	-1.7	-0.7
Net export	-16.0	23.1	4.9
Export	-2.2	-9.2	3.4
Import	-13.8	32.3	1.4
	in % of GDP		
Domestic credits	90.9	81.5	76.8
Annual nominal growth	24.7	-13.5	-4.3
Private deposits	49.4	47.6	48.0
Foreign reserves growth	-5.0	1.9	-3.5
Central Bank's reserves abroad	9.4	11.6	8.0
Current account balance	-50.7	-30.1	-24.6
Foreign capital flows	38.1	20.0	21.1
FDI	17.9	30.6	19.8
Banks and other	20.2	-10.6	1.3

1) Provided that the average deflator growth equally refers to all components

Source: MONSTAT, Central Bank of Montenegro, Ministry of Finance

2.1.1. Gross Domestic Product

Crisis in the banking sector and general economic expectations resulted in severe decline in liquidity at the end of 2008 as well as decline in GDP at the beginning of 2009 (see graphs 1 and 2). A temporary standstill was observed in the fourth quarter of 2009 both in public and private sector, as a result of privatisation of the Electric Power Industry of Montenegro that caused economic growth to the amount of 1.6% in that quarter, while the overall trend of illiquidity and negative growth was observed up to mid-2010.



Third quarter of 2010 showed significant recovery based on positive results achieved in the tourist season, as well as recovery in the sector of industrial production and decline in unemployment, although it is more a seasonal fluctuation. Growth recovery should be observed in the light of the very poor third quarter of 2009, which was lower than the third quarter of 2008, but still providing basis for optimism that this moderate growth will continue in 2010 as well, having in mind that the third quarter participates with almost 1/3 in the overall GDP.

Banking sector has been stabilised, and it is expected that the credit activity will continue to grow. Private sector demand is stronger, which can be observed through higher turnover in trade and increase in import[4] in three successive quarters; industrial production has been considerably recovered (from a considerably low level) as well as agriculture after spring floods; export of goods has also increased, though from a low level. Unemployment rate has shown a modest downward trend in the last six months, although it started to grow after the season, as it was expected. However, causes of concern are the number of blocked accounts, amount of frozen assets (in terms of value), increase in tax claims, loans in default and toxic assets, as well as uncertainty in FDI inflow. Further increase in illiquidity could prevent recovery, with accompanying negative consequences of such trends. According to general estimations of the Government, the economy already generates below its potentials, due to poor liquidity.

Recovery of demand is particularly evident through retail turnover increase that showed 9% of growth, in terms of seasonally adjusted data, compared to the lowest level in 2009, which was at the level of third quarter of 2008. Export of goods was 11% higher in the first eight months of 2010 compared to the same period in 2009, partly as a result of increased demand for aluminium, but it is still 30% lower compared to 2008. In the same period, after a decline in the first half of 2010, import recovered in the third quarter, which represents an indicator of demand recovery.

As regards production as a part of economy, indicators of growth trends are noticeable in the majority of sectors (estimations given in Table 2). Agricultural production was severely affected by the rain and spring floods in the second quarter. Production recovered in the third quarter and it is expected that it will continue to increase in the fourth quarter as well as in 2011 (for approximately 8%). With qualitative adjustments, 3.0% increase in the physical volume of primary production was recorded in 2009 compared to the previous year. The growth was recorded in plant production (6.0%), particularly in production of vegetables (8.0%) and fruit (11.0%).

Table 2 : Sources of growth by quarters, 2009-2010

		2009				2010[5]			
		Q1	Q_2	Q3	Q_4	Q1	Q_2	Q3	Q_4
	Share in 2009	Growth by sectors - quarter/quarter							

[4] In chapter 2.1.4 Balance of Payments, import data for the first six months are negative; however, preliminary results have shown increase in import in three quarters of 2010 compared to 2009.

[5] Estimations made by the Ministry of Finance; MONSTAT still does not publish quarterly GDP data.

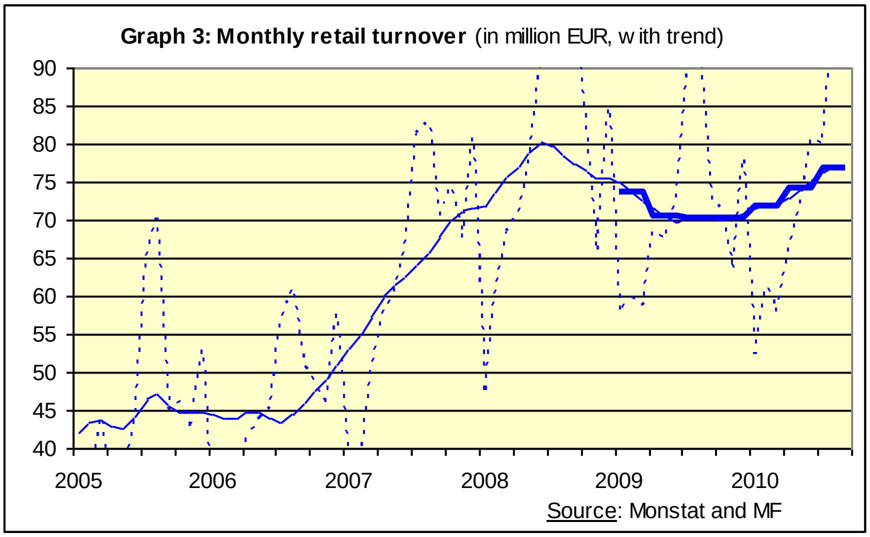
GDP by sectors	**100**	***-1.9***	***-3.2***	***-8.7***	***1.6***	***-5.8***	***-0.9***	***6.8***	***4.2***
Agriculture	8.3	*1.9*	*0.7*	*-1.5*	*1.5*	*-2.6*	*-1.8*	*-0.1*	*0.7*
Industrial production	11.2	*3.6*	*2.0*	*-3.3*	*-0.9*	*-3.3*	*2.3*	*2.2*	*1.0*
Construction	5.4	*-0.5*	*-1.3*	*-0.9*	*-1.0*	*-0.4*	*0.0*	*0.3*	*0.3*
Trade	12.0	*0.3*	*-1.3*	*-1.4*	*-0.7*	*-0.4*	*0.6*	*1.1*	*0.7*
Hotels	5.1	*0.3*	*0.4*	*1.4*	*0.2*	*-0.1*	*0.3*	*0.9*	*0.1*
Financial intermediation, real estate	9.5	*0.0*	*0.0*	*0.0*	*0.0*	*0.4*	*0.3*	*0.3*	*0.3*
Transport	12.5	*-4.6*	*-0.2*	*1.6*	*1.8*	*-0.6*	*-2.6*	*0.2*	*0.4*
Public services	18.9	*0.6*	*0.6*	*0.5*	*0.6*	*-0.2*	*-0.2*	*-0.2*	*-0.2*
Taxes – subsidies	17.1	*-3.6*	*-4.1*	*-5.0*	*0.1*	*1.5*	*0.2*	*2.1*	*1.0*

Source: MONSTAT, Ministry of Finance

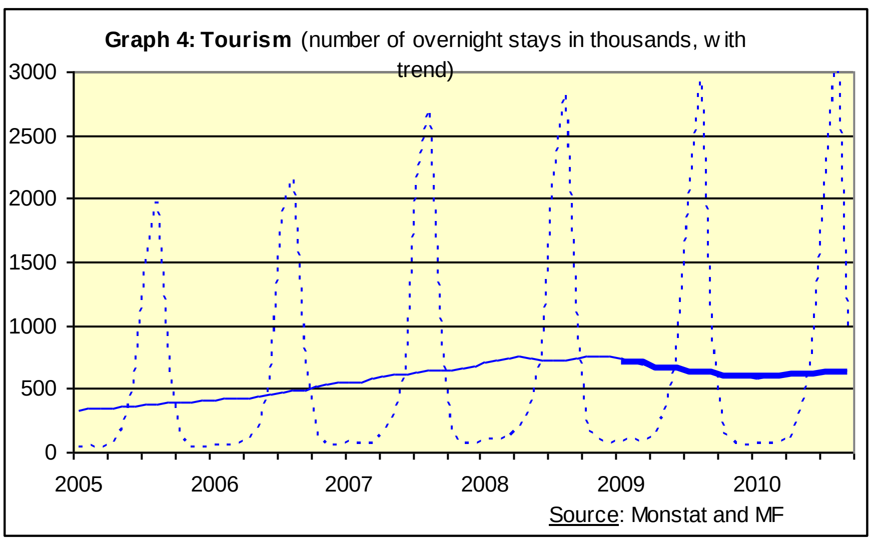
Since the beginning of transition process, structure of the Montenegrin economy has been significantly changed. In 2001, share of industrial sector in GDP was 19%, whereas in 2009 it decreased to 11% of GDP. Besides, industrial sector was the main source of negative growth during 2009 and 2010. In the years of high economic growth, before the crisis erupted, the sectors of trade and services have become main sources of growth and recovery (although the increased production in the Aluminium Plant Podgorica made a significant contribution to growth in 2010).

Significant growth in the services sector started in the second, and particularly in the third quarter of 2010. Recovery of trade commenced in the second quarter, after four quarters of successive decline and 10% decrease in retail turnover, from its peak in mid-2008 to its lowest point at the beginning of 2010 (see graph 3). Moderate growth up to 6% (on annual basis) in 2011 would restore the trade to its pre-crisis level by the end of the year. Recovery in the trade sector has also caused growth in the transport sector, so it is expected that this sector will be recovered during 2011.

Monthly retail turnover has important correlation with GDP trends in the forthcoming period. This indicator has scored significant decline from mid-2008 to mid-2009. Level of retail turnover showed increase in the first three quarters of 2010, and now it is almost at the level recorded in mid-2008. It can be therefore concluded that trust of consumers has been won again and consumption increased, mostly as a result of a successful summer tourist season.

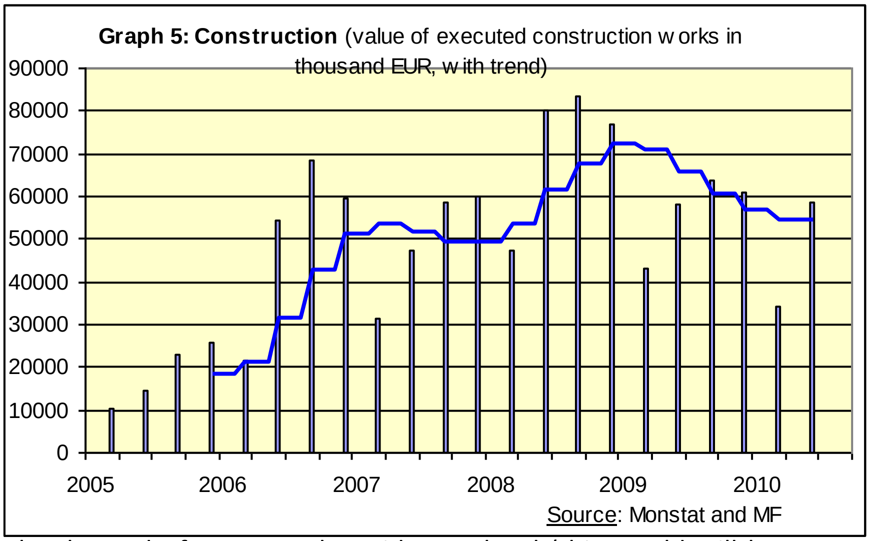


Despite poor crediting by the banking sector as well as by the very structure of services companies, composed mostly of small and medium-sized enterprises, it is important to mention that the services sector is the sector which scored insignificant decline in 2009 to the amount of 0.2%, whereas this year it recorded growth. Tourism recovered considerably in 2010, which can be understood from increase in the number of overnight stays for 5.4% in the first eight months compared to the same period of 2009, i.e. for 3.4% compared to the pre-crisis period in 2008 (see graph 4). Tourist arrivals were higher for 4.6%, while the number of border crossings in nine months of this year was 4% higher than in the same period of previous year. Tourism becomes more diversified, having in mind 18% of overnight stays recorded in the mountain tourist centres, raising expectations that growth will be achieved in the winter tourist season as well. The World Travel & Tourism Council's data confirm the importance of this sector for the entire Montenegrin economy, estimating that direct and indirect revenues from tourism and travel amounted 20.8% of GDP in 2009.



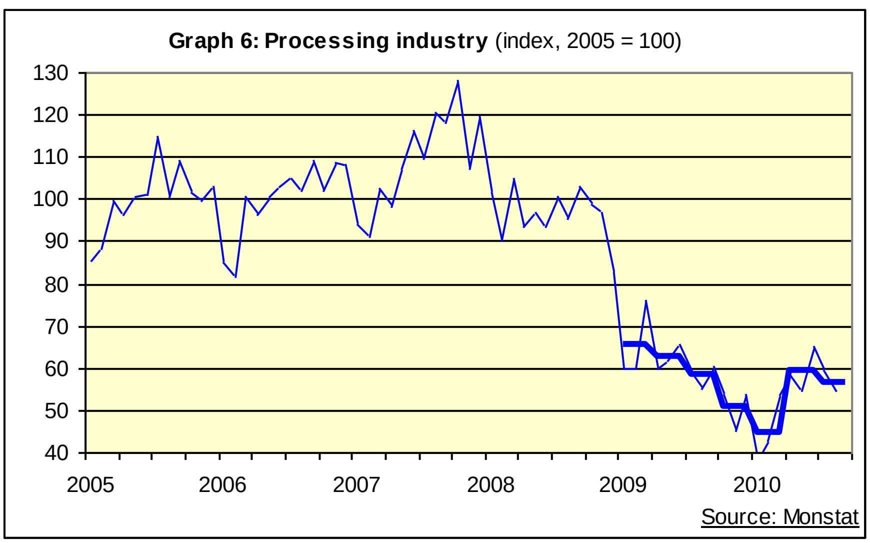
At the same time, the tourism sector generated 29,000 work posts in 2009, i.e. 17.8% of overall employment. Trends in the third quarter have more than compensated negative results in the first half of this year, although season peaks are higher each season.

Indicators show that activities in the construction area reached the lowest level in the second and third quarters of this year, after significant decline in 2009. Return to moderate growth of approximately 5% (at the annual level) would restore activities in this sector, by the end of 2011, to the mid-2009 level (this would still be 15-20% below the highest level of activity recorded in mid-2008 (see graph 5)).

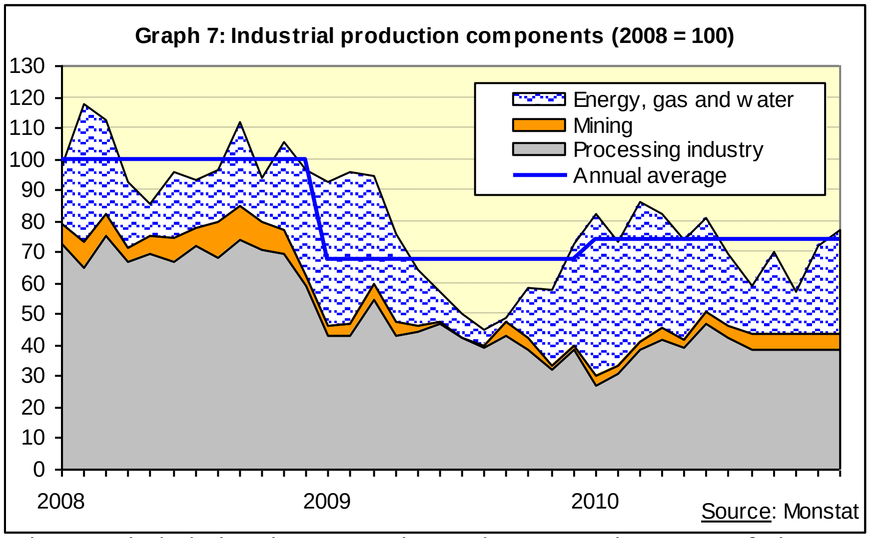


“1000+ apartments” project to the value of EUR 25 million, launched by the Government with support of the Council of Europe Development Bank, could stimulate development of this sector and contribute to stronger recovery. Indicator of value of executed construction works has been stabilised in the second quarter, after consecutive downturn during five quarters, and currently it is at the same level as it was in early 2008. Value of executed works decreased for 8.5% in the first two quarters of 2010 compared to the first half of 2009, but the value of new building contracts was 19% higher. These data might be unreliable, but evidence on stabilisation is supported by figures on increase in the number of workers at building sites in the first two quarters of 2010. In nine months of 2010, 59 building permits were issued to the estimated value of EUR 246 million, while in the same period of previous year 88 building permits were issued to the estimated value of EUR 243 million.

Growth in processing industry and energy production (see graph 6) has been caused by re-opening of the Thermal Power Plant of Pljevlja (and heavy seasonal rains) as well as by increased production of aluminium (in the Aluminium Plant Podgorica). Processing industry in 2010 was 9% higher than in 2009, but it is questionable whether and when it will accomplish the 2008 level (record-high prices of aluminium).



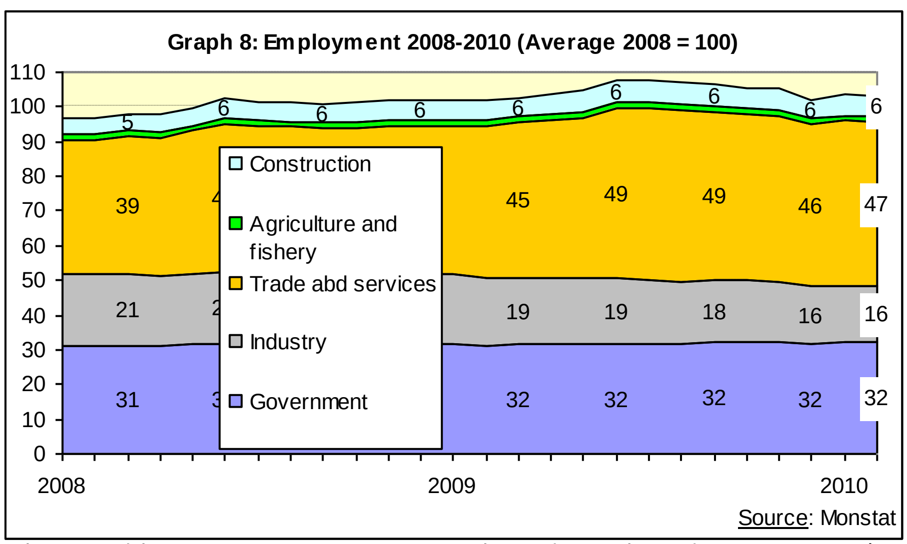
Processing industry share in the total industrial production is 50%, i.e. it was reduced after 70% share recorded in 2008 (see graph 7), whereas base metals production share in the processing industry declined from 65% in 2008 to 40%. It can be concluded that base metals production makes 20% of the total industrial production, with 45% share recorded in 2008, implying that, apart from increase of the services sector share in the industrial sector, more competitive branches and branches resistant to external effects (such as energy production) become more and more important in the industrial sector.



With the view to creating conditions for ensuring short-term stability and long-term sustainability of the Aluminium Plant Podgorica and Ironworks Nikšić, relevant restructuring plans have been implemented. Production in the Aluminium Plant Podgorica in the period January-September 2010 increased for approximately 30%, therefore it could be expected that the planned annual production volume (80,000 tons of aluminium) will be achieved.

2.1.2. Labour market

Trends in employment growth continued to develop in the first half of 2009, having in mind that demand for labour force in sectors of trade and services has absorbed and surpassed the unemployment growth caused by restructuring process in the industrial production sector (see



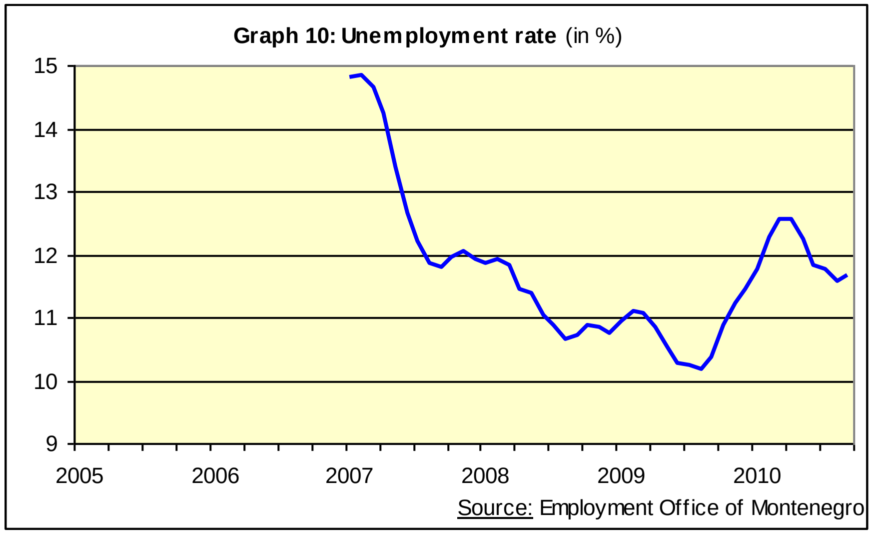
graph 8).

This trend, stimulated by transition, is indicative of economic restructuring, which has significantly relied on metal production and services sector. Employment rate became stagnant in mid-2009, then it declined significantly during the second half of 2009, but recently it started to increase again, reducing the unemployment rate for 1 percentage point from 12.7% at the beginning of 2010 (see graph 9)[6].

What is a cause of concern but also a need in Montenegro, considering the low rate of working population and the structure of economy (mostly labour intensive) is the still lacking stronger growth in employment. Approximately 10,000 work permits were issued in the period January-September 2010, which represents a significant drop compared to 14,000 work permits issued in the same period of 2009. In the same period of 2010, around 26,200 vacancies were announced, which is circa 12,000 posts less than in 2009.

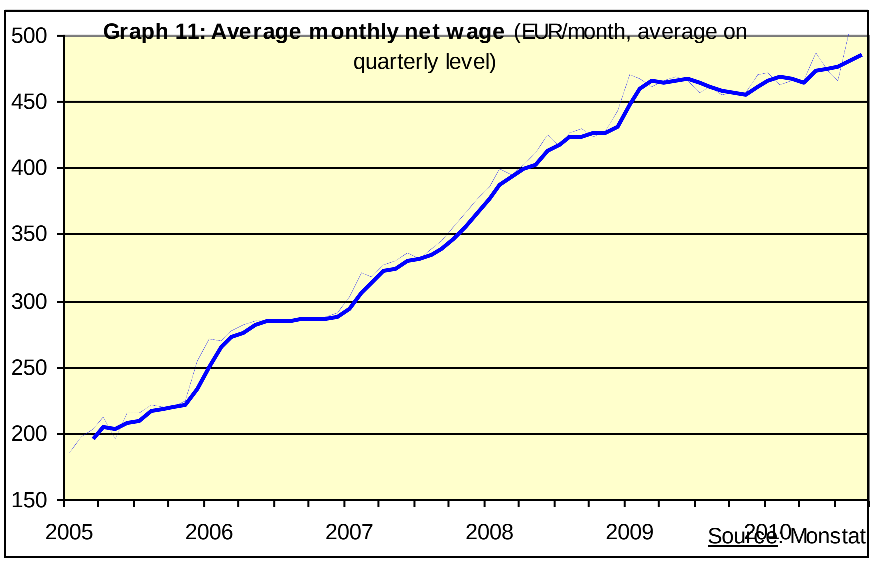
[6] Number of employed persons at the end of first quarter has been estimated, since there were no official data for this period. So far, MONSAT has been responsible for publishing data on the number of employed persons in Montenegro, based on data submitted by the Pension and Disability Insurance Fund and Health Care Fund and in line with the Methodology for Determining the Number of Employed Persons adopted by the Government of Montenegro in 2005. By establishing the Taxpayers Central Register and by launching the project of integrated registration of taxpayers and persons subject to payment of contribution, the Tax Administration has become the sole source of data (by means of adequate forms) on persons subject to payment of taxes and contributions. Adjustment of data between these two institutions is under way, and due to the aforementioned, publication of data has been running behind the schedule since April till nowadays. Data for the previous period, as well as for the previous years, will be published subsequently.

New employment has been negatively affected by the Government's decision on suspension of new employment in the public sector. According to data provided by the Employment Office of Montenegro, unemployment rate increased for 2.4% since the end of 2009, and in the first quarter of 2010 it amounted 12.6% of labour force. In mid-2010, unemployment rate started to decline again (see graph 10). During summer months, 1% of downturn was recorded, implying that the number of unemployed persons was reduced for 2,600 persons in this period.



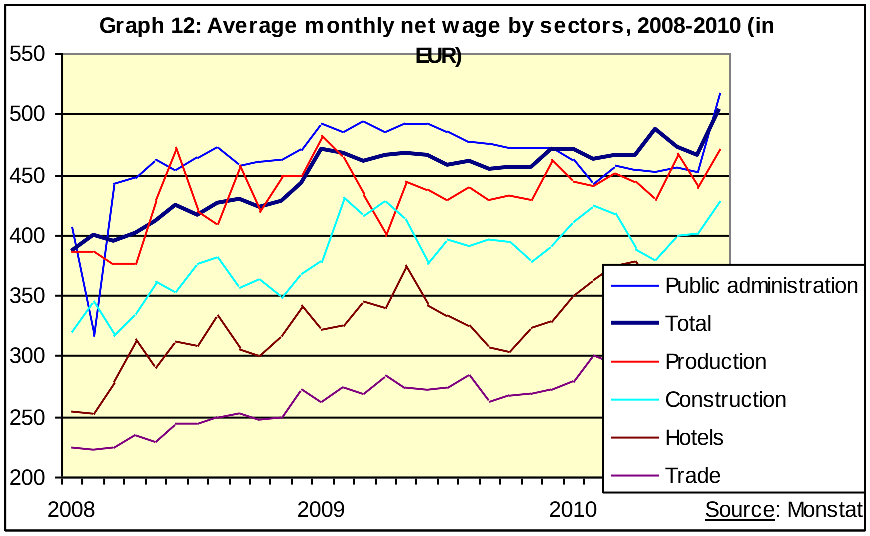
Average net wage started to increase at the beginning of 2010 (see graph 11), following the stagnation in 2009.

Wages in the tourism sector recorded major growth at the end of 2009 and beginning of 2010, after the significant cut in mid-2009.



Wages have recovered in the trade sector as well, while wages in the industrial sector have remained stable and recorded no growth (see graph 12). Due to budgetary restrictions, wages in the public sector have continued to decrease since 2009.

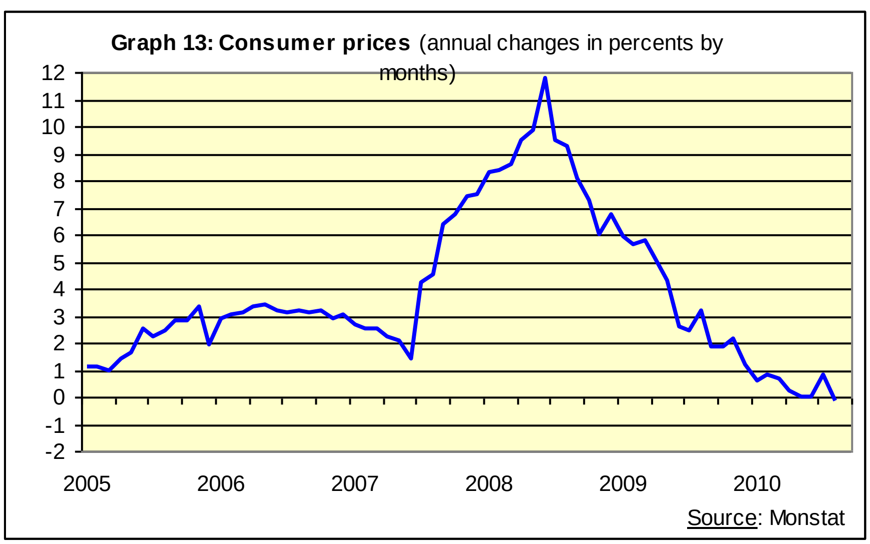
It is important to mention that MONSTAT's methodology for calculation of wages has been modified, as a result of taxation of personal earnings (food allowance and annual leave allowance) in 2010. According to that methodology, the mentioned earnings have been included in the amount of wages. Therefore, statistical increase of wages was caused by the methodology modification. Employment represents a very important indicator for the future economic growth, primarily due to the fact that public spending has been reduced by the restrictive policy whereas the private spending has become more dominant, as well as that Montenegrin economy is mostly labour intensive.



2.1.3. Inflation

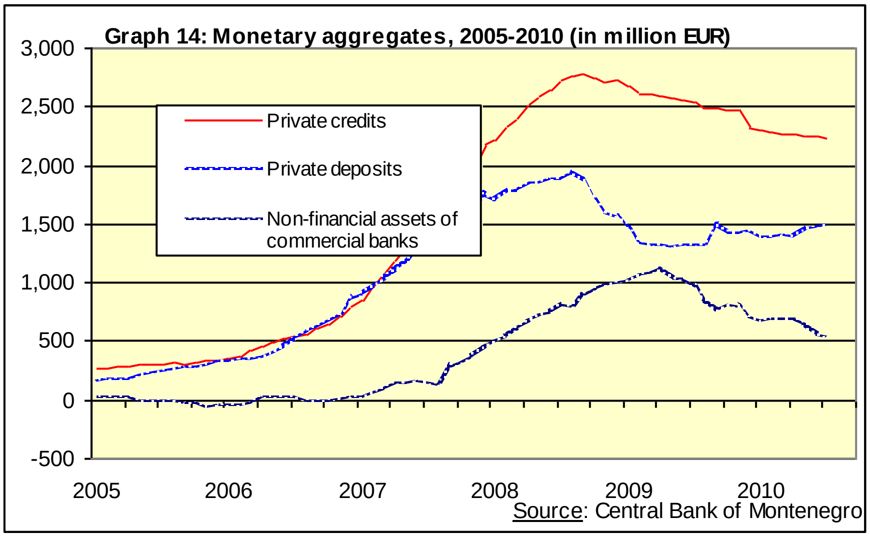
A drop in the economic activity in almost all sectors as well as reduction of aggregate demand influenced inflation trends and levels in 2009. Measured by the consumer price index, inflation amounted 1.5% in December 2009 compared to December 2008, whereas the average rate in the period January-December 2009 was 3.4% compared to the same period of 2008. In 2010, trend of inflation rate reduction was continued (see graph 13).

Consumer prices in September 2010 were only 0.2% higher than in December 2009, annual growth rate was 0.3%, while average rate for the period January-September 2010 was 0.4% compared to the same period of 2009, which is below the expected rates, and it had significant impact on lower nominal growth of budgetary revenues during this year.



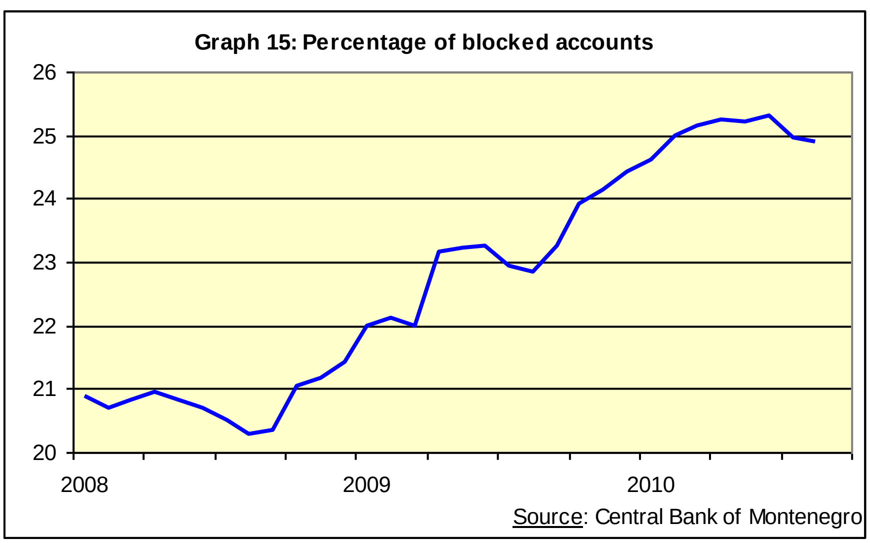
2.1.4. Banking sector and liquidity

Severe drop in private sector deposits ended at the beginning of 2009 (see graph 14), partly as a result of introducing Government's guarantees for deposits and granting credits and guarantees to the banking sectors, subsequently followed by stabilisation of the level of deposits at approximately 48% of GDP.



When the crisis arose, the banking sector was supported by foreign owners, causing increase in foreign liabilities of banks at that period. However, since mid-2009, foreign liabilities of banks have considerably declined as well as private sector credits.

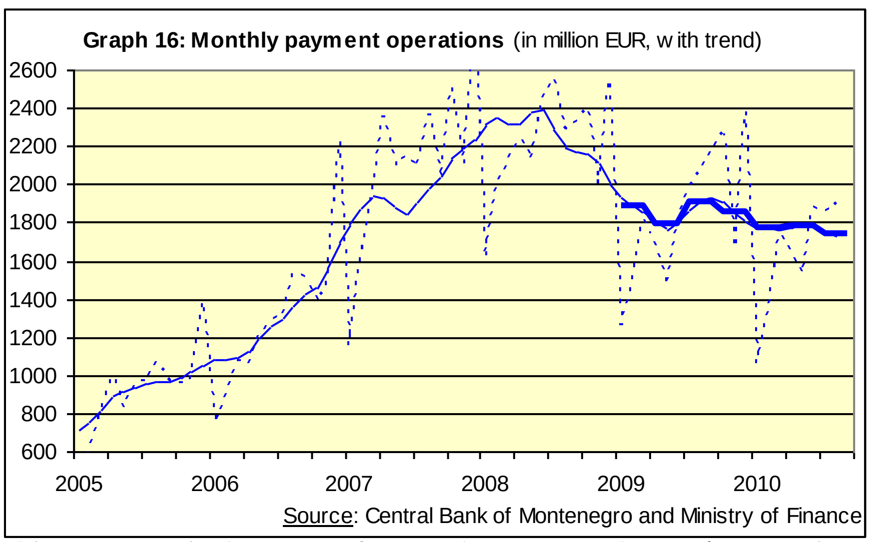
In spite of that, decline in credits was lower that it could be understood from the graph, since a part of credits has been transferred to parent banks abroad and recorded in parent banks' balances. Therefore, according to estimations, growth in credits in 2010 amounted around 5%, although some recent information suggest drop in credit activities for 4.3%.



The constant increase in the number of blocked companies represents a disturbing signal (see graph 15). Share of blocked accounts in the total number of accounts has increased from 20% in 2008 to very high 25% at the beginning of 2010, and since then it has been stabilising. However, value of the blocked accounts has increased from circa EUR 90 million in 2008 to EUR 220 million at the end of

September 2010. One of indicators is also the increase in the number of legal persons with blocked accounts from 9,000 in August 2008 to 13,000 legal persons at the end of September this year. The number of natural and legal persons with blocked accounts in the first quarter of 2010 was somewhat higher, whereas a minor decrease was recorded in the third quarter compared to the second quarter.

Although the liquidity of banks has been improved, main risk in the banking sector are loans in default, with an increasing trend. Share of non-performing assets in total credits amounted 14.4% in the third quarter of 2010, while this share in the fourth quarter of 2009 amounted 11.4%. Share of loans in default in total loans amounted 17.6%, whereas in the last quarter of 2009 they totalled 13.5%. Main indicator in projections for further credit activity growth is the credit potential of companies, which is difficult to evaluate since data varies from sector to sector. In some sectors, such as real estate, trade, services and tourism, decrease in the number of granted credits from 2009 has been continuing, while credits have been recovered in construction industry and transport. Furthermore, number of retail loans has been reduced as well as indebtedness per capita, which can, on the other hand, imply that the process of reducing banks' exposure is under way and that the envisaged growth in credits could be expected to happen next year, although it will depend on trends of the loans in default.



Level of payment operations is one of the most important indicators of economic activity as well as indicator of the overall liquidity of economy (It is especially important as an indicator of GDP trends in the next two or three quarters). Level of payment operations had been seriously decreasing from mid-2008 to mid-2009 (see graph 16, where the bold line indicates the payment operations trend). After mid-2009, it has temporarily increased, as a result of recapitalisation and partial privatisation of the Electric Power Company of Montenegro, but it is still 20% lower compared to the same period of the previous year.

2.1.5. Balance of payments

Current account of the balance of payments underwent the greatest changes in 2009, as a result of the eruption of crisis at the end of 2008 (Table 3). Export decreased for more than 5%, whereas import recorded even 28% decline. Main characteristics of the balance of payments in

2009 were significant drop in import of goods, resulting in downturn in the foreign trade deficit, deficit of the balance-of-payments current account, significant decrease in export, and high net inflow of foreign direct investments. In 2009, the greatest inflow of foreign direct investments was generated through partial privatisation of the Electric Power Company of Montenegro. Decline in export was largely caused by decline in the export of processing industry, primarily aluminium, whereas decline in import was caused by decline in aggregate demand, both private and public.

The table 3 below demonstrates the balance of payments of Montenegro, in million of Euros, for 2008 and 2009 as well as for the first two quarters of 2010 compared to the same period of 2009:

Table 3: Balance of payments of Montenegro	2008	2009	I-II Q of 2009	I-II Q of 2010	Changes in %
A. CURRENT ACCOUNT (1+2+3+4)	-1.564.286	-896.271	-551.517	-512.456	-7.1
1. Goods*	-2.082.340	-1.371.496	-639.501	-607.662	-5.0
1.1. Export	467.384	296.284	134.408	155.161	15.4
1.2. Import	2.549.724	1.667.780	773.909	762.823	-1.4
2. Services	399.381	384.521	40.675	42.933	5.6
2.1. Revenues	750.591	680.487	180.674	188.806	4.5
2.2. Expenditures	351.210	295.965	140.000	145.872	4.2
3. Income	45.613	5.327	9.336	27	-99.7
3.1. Revenues	168.642	162.722	81.877	75.433	-7.9
3.2. Expenditures	123.029	157.395	72.541	75.406	3.9
4. Current transfers	73.060	85.377	37.973	52.246	37.6
4.1. Revenues	109.308	117.681	54.584	66.598	22.0
4.2. Expenditures	36.248	32.304	16.611	14.352	-13.6
B. CAPITAL AND FINANCIAL ACCOUNT	1.329.746	539.817	397.062	326.373	-17.8
B1. Capital account	-463	1.959	1.992	-273	-113.7
B2. Financial account	1.330.209	537.858	395.070	326.646	-17.3
1. Direct investments	551.709	910.907	326.285	310.535	-4.8
1.1. Abroad	-73.704	-32.890	-15.367	-26.083	69.7
1.2. In Montenegro	625.414	943.797	341.652	336.618	-1.5

2. Portfolio investments	-15.528	-41.851	-29.120	-617	-97.9
2.1. Resources	-11.642	-38.261	-27.890	3.343	-112.0
2.2. Liabilities	-3.886	-3.590	-1.231	-3.960	221.8
3. Other investments	638.726	-274.607	23.241	-78.755	-438.9
3.1. Resources	-179.100	-310.673	-51.428	-91.145	77.2
3.2. Liabilities	817.827	36.066	74.668	12.390	-83.4
B3. Changes in reserves at the Central Bank of Montenegro	155.301	-56.590	74.664	95.484	27.9
C. NET ERRORS AND OMISSIONS	234.540	356.454	154.455	186.082	

According to MONSTAT preliminary data, total foreign trade in goods in the first half of 2010 amounted EUR 896.2 million, out of which the export amounted EUR 142 million whereas the import amounted EUR 754 million. Observed by quarters, the highest value of export since the end of 2008 was achieved in the second quarter of 2010 to the amount of EUR 86.4 million, which is 66.1% higher compared to the same quarter of 2009. In 2010, coverage of import by export was still low, reflecting the character of Montenegrin economy with dominant share of the services sector – primarily tourism, whose trends significantly affect the level of import of goods and services, i.e. growth in tourism turnover is caused by higher import. This was particularly evident this year, when the credit activity of banks was low, so the import growth was not financed by the growth in credit activity of banks, i.e. by increased indebtedness of population and economy.

Trends in the first half of 2010 demonstrated gradual recovery of economic and foreign trade activities. Data on foreign trade of Montenegro show downturn in the foreign trade deficit and surpluses in the accounts of services, current transfers and income, compared to the same period of the previous year (first and second quarter of 2009). Recovery was recorded in the export of goods (15.4% growth), whereas import still shows trend of deceleration (1.5% decline). According to preliminary data, deficit of the balance-of-payments current account in the first half of 2010 amounted EUR 508.8 million, or 7.7% less compared to the same period of the previous year. Reduction in the current account deficit was influenced by reduction in the foreign trade deficit as well as by increase in surplus in the services account and current transfers. In the services sector, positive result was scored only in the transport sector, whereas unlike the previous year when investments were significant in the energy sector, structure of FDIs in 2010 is dominated by investments in the sectors of finances (recapitalisation of banks), telecommunications and tourism.

Table 4: Balance of payments trends in % of GDP – 2008-2010

	2008	2009	Estimation 2010[7]
	in % of GDP		
Current account	**-50.7**	**-30.1**	**-24.6**
Export	39.5	32.8	35.4
Services	24.3	22.8	24.3
Goods	15.1	9.9	11.1
Import	-94.0	-65.9	-63.7
Other	3.8	3.0	3.6
Net errors and omissions	7.6	12.0	0.0[8]
Capital and financial account	38.1	20.0	21.1
Banks and other	20.2	-10.6	-5.3
Foreign direct investments	17.9	30.6	19.8
Government loans (net)			6.6
Reserves (decline)	5.0	-1.9	3.5

Sources: Central Bank of Montenegro, Ministry of Finance

As regards projections for the rest of 2010, the Government estimates that the import growth will remain at the same level as in 2009, whereas export of goods and services should increase for 1%. The import growth is mostly caused by increase in tourism activities (good tourist season), while reduction in investment activity will, on the other hand, lead to decrease in import. It is expected that other components of the current account (incomes and transfers) will also achieve recovery. Data related to net errors and omissions for 2008 and 2009 are very interesting. Reasons for their high level are primarily higher revenues from tourism (cash

[7] Estimation made by the Ministry of Finance

[8] The figure 0 is used for the projection needs, although data for the first two quarters show that net errors and omissions amount EUR 186 million, more than in the same period of the previous year, and they will be used for financing a part of the current account deficit.

payments), unrecorded transfers from abroad, understated export revenues, etc. Such a high level of errors and omissions is not unusual for countries in transition – in this case, it seems that the level of aggregate demand and supply was higher than statistically recorded. In 2010, current account deficit will be principally financed out of foreign direct investments and Government loans, and probably from undefined sources (net errors and omissions), although in Table 3 we projected that there will be no net errors and omissions.

It is expected that flows of banks' financing abroad from 2009-2010 will gradually decrease and disappear in 2011, as well as that direct foreign investments will probably decline from a very high level of more than 30% of GDP (in 2009) to a more sustainable ratio of GDP share.

2.2. MEDIUM-TERM MACROECONOMIC SCENARIO

Economic recovery in the forthcoming period will depend on an entire spectrum of factors, primarily on the triangle – employment, banking sector and foreign direct investments. Increase in the number of employed persons in the private sector will depend on two primary sources of funds – bank loan (through foreign investments into the banking sector and growth in crediting) and level and structure of foreign direct investments. Furthermore, economic recovery in Montenegro will, to a certain extent, depend also on recovery of economic activity in the neighbouring countries and EU member states. Medium-term growth rates of Montenegrin economy must be considered in the context of the following characteristics:

- Transition towards market economy was initiated ten years later than in other countries, and it was hindered by the process of regaining independence until 2006. The economy has not yet achieved its potential level, and apart from the period from the end of 2006 to the third quarter of 2008 when the cyclical component of growth was evident, the economy already generates below its potentials in 2010, according to estimations made by the Government.[9]
- As a very small economy, relatively lower nominal investments, particularly in labour intensive sectors, can lead to growth rates higher than the stated medium-term projections.
- Share of service activities, which mostly generate products and services with additional value, in the economy of Montenegro has been steadily growing compared to the processing industry, which reduces GDP share and produces raw materials and semi-finished products. Furthermore, within the industrial production, there is an increase in production of competitive products such as energy, which amounts to 60% of total

[9] Difference between the potential and real growth is explained in more details in the chapter 2.2.4.

production. These trends lead towards strengthening competitiveness of the economy and resistance to external shocks, as well as towards more dynamic growth rates.

- Consolidation of balances in the banking sector, required after decline in deposits of approximately 30% at the end of 2008, has not been finished yet. Loans to private sector have continued to decrease (20% compared to the maximum level achieved in mid-2008) as a result of banks' efforts to reduce risk exposure, but a significant number of these credits have been recorded in the parent banks' balances. Taking this into consideration, it is possible that credits could increase to some extent in 2010. Liquidity of the banking sector is improved compared to the previous year, but there is a concern about the number of loans in default, which continues to grow, indicating the growing illiquidity of the economy and population.
- Development of economies in the Eurozone and in the neighbouring countries is of particular importance for Montenegro, because of its size and exposure, since this could have a positive effect to tourism and FDI inflow.

Base scenario envisages 2.5% growth in economy in 2010, based on which the 2011 Budget was prepared and adopted. Projections of growth in 2011 and 2012 in this EFP are somewhat lower than the last year projections. Nevertheless, 2.5% growth has been projected on the basis of current economic trends, analysis of output gaps, leading economic indicators and real expectations of banks' credit activity, FDI inflow and trends in the labour market.

Differences between the base, higher and lower scenarios mostly represent results of various assumptions about economic trends in 2011 and dynamics in recovery of economic growth following recession, and therefore growth rates for the period 2012-2013 in all three scenarios are practically the same, although the base year (2011) is different.[10] Furthermore, the chapter 2.2.4 for the first time provides short overview of potential output gap, i.e. difference between the potential and possible growth rates, which could give rise to higher economic growth rates in medium-term, provided that our assumptions are precise and there is no negative gap. Output gap analyses have been carried out for the first time and they will be worked out in detail in the first Pre-Accession Economic Programme (PEP) that Montenegro, as a candidate country, will prepare next year.

However, more important are the implications that could be caused by growth rates projected by the lower scenario, which are not excluded due to current economic circumstances in Europe.

The table 5 below provides summary macroeconomic overview of the base scenario and two alternative scenarios for the medium-term 2011-2013.

[10] More detailed differences among these scenarios are presented in the risk map given at 2.2.2. Map of risks and possibilities in the economy of Montenegro in the period 2011-2013

Table 5: Scenarios			Base scenario			Higher growth scenario			Lower growth scenario		
	2009	2010	2011	2012	2013	2011	2012	2013	2011	2012	2013
GDP (in million of EUR)	2.981	3.025	3.170	3.363	3.585	3.231	3.444	3.671	3.106	3.296	3.513
Real growth	*-5.7*	*0.5*	*2.5*	*3.5*	*4.0*	*4.5*	*4.0*	*4.0*	*0.5*	*3.5*	*4.0*
Deflator (rate)	*2.4*	*1.0*	*2.2*	*2.5*	*2.5*	*2.2*	*2.5*	*2.5*	*2.2*	*2.5*	*2.5*

Base macroeconomic scenario 2011-2013

Base medium-term macroeconomic scenario for the period 2011-2013 is grounded in projections that the recovery trend, which emerged in the third quarter of 2010, will be continued, with somewhat lower initial growth and higher rates in 2012-2013, although it cannot be neglected that there are some risks related to the banking sector and FDI inflow that could decelerate this recovery and growth.

Base scenario envisages moderate recovery in the period 2011-2013, as well as economic growth up to 2.5-4.0% of real growth in 2011-2013 (see table 6). There is no strong inflation growth expected, although its growth of around 0.7% is higher than the one projected for Eurozone, but still below the inflation rate projected for economies of Central and Eastern Europe in the same period.

In base scenario, main contribution to the growth should be given by growth in the services sector, mostly tourism, and increase in household consumption that should remain at the level of 84% share in GDP, based on moderate growth in employment and wages.

Table 6: Base scenario			Base scenario		
	2009	2010	2011	2012	2013
GDP (in million of EUR)	2.981	3.025	3.170	3.363	3.585
Real growth	*-5.7*	*0.5*	*2.5*	*3.5*	*4.0*
Deflator (rate)	*2.4*	*1.0*	*2.2*	*2.5*	*2.5*

	(in % of GDP)				
Main characteristics:					
Current account balance	-30.1	-24.6	-19.3	-18.2	-17.3
Export	32.1	35.4	36.3	37.2	38.1
Import	-65.4	-63.7	-59.2	-59.1	-59.1
Other	3.2	3.6	3.7	3.7	3.7
Private deposits	47.6	48.0	48.0	48.0	48.0
Domestic bank loans	81.5	76.8	76.7	76.0	76.9
Household consumption	84.0	84.0	84.0	84.0	84.0
Investments in gross capital	27.1	22.9	18.1	17.9	17.8
Public spending	22.2	21.4	20.8	20.1	19.3
	(contribution to growth, in percentage points)				
Real growth of GDP:	**-5.7**	**0.5**	**2.5**	**3.5**	**4.0**
Household consumption	-12.0	0.4	2.1	2.9	3.4
Investments in gross capital	-15.1	-4.1	-4.3	0.4	0.6
Public spending	-1.7	-0.7	0.0	-0.1	-0.1
Net export	23.1	4.9	4.7	0.3	0.1
Export	-9.2	3.4	1.8	2.2	2.4
Import	32.3	1.4	2.9	-1.9	-2.4
	(% of annual growth, except if otherwise stated)				
Key assumptions:					
Employment growth	0.4	0.2	1.3	1.8	2.0
Wage growth	6.1	9.3	2.2	2.5	2.5
Unemployment (decline, end of year)		11.6	11.1	10.3	9.2

FDI (in % of GDP)	30.6	19.8	17.3	17.4	15.0
New credits (% of credit growth)	-13.5	-4.3	4.6	5.2	7.8
Growth in export	-21.4	11.8	7.3	8.7	9.2
Growth in import	-32.8	-1.2	-2.5	5.9	6.6

Sources: MONSTAT, Central Bank of Montenegro, Ministry of Finance

Positive contribution to GDP growth could be given by the increase in gross investments in fixed assets, considering the projected moderate growth in banking activity. At the same time, it is envisaged that private deposits will increase in line with GDP growth. New bank loans should achieve the growth level of 4.6% and 5.2% respectively in 2012-2013, which should result in minor decrease in unemployment. Simultaneously, consolidation of public spending should be continued, which could have slightly negative effect on GDP growth.

Current account deficit should remain relatively high, although there is a trend of reduction, reflecting the significant contribution to growth given by consumption and investment activity, but this requires combination of high foreign investments and moderate growth in banking activity.

Improvement of business environment, strengthening of activities of small and medium sized enterprises and maintenance of production in large industrial systems, with effects on activities of related companies, will result in creating conditions for new employment and 1.3% growth of employment compared to 2010.

Stable interest of foreign investors in the circumstances of economic regeneration should result in sustained increase in foreign direct investments. These assumptions are grounded in implementation of capital infrastructure projects in medium term (Bar – Boljare highway; hydroelectric power plants on the river Morača; small hydroelectric power plants; wind turbines; projects on construction of hotels – Luštica, Ada Bojana, Valdanos, etc.; facilities for treatment of solid waste and waste water; other facilities of local and regional public utility infrastructure) and drawing of funds on signed credit arrangements mostly intended for infrastructure projects (currently, there is approximately EUR 130 million of non-drawn funds). The expected level of foreign direct investments in 2011 is approximately EUR 550 million.

2.2.1. Alternative scenario

Higher growth scenario (see table 7) envisages stronger stimulus to gross investments in fixed capital in 2012-2013, due to higher level of foreign direct investments and higher export than those envisaged by the base scenario. Furthermore, credit growth is higher than in the base scenario. Foreign direct investments (FDIs) in both years are higher for 1.5% of GDP than in the base scenario, and they amount 18% of GDP in 2012, prior to their decline to 15.3% in 2013. Overall, FDIs during three years are EUR 100 million higher than in the base scenario, which is in line with planned construction of hotels and investments in infrastructure. As a result of higher FDIs, investment spending participates with additional 1.4% of GDP in all three years (also due to higher credit growth), stimulating household consumption for 1.6% of GDP compared to base scenario. This scenario also envisages higher export growth, especially in 2011 when it is expected that export will increase for 2.1% more than in the base scenario. Total export growth in all three years is 2.6% higher than in the base scenario. Combined stimulation in 2011 will contribute to 3.2% growth, but it is still partly neutralised, due to import increase for 1.2%, resulting in total 2% contribution to GDP growth. Overview of differences between the base scenario, higher growth scenario and lower growth scenario is given through the overview of main economic variables in the chapter 2.2.3 Map of risks and possibilities in the economy of Montenegro in the period 2011-2013.

Table 7: Higher growth scenario			Higher growth scenario		
	2009	**2010**	**2011**	**2012**	**2013**
GDP (in million of EUR)	2.981	3.025	3.231	3.444	3.671
Real growth	*-5.7*	*0.5*	*4.5*	*4.0*	*4.0*
Deflator (rate)	*2.4*	*1.0*	*2.2*	*2.5*	*2.5*
			(in % of GDP)		
Main characteristics:					
Current account balance	-30.1	-24.6	-19.3	-18.3	-17.4
Export	32.1	35.4	36.3	37.2	38.1
Import	-65.4	-63.7	-59.2	-59.1	-59.1
Other	3.2	3.6	3.6	3.6	3.6
Private deposits	47.6	48.0	48.0	48.5	48.5
Domestic bank loans	81.5	76.8	75.5	74.7	75.4
Household consumption	84.0	84.0	84.0	83.8	83.6
Investments in gross capital	27.1	22.9	18.5	18.5	18.6

Public spending	22.2	21.4	20.5	19.6	18.8
	(contribution to growth, in percentage points)				
Real growth of GDP:	**-5.7**	**0.5**	**4.5**	**4.0**	**4.0**
Household consumption	-12.0	0.4	3.8	3.2	3.1
Investments in gross capital	-15.1	-4.1	-3.6	0.8	0.9
Public spending	-1.7	-0.7	0.0	-0.1	-0.1
Net export	23.1	4.9	4.3	0.1	0.1
Export	-9.2	3.4	2.5	2.4	2.4
Import	32.3	1.4	1.8	-2.2	-2.4
	(% of annual growth, except if otherwise stated)				
Key assumptions:					
Employment growth	0.4	0.2	2.3	2.0	2.0
Wage growth	6.1	9.3	2.2	2.5	2.5
Unemployment (decline, end of year)		11.6	10.3	9.2	8.1
FDI (in % of GDP)	30.6	19.8	18.1	18.1	15.3
New credits (% of credit growth)	-13.5	-4.3	5.0	5.5	7.6
Growth in export	-21.4	11.8	9.4	9.2	9.2
Growth in import	-32.8	-1.2	-0.7	6.4	6.6

Sources: MONSTAT, Central Bank of Montenegro, Ministry of Finance

Current account of the balance of payments would experience minor changes, but it would remain at 17.4% of GDP in 2013. Although household consumption would decrease in comparison with GDP, private sector deposits would slightly increase. However, higher deficit of current account would be financed by the higher level of foreign direct investments.

As in the base scenario, public spending would still negatively react to aggregate demand than it is the case in the higher growth scenario. Export would remain higher for approximately 2.6% of GDP in the period 2011-2013 compared to the base scenario. Increased investment activities would, however, cause decrease in unemployment, resulting in 8.1% of unemployment by the end of 2013. Unemployment rate in this scenario would partly depend on current policies for reduction of employment in the public sector, which has been implemented both at the central and local level.

Lower growth scenario[11] (see table 8) differs from the base scenario in the growth of export and investment activities, which are significantly lower in the period 2011-2013, whereas the credit growth is decelerated. Increase in exports in 2011 is almost 3% lower than in the base scenario, while in 2013 it is the same as in the base scenario. This scenario implies slower increase in tourism revenues from 4% in 2011 to 7% after 2011, which would be in line with the decelerated growth in Europe, as well as repeated decrease in the processing industry.

Table 8: Lower growth scenario			Lower growth scenario		
	2009	**2010**	**2011**	**2012**	**2013**
GDP (in million of EUR)	2.981	3.025	3.106	3.296	3.513
Real growth	*-5.7*	*0.5*	*0.5*	*3.5*	*4.0*
Deflator (rate)	*2.4*	*1.0*	*2.2*	*2.5*	*2.5*
		(in % of GDP)			
Main characteristics:					
Current account balance	-30.1	-24.6	-19.4	-18.4	-17.5
Export	32.1	35.4	36.0	36.9	37.8
Import	-65.4	-63.7	-59.3	-59.1	-59.1
Other	3.2	3.6	3.8	3.8	3.8
Private deposits	47.6	48.0	47.5	47.0	46.5
Domestic bank loans	81.5	76.8	76.8	76.4	77.5
Household consumption	84.0	84.0	84.5	85.3	85.7

[11] Detailed explanation of differences between the lower scenario and base scenario is given in the chapter 2.2.3.

Investments in gross capital	27.1	22.9	17.4	16.4	15.9
Public spending	22.2	21.4	21.3	20.5	19.6
	(contribution to growth, in percentage points)				
Real growth of GDP:	**-5.7**	**0.5**	**0.5**	**3.5**	**4.0**
Household consumption	-12.0	0.4	0.9	3.8	3.8
Investments in gross capital	-15.1	-4.1	-5.4	-0.5	0.2
Public spending	-1.7	-0.7	0.0	-0.1	-0.1
Net export	23.1	4.9	4.9	0.3	0.0
Export	-9.2	3.4	0.8	2.2	2.4
Import	32.3	1.4	4.1	-1.9	-2.4
	(% of annual growth, except if otherwise stated)				
Key assumptions:					
Employment growth	0.4	0.2	0.2	1.8	2.0
Wage growth	6.1	9.3	2.2	2.5	2.5
Unemployment (decline, end of year)		11.6	12.0	11.2	10.2
FDI (in % of GDP)	30.6	19.8	17.4	16.8	14.3
New credits (% of credit growth)	-13.5	-4.3	2.7	5.5	8.2
Growth in export	-21.4	11.8	4.5	8.7	9.2
Growth in import	-32.8	-1.2	-4.4	5.8	6.6

Sources: MONSTAT, Central Bank of Montenegro, Ministry of Finance

FDI inflow in the period 2011-2013 is 1.3% of GDP lower than in the base scenario, i.e. for EUR 75 million in absolute amount, which has direct effects on GDP reduction to the approximately same amount. If combined with effects of significantly lower credit growth in the banking system, this leads to decrease in investment activity up to 16% of GDP, compared to 17.8% in the base scenario. Lower investments reduce the real GDP growth for averagely 0.8% in the period 2011-2013, whereas household consumption in 2011-2012 reduces GDP growth for additional 0.4%. Lower demand leads to lower import, so the overall effect on growth is restricted to averagely 1% in 2011. Due to lower household consumption, lower investments and lower export, combined stimulation reduces the growth in 2011 for 3.2%. However, this negative impact is partially neutralised as a result of higher export, contributing to the growth up to 1.2%, with final reduction effect of 2%.

Current account of the balance of payments would experience minor corrections than in the base scenario – it would still amount 17.5% of GDP in 2013 – whereas the household consumption steadily increases in percents in comparison with GDP, partially financed by the decrease in private sector deposits.

Combination of lower export and investment activity, as assumed on the basis of lower credit growth and household consumption, would result in a decrease in unemployment, after its growth in 2011, leading to the lowest unemployment rate to be achieved in 2013 – 10.2%, formerly recorded in mid-2009.

2.2.2. Map of risks and possibilities in the economy of Montenegro in the period 2011-2013

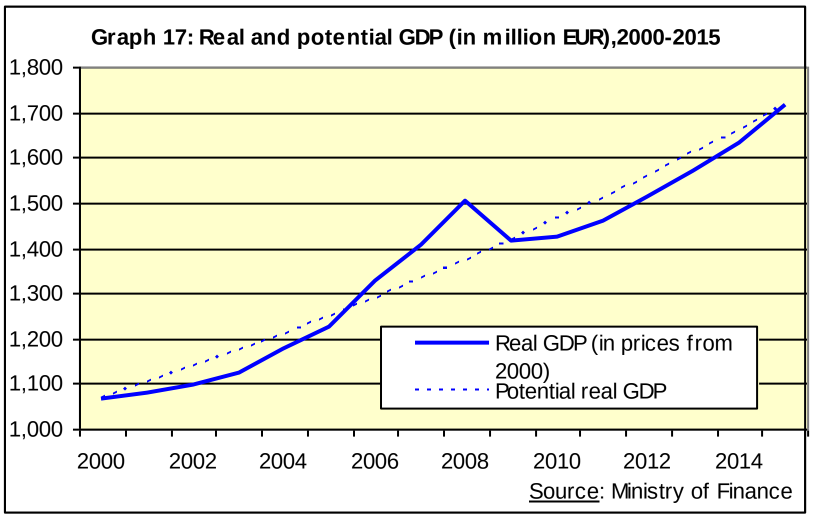
The table 9 below gives assessments of risks and possibilities that could negatively or positively affect the base scenario for the period 2011- 2013. It demonstrates in details various risks or possibilities in the lower and higher growth scenarios.

	Risk	Situation in 2010	Base scenario	"Higher growth" scenario	"Lower growth" scenario
	Export	Export will increase for 12% in 2010, following the 21% decrease in 2009. Recovery is mostly caused by the growth in tourism (up to 8%) and aluminium sale (up to 25%).	It is projected that revenues from tourism will increase for 8% in 2011 and will continue to increase afterwards up to 10% at the annual level. Aluminium export is projected to remain stable at the level recorded at the end of 2010 by 2013, as well as that it will benefit from moderate price increase after 2011. Export of other types of goods is projected to increase averagely for 8% at the annual level in medium term.	Initial stimulation to growth in tourism (11% in 2011) or permanent increase in aluminium export up to 15% would cause real GDP growth for 1 percentage point in 2011-2012.	Decelerated growth in tourism of -4% in 2011 and 7% afterwards – or return to the 2009 level of aluminium export – would result in reduction of real GDP growth for 1% in 2011 and its stagnation in the period after that.
	Foreign direct investments	From EUR 911 million in 2009, FDIs declined to EUR 600 million in 2010, but still with a very high share in GDP – 20 percentage points, even more than in 2008.	FDIs will decrease to 15 percentage points of GDP by 2013, whereas gross investments will decrease from 23 percentage points of GDP in 2010 to 18 percentage points of GDP in 2011 and afterwards.	FDIs will gradually decrease to 15.5% of GDP by 2013, whereas gross investments will decrease to 18.5% of GDP. Investments will contribute 1.5% more to GDP in the period 2011-2013.	FDIs will decrease rapidly to 14.5% of GP in 2013, whereas gross investments will decrease to 16% of GDP. Investments will contribute 2.5% less to GDP in the period 2011-2013.
	Credit activity of banks	Bank loans continue to decline, but could be stabilised.	Bank loans will increase for 5% in 2011-2012, whereas in 2013 they will increase for 8%.	Bank loans will increase faster in 2011-2012, whereas in 2013 they will increase for 8%.	Loans will increase slowly, whereas in 2011 they will increase for 3%.
	Household liquidity	Number of blocked accounts reached its maximum at the end of the year, but the liquidity is still low.	Liquidity will be reduced and deposits will be stabilised at 48% of GDP.	Liquidity will be improved and private deposits will increase up to 48.5% of GDP.	Liquidity will be reduced and private deposits will decrease to 46.5% of GDP.
	Household consumption	Higher consumption additionally increases the real growth for 0.5%.	Household consumption will gradually recover and contribute to real GDP growth up to 2-3% in the period 2011-2013.	Household consumption will gradually recover and contribute to real GDP growth up to 3-4% in the period 2011-2013.	Household consumption will contribute to real GDP growth up to 1-4%.
	Investment spending	Further decline in investment spending results in 4% decrease of GDP.	Investments will reduce the real GDP growth for 4% in 2011, after which investments will recover and contribute to GDP growth up to 0.5% in 2012 and 2013.	Investments will reduce the real GDP growth for 3.5% in 2011, after which investments will recover and contribute to GDP growth up to 1% in 2012 and 2013.	Investments will reduce the real GDP growth for 5.5% in 2011, after which they will not contribute to GDP until 2013.
	Import	Import declines to less than 64% of GDP, whereas the current account decreases to less than 25%.	In each scenario, import will be stabilised at below 60% of GDP, whereas current account deficit will decrease to 17.5%. In the higher scenario, investments and export are higher whereas household consumption is lower, resulting in reduced pressure on import. Situation is quite the opposite in the lower scenario.		

	Unemployment rate	After a period of growth, the unemployment rate could fall to 11.6% by the end of the year.	Unemployment rate will decrease to 9.2% at the end of 2013, whereas wages will increase in line with the inflation rate.	Unemployment rate will decrease to 8.1% at the end of 2013, whereas wages will increase in line with the inflation rate.	Unemployment rate will decrease to 10.2% at the end of 2013, whereas wages will increase in line with the inflation rate.

2.2.3. Output gap

All medium-term scenarios are based on the essential assumption that potential real growth rate in Montenegro is around 3.2% at the annual level. Lack of elementary data does not allow assessments based on factor productivity, but if proceeding from the assumed growth rates, Montenegro can expect to restore the growth rate recorded prior to transition (by its upward adjustment to low growth rates in medium-term) by 2015. Since 2000, GDP has decreased to 75% of its level recorded prior to transition, and according to EBRD estimations, GDP could return to the pre-transition level by 2015.



3.2% rate is close to the geometric average recorded in the previous ten years. Growth rates have remained below potentials in the years after transition (see graph 17), until 2006 when they reached their potential level. Afterwards, GDP had been increasing, through its mid-term potential, by the third quarter of 2008 when the crisis began in Montenegro. In 2009, GDP returned to its potential level, whereas in 2010 it decreased below its potential. According to the base scenario, real GDP will again reach its mid-term potential level in 2015.

It should be emphasised that projections of output gap should be taken with reserve, because of short series of data. However, as previously mentioned, output gap, if there is any, can significantly influence mid-term growth rates. Due to the fact that there is a potential output gap, our projections of economic growth in 2012 and 2013 envisage more or less same growth rates in all three scenarios, since we expect that the economic decline below the real growth rates in 2010, even with lower growth rates in 2011, will be compensated in the period up to 2015.

Furthermore, it should be noted that potential growth caused by the crisis could result in complete loss of a part of production capacities of the Montenegrin economy, leading to decelerated economic recovery in medium term, i.e. below the average 3.2%.

3. PUBLIC FINANCES

3.1. TRENDS AND PROJECTIONS

Public expenditure of Montenegro encompasses the following:

- √ The Budget of Montenegro with state funds (which have been the integral part of the budget since 2008), namely: Pension and Disability Insurance Fund, Health Insurance Fund, Compensation Fund and Employment Office;
- √ Budgets of local self-government units (Historic Royal Capital Cetinje, Capital Podgorica and 19 municipalities).

Former extra-budgetary funds were granted the status of state funds by virtue of the amendments to the organic Budget Law in 2007. Consequently, in the period 2008-2010 all funds have represented an integral part of the Budget of Montenegro. Therefore, both budget transparency and the control of budgetary funds spending were increased.

3.1.1. Public Finances Trends in the period 2009 – 2010

Area of public finances has been greatly affected by the economic crisis. Temporary direct revenues decreased significantly due to overheating of the economy, tremendous growth of bank loans and aggregate demand. This primarily implies the indirect taxation (VAT and customs) and it led to adjustments in budgetary expenditure and expenditure of local self-government units.

The following table (Table 10) provides the data on realised expenditure in 2008 and 2009, generated revenues in 2008 and 2009 as well as the projections of public revenues and expenditures for 2010.

Table 10

PUBLIC EXPENDITURE	2008 Annual Accounts		2009 Annual Accounts		Projections for 2010	
	mil €	% GDP	mil €	% GDP	mil €	% GDP

DIRECT PUBLIC REVENUES	**1544,44**	**50,06**	**1352,97**	**45,39**	**1265,68**	**41,84**
Taxes	926,40	30,03	795,66	26,69	755,78	24,98
Contributions	339,91	11,02	307,54	10,32	349,73	11,56
Fees	36,09	1,17	29,03	0,97	28,75	0,95
Charges	165,76	5,37	105,58	3,54	88,27	2,92
Other revenues	67,28	2,18	60,34	2,02	38,81	1,28
Loan repayment receipts	9,00	0,29	54,81	1,84	4,34	0,14
Expenses	**1556,55**	**50,46**	**1524,04**	**51,13**	**1386,49**	**45,83**
Current public expenditure	**1245,67**	**40,38**	**1299,34**	**43,59**	**1228,63**	**40,62**
Current expenditures	**574,95**	**18,64**	**561,02**	**18,82**	**585,03**	**19,34**
Social protection transfers	**350,42**	**11,36**	**413,07**	**13,86**	**424,50**	**14,03**
Transfers to institutions, individuals and non-governmental and public sector	**237,55**	**7,70**	**235,06**	**7,89**	**198,37**	**6,56**
Capital expenditures	**310,89**	**10,08**	**251,21**	**8,43**	**157,86**	**5,22**
DEFICIT/SURPLUS	**-12,12**	**-0,39**	**-171,07**	**-5,74**	**-120,81**	**-3,99**
Primary deficit	**11,69**	**0,38**	**-145,55**	**-4,88**	**-91,40**	**-3,02**
Debt repayment	**145,62**	**4,72**	**187,78**	**6,30**	**143,25**	**4,74**
Repayment of the principal to residents	52,84	1,71	76,65	2,57	21,47	0,71
Repayment of the principal to non-residents	19,91	0,65	25,40	0,85	43,34	1,43
Repayment of liabilities from the previous period	72,86	2,36	85,73	2,88	78,44	2,59
Repayment of guarantees	0,05	0,00	0,00	0,00	0,00	0,00
Deficient funds	**-157,73**	**-5,11**	**-358,85**	**-12,04**	**-264,05**	**-8,73**
Financing	**157,73**	**5,11**	**358,85**	**12,04**	**264,05**	**8,73**

Borrowings and loans from domestic sources	14,91	0,48	125,66	4,22	5,71	0,19
Borrowings and loans from foreign sources	13,05	0,42	148,64	4,99	200,00	6,61
Revenues from privatisation	38,56	1,25	129,75	4,35	32,64	1,08
Use of deposits	87,00	2,82	-45,20	-1,52	25,71	0,85

In public finances system, after the decrease of direct revenues, mostly »temporary« revenues, and the growth of deficit and debt in 2009, our projections show that during this year, although the revenues have not recovered, public finances deficit will decrease to around 4% of GDP from 5.74% of GDP in 2009 while the public finances primary deficit will fall from 4.88% of GDP in 2009 to 3.02% GDP in 2010.

Public revenues

On revenue side, apart from the significant revenues' decrease of 8% in total share in GDP in 2010 compared to 2008, there were some changes in structure of direct and indirect revenues (45:55) compared to 35:65 from the period of strong economic growth (2006-2008). At the same time, the structure of VAT as the most significant budgetary revenue has also changed by the change in relation of imported and internal VAT (58:42).

The following table shows the trends of direct public revenues in the period 2008-2010 categorised into direct, indirect and other revenues:

Table 11

Direct public revenues 2008-2010						
DESCRIPTION	**Outturn 2008**		**Outturn 2009**		**Projections 2010**[12]	
	mil €	**% GDP**	**mil €**	**% GDP**	**mil €**	**% GDP**
DIRECT PUBLIC REVENUES	**1544.44**	**50.06**	**1352.97**	**45.39**	**1341.02**	**44.33**
1. TAX REVENUES	1266.31	41.04	1103.20	37.01	1144.40	37.83
a) Direct taxes	544.39	17.64	483.65	16.22	479.37	15.85
Personal income tax	141.67	4.59	121.37	4.07	105.86	3.50
Corporate profit tax	62.80	2.04	54.74	1.84	49.58	1.64
Contributions	339.91	11.02	307.54	10.32	323.93	10.71
b) Indirect taxes	721.92	23.40	619.55	20.78	665.03	21.98
Property tax	38.09	1.23	19.80	0.66	18.83	0.62
Value added tax	440.06	14.26	370.78	12.44	398.86	13.19
Local taxes	120.30	3.90	128.68	4.32	149.89	4.96
Excise	72.93	2.36	49.12	1.65	48.87	1.62
Tax on international trade and transactions	42.00	1.36	42.25	1.42	38.79	1.28
Other Republic taxes	8.53	0.28	8.92	0.30	9.79	0.32
2. NON-TAX REVENUES	278.13	9.01	249.76	8.38	196.62	6.50
Fees	36.09	1.17	29.03	0.97	30.11	1.00
Charges	165.76	5.37	105.58	3.54	110.02	3.64
Other revenues	67.28	2.18	60.34	2.02	49.65	1.64
Loan repayment receipts	9.00	0.29	54.81	1.84	6.84	0.23

Realised level of direct public revenues in 2010 corresponds to great extent to the level of Montenegrin economy development, reduced for a part relating to revenues unpaid due to increase of illiquidity.

[12] Projection of direct revenues for 2010 has been prepared on basis of the nine months' outturn and expected trends in the last quarter of the year.

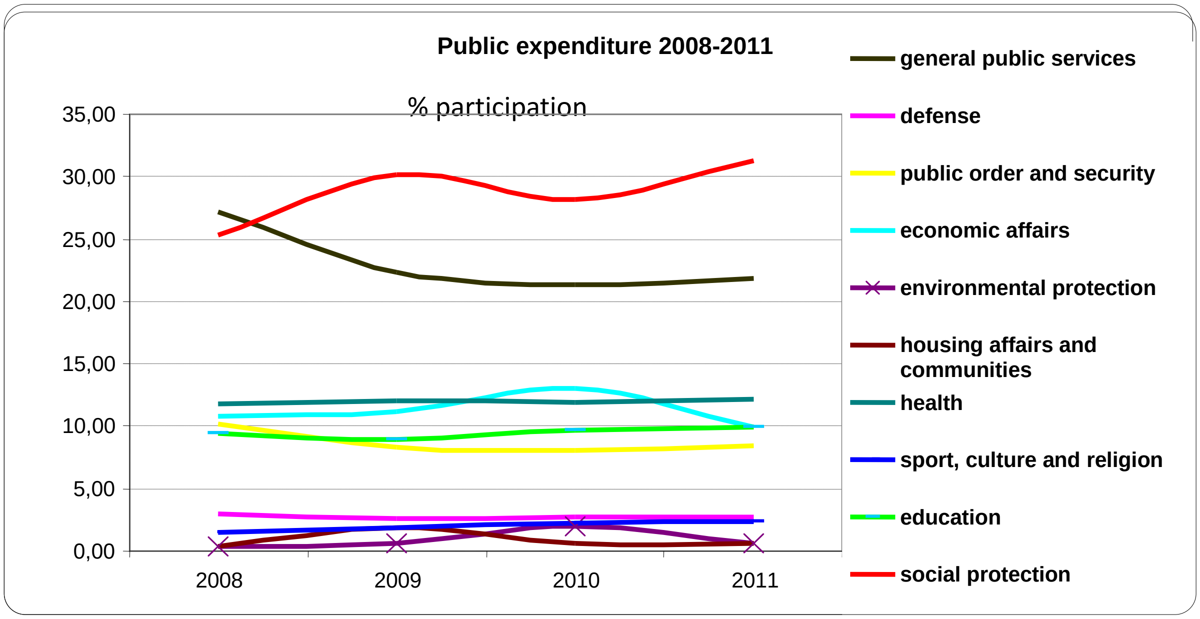
Unlike the period between the end of 2006 and the end of 2008 when, due to strong inflow of investments and bank loans, the collection of revenues exceeded the potential of the economy, in 2010 the revenues will probably not reach their potential. Variations of revenues from 2010 Plan are mainly caused by profit tax, more precisely by legal amendments envisaging the possibility for the tax not to be paid in advance. Other revenues are realised in accordance with the plan or even outperform it (e.g. taxes and contributions to wage). Inflation rate lower than projected and growth of tax debt by 30 mil compared to the end of 2009 will contribute to smaller collection of revenues than projected.

Public expenditure

In 2008, the period of sharp growth of Montenegrin economy, public expenditure recorded level of €1.55 billion or over 50% of GDP. In 2009, public expenditure reaches record high 51% of GDP although the spending was reduced by 9% due to restrictive fiscal policy and primarily due to complete integration of the two largest state funds in the Budget- Health Insurance Fund and the Pension and Disability Insurance Fund, fall of the economy and revision of GDP by the Statistical Office. 2010 Budget reduces the public spending to the level of 48.9% of GDP in 2010 while the data for 10 months and the estimate of the last two months predict the public spending amounting to 45.8% of GDP at the end of 2010. Furthermore, compared to the projections, current expenditure in 2010 recorded the increase in social benefits and pensions expenditures of €18mil or 0.6% of GDP. However, due to savings, this increase will be more than compensated in all other categories of current expenditure.

The following graph shows the share of certain functions in public expenditure per years:

Graph 18



According to the functions, social protection has the greatest share in public expenditure in all years increasing from 25% of public expenditure in 2008 to 31% in 2011. General public service is the second largest function in public expenditure (including the spending of local self-government) with the decreasing trend from 27% to 21%. Health service is the next greatest function with fairly balanced share level in all years totalling from 11.7% to 12%, followed by the functions of economic activities and education with 10% each, public order and security with the share of 10% in 2008 and 8.5% in 2011.

Functions with the smallest share are defence with 3%, sport, culture and religion with 2%, housing and community affairs and environmental protection with around 1% share in public expenditure.

Public expenditure cuts and reduction of deficit

Table 12 shows the effect of measures that have been enforced on revenues and expenditure side since the beginning of the crisis, expressed in percentage share in GDP. The measures have been undertaken primarily through revision of the 2009 Budget adopted in July 2009, savings measures and adopted 2010 Budget.

Table 12

	2009	**2010**
	% of GDP	
Basic measures on revenues side	-0.9	0.1
Reduction of income tax rate to 9%	-1.0	-1.0
Reduction of contribution rates	-0.6	0.0
Increase of contribution rates	0.0	0.5
Increase of excise tax to tobacco products and the fuel	0.7	0.3
Elimination of some exemptions from taxes	0.0	0.3
Basic measures on expenditure side	7.2	1.6
Reduction of the Capital Budget	4.0	0.0
Capital expenditures cuts in Current Budget	1.0	0.0
Reduction of public sector wage fund	0.9	0.2
Reduction of expenses for material and services	2.0	1.0
Application of new contribution rates	0.0	0.5
Project “Job for You”	-0.6	0.0
Social programme for reconstruction of Aluminium Plant	-0.1	-0.1
Net effect	**6.3**	**1.7**

The table 12 shows the total net effect of adjustment in 2009-2010. Due to reduction of tax rates in 2009, net effect on revenues side is negative while the adjustments on expenditure side in the reporting period amount to 9% of GDP, capital budget and current expenditure were decreased respectively by 4% and 5%.

Having in mind the repercussions of the economic crisis, the Government undertook already in February 2009 the savings measures with a view to cutting the public expenditure. These measures implied, inter alia, the suspension of employment in the public sector, rationalisation of all expenditure categories especially of discretionary expenditure. Revision of the Budget, adopted in July 2009, reduced expenditure by 4% which was followed by the additional reduction of €50mil due to savings measures resulting in deficit of 4.40% of GDP[14] in spite of revenues decrease in the amount of €84.34mil compared to the revision plan.

Adopted budget of the central Government and local self-governments for 2010 further reduced the public expenditure for €93 mil or over 3% of GDP. Although the 2010 Central Budget (with state funds) is at the level of execution in 2009, it is important to note that current expenditure is by €11mil lower, that inclusion of the two largest state funds (Health Insurance Fund and Pension and Disability Insurance Fund) led to the real increase of expenditure of €40mil (previously funds could use deposits and loans to increase consumption). Also, the 2010 Budget stipulates the amount of €63mil for loans and donations for financing the consumption (according to GFS it would be largely above the staff) which will be realised to small extent during this year, as shown by execution (15.4 mil by the end of October this year).

It is estimated that public expenditure in 2010 will amount to €1.386,49 mil , which is by €137.5mil or 4.55% of GDP lower for 2010 when compared to the expenditure in previous year. On expenditure part, discretionary expenses further decreased as well as the capital budget in smaller part although the expenses related to pensions, social benefits and interests increased to the total amount of €53mil if compared to 2009.

Reducing the wage fund is one of basic measures introduced in 2009-2010 aiming at public expenditure cutting. To this end, adopted amendments to the Law on Earnings of Civil Servants and Employees entrust, among other things, the full control over the employment to the Ministry of Finance. Furthermore, the Government adopted Human Resources Plan which provides for restrictive employment as well as the criteria to be met by a spending unit to realise new employment (one civil servant may enter into employment on retirement of three civil servants or on two becoming redundant), provides the possibility to spending units to make necessary employment by internal transfers. Decision on increasing the wage of civil servants and employees for performing certain activities was adopted and it clearly defines working positions eligible for the increase thus reducing the wage fund and at the same time identifying the positions of special importance in terms of work with clients and collection of revenues. On the other hand, variable part of income has been completely abolished.

[14] It should be noted that the amendments to the organic Budget Law envisage new methodology of calculating deficit/surplus and that the application of the new method enabled the deficit increase of 1% of GDP, through inclusion of part of outstanding liabilities repayment into current expenditure ("above the staff").

In the previous period, as a follow-up to these measures, the Ministry of Finance initiated the control over the real wage accounting in all spending units financed from the Budget. This contributed greatly to results and savings in the mentioned period. Pursuant to the Law on Earnings of Civil Servants and Employees, the Government adopted the Decision on severance pay and thus created the conditions for layoff of staff and for hiring of deficient cadre if the conditions under the Human Resources Plan have been met.

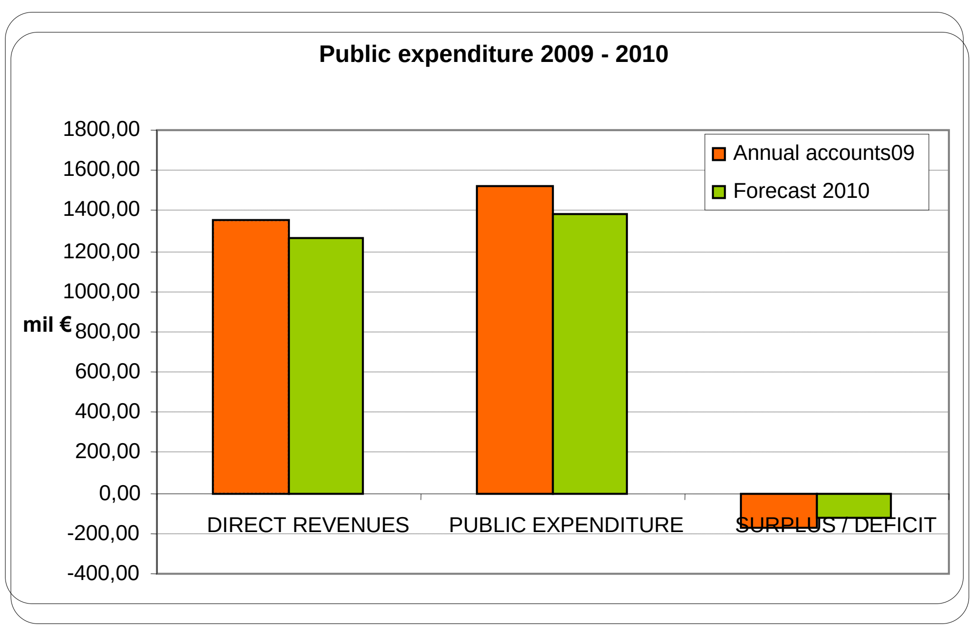
In cooperation with the Public Procurement Directorate, tender approving procedure has been operationalised in details and thus stricter control and predictability in expense planning was ensured.

Regarding the execution for nine months of 2010, both the budget of the Government and of the municipalities are balanced primarily due to lesser execution of the capital budget and lesser withdrawal of loans and donations. Projections of the Ministry of Finance show that public sector deficit will stay below 4% in 2010 although the revenues will be lower for around €40mil while some categories will record the increase primarily in pensions and social benefits related expenditures.

It is estimated that the public expenditure deficit for 2010 will be by €50.26mil or 1.75% of GDP lower if compared to the previous year. Budget deficit is estimated to be at 3.96% of GDP while the estimations show that local self-government shall realise insignificant deficit. Primary deficit for 2010 will be lower by 1.86% of GDP that is it will decrease from 4.88% in the previous year to 3.02% of GDP.

The following graph 19 clearly shows the fall in the level of direct revenues and the level of public expenditure as well of the deficit in comparison to 2009.

Graph 19



Economic crisis also strongly affected the budgets of local self-government units. In 2009 and in early 2010, public finances system faced the decrease in current revenues, growth of outstanding liabilities and illiquidity, growth of credit indebtedness, high level of budget deficit and unrealistic planning of its financing as well as the high level of employment in local self-government bodies, public enterprises and institutions established by municipality. Due to the abovementioned problems, majority of local self-government units realise the programme of savings and rationalisation in local self-government bodies, public enterprises and institutions established by municipality, plan for reprogramming liabilities to suppliers, solving the redundancy programmes.

Public finances at local level were stabilised in the second half of 2010 with still evidently high level of repayment of liabilities from the previous period.

With respect to the financial problems of municipalities, the Ministry of Finance proposed amending the legal solutions regulating the municipalities' financing system taking into account the stability of finance sources, optimal expenditures of municipalities that are to be adjusted with the current functions of local self-governments in order to ensure the long-term stability of finances and to regularly fulfil the legal commitments of municipalities.

Basic reasons for amendments to the current Law on Financing of Local Self-Government, adopted by the Parliament of Montenegro, are explained by the need for:

- further improvement of financing system of legally defined functions of local self-government,
- alignment of existing solutions with the amendments to substantive laws regulating local self-government especially in terms of suspension of certain sources which directly affect the budget liquidity of local self-government units,
- further improvement of business environment through abolition of taxes which have had the insignificant net effect to revenues of municipalities taking into account the small share in revenues and costs of their administration,
- alignment of the existing solutions with the European Charter of Local Self-Government and international conventions on local self-government.

3.1.2. Mid-term basic goals and fiscal policy risks

Bearing in mind the mentioned fiscal risks, as well as the fact that high level of public expenditure would lead to longer and slower recovery of Montenegrin economy, fiscal policy defined the following basic goals and directions for the next mid-term period:

- Establishment of sustainable public finance system complying with previously defined fiscal „anchors" and rules. Main fiscal anchors for the period to 2013 are: public expenditure cuts and reduction of public debt; balanced budget in 2012 and budget surplus in 2013; wage fund growth limitation, reduction of subsidies through parallel limitation of share of mandatory costs; increase of capital budget (capital budget of the central Government) to the level of around 3% of GDP in 2013 and the possibility to finance capital projects through public-private partnerships; structural revenues should cover current expenditures and major part of the capital budget. Thus, current public expenditure would reach the level of around 35% of GDP in 2013.
- *Establishment of sustainable pension system;* Full integration into state Treasury system in 2010 enabled receipts and expenditures of Pension and Disability Insurance Fund to be registered and processed through the Treasury. This provided for both better transparency and the control over budgetary spending as well as for liquidity. At the same time, starting from 2011 the expenses of the „consolidated healthcare system" – including public healthcare institutions will be presented in details through economic classification, not as transfer as it is the case at this point. Transparency of the budget will thus be additionally increased. Amendments to the law on pension and disability insurance are adopted by the Parliament and it is expected that they will additionally strengthen both the sustainability of pension-disability insurance system and the overall public finances.

In realisation of the mentioned goals, the following measures i.e. instruments of economic and especially fiscal policy will be used:

- Implementation of strict employment policy in terms of rationalisation of number of employees and internal transfers (legal possibility of transferring an employee from one spending unit to another), identification of redundant positions in public sector, retraining of work force and centralisation of wage calculation.
- creation of conditions for more flexible position of the Government in creation of budgetary expenditure primarily through reduction of mandatory costs in relation to discretionary expenditure.
- increase of current expenditure only for development projects with parallel suspension of irrational public expenditure programmes.
- expenditure reduction would create preconditions for further reduction of tax rates or their maintenance at current level.

When projecting macroeconomic and fiscal indicators for the next period, the following factors should be taken into account. These factors could pose a risk to Montenegrin public finances in 2011 as well as to the observed mid-term framework:

- Receipts on grounds of pensions and social benefits show the growing trend. Pensions are 6.8% higher in 2011 comparing to the planned amount for 2010 while the social transfers are 22.7% higher for 2011 comparing to the 2010 plan and there is a possibility of their growth in the following years. Apart from this, due to rising commitments related to European integration, increased expenditures could be expected in the next period for establishment of new institutions and co-financing of joint projects. On the other hand, public expenditure cuts in 2011 aimed at sustainability of public finance system will have negative effect resulting in additional contraction of aggregate demand. This will have negative implications to the economic growth. Additional negative effect to the level of public expenditure will be posed by the costs for restoring the damage caused by floods in eleven municipalities in Montenegro.

- Uncertainty in banking sector continues. Although the retail deposit growth of 6.4% and strengthening of banking sector liquidity were evident in 2010, this sector still faces numerous problems. One of the most significant ones is the high level of loans in delay, exposure to sectors especially affected by the crisis e.g. processing industry and civil engineering. At the same time, consolidation and still uncertain future crediting policy for significant banks in the system – Commercial Bank of Montenegro, Hypo Alpe Adria Bank and the First Bank contribute greatly to the uncertain estimation of net crediting for 2011 the market share of which is still high in spite of the decrease from 70% in previous years to around 52%. Growth in crediting of other banks may not fully compensate the fall of credit activity of the three mentioned banks. Growing illiquidity of the economy financed exclusively through our banking system should also be addressed in the context of the banking sector.

- As already stated in this text, FDI along with bank loans were the main generator of the economy growth during the boom and they will surly represent the significant growth factor in the following period. Even in 2009 the growth of 65% was recorded, if compared to 2008. However, despite the fact that there is a whole set of projects awaiting implementation, uncertainty in terms of FDI inflow remains considering the general vigilance against investment in more risky projects and circumstances in financial market.

- Uncertainty regarding the recovery of companies in processing sector. Recovery of the aluminium price in second half of 2010 reduced the pressure exerted on Aluminium Plant while the price of steal in global market does not provide for profitable operations of companies in this sector. This even jeopardise their operations in short-term. Reconstruction of these companies for the purpose of reducing costs to the level which could provide for profitable operating is ongoing.

3.1.3. Mid-term fiscal framework 2011-2013

The following table provides the outline of the fiscal baseline scenario which is based on macroeconomic baseline scenario (see subchapter 2.2). Its main characteristic is the elimination of public finances deficit by 2012 and transit to surplus amounting to 1.7% of GDP in 2013. This fiscal consolidation will be realised along with the continuation of restrictive policy. On expenditure side, decrease of 4% of GDP is stipulated (from 44% to 40% of GDP) with stagnation of direct public revenues at the level of 42% of GDP. Due to increased payment of interests, primary surplus should grow to 3.2% in 2013. This subchapter presents this scenario in more details.

Table 13

Mid-term fiscal scenario 2011-2013 (in per cents of GDP)

	2011	2012	2013
Direct revenues	42.0	42.1	42.0
Public expenditure	44.4	42.2	40.3
Deficit	-2.4	-0.1	1.7
Primary deficit	-0.9	1.5	3.2
Nominal GDP in EUR mil	*3,170*	*3,363*	*3,585*
Nominal growth	*4.8*	*6.1*	*6.6*
Real growth	*2.5*	*3.5*	*4.0*

PUBLIC EXPENDITURE	Projections 2010		Plan 2011		Projections 2012		Projections 2013	
	mil €	% GDP	mil €	% GDP	mil €	% GDP	mil €	% GDP
DIRECT REVENUES	**1265,68**	**41,84**	**1331,90**	**42,01**	**1417,53**	**42,15**	**1506,33**	**42,01**
Taxes	755,78	24,98	811,15	25,58	866,11	25,75	923,04	25,74
Contributions	349,73	11,56	359,61	11,34	380,37	11,31	403,60	11,26
Fees	28,75	0,95	30,02	0,95	32,59	0,97	34,33	0,96
Charges	88,27	2,92	82,84	2,61	85,98	2,56	90,27	2,52
Other revenues	38,81	1,28	43,95	1,39	47,72	1,42	50,04	1,40

Loan repayment receipts	4,34	0,14	4,34	0,14	4,75	0,14	5,06	0,14
PUBLIC EXPENDITURES	**1386,49**	**45,83**	**1408,64**	**44,43**	**1420,03**	**42,22**	**1446,47**	**40,34**
Current public expenditure	**1228,63**	**40,62**	**1245,90**	**39,30**	**1251,13**	**37,20**	**1264,80**	**35,27**
Current expenditures	585,03	19,34	736,30	23,22	732,48	21,78	735,69	20,52
Social protection transfers	424,50	14,03	438,95	13,84	446,72	13,28	453,75	12,65
Transfers to institutions, individuals and non-governmental and public sector	198,37	6,56	55,23	1,74	56,20	1,67	59,19	1,65
Capital expenditures	157,86	5,22	162,75	5,13	168,90	5,02	181,67	5,07
DEFICIT/SURPLUS	**-120,81**	**-3,99**	**-76,74**	**-2,42**	**-2,50**	**-0,07**	**59,86**	**1,67**
Primary deficit	**-91,40**	**-3,02**	**-28,19**	**-0,89**	**49,08**	**1,46**	**114,56**	**3,20**
Debt repayment	**143,25**	**4,74**	**174,44**	**5,50**	**157,52**	**4,68**	**158,43**	**4,42**
Repayment of the principal to residents	21,47	0,71	41,51	1,31	27,29	0,81	28,96	0,81
Repayment of the principal to non-residents	43,34	1,43	56,34	1,78	61,66	1,83	69,40	1,94
Repayment of liabilities from the previous period	78,44	2,59	76,59	2,42	68,57	2,04	60,07	1,68
Deficient funds	**-264,05**	**-8,73**	**-251,18**	**-7,92**	**-160,02**	**-4,76**	**-98,57**	**-2,75**
Financing	**264,05**	**8,73**	**251,18**	**7,92**	**160,02**	**4,76**	**98,57**	**2,75**
Borrowings and loans from domestic sources	5,71	0,19	5,00	0,16	2,00	0,06	0,00	0,00
Borrowings and loans from foreign sources	200,00	6,61	151,00	4,76	111,00	3,30	72,00	2,01
Revenues from privatisation	32,64	1,08	22,00	0,69	21,00	0,62	21,00	0,59
Donations	0,00	0,00	1,92	0,06	2,06	0,06	2,23	0,06
Use of deposits of state	25,71	0,85	71,26	2,25	23,96	0,71	3,34	0,09

Central to the fiscal and budgetary policy in 2011 will be the establishment of sustainable public finances system through compliance with previously defined fiscal „anchors".

Planned direct revenues for 2011 amount to €1.331,90 mil or around 42 % of GDP. Taxes and contributions take the greatest share in revenues with 25.58% of GDP and 11.34 % of GDP respectively.

Planned public expenditure amounts to €1.408,64 mil or 44.43% of GDP of which current public expenditure totals 39.30% of GDP while planned capital expenditures amount to 5.13%. Public expenditure deficit for 2011 is planned at €76.74 mil i.e. 2.42% of GDP, while the primary deficit is planned in the amount of €28.19 mil or only 0.89% of GDP. In terms of economic classification, the greatest share in expenditures is taken by social protection transfers – € 438.95 mil or 13.84 % of GDP, expenses for gross wage – €399.75 mil or 12.6 % of GDP and material and services-related expenditures amounting to €173,97 mil or 5.5% of GDP. Proposed 2011 Budget will additionally improve the characteristics of public finances so the public expenditure will fall further for additional 1.5%of GDP, primary deficit will decrease by 2.13% of GDP comparing to 2010 while the public debt will remain at around 43% of GDP in spite of significant indebtedness undertaken for deficit financing.

It should be noted that the amount of public expenditure equalling 44.43% of GDP in 2011 include certain expenditures which are the subject of consolidation e.g. contributions at the expense of employer when the employer is the state, public utilities charge. Therefore, consolidated public expenditure totals 43.1% in 2011, 44.8% in 2010 and 50.1% in 2009.

2011 Budget Law envisage further reduction in budgetary expenditure (comparing to the previous period) so the planned expenditures under the budget amount to € 1253.7 mil or 39.5% of GDP, which is € 44.4 mil lower than adopted 2010 Budget of which current budget reduction amounts to €4.8 mil and the reduction of the capital budget to €39.6 mil. In relation to GDP the expenditure is reduced by 3.4% of GDP. Reduction of deficit of nearly 2% of GDP is planned for the next year comparing to the 2010 Plan so the planned deficit for 2011 amounts to €83.02 mil comprising 3.8% of GDP. Projections of primary deficit (without interests) amount to 3.8% of GDP for 2010 and 1.14% of GDP or €36.24 mil for 2011.

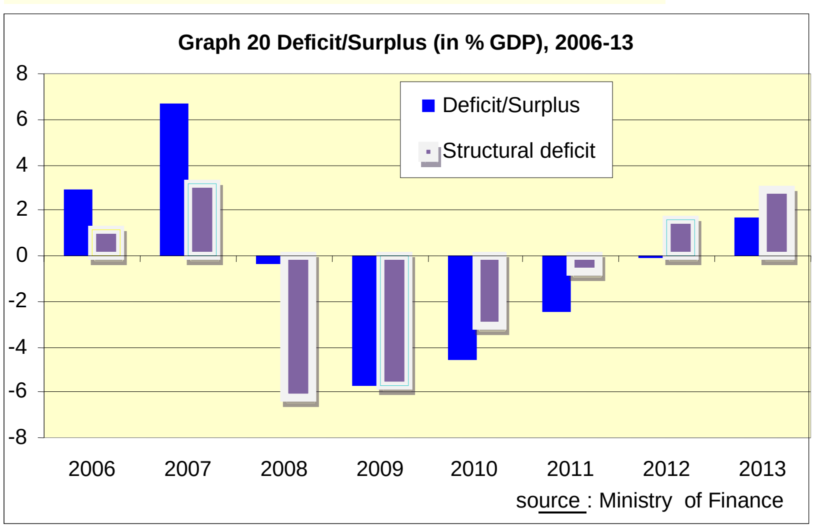
Gradual growth of direct revenues is projected for the period 2011-13, in the absolute amount moving from €1331.9 mil in 2011 to €1506 mil in 2013 while perceived as percentage in GDP slight fall from 42% to 41.2% of GDP is expected. The greatest growth is expected in indirect revenues especially in value added taxes, excise tax and customs duties while in direct taxes certain growth caused by the projected employment growth could be expected. It will however be partly amortized by pay freeze and blockage of employment in public sector. Projections of public revenues growth have been defined primarily on the basis of projections of economy recovery rates, inflation trends in the given period and the flexibility of revenues trends in relation to GDP growth rates. It is expected that only in 2013 the revenues will reach the level of realisation as in 2008 when the cyclic revenues component amounted to 6% of GDP according to the Government's estimate.

Estimate of 2011 direct revenues is around €45 mil (1.4% of GDP) higher compared to the revenues' projection for 2010. Also, projecting the revenues one should consider the results of provided analysis (chapter Structural Deficit) concerning the estimation of structural deficit as well as higher than planned revenue collection (partly through tax debt reduction) with the tendency of growth in 2010.

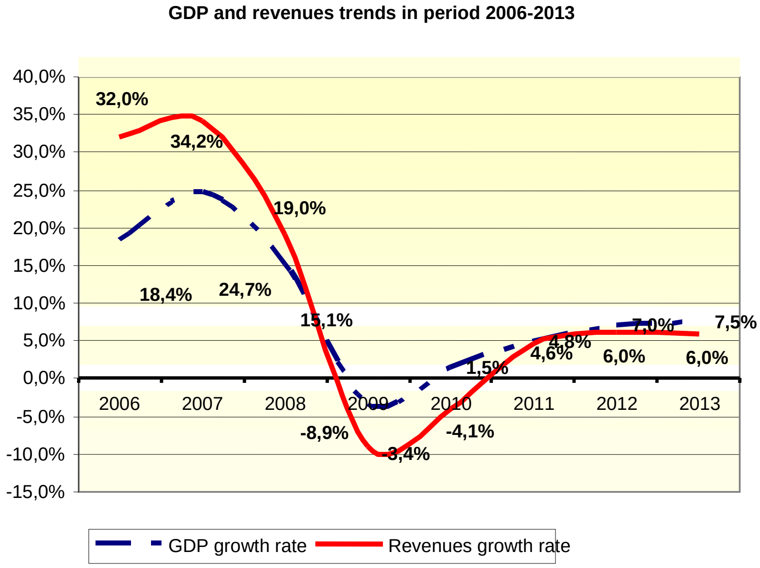
On expenditure side, in the period of the next three years and with a view to realising surplus at the end of the period, it is planned for slight increase of expenditures primarily for material and services while main categories of expenditures such as wage, pensions and social benefits will maintain at fairly same level as at in this moment. Amount for subsidies will be cut in half. Main causes of current expenditure growth in the previous period were precisely public sector wages and pensions. To this end, the Government adopted whole set of regulations strictly governing the employment in public sector and defining the principles and priorities in employment It is expected that in the mentioned period, public expenditure will fall from 44.4% in 2011 to 40.3% in 2013. Basic goal is that in mid-term current public expenditure should fall from 39.3% to below 35% in 2013 and at the same time to maintain the capital budget to around 5% of GDP.

3.1.4. Structural deficit

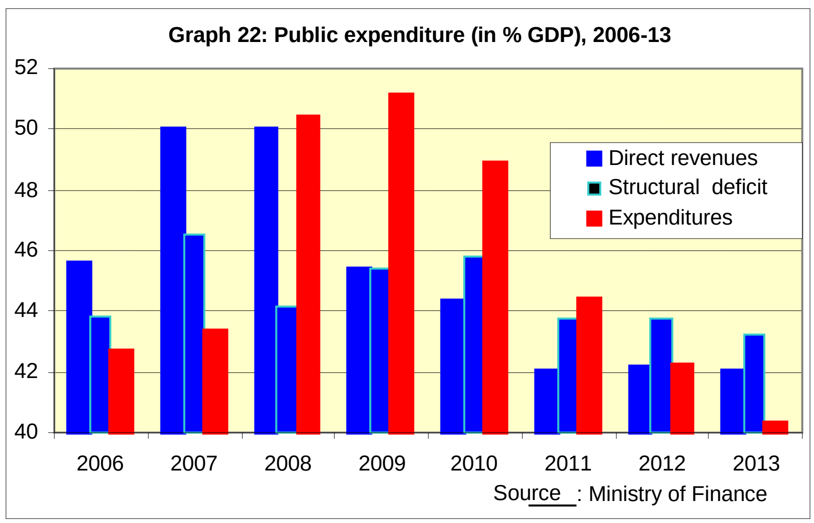
Based on simple model provided in Chapter 2.2.4., real GDP exceeded the potential in period 2006-2008, followed by decrease to the level close to potential in 2009 and will remain so (according to mid-term projections of central budgetary scenario for 2010) as shown in graph 20.



The graph 21 provides comparate presentation of nominal rate of GDP growth and the rate of revenues growth for the period 2006-2009 as well as mid-term projections of growth rate (2011-2013). Table shows that in the period of intensive growth and in the period of the economy's fall, revenues show uneven variation from GDP trends which was primarily caused by cyclic growth component. In the following period, it is expected for less volatility in flexibility and that changes of revenues will mainly follow the nominal growth rate of GDP.

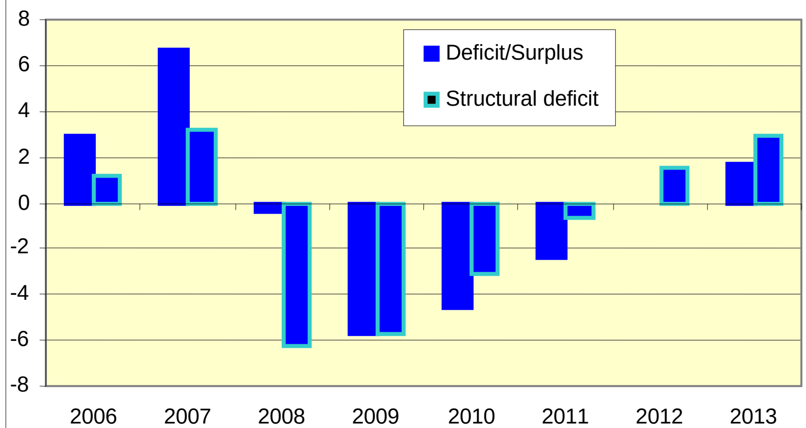


As the result, realised direct revenues were collected below the potential in the period 2006-2007 just to outperform the potential in 2008 by 6% (graph 22). In these circumstances and in the context of surplus reaching almost 7% of GDP in 2007, expenditures increased also by 7 percentage points of GDP comparing to the previous year.



This implies that public finances in 2008 were balanced, however structural deficit amounted to around 6 % of GDP (graph 23). This fact became evident with the emergence of crisis in 2009, in the moment when economic growth moved back to the framework of potential and as a consequence, public finances deficit in 2009 reached the level of 5.7% of GDP. However, in 2010 structural deficit is the below real one and in 2011 structural deficit amounts only to 0.5% of GDP.

Graph 23. Surplus/ Deficit (in% GDP), 2006-13.



Source: Ministry of Finance

Alternative scenarios

Government of Montenegro elaborated two alternative macroeconomic scenarios as well as compliant mid-term fiscal scenarios. Fiscal projections are based on macroeconomic scenario which implies faster/slower growth of economy than that envisaged by budgetary scenario. We hereby note that in case of lower or higher growth in 2011 it would be difficult to predict the dynamics of Montenegrin economy recovery in the period 2012-2013. For example, lower growth rate in 2011 could lead to higher growth rate in 2012 than projected in the table. As explained in the part relating to macro-economy, scenarios defer depending on expected restoration of growth rate of GDP e.g. in baseline scenario and lower scenarios it is expected in 2012 and 2013 while in positive scenario we expect it already next year.

Lower scenario envisages that in 2011 we shall have growth rate of GDP of 0.5% and lower expense level so more significant recovery could be expected only 2012. Higher scenario stipulates higher rate of GDP and consequently higher rate of direct revenues growth while with regard to expenditure the increase is expected in current expenses and slightly in capital budget.

It is important to emphasise that, in all three macroeconomic scenarios, budget is expected to move back to surplus, of course in different percentage and nominal amounts and this is the basic focus of our fiscal policy.

Fiscal scenario of higher growth

This scenario stipulates that in the following period the level of bank loans and inflow of foreign investments will grow. This will be reflected in growth of private consumption and growth of gross investments in economy. Level of public revenues will grow as the import grows.

Table 14

Mid-term fiscal scenarios of higher growth 2011-2013 (in per cents of GDP)

	2011	2012	2013
Direct revenues	42.60	42.27	41.64
Public expenditure	43.85	41.77	39.83
Deficit	-1.19	0.50	1.82
Primary deficit/surplus	0.30	1.98	3.28
Nominal GDP in EUR mil	*3,231*	*3,444*	*3,671*
Nominal growth	*6.8*	*6.6*	*6.6*
Real growth	*4.5*	*4.0*	*4.0*

Assuming that the expenditure is at lower level comparing to the baseline scenario, increased level of revenues would lead to surplus in 2012 amounting to 0.50% of GDP reaching 1.82% in 2013. Surplus in 2013 would cover the repayment of debt amounting to €152 mil and the remainder would be used to increase deposits, increase of capital investments (5% of GDP) or for possible prepayment of a high debt.

Table 15

PUBLIC EXPENDITURE	Projections 2011		Projections 2012		Projections 2013	
	mil €	% GDP	mil €	% GDP	mil €	% GDP
DIRECT REVENUES	**1376.23**	**42.60**	**1423.84**	**41.34**	**1454.86**	**39.63**
Taxes	848.33	26.26	873.40	25.36	887.10	24.16
Contributions	382.95	11.85	394.43	11.45	402.13	10.95
Fees	28.20	0.87	29.80	0.87	31.47	0.86
Charges	70.44	2.18	75.16	2.18	80.14	2.18
Other revenues	41.90	1.30	46.41	1.35	49.16	1.34
Loan repayment receipts	4.41	0.14	4.63	0.13	4.87	0.13
CONSOLIDATED PUBLIC EXPENDITURES	**1416.58**	**43.85**	**1438.49**	**41.77**	**1462.22**	**39.83**
CURRENT PUBLIC EXPENDITURES	**1254.86**	**38.84**	**1265.55**	**36.75**	**1274.41**	**34.71**
Current expenditures	722.10	22.35	716.38	20.80	713.98	19.45
Social protection transfers	435.87	13.49	441.21	12.81	448.22	12.21
Transfers to institutions, individuals and non-governmental and public sector	53.69	1.66	54.64	1.59	56.43	1.54
CAPITAL EXPENDITURES	**161.72**	**5.01**	**172.94**	**5.02**	**187.81**	**5.12**
DEFICIT/SURPLUS	**-38.43**	**-1.19**	**-14.65**	**-0.43**	**-7.36**	**-0.20**
PRIMARY DEFICIT	**9.82**	**0.30**	**36.22**	**1.05**	**46.41**	**1.26**
DEBT REPAYMENT	**166.44**	**5.15**	**150.72**	**4.38**	**152.11**	**4.14**
Repayment of the principal to residents	40.51	1.25	26.29	0.76	27.96	0.76
Repayment of the principal to non-residents	55.34	1.71	60.66	1.76	68.40	1.86
Repayment of liabilities from the previous period	70.59	2.18	63.77	1.85	55.75	1.52
DEFICIENT FUNDS	**-204.87**	**-6.34**	**-165.37**	**-4.80**	**-159.47**	**-4.34**

FINANCING	**204.87**	**6.34**	**165.37**	**4.80**	**159.47**	**4.34**
Loans and borrowings from domestic sources	5.00	0.15	0.00	0.00	0.00	0.00
Loans and borrowings from foreign sources	131.00	4.05	80.00	2.32	25.00	0.68
Revenues from privatisation and selling of property	22.00	0.68	19.00	0.55	19.00	0.52
Use of deposits of the state	46.87	1.45	66.37	1.93	115.47	3.15

Fiscal scenario of lower growth

As already noted, economy recovery rate after the crisis in financial sector is very uncertain so the Government developed a model of lower growth rate. It evident that it would lead to increase of budget deficit in 2011, decrease if revenues would be compensated to small degree with the reduction of expenditure and increase of indebtedness. In 2013 surplus in this scenario would amount to 0.29%.

Table 16

Mid-term fiscal scenario of lower growth 2011-2013 (in per cents of GDP)

	2011	2012	2013
Direct revenues	40.50	41.54	40.51
Public expenditure	44.63	42.58	40.22
Deficit	-4.14	-1.04	0.29
Primary deficit	-2.58	0.50	1.82

Nominal GDP in EUR mil	*3,106*	*3,296*	*3,513*
Nominal growth	*2.7*	*6.1*	*6.6*
Real growth	*0.5*	*3.5*	*4.0*

PUBLIC EXPENDITURE	Projections 2011		Projections 2012		Projections 2013	
	mil €	% GDP	mil €	% GDP	mil €	% GDP
DIRECT REVENUES	**1258.08**	**40.50**	**1369.10**	**41.54**	**1423.40**	**40.51**
Taxes	814.84	26.23	826.79	25.08	861.26	24.51
Contributions	377.29	12.14	388.61	11.79	398.15	11.33
Fees	27.79	0.89	29.36	0.89	31.16	0.89
Charges	69.40	2.23	74.05	2.25	79.34	2.26
Other revenues	41.28	1.33	45.73	1.39	48.67	1.39
Loan repayment receipts	4.34	0.14	4.56	0.14	4.82	0.14
PUBLIC EXPENDITURES	**1386.58**	**44.63**	**1403.49**	**42.58**	**1413.22**	**40.22**
CURRENT PUBLIC EXPENDITURES	**1224.86**	**39.43**	**1240.55**	**37.64**	**1244.41**	**35.42**
Current expenditures	722.10	23.24	716.38	21.73	713.98	20.32
Social protection transfers	435.87	14.03	441.21	13.39	448.22	12.76
Transfers to institutions, individuals and non-governmental and public sector	53.69	1.73	54.64	1.66	56.43	1.61
CAPITAL EXPENDITURES	**161.72**	**5.21**	**162.94**	**4.94**	**168.81**	**4.80**
DEFICIT/SURPLUS	**-128.50**	**-4.14**	**-34.39**	**-1.04**	**10.18**	**0.29**

PRIMARY DEFICIT	**-80.25**	**-2.58**	**16.47**	**0.50**	**63.95**	**1.82**
DEBT REPAYMENT	**166.44**	**5.36**	**150.72**	**4.57**	**152.11**	**4.33**
Repayment of the principal to residents	40.51	0.00	26.29	0.00	27.96	0.00
Repayment of the principal to non-residents	55.34	0.00	60.66	0.00	68.40	0.00
Repayment of liabilities from the previous period	70.59	0.00	63.77	0.00	55.75	0.00
DEFICIENT FUNDS	**-294.94**	**-9.49**	**-185.11**	**-5.62**	**-141.93**	**-4.04**
FINANCING	**294.94**	**9.49**	**185.11**	**5.62**	**141.93**	**4.04**
Loans and borrowings from domestic sources	5.00	0.16	0.00	0.00	0.00	0.00
Loans and borrowings from foreign sources	190.00	6.12	140.00	4.25	70.00	1.99
Revenues from privatisation and selling of property	22.00	0.71	19.00	0.58	19.00	0.54
Use of deposits of the state	77.94	2.51	26.11	0.79	52.93	1.51

3.1.5. Public debt trends

On 30 September 2010, public debt of Montenegro amounted to €1.279,2 mil or 42.3% of GDP. Internal debt amounts to €361,5 mil or 12,0% of GDP, while external debt totals €917.7 mil or 30.3% of GDP-a[15]. On 30 September 2010, deposits of the Ministry of Finance amounted to €275.9 mil, including 38.477 ounces of gold so net amount of public debt amounts to around 33.2 % of GDP.

Table 17 Public debt balance on 30 September 2010

Public debt balance

[15] Total debt of public sector of Montenegro (public debt plus the debt of companies with majority state ownership) amount to €1.587,9 mil. or 52.5% of GDP. Liabilities of companies with majority state ownership has been calculated on grounds of the Government's guarantees, data of the Central Bank and data submitted by the companies.

Creditor	Debt balance	GDP	Foreign debt/GDP
Foreign debt in EUR (millions)			
International financial institutions[16]	476,4	3,025.0	15,7%
Bilateral soft borrowings[17]	135,1	3,025.0	4,5%
Banking institutions[18]	306,2	3,025.0	10,1%
TOTAL Foreign debt	**917,7**	3,025.0	**30,3%**
Domestic debt in EUR (millions)			
Old foreign currency savings	99.9	3,025.0	3.3%
Local self-government debt	46.4	3,025.0	1.5%
Liabilities in respect of compensations	79.1	3,025.0	2.6%
Loans with commercial banks	27.2	3,025.0	0.9%
Loans with non-financial institutions	20.9	3,025.0	0.7%
Pensions in arrears	32.5	3,025.0	1.1%
Treasury bills	55.5	3,025.0	1.8%
TOTAL Domestic debt	**361.5**	3,025.0	**12.0%**
TOTAL Domestic debt	**1,279.2**	3,025.0	**42.3%**

As shown in the following table, public debt in the last two years was increased. This was caused by the increase of external debt balance in the amount of €436 mil in the period between the end of 2008 and 30 September 2010 of which €306 mil was the state borrowing needed for covering of the budgetary deficit provoked by the crisis.

Table 18 Public debt trend in the period 2008 – 2010

	31.12.2008.	31.12.2009.	30.09.2010.
Foreign debt	481,7	699,9	917,7

[16] World Bank (IBRD, IFC, IDA), Paris Club, EIB, EBRD, CEB, European Community, KfW

[17] Bilateral agreements with governments of Austria, Hungary, Poland, France, Spain, Eurofim, Chetz Exim Bank, Hungarian Exim Bank, Societe Generale for IT and Steiermarkische Bank und Sparkassen AG for firefighting vehicles:

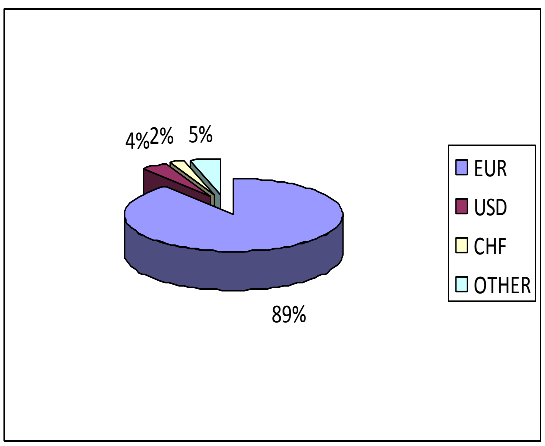
[18] Credit arrangements for the needs of the budget (Eurobond, Credit Suisse, Erste Bank)

Internal debt	413,0	440,3	361,5
Public debt	894,7	1.140,2	1.279,2
Public debt/GDP	26,8%	38,0%	42,3%

In respect of main public debt parameters relating to currency and interest structure, maturity the indicators are favourable. The mentioned parameters are aligned with the 2008-2010 Public Debt Management Strategy as well as with the guidelines provided in draft 2011-2013 Public Debt Management Strategy[19]

As for the currency structure of debt, as shown in Graph 24 89% of total public debt was expressed in euro whereas 9% of debt was expressed in other currencies. In this respect, the Government will continue the policy of borrowings and taking of loans in euros.

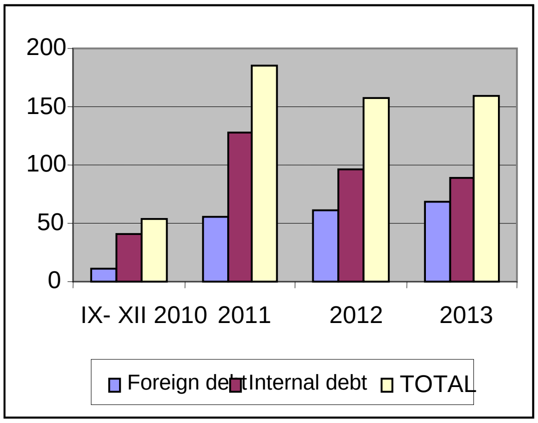
Graph 24 Currency structure of public debt on 30. 09.2010



With regard to repayment of debt, it has been relatively balanced as shown in Graph 25. In part of maturity of loan repayment, the average maturity is relatively long and reaches around 9.5 years which is caused by the fact that majority of loans is concluded with international financial institutions.

[19] 2011-2013 Public Debt Management Strategy was elaborated in accordance with mid-term macroeconomic projections envisaged by the 2011 Budget Law. The Strategy was elaborated in cooperation with IMF consultant. Purpose of the Strategy is to provide guidelines for financing expenditures of the state budget with reduction of debt costs, taking into account the relevant risks and ensuring the consistency in debt management activities in given macroeconomic environment. The new Strategy also provides certain guidelines related to further borrowings, management of Government funds i.e. deposits, guarantees and transfer loans.

Graph 25 Repayment of public debt for the period 30.09.2010 – 2013



With respect to interest structure of public debt, the significant part of external debt has fixed interest rate. Recently, there has been an increase in borrowings with variable interest rate mainly due to commercial bank loans. At the end of 2010, the external debt with fixed interest rate amounted to 65% of outstanding external debt. Domestic debt mostly has fixed interest rate so total debt with fixed interest rate at the end of 2010 amounted to 70% of total debt.

Table 19 Servicing of public debt in the first three quarters of 2010

Budgetary position	**Paid in the first three quarters of 2010**
4611 – Repayment of the principal to residents	37,1
4612 - Repayment of the principal to non-residents	32,3
4630 – Repayment of liabilities from previous years	82,6
4151 – Repayment of interest to residents	5,0
4152 – Repayment of interest to non- residents	18,3
TOTAL	**175,3**

External debt trends

Foreign debt balance was increased in 2010 mostly due to the issuance of Eurobonds in the amount of €200.0 mil in September 2010 and to withdrawal of funds of signed credit arrangements: IBRD loan for the project “Healthcare” in the amount of €0.6 mil, project „Energy Efficiency” in the amount of €0.5 mil and project „MIDAS“ in the amount of €0.9 mil, Hungarian loan in the amount of €1.6 mil, EBRD loan for railway in the amount of €2.1 mil, IDA loan in the amount of €1.5 mil, loan for financing of project „Purchase of special vehicles for fire extinction and rescue“ with Austrian Steiermarkisiche Bank und Sparkassen AG in the amount of €12.9 mil, EIB loans for railway in the amount of €7.0 mil, EIB loan for project relating to waste waters in Nikšić in the amount of €1.0 mil, EIB loan for project „Roads and Bridges“ in the amount of €3.0 mil, commodity loan of the Government of Spain for recycling centre in Podgorica in the amount of €3.0 mil, Polish loan in the amount of €0.2 mil, KfW loan for the project of water supply (phase II and phase III) in total amount of €2.2 mil, as well as loans of Hungarian Exim Bank for financing project for construction of school in Bar in the amount of €0.3 mil. Withdrawal of commodity loan of Erste Bank Austria, allocated for financing of the Health Fund’s project in the value of €6.0 mil, was recorded.

Foreign debt balance was partly increased due to increase in value of dollar compared to euro which caused growth of euro value of dollar credits. Foreign debt balance was reduced on grounds of regular repayment of principle in the amount of around €32.3 mil.

The amount of foreign debt does not include liabilities on grounds of outstanding debts toward Libya, Kuwait, Czech Republic and Slovakia and UBS Bank on grounds of bonds issued under London Club. Debt towards the governments of these four countries was assigned to Montenegro on grounds of unallocated debt distribution (5.88% of 38% for Serbia and Montenegro), and according to the Succession Agreement from Vienna of 29 June 2001 it is solved through aligned positions within the Committee for Allocation of Financial Assets and Expenditures of Former SFRY.

With regard to API bonds, it is expected that in the course of 2011 the negotiations with representatives of UBS Bank will be held with a view to finding possibilities for bilateral settling of this issue. Total amount of liabilities on grounds of outstanding debts will probably amount to around 1% of GDP and it is included into projections of debt trends in 2010-2013. The mentioned data on foreign debt balance implies the amounts of active (withdrawn) credit funds of certain credits.

Table 20 Data on foreign debt balance and the amount of not-withdrawn credit funds

Foreign debt		
Creditor	**Debt balance**	**not-withdrawn funds**
International Bank for Reconstruction and Development (IBRD)	178,9	29,7
International Financial Corporation (IFC)	5,7	

Paris Club member countries	123,3	
International Development Agency (IDA)	57,4	8,4
European Investment Bank (EIB)	72,4	35,0
European Bank for Reconstruction and Development (EBRD)	20,3	0,6
Council of Europe Development Bank	0,7	
European Community	5,5	
Reconstruction Credit Bank-Germany (KFW)	12,2	50,5
Austrian loan	10,1	
Hungarian loan	14,0	0,5
Polish loan	11,6	0,1
Societe Generale - Education IT	1,1	
French loan	8,5	
EUROFIMA – Iron Works' debt	26,0	
Czech EXIM - Iron Works' debt	37,7	
Steiermarkische Bank und Sparkassen AG	22,0	
Erste Bank	30,0	
Credit Suisse Bank	76,2	
Spanish credit for construction of landfill	3,9	1,0
Exim Bank Hungary	0,2	4,0
EUROBOND	200,0	
TOTAL	**917,7**	**129,8**

Internal debt trends

In the first three quarters 2010 the internal debt was reduced by €78.8 mil comparing to the end of 2009. Decrease of internal debt in first three quarters 2010 was caused by reduction of debt related to restitution in the amount of €21.8 mil, reduction of municipalities' indebtedness for around €14.2 mil, repayment of loans with commercial banks and non-financial institutions amounting to around €37.1 mil, repayment of regular instalment for foreign currency saving, repayment of regular instalment on grounds of indemnification to pensioners amounting to €15.3 mil and regular instalment for foreign currency saving totalling €9.1mil. On the other hand, internal debt was increased by around €16.9 mil namely: due to indebtedness amounting to €6.0mil for realisation and completion of construction works on the Police Directorate building, due to indebtedness totalling €5.0mil for restoration of monuments in Cetinje and due to emission of treasury bills amounting to €5.9 mil.

Total liabilities on grounds of restitution amount to €79.1 mil which is by €21.8mil lower than at the end of 2009. Reduction of debt on grounds of restitution was induced by repayment of regular instalment for restitution and redemption of bonds FO01 i FO02 in stock exchange by the state. With a view to reducing internal debt, the Government initiated redemption of restitution bonds in January 2009 and continued it throughout 2010, on grounds of indemnification of former owners, before due date. So far, around €25.5mil worth of bonds have been redeemed of which €5.5mil mil was paid for in 2009 and €2.9mil in 2010. In 2008, the Government adopted the Decision on redemption of foreign exchange savings bonds for 2016 and 2017 and so far €1.22 mil worth of bonds have been redeemed of which €0.5 mil in 2009 and in first, second and third quarters of 2010 €0.04 mil.

According to the latest data delivered by municipalities, municipalities' debt amounts to around €64.0 mil. It is shown in the table in two manners:

- foreign debt balance includes also the debt of municipalities according to contracts signed by the Government with foreign creditors and sub-loan agreements signed with municipalities amounting to €17.6 mil (amount of withdrawn funds).

- domestic debt balance, as a debt of local self-governments to credit institutions amounting to €46.4 mil.

Issued guaranties trends

The Government issues guarantees in accordance with the organic Budget Law, complying with restrictions defined in annual budget laws, in accordance with the Law on State Aid and the guidelines of the 2008-2010 Debt Management Strategy. The organic Budget Law envisages that the loan users pay the risk fee amounting to 0.5% of the guarantee. The increase in the amount of issued guarantees in the last two years was primarily caused by intervention of the state with a view to improving liquidity of the banking sector and by the assistance to processing industry which was especially affected by the crisis. Until the emergence of the financial crisis, the Government issued guarantees for important infrastructure and development projects which were realised through public enterprises (road, railway infrastructure, air transport, municipal projects). In the previous period, guarantees were issued for credit arrangements mostly with international financial institutions where debtor was not in possibility to be awarded a loan, without the mentioned security or where the state recognised the interest to support certain project. Also, issuance of guarantees provided for debtor more favourable financial conditions of crediting. The Government's intention was to limit the amount of guarantees in the following period only to infrastructure loans with international financial institutions. 2010 Budget Law also envisages guarantees in the amount of 72.8 mil of which 42.8 mil for important infrastructural projects

Total amount of foreign and domestic guarantees of Montenegro on 30 September 2010 amounted to €289.9 mil or 9.6% of GDP i.e. 22.7% of public debt. As presented in Table 21, foreign guarantees of Montenegro amount to €251.7 mil or 8.3% of GDP that is 19.7% of public debt.

Table 21 Foreign guarantees

Creditor	Loan	Debtor	Signed amount	Debt balance on 30.09.2010.
EIB	European roads project	Monteput	24.000.000	24.000.000,00
EIB	Reconstruction of electric power system	Montenegrin Electric Power Company	11.000.000	7.811.472,00
EIB	Modernisation of airports	PE Airports of Montenegro	12.000.000	10.800.000,00
EIB	Small and medium size enterprises through commercial banks	commercial banks	91.000.000	43.217.000,00
EBRD	Modernisation of airports	PE Airports of Montenegro	11.000.000	7.246.974,00
EBRD	Regional water supply project – south extension phase I	PE Regional Water Supply	8.000.000	7.666.666,67
EBRD	Construction of the Regional Water supply System – south extension, phase II	PE Regional Water Supply	7.000.000	6.708.333,33
EBRD	Project of reconstruction of railways– phase III	PE Railways of Montenegro	4.000.000	890.709,63
EBRD	Project of urgent reconstruction of	Railway infrastructure AD	15.000.000	650.000,00

	railways II	Podgorica		
KfW	Perucica	Montenegrin Electric Power Company	3.580.000	1.871.831,97
KfW	Piva	Montenegrin Electric Power Company	16.000.000	2.572.039,37
KfW	Sub-station Ribarevine	Montenegrin Electric Power Company	5.400.000	536.000,00
KfW	Filter replacement in the sub-station Pljevlja and extension to the sub-station Podgorica-Ribarevina	Montenegrin Electric Power Company	15.000.000	8.863.740,00
KfW	Opportunity Bank	Opportunity Bank	15.000.000	15.000.000,00
KfW	NLB	NLB	16.000.000	16.000.000,00
OTP	KAP	KAP	49.680.000	49.680.000,00
EXIM China	Supply and repair of ships	Montenegro Shipping Company	47.396.000,00	
WTE Wassertechnik	Waste Water Project	Municipality Budva	29.250.000,00	
Abu Dhabi Development Fund	Water Supply Project	Regional Water Supply	18.977.884,37	
Credit Suisse	Support to Iron Works Niksic A.D.	Iron Works Niksic	26.300.000,00	26.162.358,65
Deutsche Bank	Support to the Aluminium Plant Podgorica	Aluminium Plant Podgorica	22.000.000,00	22.000.000,00
TOTAL ON 30 September 2010.				251.677.125,62

As provided in Table 22, domestic guarantees of Montenegro on 30 September 2010 amounted to €38.2 mil or 1.3% of GDP i.e. around 3% of public debt.

Table 22 Issued domestic guarantees

Creditor	Debtor	Signed amount	Debt balance 30.09.2010.
NLB Montenegrobank	Boxite Mines A.D. Nikšić	5.000.000,00	5.000.000,00
Podgorička banka	Pobjeda A.D. Podgorica	2.970.000,00	2.970.000,00
Hipotekarna banka A.D.	Montenegro Airlines	2.700.000,00	2.700.000,00
NLB Montenegrobanka	Montenegro Airlines	1.800.000,00	1.800.000,00
Erste banka A.D. Podgorica	Montenegrin Fund for Solidarity Housing Development	3.800.000,00	3.800.000,00
Erste bank A.D. Podgorica	Railway Transport Montenegro	7.000.000,00	7.000.000,00
Erste banka A.D. Podgorica	Pobjeda A.D. Podgorica	3.500.000,00	3.500.000,00
Erste banka A.D. Podgorica	Regional Water Supply	7.000.000,00	7.000.000,00
Hipotekarna banka A.D.	MI-RAI GROUP DOO Nikšić	800.000,00	800.000,00
NLB Montenegrobanka	Gradir Montenegro doo Nikšić	900.000,00	900.000,00
NLB Montenegrobanka	Gradir Montenegro doo Nikšić	700.000,00	700.000,00
NLB Montenegrobanka	Gradir Montenegro doo Nikšić	2.000.000,00	2.000.000,00
TOTAL on 30.09.2010.		**38.170.000,00**	**38.170.000,00**

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With regard to risks related to the issued guarantees, these can eventually be posed in case of guarantees issued for credit arrangements for assistance to Aluminium Plant Podgorica and Iron Works Niksic. However, through its representatives in board of directors and shareholders' assembly, the state follows the situation in the mentioned companies and in case of possible difficulties in fulfilling the commitments it may act on time. In case of eventual activation of guarantees, the Government of Montenegro disposes of deposits that can be used for covering the occurring liabilities. Also, in case of activation of guarantees there is a step-in possibility by virtue of which the state would assume commitment of servicing the loan as provided in credit arrangements. Thus, the exposure of state upon the guarantees in question would be reduced. Aluminium Plant Podgorica and Iron Works duly fulfil liabilities arising from credit arrangements.

It also important to note that the 2011 Budget Law stipulates the subsidies for the two mentioned companies amounting to €25 mil. This represents a certain reserve in the event that the liabilities are not duly serviced. In such a case the commitments would be serviced from the mentioned funds.

Projections of public debt trends in the period 2010 - 2013

In line with the projections, total public debt is projected to be 41.79% of GDP at the end of 2010. Increase of debt, in comparison to the end of 2009 when it totalled 38% of GDP, was induced mostly due to issuance of Eurobonds in September 2010[20].

In line with GDP trends projected in baseline scenario, projections for the following period show slight increase of public debt until 2012 when the amount of debt is expected to start falling. Increases will mostly be influenced by the growth of foreign debt assumed for the needs of the budget in the amount of up to €180 mil for 2011, for 2012 and 2013 it is planned for additional indebtedness of €110 mil and €72 mil respectively. In the period 2011-2013, domestic debt will decrease fostered by higher repayment of domestic debt in relation to new obligations. These projections were prepared in line with the plan for assuming indebtedness for budgetary needs, planned withdrawal of funds i.e. conclusion of new credit arrangements as well as with the repayment of public debt. Projections will also depend on realisation of revenues from privatisation and eventual servicing of issued guarantees.

[20] In line with guidelines provided in draft 2011-2013 Debt Management Strategy, the Government will implement the policy implying that cash and other liquid funds' reserves should not decrease below €60 mil threshold which is nearly equal to monthly Government budget expenditure for salaries and pensions

Table 23 Public debt trends according to central scenario

Type of debt	2010	2011	2012	2013
GDP	**3025**	**3170**	**3363**	**3585**
Foreign debt	911.15	1037.02	1117.66	1153.86
GDP%	**30.12**	**32.71**	**33.23**	**32.19**
Domestic debt	352.9	322.22	256.72	189.92
GDP%	**11.67**	**10.16**	**7.63**	**5.30**
Total	1264.05	1359.24	1374.38	1343.78
GDP%	**41.79**	**42.88**	**40.87**	**37.48**

In the event of higher GDP growth, it is planned for lower indebtedness for the needs of budget for 2011, 2012, 2013 than in baseline scenario whereas due to growth of GDP the relation of public debt to GDP will be slightly lower. Also, there will be no changes in relation to baseline scenario in part of withdrawal of funds, and redemption of principal of domestic and foreign debt.

Table 24 Public debt trends in case of alternative fiscal scenario (higher growth)

Type of debt	2010	2011	2012	2013
GDP	**3025**	**3231**	**3444**	**3671**
Foreign debt	911.15	1018.02	1067.66	1056.86
GDP%	**30.12**	**31.51**	**31.00**	**28.79**

Domestic debt	352.9	322.22	256.72	189.92
GDP%	**11.67**	**9.97**	**7.45**	**5.17**
Total	1264.05	1340.24	1324.38	1246.78
GDP%	**41.79**	**41.48**	**38.45**	**33.96**

In accordance with the planned model of lower growth of GDP, it is planned for indebtedness for budgetary needs in the amount of €190 mil for 2011 whereas for other years indebtedness is envisaged in accordance with the baseline scenario and the scenario of higher growth. Other items (additional indebtedness, repayment of loan) will remain the same. Funds for budget financing will be provided by international financial institutions (World Bank, IMF and others) or through issuance of Eurobonds. To this end, negotiations are conducted with the World Bank on conclusion of Development Policy Loan which would provide for around 80 million US dollars while the rest would be provided from other financial institutions. Issuance of Eurobonds may also be used as a source for budget financing. In 2010 Montenegro issued Eurobonds successfully and provoked positive reactions in international financial institutions.

Table 25 Public debt trends in case of alternative fiscal scenario (lower growth)

Type of debt	2010	2011	2012	2013
GDP	**3025**	**3106**	**3296**	**3513**
Foreign debt	911.15	1077.02	1127.66	1180.86
GDP%	**30.12**	**34.68**	**34.21**	**33.61**
Domestic debt	352.9	322.22	256.72	189.92
GDP%	**11.67**	**10.37**	**7.79**	**5.41**

Total	1264.05	1399.24	1384.38	1370.78
GDP%	**41.79**	**45.05**	**42.00**	**39.02**

It is important to note that all scenarios make the difference between the level of projected public debt and the level of debt calculated based on budget scenarios. Difference between the planned repayment of liabilities and borrowings provided in the Budget of Montenegro and projections of public debt trends provided in this chapter occurs because the projections of public debt trends in the Budget do not include the repayment of part of domestic debt relating to previous court decisions and commitments of state institutions, withdrawal of funds from already signed and not-withdrawn loans as well as assuming the debt of public enterprises.

Regarding debt management, it is important to emphasise that implementation of cash flow projections is ongoing, that Debt Management Strategy is being prepared and that, in cooperation with domestic banks, simpler system of indebtedness and available funds management is being established. The mentioned strategy is prepared in cooperation with the IMF consultant. Also, the Ministry of Finance established cooperation with representatives of UNDP with a view to providing cooperation and assistance in the area of improving cash flow management and public debt management. Consequently, the cooperation has been established with the Ministry of Finance of the Republic of Slovakia, implying technical cooperation that is the visit of representatives of Ministry of Slovakia to the Ministry of Finance of Montenegro in view of further improvement in the abovementioned areas.

In accordance with recommendations which are to be incorporated in the Strategy, in the following period the Government will tend, through aligning the maturity and using more flexible indebtedness instruments, to reduce the costs of maintaining the high amount of deposit funds to optimal level. In this respect, it is planned for the activities related to the development of domestic market i.e. for bringing of domestic bank market into focus, through issuance of short-term treasury bills and long-term bonds with lower interest rates than in international market which will lead to reduction of indebtedness.

3.1.6. Budgetary implications of main structural reforms

Table 26 provides the summary review of fiscal effects of programmes and measures of adopted and proposed structural policies which are elaborated in Chapter 4 (for fiscal effects of certain structural policies see Chapter 4). In 2010, budgetary expenditures aligned to structural policies amount to €-315.2 mil that is 10.4% of GDP. This amount is gradually reduced and in 2011 it amounts to €-200/97 mil, in 2012 €-167.3 mil and in 2013 €157.7 mil. The greatest influence to the amount of net budgetary expenditures aligned to structural policies are posed by the pension system reform, social protection, labour market, energy sector (subsidies to electric power users), current expenditures related to transport infrastructure and state aid. On the other hand, greatest revenues are expected from privatisation.

Gradual reduction of net budgetary revenues related to structural policies in 2011 is still partly the consequence of unavailable data on state aid expenditures (in 2010, these amounted to around €50 mil and will be gradually reduced in the following years). In 2011, expenditures related to support to the sector of small and medium size enterprises will be significantly increased.

Apart from the direct budgetary effects' limit of structural policies, Montenegrin investments in energy and infrastructure are of great importance. Energy projects which are to be implemented until 2016 include power-transmission line Podgorica-Tirana, small hydro-power plants, wind-power plants, hydropower plants on Moraca, hydropower plant Komarnica and investments related to cable between Italy and Montenegro. Overall investments in these projects amount to around €1.050 mil. There is also the investment in revitalisation of railway Bar-Beograd and Podgorica-Niksic amounting to around €100 mil. These projects are mainly financed under international loans but, as a rule, the Government of Montenegro provides the guarantees for these credits.

TABLE 26: Net fiscal effects of structure policies in €: summary review based on analysis in Chapter 4

	2010	2011	2012	2013
4.1. ENTERPRISE SECTOR				
4.1.1.PRIVATISATION	+2.128.500	+56.771.061	+29.242.031	+25.144.282
4.1.2.COMPETITION, STATE AID AND PUBLIC PROCUREMENT				
Implementation of competition policy	-183.119	-189.395	-223.780	-277.730

State aid	-50.000.000			
4.1.3. BUSINESS ENVIRONMENT AND TAX POLICY				
Improvement of business environment (work of the Regulation Reform Council, Project for regulation reform and improvement of business environment)	-120.000	-210.000	-150.000	-150.000
Support to SMSs (Investment and Development Fund- loans, stimulation of employment and entrepreneurship by the Employment Office)	-7.621.382*	-21.000.000		
4.1.4. NETWORK INDUSTRIES				
Energy (Subsidies for electric power users) ****	-30.000.000,00	-27.000.000,00		
Transport				
Road infrastructure and road transport **(**Reconstruction of cross roads in state roads, regular maintenance of roads, Adriatic-Ionic highway) ****	-14.980.000	-12.000.000	-10.000.000	-10.000.000
Railway infrastructure **(**Current and investment maintaining of infrastructure) ****	-10.000.000	-10.000.000	-10.000.000	-10.000.000
Electronic communications				
Broadcasting	-150.000	-900.000	-2.200.000	
Postal services		-1.674.652		
4.3. LABOUR MARKET AND SOCIAL INSURANCE				
4.3.1. LABOUR MARKET*****	-23.337.000	-18.490.000	-18.440.000	-19.730.000
4.3.2. EDUCATION AND RESEARCH	-621.403	-1.244.000	-1.316.000	-1.440.000
4.3.3. PENSION SYSTEM REFORM***	-132.360.000	-124.650.000	-116.730.000	-108.730.000
4.3.4 HEALTHCARE SYSTEM REFORM		-11.128.450	-6.594.901	
4.3.5. SOCIAL PROTECTION**	-47.929.389	-53.262.238	-54.860.106	-56.505.909
4.4. ADMINISTRATIVE REFORMS				
4.4.1. STATE ADMINISTRATION				
Rationalisation of state administration		+4.000.000	+4.000.000	+4.000.000
Suppression of grey economy		+20.000.000	+20.000.000	+20.000.000
TOTAL NET BUDGETARY EFFECTS	**-315.173.793**	**-200.977.676**	**-167.2727.787**	**-157.689.357**

* First 11 months

** Social protection represents total amount of allocations from the budget and increase of social allowances by 5% will have net effect to the increase of expenditures amounting to around 5 million of euros annually.

*** Given amount represents the difference between total cost related to pensions and contributions and revenues related to contributions i.e. net budgetary allocations that are expected to be decreased in the following period

**** Amount given in the table presents total budgetary amount of annual allocations

***** Expenses in this category encompass budgetary expenditures of the Employment Office, Labour Fund and the Agency for Peaceful Settlement of Labour Disputes and the effects to smaller degree

3.2. QUALITY OF PUBLIC FINANCES

The area of public finances was improved in 2011. The improvement is, inter alia, reflected in harmonisation of the procedure for budget preparation. The Ministry of Finance prepared and submitted to the Government, before the statutory term, the draft 2011 Budget Law. The Government adopted proposal for the Budget Law and submitted it to the Parliament on 21 October. The Parliament passed the Budget Law on 2 November, before the statutory term of 30 November.

The structure of rationale to the 2011 Budget has been significantly improved and aligned to the structure of Economic and Fiscal Programme.

a) Pension System Reform

Considering that the Law on Pension and Disability Insurance was passed seven years ago and bearing in mind the necessity of enhancement of this law in accordance with the European practice, the Parliament of Montenegro adopted amendments to this law in the framework of the pension system reform.

Adopted amendments to the Law on Pension and Disability Insurance reflect the responsibility for the future and are focused on sustainability and regularity of payment from the PDI system. This is a manner to create stable and sustainable pension system in long-term. Basic amendments that will affect the sustainability of the pension system in the long-term relate to raising the age limit for acquiring the right to pension and to changes in methodology for alignment of pensions. Title 4 – Structural Reforms provides detailed explanation of pension reform.

b) Amendments to the Law on Financing the Local Self-Government

With regard to sustainability of public finances system, the amendments to the Law on Financing the Local Self-Government relating to abolition of certain sources of municipalities' revenues, that were proved in the practice as inefficient, are in force starting as of 2011. At the same time, the allocation of joint revenues was modified in favour of local budgets and some of previous revenues of the central budget have become direct local revenues.

The following direct municipalities' revenues have been abolished:

- consumption tax
- corporate taxes or trade name taxes
- taxes on games of chance

The allocation between central and local budgets has also been modified in respect to the following direct revenues. Thus, the municipalities' revenues will be increased in 2011 and at the same time the revenues of the central budget will equally be lower. Proposed changes are as follows:

- Charges for use of natural resources (concession charges); according to amendments - 70% of collected charges will be allocated to municipalities instead of previous 30%.
- Tax on real-estate turnover; according to amendments 90% of collected tax will be allocated to municipalities (80% directly to municipality in which the tax was collected and 10% for financing of Equalisation Fund) instead of previous 70%.
- Charges on games of chances have so far been 100% budgetary revenue and according to the proposal 40% of this revenue will be used for financing of Equalisation Fund
- Tax on use of passenger motor vehicles, vessels, aircrafts; so far have been 100% budgetary revenue; and according to the proposal it will be used for financing of Equalisation Fund
- Personal income tax; so far 21% (10% directly to municipalities and the Capital, 15% to Historic Royal capital Cetinje and 11 % to Equalisation Fund) of collected tax represented the share of municipalities in allocation and according to the proposal the municipality share will be higher from now on, 12% of personal income tax to municipalities, Podgorica 13% and Cetinje 16%, while the Equalisation Fund remains at 11 %.
- Amendments to the law also envisage the cession of to municipalities of 30 % of charges for use of passenger motor vehicles and trailers charged when registrating the vehicles
- Starting from 2011, amendments to the Law on Property Tax are in force parallely with the amendments to the Law on Financing the Local Self-Government. The amendments

envisage the increase of current tax rates and estimated fiscal effect amounts to €8 mil in 2011.

- For 2012, the share in concession for forests increased to 70% while in 2011 it will remain at 50%.
- Share of municipalities is introduced in concessions from Morsko dobro (Costal Management Agency) in amount of 50% starting from 2013 and 20% in 2012.

c) Amendments to the Law on Excise Tax

With regard to alignment with the EU regulations, amendments to the Law on Excise Tax induced the increase in excise tax on tobacco and tobacco products. It is planned for alignment of excise tax to tobacco and tobacco products with the EU average within five years. Amendments to the Law on Excise Tax envisage fiscal impact will amount to €12-15 mil in 2011. Amendments to this Law refer to increase of excise tax to cigarettes and excise tax to beer. Additional increase in revenues related to value added tax, caused by increase of retail price of cigarettes, should also be taken into account.

d) Modification of methodology used in revenue overview

Another important change that will affect the quality and transparency of public finances is the change in overview of revenues by economic classification in certain budget users. Transfers have not presented gross wages, capital expenditures, expenses for material and services and other expenses so the economic budgetary classification did not show real amount of certain expenditure categories. 2010 Budget of Montenegro presents in detail cultural institutions according to economic classification. In 2011, it is also planned for adjustment of economic classification in „consolidated healthcare system“- Health Insurance Fund and public health institutions i.e. for separate presentation of the wages in Fund. Therefore, all wages paid from the Budget of the central Government are presented in separate position thus enabling transparency and better control.

e) Capital budget reform

In 2010, the Government adopted Decision on drawing up the capital budget with a view to its further improvement. The decision will be applied as of 2011 instead of previous Guidelines for drawing up the capital budget. The mentioned Decision improves the capital budget preparation and drawing up procedure, defines capital projects more precisely as well as the their contents, conditions and criteria on basis of which the priorities are defined on the occasion of selection and candidating capital projects on the part of spending units and units of local self-government. Development of the capital budget planning system requires introduction of new procedures, formulations and more precise definition of liabilities of spending units and units of local self-government on the occasion of preparation and planning of capital projects.

f) Administrative Capacity Building

In 2010, in cooperation with the representatives of International Monetary Fund, the idea of mid-term budget was elaborated and the amendments to the organic Budget Law are planned for the next year. The amendments will create formal preconditions for introduction of mid-term budget thus significantly improving the budget planning procedure and realisation of fiscal goals. Apart from this, through UNDP, cooperation with the Government of Slovenia was established. The cooperation concerns the improvement of macro-economic projecting and introduction of ESA 95 methodology and standards in med- term.

g) Access to the European Capital Market

It is important to emphasise that in 2010 Montenegro issued Eurobonds for the first time in the value of €200 mil. The overall issuance was a success, with the interest rate of €7.875% on annual level, for the period of five years. This implies that investors have trust in Montenegrin economy and its public finance system. The fact that after the issuance, in September, the transactions in securities were still intensive is encouraging.

h) Control over the employment in public sector and the wage fund

Reduction of the wage fund is one of the basic measures introduced in order to cut public expenditure. To this end, the amendments to the Law on Wages of Civil Servants and Employees were adopted thus entrusting the full control over the employment to the Ministry of Finance. Thereafter, the Government adopted Human Resources Plan which implies restrictive employment and the criteria which must be met by spending units in order to realise new employment (one civil servant may enter into employment on retirement of three civil servants or on two becoming redundant) and provides the possibility to spending units to make necessary employment by internal transfers. Decision on increasing the wage of civil servants and employees for performing certain activities was adopted and it clearly defines working positions eligible for the increase thus reducing the wage fund for over €2 mil and at the same time identifying the positions of special importance in terms of work with clients and collection of revenues. On the other hand, variable part of income has been completely abolished.

In the previous period, as a follow-up to these measures, the Ministry of Finance started with the control over real calculation of wages in all spending units financed under the Budget. This resulted in great achievements and savings in the previous period. Pursuant to the Law on Wages of Civil Servants and Employees, the Government adopted the Decision on severance pay creating the space for laying off the staff and recruitment of deficient cadre if the conditions set in Human Resource Plan are met.

3.3. PUBLIC FINANCES INSTITUTIONAL FRAMEWORK

Considering the challenges that lay before Montenegro and strategic orientations of the Ministry of Finance, the following basic goals, incorporated in the work programme of the Ministry, have been identified for the next four years:

- Support to governmental priorities through sustainable and competitive public finances,
- Optimisation of the level and structure of public finance expenditure,
- Provision of public finance revenues necessary for provision of public services through further improvement of fiscal policy by increasing efficiency of tax and customs administration,
- Establishment of own and sustainable long-term system for elaboration of macroeconomic and fiscal projections,
- Continuation of the process of systematic removal of business administrative barriers with a view to fostering the productivity of economic system actors as well as to preventive suppression of deformed phenomena such as corruption,
- Provision of framework for sound fiscal resources management in all public institutions,
- Public debt management in efficient and rational manner,
- Improvement of quality of services provided to different stakeholders,
- Demonstration of the leading role of the Ministry of Finance among public institutions in respect of good governance, responsibility and transparency of operations,
- Establishment of structures which would be responsible for entire establishment and efficient functioning of EU funds financial management.

Commitments that Montenegro assumed towards international organisations, primarily within the EU integration process require the establishment of new institutions to be financed under the Budget of Montenegro. In the conditions induced by the economic crisis and necessary rationalisation maximum account is taken not contribute to the increase in current expenditure during the establishment of new institutions. In this regard, new institutions are situated in the premises already used by public institutions and administrative staff is provided through transfer of employees from line ministries and other state institutions. Planned and partly implemented in 2010, the institutional framework is as follows:

- Administration for Hydrocarbons, under the competence of the Ministry of Economy, has not become operational in 2010 as planned but will start to work as of 2011

- Labour Fund and the Agency for Peaceful Settlement of Labour Disputes were planned to be established under the Ministry of Labour and Social Welfare

However, the Labour Fund has the status of state fund along with the Pension and Disability Insurance Fund, Health Insurance Fund and Employment Office, while the Agency for Peaceful Settlement of Labour Disputes is a separate institution- spending unit. .

Apart from this, pursuant to the Law on State Property, institution- Protector of Property and Legal Interests of Montenegro was established and became operational in 2010.

In mid-term framework, conclusively with 2013, the institutional framework reform under the competence of the Ministry of Culture and Media will be implemented. The following steps have been undertaken so far:

- Sport Administration has been established under the competence of the Ministry of Education and Culture, which had the status of a programme within the mentioned Ministry until this year
- Cultural Institutions, programmes in the Ministry up until 2010 now have the status of spending units
- Administration for Protection of Cultural Heritage is planned to be established as a public institution integrating several existing cultural institutions, pursuant to the Law on Protection of Cultural Heritage adopted in 2010
- It is planned for establishment of several institutions under the programme „ Cetinje - City of Culture 2010-2013“ with the seat in Cetinje. The institution would cover the areas of contemporary culture, film production, management and regional cultural networking.
- It is planned for establishment of the Regional Centre for Cultural Activities in Pljevlja.

4. STRUCTURAL REFORMS

4.1. Enterprise Sector

4.1.1. Privatisation

<u>Implementation and deviations from measures implementation and reasons for deviations</u>

The main method of privatization in 2010 was public tender. In 2010 the activities on preparation and realization of the tenders for privatization of companies that resulted from the processes of restructuring and privatization of companies in the transport sector were implemented (“Railways of Montenegro” “ AD Podgorica and „Port of Bar“ AD Bar): LLC »Obezbjeđenje i protivpožarna zaštita« Bar, AD MONTECARGO Podgorica, AD „Container Terminal and General Cargo“ Bar and »Maritime Affairs « Bar. The activities on privatization of DOO „ Maritime Affairs ” Bar were successfully performed, and activities regarding the privatization of AD „Montecargo” Podgorica are in the final phase. Other privatizations started in 2010 were unsuccessfully finished due to the lack of interest of investors. Moreover, activities were conducted for preparation of tender for sale of the majority package of shares in the companies „Montenegroairlines” AD Podgorica, Institute »Dr Simo Milošević« Igalo and HTP »Ulcinjska rivijera« AD Ulcinj. In addition, the activities for preparation of tender for privatization of the company »Post of Montenegro« LLC Podgorica have begun.

Within the project on valorization of tourist sites and former military property, the activities on preparation of tender have started for the following locations: military object »Orjenski bataljon« in Kumboru, the island „Mamula« – Herceg Novi and storehouse »Rakite« - Herceg Novi, whilst the activities on implementation of the tender for valorization of the site Vladanos through the long term lease are in the final phase.

The main reason for the unsuccessful finalization of the majority part of the privatization processes in 2010 is decreased interest of investors under the conditions of global financial and economic crisis. In 2011 the Government of Montenegro will try to complete the started projects on privatization which were not finalized in 2010.

Current and future programs and economic policy measures

Privatisation in 2011 will be focused on projects in tourism and transportation sector. The process of privatisation in 2011 will be dominatly determined by the suscess of the privatisation process for the national air company „Montenegroairlines“ AD Podgorica and valorization of the tourists sites which will define the concept of tourism infrastructure development in the coastal region of Montenegro. Slight recovery of the global economy brings the expectation that unsuccessful privatization projects from 2010 will be successfully finished in 2011.

The specific projects for 2011 are:

- In 2011 the procedure on choosing the investors for valorization of tourist sites will be implemented through an international public tender, with application of the private public partnership and long term lease models: Ada Bojana, Velika plaža, Njivice, Utjeha, Buljarica and Jaz and continuation of activities on valorization of the military-tourist complex „Mediteran“, Žabljak , "Bigovo – Trašte" will continue. After implementation of the tender procedure, it is expected to successfully finalize the tender for valorization of the site „Valdanos“ – Ulcinj**.**

- On the basis of a decision adopted by the Privatization Council, the preparation of the tenders for the following companies will continue: „Montenegro airlines“ AD Podgorica, „Railway Transport of Montenegro“ AD Podgorica, „ Railway Infrastrucute of Montenegro“ AD Podgorica, „Montecargo“ AD Podgorica, »Obezbjeđenje i protivpožarna zaštita« Bar, AD „Container Terminal and General Cargo “ Bar, »Maritime Affairs« Bar, „Adriatic Shipyard “ AD Bijela, N.I.G. „Pobjeda“ AD Podgorica, Institute „Dr Simo Milošević“ AD Igalo, "Zora" AD Berane, „Duvanski kombinat“ AD Podgorica, HTP „Budvanska rivijera“ AD Budva, HTP „Ulcinjska rivijera“ AD Ulcinj, „Institute of Ferrous Metallurgy“ AD Nikšić, „Bar Shipping “ Bar, „Post of Montenegro” LLC Podgorica i LLC "Montenegro bonus" Cetinje.

In the field of the privatization processes it is not envisage to adopt new laws and by-laws, neither establishing of new institutions.

<u>Budget effects of the programs and measures</u>

Planned realization of important projects through the model of private public partnership and awarding the concession for using the key infrastructure in the field of tourism and transportation, beside the positive economic effects in these sectors, will limit direct revenues of privatization to Government of Montenegro. However, the indirect positive effects of the projects to the tax income, especially because of their long term character, are recognized as a stable base for financing the future capital projects from the budget.

Estimation of the effects of the planned privatization to the budget revenues is:

Table 27:

Planned privatization	Projected income
AD "Montecargo" Podgorica	8,958,304
AD "Kontejnerski terminal i generalni tereti"Bar	20,420,160

"Montenegro airlines", AD Podgorica	4,662,910
"Zeljeznički prevoz Crne Gore" AD Podgorica (dio – Održavanje)	13,773,164
" Luka Bar" AD Bar	21,755,489
"Jadransko brodogradiište" AD Bijela	11,625,102
N.I.G. "Pobjeda" AD Podgorica	3,280,737
Institut "Dr Simo Milošević"AD, Igalo	16,803,132
HTP " Ulcinjska rivijera" AD Ulcinj	22,390,563
"Barska plovidba", Bar	4,501,180
TOTAL	**112,280,177**

Remark: Estimation is given on the base of weighted realized revenues and nominal values of shares sold in the privatization processes in the period 2007-2009.

Table 28: Impact of the privatization to the budget revenues/ expenditures, in EUR

	2010	**2011**	**2012**	**2013**
Privatization				
Net budget impact	2,128,500.	56,771,060	29,242,030	25,144,282
Direct impact on the budget	**2,150,000.**	**57,344,506**	**29,537,405**	**25,398,265**
Direct impact on the budget	21,500.00	573,445.06	295,374.05	253,982.65

Remark: Law on privatization envisages that 1% if privatization revenues should be used for covering the cost of privatization process.

4.1.2. Competition, state aid and public procurement

4.1.2.1. Competition

Implementation and deviations from measures implementation and reasons for deviations

Analysis of the applicable provisions of the Law on Competition Protection (»Official Gazette of Montenegro« No 69/05 and 37/07), especially the experience from its implementation, has shown that is necessary to adopt new Law on Competition Protection for the purpose of completing the harmonization with EU regulations in the field of competition protection. Activities regarding the adoption of the new Law on Competition Protection are not finished in accordance with the planned dynamics.

The reason for delay in the adoption of new Law on Competition Protection is the unique legal approach which still does not allow absolute implementation of the direct rules on competition, considering that is necessary to change the applicable systematic laws, which would allow the introduction of a common standard regarding the rules on competition of EU, which are harmonized with EU Aqcuis communautaire. This is related to the Law on Misdemeanor, adopted by the Parliament of Montenegro in December 2010. Having in mind the importance of misdemeanors in the field of protection of competition in the market, the Law on Misdemeanor envisages cash penalty in the framework of 1 to 10% of the annual income of the market stakeholder for heavy misdemeanor in the mentioned area.

Current and future programs and economic policy measures

It is anticipated that the new Law on Competition Protection will be adopted in 2011 and the appropriate by-laws will be adopted within next six months after the Law comes into effect, which will complete the legal framework in the field of competition. Advantage of the draft Law when compared to the applicable law is in the precise definition of sanction, as well as introduction of periodical cash penalties, and as a special simulative element for the efficient discovering of cartels, it is envisaged to stipulate the possibility of relief or decrease of penalty for the stakeholders who are willing to cooperate with the Agency (Leniency program).

The experience from the implementation of the applicable law is used for identification of the possible weaknesses which will be completely eliminated by adoption of the new Law on Competition Protection.

Currently, 11 working places are covered in the Agency, including the director position. The possibilities to increase the number of employees or for solving the status of engaged people at the working places that are not covered, were decelerated by the measures of the Government of Montenegro adopted due to the financial crisis. For the purpose of training the employees in the Agency, in June 2001, the AIM project has started and will last for 18 months. The foreign experts will support the preparation of the new Law on Competition Protection and by-laws. With the aim of strengthening the institutional capacities it is planned, as the necessary support to the implementation of the future legal framework, to organize practical trainings and seminars on the competition protection, as well as the activities on raising the awareness regarding the competition (Competition Advocacy).

Budget effects of the programs and measures

Preliminary calculation of planned budged expenditures regarding the implementation of this law is 183,118.54€ in 2010, 189,395.00€ in 2011, 223,780.00€ in 2012, 277,730.00€ in 2013. These amounts will be subject of harmonization with the Ministry of Finance, with compliance with the budget directions and midterm framework.

Impact of implementation of the new law and work of the Agency for Competition Protection to the budget revenues/expenditures in EUR[12]

	2010	**2011**	**2012**	**2013**
implementation of new law and work of the Agency for Competition Protection	-	-		
Net budget impact	-183.118,54	-189.395,00	-223.780,00	-277.730,00
Direct impact to the budget revenues				
Direct impact to the budget expenditures	183.118,54	189.395,00	223.780,00	277.730,00

4.1.2.2. State Aid

Implementation and deviations from measures implementation and reasons for deviations

The Parliament and the Government of Montenegro previously adopted a set of regulations on state aid, as follows: (i) The Law on the State Aid Control ("Official Gazette of MN", no 74/09); (ii) Decree on Further Criteria, Conditions and Manner for Awarding the State Aid ("Official Gazette of MN", no 27/10); (iii) Decree on the Manner of Keeping the Records on State Aid ("Official Gazette of MN ", no 27/10) and (iv) Decree on the Manner and Procedure for Submission of Applications for State Aid ("Official Gazette of MN", no 27/10). The subject regulations were developed in

[12] The Agency for Competition Protection has not adopted the tariff rules so far, therefore it was not possible to show revenues from the operations of the Agency for the Competition Protection. After the adoption of the New Law on the Competition Protection, the conditions will be created for the adoption of the Tariff Rules.

cooperation with EU experts and are in major part harmonized with the Acquis and the Treaty on Establishing the EC.

The economic crisis had as a result the increase in absolute amount of awarded state aid in Montenegro. In the year 2009, the state aid was awarded in the total amount of 50,553,187.99 euros, which represents an increase of 10.15% (45,895,844 euros) in respect to 2008 and increase of 103.46% (24,847,000 euro) in respect to 2007. The share of state aid in GDP was increased from 0.88% in 2007 to 1.49% in 2008 and to 1.68% in 2009. The main characteristics of the awarded state aid in 2009 is resembled in the significant increase of awarded state aid for recovery and restructuring on the one hand, and in awarding so called “good” state aids, namely for research and development, environment protection programs, energy saving and increase in the use of alternative and renewable energy sources, on the other hand. This is consequence of the need to forestall and recover the consequences of the economic crisis which marked the year 2010.

Share of the state aid for recovery and reconstruction in the total awarded state aid in 2007 was 2.75%, in 2008 was 0%, and in 2009 was 61.91%, respectively 31.3 million euros. 79.18% of this amount (24.788 mil. euros) was awarded to Kombinat aluminijuma Podgorica (KAP) and Rudnik boksita Niksic (RBN) for the purpose of ensuring the long-term sustainability of operations in these companies.

<u>Current and future programs and economic policy measures</u>

Having regard to the size and economic importance of KAP to the economy of Montenegro and the implemented recovery and reconstruction programs, it is realistic to expect that the share of state aid based on the recovery and reconstruction, therefore the total amount of awarded state aid, will be reduced. This is particularly if taking into account that in 2010 another, for Montenegrin circumstances, large system – steel-mill Željezara Nikšić went through restructuring program. At the same time, in the future period the public funds will be in major part committed to awarding the so called “good” state aid for research and development, environment protection programs, energy saving and increased use of alternative and renewable energy sources.

In addition, the following will be performed in the future:

- develop consolidated list of regulations that were base for awarding, namely which are the base for awarding the state aid, which will together with the proposed measures be submitted to the Government for the purpose of its harmonization with the legislation in this field;

- provide IT system for keeping the record on state aids, so that all stakeholders could have possibility to have insight into the manner and procedure of the state aid award.

The above stated solutions will contribute to t further development of the transparent state aid system.

Budget effects of the programs and measures

The existing Budget does not quantify separately the state aid effects. The amounts of state aid incorporated into the Annual Report refer only to the realized support, thus the report for 2010 will include also part of the amount approved to Aluminum Plant (KAP) in 2009, therefore it is to expect to have for 2010 approximately the same percent of awarded state aid share in GDP.

Ultimately, if taking into account the fact that large Montenegrin systems (KAP and ZNK) went through the restructuring phase, it is reasonable to expect that in future the total amount of awarded state aid in GDP will be significantly reduced.

4.1.2.3 . Public Procurement

Implementation and deviations from measures implementation and reasons for deviations

Action policy regarding the public procurement system in Montenegro in 2010 was linked to the development of the new Public Procurement Law. The Law will ensure implementation of obligations from the clause 41 of the Interim Agreement on further harmonization of public procurement legislation with the European Union system and other regulations and standards of the Union, respectively harmonization with the Directive 32004R0017 on the utility services sector, the new directive in the protection of rights and full harmonization with the Directive 32004R0018, which envisages new procedures in the part related to the new procedures, public procurement limitation values, deadlines for public announcement duration and other improvements to the text of the Law.

Within IPA Project of support in 2007 “Further Development and Strengthening of the Public Procurement System in Montenegro”, which started implementation in June 2009, the support was provided for harmonization of legislation. Design, development and support to the operation of web-based system for collection and issuing of notices on public procurement was performed as a part of this project, as well as the strategy on introduction of the electronic public procurement system.

Current and future programs and economic policy measures

The development of draft bylaws for public procurements, models and standard forms will be performed in the second quarter of 2011. The proposal of new- innovated secondary regulations, models and standard forms for implementation of the new Public Procurement Law, pursuant to the obligations for their adoption and deadlines defined by the legal decisions thereof, will be finalized in the third quarter of 2011. Such activities will be accompanied with the development of Manuel for public procurements and other professional literature for facilitating implementation of the Public Procurement Law, secondary legislation, models and forms, and will serve as a support to the employees engaged in public procurement affairs when conducting work and in application of prescribed public procurement procedures. Moreover, the Program on professional development and training in public procurement will be adopted for 2012 and 2013.

Program will include organizational issues regarding the implementation of professional trainings, content of professional development and training segments in respect to the categories of persons (civil servants for public procurements, employees in public procurement affairs and other employees engaged in public procurement and audit, state audit, judges and affiliates of competent court, bidders, media and others), training of trainers and other stakeholders and entities.

The year 2012 will be resembled with development of comments on public procurement regulations for the purpose of easier implementation of the Public Procurement Law, secondary regulations, models and forms, which will serve as assistance to the employees in public procurement affairs when performing work and application of prescribed public procurement procedures, whilst also the trainings on public procurement will be intensified.

Introduction of the new Public Procurement Law will be accompanied by the development of the new Rulebook on internal organization and systematization in the Public Procurement Directorate.

Budget effects of the programs and measures

Budget effects, in the sense of engaging the additional number of employees, are not presented, since the employment dynamics is to be subsequently defined.

4.1.3. Business environment and tax policy

Tax aspect of the business environment

Implementation and deviations from measures implementation and reasons for deviations

Taxation policy in 2010 represented a continuation of the previous activities in this area, with measures aimed at mitigating the effects of financial crisis and overcoming liquidity problems, including the application of the rescheduling institute of tax and non-tax debt, as well as deferred payment of customs debt. Special emphasis has been given to activities related to the harmonization of tax and customs legislation with the Acquis.

In 2010, the image of a competitive tax system was held. It included low and equable tax rates13 and the continuous reduction of administrative barriers and costs imposed to taxpayers. In order to create favorable conditions for business operations and to improve liquidity of taxpayers, the Government has taken the following measures:

- Decrees 14 which allow deferred payment of tax and customs debt were adopted. Their implementation will not adversely affect the revenues of the state budget, but will only have impact on dynamics of their realization.
- Adoption of Proposal for the Law on Amendments to the Law on Financing Local Self – Government and Amendments to the Law on Propery Law, which were adopted by the Parliament of Montenegro in December 2010. The laws provide more stable sources of financing the local government functions in the longe term, through the increase of individual tax rates15 and by providing new revenues to local government from the state. Given that negligible share in the revenues and costs of administration of certain municipal tax levies (the consumption tax, corporate tax, tax on games of chance), they have been abolished , which will further improvebusiness environment. With the implementation of the adopted solutions, the positive effects on the budgets of municipalities on an annual basis, using a conservative estimation method, will amount to approximately €20.5 million, and would be realized from the increase of the current tax rate on real estate and from taxation of certain types of real estate (buildings that are not constructed in accordance with the law, restaurants that are located in the zone of priority tourist sites). Due to the increase in the percentage of assigned revenues to

[13] The corporate profit tax rate and personal income tax rate is 9%.

[14] Decree on deferred payment of customs debt (Official Gazette of MNE, no. 13/10), Decreeon conditions for the postponement of collection of tax and non-tax claims (Official Gazette of MNE, no. 67/09 and 23/10) and the Decree on deferred payment of corporate profit tax (Official Gazette of MNE, no. 23/10).

[15] Proposes a new range of real estate tax rate from 0.10% to 1.00% of the real estate market value (according to the current solution the range is from 0.08% to 0.80%).

municipalities (tax on real estate, concessions and other compensation for the use of natural resources) negative effects on the state budget would annually amount between €15.5 million and €17 million.

- Activities aimed at conclusion of agreements on avoidance of double taxation have been intensified. They will create a favorable environment for attracting foreign investment and further stimulation of economic and financial relations between the contracting states. In 2010 Montenegro has concluded an agreement on avoiding double taxation with the Republic of Ireland, and the negotiations for the conclusion of these agreements have been initiated with the United Arab Emirates and Belgium.

Current and future programs and economic policy measures

In addition to abovementioned, the economic policy in the tax aspect of the business environment in 2011 will be based on the following elements:

- Ministry of Finance is preparing amendments to the Law on Administrative Fees, which will abolish the obligation to pay tax for certain writings (documents) and actions to the Customs (e.g. submission of customs declarations, issuance of binding information), all in order to meet obligations under the SAA.
- In addition to maintaining a competitive tax system by amending the existing tax regulation, the intent is to improve the tax culture of taxpayers and thus improve the voluntary payment of taxes through a system of electronic registration and payment of all tax forms, which is planned to be realized by the end of 2012. Also, to the raising of tax discipline should also contribute the full implementation of the unified model of registration and collection of income tax and social security contributions. Because of the fact that the technical infrastructure (electronic signature) necessary for the functioning of the unified collection model has not been established yet, its implementation was postponed for the first quarter of 2011. , Continuously it will be also worked on the establishment of efficient and high quality service to taxpayers with a professional administration that would provide greater transparency and lower discretion rights, and thus ensure higher legal certainty to taxpayers and better business conditions.

Budget effects of the programs and measures

Budgetary effects of programs and economic policy measures in the tax aspect of the business environment can be assessed only indirectly through the following elements:

- Not only because of the reduction of economic activity, but also because of economic policy measures in 2009, we have recorded 14.4% reduction in budget revenues from taxes compared to 2008.

- Anticrisis tax measures which are being applied as of January 2010, for the first eight months of this year, compared to the same period of last year, contributed to the increase in budget revenues from taxes in the amount of 1.6%. Income from contributions for compulsory social insurance for the first eight months of 2010 rose by 24.2%, as a result of increased business activity and a higher rate of this kind of contribution for 1.8 percentage points.
- With the application of conservative method of assessment, the Law on Amendments on the Law on Local Governance Financing and the Law on Property Tax will have positive effects on budgets of municipalities in the amount of approximately €20.5 million per annum. At the same time, due to the increase in the percentage of revenues transferred to municipalities, negative effects on the state budget annually will amount between €15.5 million and €17 million.

Improvement of business environment

Implementation and deviations from measures implementation and reasons for deviations

In 2009, the creation of an additional institutional capacity for improvement of business environment in Montenegro has been set up, with the establishment of the Council for Regulatory Reform and Improvement of Business Environment, as well as the Department for Improvement of Business Environment in the Ministry of Finance. At the operational level, the most important activities are implemented through Regulatory Reform Project and making of an omnibus law – the Law on Improvement of Business Environment.

The first phase of activities in the so-called Guillotine process is completed. It involves: (i) a inventory of the entire regulation and administrative procedures at the national level, (ii) initiated activities to introduce the Regulatory Impact Assessment (RIA)16, (iii) activities undertaken to simplify the registration of companies through unification of procedure for issuing identification number with the Central Registry of the Commercial Court (instead of MONSTAT, as previously was the case), (iv) a unified taxpayer registration procedure and tax contributions with the Tax Administration, (v) with the Law on Improvement of Business Environment the reduction in judicial and administrative fees, simplified procedures to facilitate the employment of foreigners, revocation of renewal of business registration, abolishment of the Law on Public Enterprises and Law on Social Affairs, which represent the legacy of the socialist system.

Potential problems and risks in implementing reforms related to improvement of business environment refer to the still immature consciousness of the state administration for the need to create business friendly regulation as well as creation of as simple as possible administrative procedures for conduction of business operations. At the same time, there is risk involved in the

[16] According to the anticipated project schedule RIA will be established by end of 2011.

implementation of the Law on Electronic Signature, for which full functionality there is a need to establish so-called certification body.

Current and future programs and economic policy measures

Plans for short and medium term refer to the further implementation of activities envisaged by the Regulatory reform project and improvement of business environment:

- Completion of the so-called Guillotine process, which will result in making recommendations on regulation which is necessary to be changed or abolished;
- Full implementation of regulatory impact assessment (RIA) in the process of regulation adoption;
- Establishment of one stop shop for registration of companies by merging the procedure with the Central Registry and the Tax Administration;
- Reform of regulation and procedures for issuing construction permits;
- Improvement of executive procedures by passing a new Law on Executive Procedures;
- Simplification of procedures related to employment of foreigners;
- Expansion of coverage of the credit registry in accordance with the new Law on the Central Bank.

Budget effects of the programs and measures

The financial effects of these activities are envisagedin the budgets of relevant institutions. The funds provided for the Council for Regulatory Reform and Improvement of Business Environment is in the amount of €150,000 for 2011. The same amount will be projected for the next two years, which is 2012 and 2013. The Project of regulatory reform and improvement of business environment amounts to $950,000 of which the contribution of IFC is $700,000, while $250,000 is the contribution of the Council for Regulatory Reform and Improvement of Business Environment.

After completing the training for the Regulatory Impact Assessment, which will include the training on the application of so-called Standard cost mode, the opportunity to give precise data on the effects of this kind of regulation changes on the budget will be provided. Rough estimates project that the effects of the implementation of Guillotine process and the introduction of RIA are usually ten-fold in comparison to invested assets.

Table 29: Impact of measures in the area of improvement of business environment on the budget revenues / expenses, EUR

	2010	2011	2012	2013
Work of the Council for Regulatory Reform and Improvement of Business Environment	- 100.000	-150.000	-150.000	-150.000
Net budget impact				
Direct impact on budgetary revenues				
Direct impact on budgetary expenditures	- 100.000	150.000	150.000	150.000
Project of regulatory reform and improvement of business environment				
Net budget impact	20.000	60.000		
Direct impact on budgetary revenues				
Direct impact on budgetary expenditures		60.000		

Support programs for SME sector

Implementation and deviations from measures implementation and reasons for deviations

The figures indicate the dynamic growth of SMEs and their growing importance in the Montenegrin economy. Despite the global economic crisis which had a negative impact on the business operations of the SME sector in Montenegro and which was particularly pronounced in the last two years, the indicators suggest that there has been a realization of the 3 strategic objectives, as follows:

- increase in the number of SME companies in the period 2006 - 2009, from 11,522 to 15,229, i.e. 32.17% (projection to be achieved was 30%),
- increase in the number of employees in SMEs in the period 2006 - 2009, from 85,065 to 105,038, i.e. 23.48% (projection to be achieved was 20%),
- increase of the participation of SMEs in exports in the period 2005 - 2009 from 22.23% to 31% (projection to be achieved was 30%),
- increase of the participation of SMEs in GDP to 60% by the end of 2010[17].

[17] There are no official estimates on the participation of SMEs in GDP since 2003.

Current and future programs and economic policy measures

Current and future policies and measures for small and medium enterprises refer to the following:

1. Development and implementation of Strategy for development of small and medium enterprises through four strategic objectives: improvement of business environment, strengthening of financial support, strengthening the competitiveness of SMEs and promotion of entrepreneurship and support for start up businesses.
2. Strengthening of institutional support for small and medium enterprises through improvement of capacities of existing regional / local business centers and through formation of new business incubators in the North (Berane). Support for the development of cluster connections as well as initiation of activities on the formation of a technology park will continue to be provided.
3. Stimulation of export orientation and strengthening the competitiveness of SMEs through workshops / trainings for the use of the information which information market service provides, the development of sectoral market studies for promotional events (international fairs, business meetings, etc.), and creation of directory of exporters - Montenegrin database on exporters and products intended for export. In the future period, it will be worked on development of the project „Fostering competitiveness at the micro level" whose main goal is to assess the current level of competitiveness of Montenegrin enterprises through the analysis of business performance. Preparation of development programs for the markets in which there are maximum opportunities for exports of the Montenegrin companies (markets of Albania, Turkey, the CEFTA countries) has also been planned.
4. Strengthening of financial support - Investment-Development Fund for 2011 plans to provide a set of financial support measures for the sector of micro, small and medium enterprises as well as to entrepreneurs. Support will be seen through three instruments: credit support, implementation of credit-guarantee scheme and factoring. In 2011 Employment Agency of Montenegro will work on encouraging the development of entrepreneurship and small businesses by providing loans for economically viable business ideas that include new employment opportunities through the Innovation Program of self-employment.
5. Improvement of business knowledge through implementation of educational and training programs in the areas of business skills, management, marketing, business communication, internationalization and export through organizing seminars and workshops. The plan is to analyze the training needs of small and medium enterprises, to form a consulting registry for small and medium enterprises as well as the adoption of a national qualifications framework. The work will also continue in implementing activities under the Action Plan based on the Strategy for Entrepreneurial Learning.

Budget effects of the programs and measures

Funding support for the SME sector from the newly formed Investment - Development Fund in the first 11 months of 2010 shows approval of a total of 89 projects with total value of € 7,662,547.00. The planned amount of funds for loans in 2011 accounts for €20 million, while the planned guarantee potential accounts for €20 million.

In the first 11 months of 2010, the Employment Agency within the Innovated program for continuous stimulation of employment and entrepreneurship approved 427 loans worth € 2,808,000.00[18], which realization enabled the creation of 562 new work places. For 2011, €1 million of funds for lending has been planned.

Table 30: Impact of measures in the area of support to the SME sector on budget revenues / expenses, EUR

	2010	2011	2012	2013
Employment Agency's Innovated program for continuous stimulation of employment and entrepreneurship	First 11 months			
Net budget impact	41,164.75			
Direct impact on budgetary revenues	2,506,164.75			
Direct impact on budgetary expenditures	2,465,000.00	1,000,000.00*		

* planned potential for loans

[18] € 2,808,000.00 was approved, paid € 2,465,000.00

4.1.4. Network Industries

4.1.4.1. Energy

Implementation and deviations from measures implementation and reasons for deviations

Electricity: System framework and liberalisation of the electricity market. In April 2010, new Energy Law *("*Official Gazette of Montenegro", No. 29/10) and Energy Efficiency Law are adopted by which the legal framework in the field of energy is completed. Law on Exploration and Production of Hydrocarbons (Official Gazette of Montenegro, No 41/10 of 23 July 2010) was adopted in June 2010. Starting from the 1st of January 2009, the electricity market is open for all consumers, excluding households. From the 1st of January 2015 the market will be open for households as well. The basic normative prerequisites for entrance of the competition in energy sector of Montenegro are created by adopting the Decision on Opening of the Electricity Market and many other relevant documents. Until the entry of competition in supply, all end-users have right to be supplied from public suppliers according to the regulated tariffs, except for buyers supplied under special contracts.

Prices and Subsidizing electricity consumers. There were not increases in prices of electricity in 2009 . The new decision on electricity prices for 2010 has been adopted by the Energy Regulatory Agency. Pursuant to the Decision, the average electricity prices for the end users, comparing to the approved for 2009 decreased for 15, 72 %.

In order to protect consumers and find options to establish more regular payment of invoices for electricity, the Government of Montenegro subsidised consumers of electricity in amount of approximately 40,32 million € in 2009. During the 2010 the Government of Montenegro subsidized the following consumers of electricity: social vulnerable consumers, Aluminium plant AD Podgorica i Iron Works Nikšić AD Nikšić. The Budget Law for 2010 envisages assets for subsidies in the amount of 30 million €. The program of the subsidy will be continued during the 2011, and according to that the Budget Law for 2011 provides 27 millions for that purpose.

Investments and generationcapacities. In order to create conditions for the construction of new as well as revitalisation and optimisation of existing electricity capacities the partial privatisation and additional capital increase of the Electric Power Industry (EPCG) of Montenegro AD Nikšić was carried out, and the Italian company A2A S.p.A became the owner of 43,7 % shares of EPCG.

During the 2009 many activities on the revitalization of energy capacities for generation are implemented (TPP ''Pljevlja'', HPP ''Perućica'' i HPP ''Piva''), and the total amount of the investments is 35,9 million €. The highest investments were in TPP ''Pljevlja'' in the amount of 27.5 million €, which resulted by the increasing of the capacity for approximately 8.5 MW. As the result of this investment, it is expected the increasing of the annual generation of TPP ''Pljevlja'' for 300 GWh, which will influence on the decreasing of the electricity deficit . The activities on the construction of the 400kV transmission line Podgorica-Tirana, on Montenegrin side has been finalized and the technical acceptance has been performed. The value of the work is approximately 11 million €, and value of the project is 43, 9 million €.

Based on two stage bidding procedure according to the Public announcement for prequalification for concession award for exploration of water flows for construction of small hydro power plants in Montenegro, announced in September 2009, the first ranked bidders for five water flows are selected in June 2010. Estimated value of the investments for construction of small hydro power plants on these water flows is approximately 52 million €. For the eight water flows, for which the concession contracts are signed in September 2008, estimated investment value is approximately 87 million €. These projects do not have any fiscal and macroeconomic effects in 2010.

After the finalization of the public bidding procedure according to the Public announcement for selection of investor for construction of wind power plants and lease of the state owned land, the contracts with the selected investors for the construction of wind power plants on the locations Mozura and Krnovo, are signed in July and August 2010. The estimated investment value for the construction of wind power plant on these locations is 135-155 million €, which depends on total installed capacity of the wind power plants. These projects do not have fiscal and macroeconomic effects in 2010.

Oil and oil derivatives: The functioning of companies operating in the field of oil and oil derivatives is organized as a market-based activity. Numerous oil companies are engaged in supply of oil derivatives of consumers in Montenegro, thus it could be said that the competition principles are achieved.

Coal: The tender for awarding the concession for exploration of coal in the Maoče Basin (territory of Pljevlja), conditioned by the construction of a thermal power plant with the estimated capacity of 500MW, published on 9 November 2009, was not successful because of lack of interest by investors for this project.

Increasing of the energy efficiency. In 2009, realized losses of electricity in the transmission network are higher than planned for 4.2%, and less for 3.5% than in previous year. The percentage of the losses in the transmission network in last few years has decreasing tendency. The overall losses realized in the distribution network in 2009, were 12.6% higher than it was planned, and 0.4% higher than in previous year. The losses in the distribution network are much higher than optimal. For further decreasing of losses of electricity, the realization of new investments and activities is necessary.

In the framework of the project “Year of Energy Efficiency”, which is successfully implemented at the end of 2009, the priority activities for improvement of energy efficiency are implemented through 17 different programs. Experts for performing of the energy audits have been educated, reports about the realized audits has been prepared, many activities regarding to the improvement of the energy efficiency within education and health utilities have been implemented.

<u>Current and future programs and economic policy measures</u>

In the field of the energy policy, in further period the following activities will be realized:

- Creating the innovated Energy policy of Montenegro and innovated Energy Development Strategy till 2025. , with the aim of redefining the priorities for the improvement of energy sector and creation of more favorable framework for the investments in the energy sector;
- Announcement of the third tender for the construction of small hydro power plants;
- Adoption of National Action Plan for energy efficiency 2010-2012;
- Activities in the Project of construction of the Ionian-Adriatic gas pipeline;
- Announcement of the tender for exploration of hydrocarbon and oil on the Montenegrin offshore – Block 3 (the aim is the selection of investor / strategic partner for the development of oil and gas sector and better positioning of Montenegro at the energy market).

<u>Investments and generation capacities in the field of electricity.</u> The central orientation of the Montenegrin energy policy is construction of new capacities in the field of electricity. In that field, the following projects are expected:

- Activities regarding to the realization of the Project of construction of hydro power plants on Moraca river are ongoing. In the open and two stage process for awarding of the concession for hydropower plant (4 cascade HPP on Moraca river, total designed capacity is 238MW, estimated annual generation is about 721GWh) in May 2010, the qualified bidders for second stage of the tender procedure are selected. Regarding to the expected dynamics, the finalisation of tender procedure and signing of the concession contract should be finished by the beginning of 2011. The estimated investment value for realisation of this project is about 540 million€. The analysis show very positive impact on the GDP, employment, fiscal balance and current account of the payment balance for the period of 2010-2016[19]. In the case of realization of the Basic Technical Solution I (cascade of 4 HPP, with total installed capacity of 238 MW, annual average generation of 721GWh) increase of GDP in 2016, compared to Zero Case Scenario (Scenario that does not takes into account construction of Moraca HPP-s), is 390 mil EUR measured in nominal prices, or 346.5 mil EUR measured in constant prices from 2010. Cumulative positive fiscal impact on the budget of Montenegro for the period 2011 – 2016, compared to Zero Case Scenario, is 174.3 mil EUR measured in nominal prices, or 166.4 mil EUR measured in constant prices from 2010.

– For HPP Komarnica (capacity of 168MW, annual generation of 232GWh), the preparatory activities for the creation of detail spatial plan for the location planned for the construction of HPP Komarnica and strategic environmental assessment, as well as the preparation for the continuation of exploration works which are necessary for the creation of preliminary project design, are being implemented.

The activities within the Project for the construction of submarine high-voltage cable between the power systems of Italy and Montenegro are ongoing. Agreement between Montenegro and Republic of Italy on the construction of submarine high-voltage cable between the power systems of Italy and Montenegro is signed on 6th February of 2010, and on 23rd November of 2010 the following agreements are signed: Agreement on sale and purchase through subscription of newly issued shares in capital increase, Strategic and shareholders' agreement, Project coordination agreement.

Estimated value of the project is about 758 million €. It is planed that Montenegrin Transmission System Operator construct all necessary internal infrastructure in Montenegro (substation in the area of Tivat with the connection on the existing 400Kv network and 400kV line Pljevlja-Tivat), the value of the investment is 100 million €.

Budget effects of the programs and measures

[19] University of Mediteran Study „ Estimation of economic impact effects of construction of the system of hydro power plants on Moraca river", September 2010.

Above mentioned programs and measures of the energy policy of Montenegro have resulted by following actual and potential effects on budget revenues and expenditures, which for the time being cannot be precisely defined:

- The activities on the revitalization of energy capacities for generation are realized in 2009 (TPP ''Pljevlja'', HPP ''Perućica'' i HPP ''Piva''), and the total amount of the investments was 35, 9 million €.
- The subsidies for electricity consumers in total amount of 40, 32 million € in 2009, 30 million € in 2010, and 27 million € in 2011.
- The activities regarding the technical acceptance of the Montenegrin part of 400 kV Podgorica –Tirana line are performed, and the value is 11 million€.
- The estimated value of total investments for the construction of small hydro power plants on 8 water flows, for which the concession contracts are signed in September 2008, is 87 million €. These projects do not have fiscal and macroeconomic impact in 2010.
- The estimated investment value for the construction of wind power plants on the location of Mozura and Krnovo is 135-155 million €, which depend on total installed capacity of the wind power plants. These projects do not have fiscal and macroeconomic effects in 2010.
- The estimated total value for Project of constructing hydro power plants on Moraca river is about 540 million€. Cumulative positive fiscal impact of these project, on the budget of Montenegro for the period 2011 – 2016, is 174.3 mil EUR measured in nominal prices, or 166.4 mil EUR measured in constant prices from 2010.
- Estimated value of the Komarnica hydro power plant project is 177 million €.
- The activities within the Project for the construction of submarine high-voltage cable between the power systems of Italy and Montenegro are ongoing. Estimated value of the project is about 758 million €. It is planed that Montenegrin Transmission System Operator constructs all necessary internal infrastructure in Montenegro (sub station in the area of Tivat with the connection on the exciting 400Kv network and 400kV line Pljevlja-Tivat), the value of the investment is 100 million €.

4.1.4.2. Transport

Transport development is defined by the Transport Development Strategy in Montenegro, adopted on July 3rd, 2008. The main goals of the strategic development of the Montenegrin transport system are: improvement of the safety and security aiming at protection of the human lives, material goods as well as preservation of the state property; EU integration and improvement of the competitiveness of the national transport sector; enhancement of the quality of the transport services; stimulation of the economic growth through more efficient and reasonably priced transport; minimization of the negative impact of the transport and infrastructure development on environment and society in general.

Road infrastructure and road transport

Implementation and deviations from measures implementation and reasons for deviations

Road transport sector is normatively and legally regulated and aligned with the EU legislation.

In 2010, in the road infrastructure area, following activities have been preformed:

- Regular activity consisting of the repair of the main and regional roads as well as the Crossroads Reconstruction Program on the Montenegrin state roads, which was adopted by the Government on July 16th, 2009. With this Program, reconstruction of the 10 crossroads in the state road network was envisaged. Estimation of the costs for the preparation of the project documentation amounts approximately EUR 560.000 and for the works approximately EUR 4.420.000. The funds for the realization of the Crossroads Reconstruction Program were planned in the capital budget of the Transport Directorate for 2010 and completion of the works was envisaged throughout 2011. PROVJERI JE LI ZAVRSENO
- Bar-Boljare motorway construction project: after elimination of the first-ranked Croatian consortium ``Konstruktor – IGH – Tehnika`` from the motorway construction tender, negotiations with the second-ranked Greek-Israeli consortium ``Actor – HCH`` have been commenced and, therefore, contractor still has not been selected.

Current and future programs and economic policy measures

In the next period Ministry of Transport, Maritime Affairs and Telecommunications will continue with the approximation of the national legislation with the EU Acquis.

In the following period, in the road infrastructure area, following activities will be performed:

- Crnagoraput Joint Stock Company Podgorica was selected as the best bidder in the tender procedure for the regular maintenance in the next four years period 2010-2014. Regular maintenance of the state roads will be financed from the general funds of the current budget. In 2010, EUR 10 million was allocated for that purpose and in 2011 the same amount will be determined.
- Activities related to the Bar-Boljare motorway construction will be continued. Fiscal impact of this project will be estimated afterwards, subsequent to certainty of the development of the situation between concessionaire and financial institutions.
- Adriatic-Ionian motorway. Based on prepared General project estimated price of the complete project is approximately EUR 7 million up to Main project level out of which EUR 2 million was planned in the Budget for 2011. Plan for regular and investment maintenance, reconstruction and construction of the state roads for 2010 envisaged that preparation of a technical documentation for this motorway should began in the first quarter of 2010 while the completion was planned by the end of 2012. However, realization was not possible having in mind that preparation of the physical and technical documentation is under way.

Budget effects of the programs and measures

Abovementioned programs have following current and future effects on budget expenditures:

- Program of the Crossroads Reconstruction on the Montenegrin state roads: EUR 560.000 for project documentation preparation and app. EUR 4.420.000 for works; in total EUR 4.980.000 in 2010.
- Regular maintenance of the roads in the period 2010-2014: EUR 10 million u 2010 and EUR 10 million in 2011. Expenditures for the period 2012-2014 are estimated on EUR 10 million yearly, with the possibility of the increase at EUR 15 million per annum beginning from 2012.
- Adriatic-Ionian motorway: estimated costs of the complete project are app. EUR 7 million up to the level of the Main project. In the Budget for the 2011 planned funds amounting EUR 2 million.
- Activities related to the Bar-Boljare motorway construction. Fiscal impact of this project will be estimated afterwards, subsequent to the certainty of the development of the situation related to negotiation between Actor and EIB.

Air transport

Implementation and deviations from measures implementation and reasons for deviations

Air transport sector is normatively and legally complete. Montenegro ratified multilateral agreement between EC and its Member States.

Montenegro Airlines, owned by the Government which has 99.88% of the shares, is in the privatization phase and tender for sale of the 30% of the shares of this company was published, in accordance with the previously defined privatization model. This model envisages recapitalization in the amount of 30% of the estimated value of the company and includes offer to the selected investor to use call option after two years aimed at purchase of the additional shares in the amount of at least 21%, but only if investor fulfils the conditions defined by the Tender Commission.

Current and future programs and economic policy measures

In the following period, focus will be on the ratification of new international conventions as well as on strengthening bilateral activities with other states.

Montenegro Airlines privatization process will be continued in accordance with the previously defined model. Montenegro Airlines will continue to work on the increase of the fleet, opening of the new destinations (Brussels and Milan have been planned) as well as on the increase of the frequency on the existing destinations.

Civil Aviation Agency is continuing with the capacity building. Currently, Ministry of Transport, Maritime Affairs and Telecommunications and the Agency use EU TA from the IPA 07 project aimed to adoption of new legislation.

Budget effects of the programs and measures

It is expected that Montenegro Airlines privatization contributes to the Budget revenues in the amount of EUR 4,662,910 (see Chapter 4.1.1.).

Railway transport

Implementation and deviations from measures implementation and reasons for deviations

Legal framework in the railway transport sector is in the line with EU legislation. Planned bilateral agreements with Albania, Serbia and Bosnia and Herzegovina have been concluded. In March 2010, Railway Directorate officially commenced with its work. Directorate represents the administrative body which will, in the following period, take over the role of regulatory authority and authority for the safety in the railway transport. Ministry of Transport, Maritime Affairs and Telecommunications secured, through IPA 2007 project, technical assistance to the Directorate in order to facilitate establishment of the abovementioned bodies and to train their employees.

Process of the restructuring of the Montenegrin railway system have been continued during 2010 and it was being implemented in accordance with the principles and goals stemming from the Strategy for the Restructuring of the Montenegrin Railways adopted in 2007. Disintegrative model of the railway restructuring was prepared, which envisages complete separation between infrastructure management and transport of passengers and freight. In accordance with the Action Plan restructuring process is currently at the end of the second phase, which includes further segmentation of the newly established shareholders companies, in a following way: (i) from the company which is infrastructure manager – Railway Infrastructure of Montenegro - (Željeznička Infrastruktura Crne Gore AD Podgorica) –(72,35 % owned by state) Maintenance of the Railway Infrastructure will be dissociated, (ii) from the company which is passenger operator – Railway Transport of Montenegro - (Željeznički prevoz Crne Gore AD – Podgorica) - (85,45 % owned by state) Maintenance of the Rail Transport Equipment will be dissociated. Companies which will be established using abovementioned approach will be subsequently privatized by the sale of the package of the shares owned by state. Company which is freight operator – AD „MONTECARGO“ Podgorica (87,64% owned by state) – and for which was, at the end of October 2009, invited tender for sale of the state owned package of shares, privatization process is currently under way and negotiations with the future owner are being conducted. Redundancy payment was discharged from the EBRD credit line amounting EUR 3.5 million for the employees which were declared redundant during the restructuring process. Those funds were used for the redundancy payment for 324 employees in total.

In the area of the railway infrastructure following activities were performed in 2010:

- In accordance with the Law on Railway and the Protocol 4 on road transport of the SAA, Montenegro implements investments for reconstruction and modernization of the railway infrastructure through annual programming budget and related credit arrangements. Actual budget expenditures, allocated to the current and investment maintenance of the infrastructure as well as to the traffic regulation, amounting app. EUR 10 million per annum.
- Investments in the railway infrastructure which have been financed with the credits of the international financial institutions and guaranteed by the Government. Investments are being implemented in the framework of the second phase of the rehabilitation of the railway infrastructure i.e. Railways Montenegro II project which is going to be implemented in the period 2007-2012.

Investment projects which were finished or which are ongoing have been financed from credits and donations of the following financial institutions: (i) EBRD amounting EUR 18.35 million, (ii) EIB amounting EUR 14.8 million, (iii) Czech Export Bank amounting EUR 57 million, (iv) IPA 2009 amounting EUR 5 million.

Current and future programs and economic policy measures

Process of the restructuring of the railway system in Montenegro will be finalized with the implementation of the last restructuring phase i.e. with the privatization of the particular segments of the railway system. For the companies dealing with transport of passengers and maintenance of the rail transport equipment privatization has been planned through joint investments with strategic partner or through sale of the share`s package owned by state. Precondition for this process is financial stabilization of both companies and definition of the level of the fees in relation with the public transport obligations of the state. Infrastructure Management and Traffic Regulation Company is majority state-owned and state`s share will be increased by recapitalization. Regarding the company which will be responsible for the maintenance of the railway infrastructure the sale of the state-owned shares has been envisaged, while the attractive railway stations and land, currently managed by Railway Infrastructure, will be offered to the concession or lease.

Regarding the systemic and regulatory field in this sector in 2011 following activities will be performed:

- Railway transport normative framework will be completed by the adoption of the relevant laws and bylaws.
- Continuation of the strengthening of the administrative capacities of the Ministry of Transport, Maritime Affairs and Telecommunications and Railways Directorate and commencement of work of the newly established bodies in the Directorate (Authority for the Safety and Regulatory Authority) as well as in the Ministry (Authority for the Investigation of the Railway Disasters and Incidents).
- With the goal of the liberalization of the transport services market, in accordance with the provisions of future Treaty Establishing the Transport Community between EU and the South East European Parties, beginning of the process for mutual recognition of licenses and certificates has been envisaged, primarily with the Republic of Serbia, and afterwards with other Southeastern European countries.

Also, in the next period, railway transport investment projects implementation has been planned which will be financed from: (i) IPA 2010 – amounting EUR 5 million, (ii) EIB for the period 2011 – 2012 amounting EUR 14 million.

Budget effects of the programs and measures

It is expected that privatization of the Joint Stock Company „MONTECARGO“ Podgorica will contribute with EUR 8,958,304 to the budget revenues while privatization of the "Railway Transport of Montenegro" Joint Stock Company Podgorica (segment – Maintenance) will contribute with EUR 13,773,164 (see Chapter 4.1.1.).

Budget expenditures related to the investments in railway traffic will be as follows:

- Actual budget expenditures for the regular and investment maintenance of the infrastructure and regulation of the railway transport amounting app. EUR 10 million yearly.
- Investments in the railway infrastructure in the framework of the second phase of the rehabilitation i.e. Railways Montenegro II project, which was planned for the period 2007-2012. During this period more than EUR 100 million will be invested in the revitalization of the railway lines Bar – Beograd and Podgorica – Nikšić.

Maritime Affairs

Implementation and deviations from measures implementation and reasons for deviations

The Port of Bar carries out 95% of all port activities in Montenegro. State is majority owner of the Port with 54,0527 % of shares. The Restructuring Program for the Port of Bar Joint Stock Company was adopted in March 2008 and envisages establishment of five subsidiary companies with limited liability which will be owned by the Port of Bar, out of which two companies were formed in 2009 – Joint Stock Company „Container Terminal and General Cargo“ and Joint Stock Company „Port of Bar“. Port Authority was established by adoption and implementation of the

Law on Ports. Privatization of the subsidiary companies and sale of the majority package of shares for the Port of Bar Joint Stock Company has been envisaged.

Current and future programs and economic policy measures

Maritime transport activities will be mostly focused on restructuring and privatization of the Port of Bar and related subsidiary companies:

- Ministry of Transport, Maritime Affairs and Telecommunications has started activities on implementation of the second privatization process related to the privatization of the Joint Stock Company Container Terminal and General Cargo through credit arrangement with EBRD amounting EUR 8,5 million, which has an aim to create better preconditions for the privatization.
- Decision has been taken for the privatization of 100% of the shares of the company Maritime Affairs LTD Bar and for awarding the concession on 30 years. Both contracts, for the privatization as well as for the concession on 30 years between the Government of Montenegro and Maritime Affairs LTD, were signed on October 22nd, 2010.
- The contract for the concession between the Government of Montenegro and Adriatic Shipyard Joint Stock Company Bijela for a period of 30 years has been concluded. Annual fixed fee for the use of the concession terrain until December 31st, 2021 will be EUR 36.000 + VAT and after expiration of this period amount of this fee will be assessed again. After submission of the revised income statement which will exclude interest rates, taxes and amortization, variable fee will be determined in case that EBITDA calculation (income minus expenditures without amortization costs) on the amount up to 5.000.000 Euros - 5% on EBITDA, and on the amount above 5.000.000 Euros - 3% on EBITDA.

The preferential credit contract for the purchase of ships between Chinese Exim Bank and Montenegrin Shipping (Crnogorska Plovidba) was signed on January 26th, 2010 in Podgorica. Delivery of the first ship is expected in November 2011, while the second ship will be delivered in January 2012. State issued guarantee to the Chinese Exim Bank amounting of USD 47.396.000.

Budget effects of the programs and measures

It is expected that privatization of the Joint Stock Company „Container Terminal and General Cargo“ Bar will contribute to the budget revenues with the amount of EUR 20,420,160, privatization of the "Port of Bar" Joint Stock Company with the amount of EUR 21,755,489, and privatization of the Joint Stock Company "Adriatic Shipyard" Bijela with the amount of EUR 11,625,102 (see Chapter 4.1.1.).

4.1.4.3. Electronic communications

Implementation and deviations from measures implementation and reasons for deviations

Legal framework in the area of electronic communications has been completed and conditions have been created for the implementation of the procedure prescribed by the law intended for a designation of the Universal service operator. With adoption of the legislative package on Universal service, conditions have been created for the implementation of the Law on Electronic Communications with the aim to enable availability with affordable prices to the citizens of Montenegro as well as a possibility of access to the electronic communications services in the range of the Universal service, regardless on their geographic location in the territory of Montenegro.

EU Delegation in Montenegro finances preparation of the proposal of the acts on RTT and EMC equipment. Experts from Hungary have been chosen in a tender procedure and preparation of these acts is under way in cooperation with the Ministry of Transport, Maritime Affairs and Telecommunications.

Broadband development strategy will not be adopted in 2011, having in mind lack of expertise and financial means.

Broadcasting

Preparations for the realization of the project of transfer from the analog to the digital broadcasting are ongoing. In accordance with the IPA program, Montenegro should co-finance this project with EUR 1.050.000 while EU donation amounting EUR 1.600.000. In March 2010, the Government of Montenegro allocated from the budget reserves EUR 150.000 in order to start the contracting procedure and preparation for the tender and for the elaboration of the Main project for digital transmitters network which will include software for planning, while the remaining funds have been planned in the Budget for 2011. Apart from this obligations, Ministry of Transport, Maritime Affairs and Telecommunications have an obligation to plan means (amounting EUR 300.000) for the covering of the costs needed during the period in which both systems (analog and digital) will work in parallel, having in mind higher electricity spending of the Broadcasting Center LTD. In 2012 funds needed for the purchase of the set of boxes (receiver boxes for decoding from digital to analog signal) have to be planned amounting EUR 1.600.000. Tender Commission has been formed and realization of this project is under way.

Budget effects of the programs and measures

Abovementioned activities will have following impact on budget expenditures:

- Preparation of tender and the Main project for transmitters network which will include software for planning: EUR 150.000 in 2010, which were secured in March 2010.
- Expenditures connected with the transfer from analog to digital broadcasting: EUR 900.000 in 2011.
- Coverage of the increased expenditures of the Broadcasting Center LTD during the period of work of both systems (analog and digital): EUR 600.000 in 2012.

- Purchase of the set of boxes (receiver boxes for decoding from digital to analog signal): EUR 1.600.000 in 2012.

Postal service

In accordance with the Decision of the Council for the Privatization and the Postal Services Development Strategy for period 2008–2018 as well as in accordance with the Program for the Restructuring of the Post of Montenegro, selection of the consultant as well as financial and legal agents for the privatization of this undertaking is underway. Tender procedure for the privatization of the Post of Montenegro is expected to be finalized by the end of 2011 which is a precondition for the liberalization of the postal market. Estimation of the potential budget revenues from this privatization still do not exist.

Preparation of the new postal law is under way.

Budget effects of the programs and measures

Budget for 2011 of the Ministry of Transport, Maritime Affairs and Telecommunications includes amount of EUR 1.674.652,20 intended for the coverage of the Universal service deficit.

4.2. Financial Sector

In 2010, financial system was distinguished by still evident effects of the crisis, adoption of the new regulation and intensified cooperation between the regulators. In 2009 and 2010, the global financial crisis consequences have resulted in the downward in the activity of the financial market players, their operating potential and business performances.

The adoption of the new Constitution of Montenegro has triggered significant changes in the financial system area, through the recognition of the Central Bank as the institution responsible for financial stability insurance. Aforementioned constitutional provision required the adoption of the new Law on Central Bank, as well as the provisioning of implementation mechanisms, starting from the fact that the Central Bank is carrying out the supervision of macro - credit financial institutions, whereas the Insurance Supervision Agency and the Securities Commission are responsible for the supervision of the remaining two financial system segments, i.e., insurance and capital market. The new role of the Central Bank was regulated in details by the regulation adopted in July 2010, primarily by the Law Financial Stability Council, which in addition to the aforementioned reason was adopted with the objective of enhancing financial stability coordination, being in compliance with the global initiatives and the EU requirements governing this area.

The Financial Stability Council was established with the objective of monitoring, identifying, preventing and mitigating potential system risks to which the overall financial system of Montenegro is being exposed to, as well as for the purpose of providing and preserving financial system stability and avoiding the influence of factors that might lead to the escalation of a large - scale financial crisis. In the light of the above and in addition to the other activities, it is envisaged to determine the Financial Crisis Contingency Plan at the entire financial system level, as well as to apply the stress testing and financial crisis simulation exercises. Pursuant to the Law, the Central Bank is obligated to publish the Financial Stability Report. Members of the Financial Stability Council are the Governor of the Central Bank, being a Chair of the Council, Finance Minister and Presidents of the Insurance Supervision Agency and the Securities Commission.

The Project titled “Strengthening the Regulatory and Supervisory Capacity of the Financial Regulators”, funded within the IPA 2008, is currently being implemented, with the objective of providing institutional capacity building through the provision of the technical assistance and the professional training of employees, establishment of the most modern procedures, cooperation enhancement between the financial regulators and the provision of a higher stability degree of the entire financial system. The objective of completed and planned activities of the Project is to ensure the harmonization of Montenegrin legislation with the European law, as well to adapt the supervisory function to the best international practice governing this area.

4.2.1. Banking Sector

2009 was challenging for both the Central Bank and the entire banking sector. A strong emphasis was placed on preserving the banking system stability and security, banking system solvency and liquidity improvements, business standards and risk management improvements, bank capitalization, as well as banking claims relaxation and the provision of the support in a rebound in almost halted credit activity.

During 2009, the Central Bank has adopted a number of regulatory and prudential countercyclical measures aimed at mitigating the position of banks and borrowers, and the provisioning of banking system security and stability. Most of these measures were ranked as the most liberal ones in the region: lowest required reserve effective rate, low allocations for provisions, quite relaxing requirements for new credits classification against the standards in the region, reprogrammed credits classification relief, etc. Although it is impossible to quantify all elements of undertaken measures, it is certain that these measures provided the “infusion” of a minimum EUR 185, 5 million of liquid funds into the banking sector, which is above 6% of GDP forecasted for 2009.

Table No. 31 – CBMNE Quantification of Measures Aimed at Banking Sector Relaxation.

Measures	Amount in million €
Decline in required reserve	76,4
Cancellation of allocations for general reserves	16
Amendment to the decision on classification of assets	10,2
Restructuring of credits under more favorable conditions	44,5
Allocation of a part of the required reserve to the treasury bills	38,4
Total:	185,5

The recession has continued in 2010. Increasing problems in the real sector (unemployment growth, growth in mutual receivables and the general economy insolvency, decline in the value of balance sheet position - assets and the growth in company's losses) have aggravated the Central Bank's efforts aimed at mitigating the crisis. On the other hand, household sector was also facing property losses additionally contributing to its indebtedness growth. It became evident that the banking system, apart from positive liquidity and solvency trends, will fail in timely reaching the parameters recorded at the time of the crisis. It is indisputable that the crisis of trust in the banking system has been behind us for a long time now, and that the system is liquid. However, the two - year worsening of the credit portfolio quality, which is disturbing and which is measured by a growth of bad credit indicators, and credits the repayment of which is late within the total amount of credits, and worse profitability of the banking sector as a result thereof, back the aforementioned statement.

Comparative data as of 30th September 2010 and 30th September 2008 are implying that the credit – deposit banking potential has been reduced by 20, 6%, or 23, 3%, respectively, and that due to accelerated deterioration in the assets quality, the banking sector has transitioned from a positive into a negative business zone. The aforementioned is being supported by the growth in the non performing loans share in the total credits from 4, 5% to 17, 5%, and credits the repayment of which is late over 30 days from 7, 7% to 23, 5%, which consequently generated growth in the provisions for potential credit losses by 120,5%. Continuing downward credit potential trend from 4th quarter of 2008 up to date, is reflecting the perception of banks that the creditworthiness of the potential borrowers has been significantly reduced under the influence of the crisis, and on the other hand it is reaffirming the opinion that the banks are aware of the harmful effects of the overemphasized liberal credit policy being implemented in the period of the credit boom in 2006 and 2007, due to which they are still paying a high price facing with the growth of the toxic assets and problems thereof.

Conservative approach applied in approving credits during 2009 and 2010, has led to the strengthening of the banking sector liquidity. Banking liquid assets have grown by 16,12%. Banking sector solvency has been preserved, especially in banks that are important for the system. The total bank capital has grown by 4,9%, due to implemented recapitalization of certain banks in the course of 2009 and 2010 that was initiated either by the bank's shareholders or at the request of the Central Bank's supervision.

At the end of the third quarter of 2010, the bank balance sheet sum, credits - deposits are generating moderate decline rates annually. Furthermore, the concentration decline trend has been continued as a consequence of the banking credit activity decline from the forth quarter of 2008.

The total bank balance sheet sum as of 30th September 2010, amounted at EUR 2,907.6 million, generating the decline at the rate of 9,81% against the comparative one - year period, while it is generating the decline at the rate of 3,89% in the current year. Seven banks in the system have generated the bank balance sum growth in one year - period. Banks have approved credits in the total amount of EUR 2,263 million, generating the decline at the rate of 5,61 %, against the end of 2009. The total banking deposit potential amounted at EUR 1,782.8 million. In a one year - period, deposits declined at the rate of 6,18%, whereas compared to the end of 2009 they are generating growth by 2,29%.

Regulatory Activities

Implementation and deviations from measures implementation and reasons for deviations

Regulatory activities during 2010 were predominantly focused on further legislative framework improvement aimed at harmonizing key regulations governing the financial services and economic and monetary policy area with the EU Acquis, as well as with the provisions of the Constitution of Montenegro, strengthening the supervisory role and competences, and the further cooperation with the international financial institutions.

The activities of the Central Bank were focused on the legislative solutions development, which following the implementation of the procedures and harmonization, were adopted by the Parliament of Montenegro in the second half of July 2010. The aforementioned solutions related to the new Law on the Central Bank of Montenegro, Law on Financial Stability Council, Deposit Protection Law, Law on Amendments to the Law on Banks and the Law on Amendments to the Law on Bank Bankruptcy and Liquidation.

The most important changes introduced by the new financial system regulation, inter alia, encompassed the establishment of the function of the Central Bank as the "lender of last resort”20, alignment with the European Directives in the area of acquiring qualified participation in banks, corporative governance, and temporary administration proceedings, transfer of assets and liabilities to other bank, revoking the business license, etc. Furthermore, the adoption of the new Deposit Protection Law increased the deposits protection amount to EUR 20.000, allowing for the transitional period up to 1st January, during which the protected deposits amount will be fully compliant with the European Directive amounting to EUR 50.000. It is worth mentioning that Montenegro, without any negative consequences reflected in the withdrawing of deposits from banks and increase in mistrust, has succeeded in switching to so - called Blank Guarantee, i.e., guaranteeing deposits to the full amount.

Legislation prepared in this period was subjected to the attention and the appraisal of relevant international financial institutions, primarily the International Monetary Fund and the World Bank. Aforementioned institutions issued positive opinion, thus it may be concluded that the regulatory framework governing the banking operations in Montenegro is, to the greatest extent, in line with the EU regulations and internationally recognized banking operations standards.

<u>Current and future programs and economic policy measures</u>

In the next period, the Central Bank will focus its activities on further strengthening and improving its capacities and supervisory function, aimed at implementing the new regulatory framework, as well as the provision of the full legislative and subordinate legislation compliance with the relevant EU regulations. The regulatory framework compliance dynamic must be in line with the National Programme for Integration (NPI) envisaging the end of 2015 as the final deadline for the completion of the regulatory compliance with the EU law in all areas, including the financial sector as well.

On the basis of a set of adopted legislations and pursuant to the established obligations, the Central Bank will continue with the subordinate legislation improvements deriving from the amendments to the aforementioned laws. Moreover, the further regulatory framework improvement will be directed to providing full compliance with the EU regulations and internationally accepted baking operations standards. A part of these activities will be implemented within the EU funded Twinning Project “Strengthening the Regulatory and Supervisory Capacity of the Financial Regulators”, as well as within the European Central Bank funded Project “Strengthening Macro and Micro - Prudential Supervision in EU Candidates and Potential Candidates“.

Table 32: Action plan of initiatives on strengthening supervision function and strengthening capacities of the CBMNE in the period 2010 – 2014.

	Planned activities	2011	2012	2013	2014

[20]This is considered a continuation of measures being envisaged by the Law on Banking Sector Safeguards.

Strengthening CBMNE Capacities					
1.	Ensuring, by mutual agreement, the position of a financial sector supervisor for the purpose of supervision on consolidated basis	X	X	X	X
2.	Strengthening connections with the ECB	X	X	X	X
3.	Revision of the reserve requirement policy	X	X	X	X
4.	Financial analysis of the real sector and the centralization of database within the CBM	X	X	X	X
5.	Capacity building in macroeconomic modeling and statistical analysis	X	X	X	X
Banking regulation and supervision on the principles of Basel II and EU Directives aimed at maintaining the financial stability					
1.	Full harmonization of the Law on Banks with the relevant EU Directives		X	X	X
2.	Full harmonization of the Law on Bank Bankruptcy and Liquidation with the relevant EU Directives		X	X	X
3.	Participation in the development of the Law on Financial Conglomerates, together with other financial sector regulators	X	X		
4.	Participation in the development of the Law on Financial Collateral Arrangement, together with other financial sector regulators	X	X		
5.	Full harmonization of the CBMNE subordinate legislation with the relevant Directives	X	X	X	X
6.	Development of supervisory modeling and centralization of database for managing various risks	X	X	X	X
7.	Licensing rating agencies	X	X	X	X
8.	Establishment of the banking ombudsman institute	X			
9.	Implementing the policy of cautious banks licensing, issuing of consents for acquiring and increasing the qualified participation in banks, as well as other	X	X	X	X

	consents prescribed by the Law				
10.	Development of cooperation with other regulatory and supervision institutions based on the efficient home – host supervision	X	X	X	X
11.	Coordination and institutional connecting in the EU accession process	X	X	X	X
12.	Develop stress testing for all financial system segments	X	X	X	X

Budget effects of the programs and measures

Budgetary effects of planned programmes and measures are not possible to assess.

4.2.2. Non – banking Sector

4.2.2.1. Capital Market

Implementation and deviations from measures implementation and reasons for deviations

Activities and measures envisaged by the previous EFP were achieved and implemented to the greatest extent. Key activities and measures implemented in 2010 were as following:

- Government of Montenegro has adopted Proposal to the Law on Takeover of Joint Stock Companies has been developed. The main changes refer to the harmonization with the amended EU Directives, especially with respect to the obligation to have a public offering and exemptions thereof, as well as the cases of indirect acquisition.
- International team of experts was engaged with the objective of developing the amendments to the concept of investment funds functioning, thus the Draft Amendments to the Law will be prepared for Government to adopt by the end of third quarter of 2011. The changes to the concept will encompass the defining the open - ended funds, umbrella funds, as well as the different structuring of connection between the principal and the agent, or the owner of fund and funds manager.
- The practice of regular publication of data and reports on operation of companies has been initiated, since the untimely publication is subjected to administrative sanctions.

- With regard to the development of corporative governance practice, the Securities Commission, together with the International Financial Corporation, has produced the Corporate Governance Manual, and SE Montenegroberza has developed the SCORECARD instrument for measuring the performance of the implementation of the corporative governance practice.
- As far as the need for expanding market connection and information is concerned, SE Montenegroberza and NEX have opted to merge and this procedure is under implementation. Furthermore, the Central Depositary Agency (CDA) undertook a significant investment aimed at upgrading the software solution with the objective of providing the best security aspects and protection of investors' property, as well as the increase in the business security level.
- As far as the regional plan is concerned, regional regulators, depositary agencies and regional stock exchanges held three meetings, with the objective of defining the Strategy for connecting the national capital market to the regional one. Signing of the "Intention Letter" by all regulatory bodies, stock exchanges and depositary agencies is scheduled at the end of 2010. This document will be presented to all political decision makers in the region for obtaining support.
- The Securities Commission carried out stronger supervision and control of the capital market during 2010, especially due to the occurrence and attempts to have investment funds transformed contrary to the regulations.

Capital Market operation in 2010. The international financial crisis has affected expectations of both investors and the public, or it reduced the expectations level and increased the fear of uncertainty. In 2009 and 2010, the capital market was operating in an unfavorable environment for a secondary investments market, while the capital formation and new capital investments are still at the high level.

At the end of September 2010, market capitalization has reached the value of above EUR 2.8 billion, representing the decline of 2,4% against the capitalization value as of 1st January 2010. The total trade generated on Montenegrin stock exchanges in the reporting period was above EUR 42 million, whereas this amount was EUR 342 million in the same period last year. It is worth emphasizing that in the period of first nine months of 2009, due to the privatization of EPCG a.d. Niksic, the trade in the issuer's shares amounted at EUR 224 million. In the structure of traded instruments in the first nine months of this year, based on traded shares of the company total generated trade was 60,05%, total generated trade in the shares of joint investment funds was 11,32%, and the share of bonds trade was 28.63 % in the total traded amount.

It is important to emphasize that a new capital being collected on the basis of issuing of shares in the first nine months of the current year, was permanently invested in Montenegrin companies, and it amounted at above EUR 177 million.

Institutional capacity strengthening. Capital market institutional capacity building in Montenegro has been continued on highly developed grounds, which has been recognized by both the IOSCO and the IMF. With the objective of further capacity building, the Securities Commission has focused on implementing several following projects:

- As far as the international projects are concerned, Securities Commission institutional capacity strengthening is primarily being achieved within the Twinning Project titled "Strengthening the Regulatory and Supervisory Capacity of the Financial Regulators – Netherlands and Bulgaria". The implementation of this Twinning Project commenced in December 2009.
- Furthermore, as a regular IOSCO member, the Securities Commission is achieving intensive cooperation with the IOSCO, thus the members of the Securities Commission are regularly attending the trainings organized by the IOSCO, being focused on the development of the practical skills and resolving the most important and current challenges faced by the capital market regulators worldwide.
- With the objective of increasing the transparency in operation and functioning of all capital market players, the Securities Commission has adopted and implemented the Rules on Contents, Deadlines and Manner of Publishing Financial Reports of Issuers of Securities ("Official Gazette of Montenegro", No. 20/09, 18/10). On the basis of such Rules, the Securities Commission has started with the intense implementation causing a large number of sanctions to be imposed on issuers that did not comply with the reporting obligation within the deadlines prescribed by these Rules. These activities have resulted in increase in discipline of the market players and the development of the public information booklet containing over 8,000 pages on financial reports and it is subjected to regular update contributing to the greater information provisioning on the market players.
- Based on the cooperation with the World Bank, the Securities Commission has provided the Data Management System, contributing its infrastructural and capacity building.

Current and future programs and economic policy measures

Future activities are focused on regulatory framework improvements, especially concerning the following:

- Adoption of the Law on Investment Funds and subordinate legislation;
- Transformation of investment funds is a process that requires time since investment funds' portfolios consist of large blocks of shares that are not easily marketable, plus a fast change of the structure of the funds' assets cannot be expected.
- Implementation of the new trading system on a unified stock exchange;
- Improving the CDA security and integrity;

- Development of the amendments to the Securities Law, in terms of the EU regulatory compliance;
- Continuation of in-depth supervision and control of authorized participants and issuers;
- Social responsibility of the Securities Commission in education and training of investors, representatives of institutions and general public;
- Continued cooperation with the national and foreign institutions and participation in the development projects (IOSCO - MMOU, Toronto Centre, IPA, EAR, IMF, World Bank);
- Internal organization, business transparency and development of the IT system of the Securities Commission.

Budget effects of the programs and measures

Budgetary effects of planned programs and measures do not require the allocation of additional funds other than those planned by the annual financial plan of the Securities Commission.

4.2.2.2. Insurance

Implementation and deviations from measures implementation and reasons for deviations

Achieved gross insurance premium at the end of the 3rd quarter 2010, is by 1, 34% lower than in the same period of 2009. This is in line with the forecasts given in the previous EFP, in relation to the indirect and late financial crisis impacts on the insurance market. Regardless of the absence in participation of domestic insurers in innovative financial arrangements, which globally have triggered losses of insurance companies, the recession in the economy, i.e., reduced demand and increased insolvency of the citizens and businesses entities represents the key factors generating the gross premiums downturn. Still present low activity in Montenegrin capital market and the reduced investment yield in the real estate market will surge the pressure on the capital of insurance companies and their profitability. In the first nine months of 2010, 88.04% of the total market portfolio relates to the non-life insurance, with the still dominant share of car liability insurance, while the life insurance remained at about the same level as the last year one, with a share of 11.96%.

Planned activities in reference to the development of the Rulebook on the Chart of Accounts for Insurance Companies and the Rulebook on the Manner of Valuation of Assets of Insurance Companies have been rescheduled from the first to the last quarter of 2010. Following the intensive communication and the alignment of opinions with the insurance companies during 2010, the Agency has adopted the Rulebook on the Chart of Accounts and it was published in the Official Gazette of MNE in November 2010. Publication of the Rulebook on the Manner of Valuation of Assets of Insurance Companies is scheduled at the end of 2010.

Current and future programs and economic policy measures

During 2011, it is envisaged the continuation of already initiated activities related to the development of the Draft Amendments to the Insurance Law, aimed at its further harmonization with the EU Directives related to the Solvency I, especially considering the following segments:

- Specification of legislative provisions relating to the acquisition of qualified participation in insurance companies;
- Specification of requirements to be fulfilled by legal entities and physical persons in conducting insurance and brokerage activities, conditions for initiating insurance and brokerage activities, relationships with insurance companies and relationships with users of insurance;
- Redefinition of the conditions for performing auditing and actuarial insurance operations, as well as defining clear measures that will be applied in the process of control of their operations;
- Amendments to the provisions on the solvency margin, capital adequacy, technical reserves, deposit and investment of technical reserves, prescribing conditions for the operation of foreign companies.

In 2011, envisaged amendments to regulations are as follows:

- Development of the Proposal for the amendments to the Law on Mandatory Insurance in Traffic, in the part relating to the harmonization with the Directive 2009/103, which applies to the insurance against civil liability from the use of motor vehicles, which encompassed the adjustment of the minimum insurance sum and the method of carrying out the operation of the Guarantee Fund;
- Development of the Proposal of the Law on Insurance Companies Bankruptcy and Liquidation , in a part relating to the harmonization with the Directive 2001/17, encompassing the harmonization of the insurance companies bankruptcy and liquidation proceedings and the introduction of obligatory reporting of the EU member states on initiated bankruptcy and liquidation procedures with the insurance companies.

Short term priority of the Insurance Supervision Agency in the area of subordinate legislation, is to adopt the Rulebook on Requirements for Acquiring the Title of Authorized Actuary, as well as the content and the manner of passing the professional exam for acquiring the title. By recognizing the market needs for actuary, as well as the requirements for employees of a specific profile, , in this manner the Agency will create legal prerequisites required for the further development of this profession.

In the forthcoming period, following the harmonization of so far inconsistent views of the National Insurance Bureau of Montenegro and the Insurance Supervision Agency, the minimum tariffs for car insurance will be increased. This increase will generate significant effects in improving the business performance indicators of the national insurance companies, primarily in the part of improving the general liquidity and adequate investment of funds in technical reserves taking into consideration the dominant share of the car insurance in the total insurance portfolio, as well as the negative trends that have been present for a long period of time in this type of insurance. Taking into account the protection of the interests of insurance companies and insurers, the Agency has accounted for that the short - term negative financial impacts of increasing the minimum tariff on the financial standard of citizens will be justified in the long run by improved sustainability and stability of this type of insurance. Furthermore, the future activities of the Agency will be directed to the analysis of the effects of future liberalization of insurance tariffs for car insurance.

With the objective of the efficient execution of activities and tasks from the area of its competency, especially in the part of supervision of insurance companies operations, the Agency with the project activities during 2010, has put a special emphasis on the development of actuary component, especially in the part of evaluating the adequacy of the level of technical reserves applying the Chain Ladder method, determination of the adequacy of self-retention of insurers, as well as the quality of reinsurance ratios. These project activities will be continued in the forthcoming period.

As far as the international cooperation is concerned, the Agency will place special attention on the development of group supervision practice. This will additionally enhance the cooperation of the regional insurance supervisors, especially those that are in charge for insurance companies founded by business entities in Montenegro.

<u>Budget effects of the programs and measures</u>

Budgetary effects of planned programmes and measures are not possible to assess.

4.3. Labour market and social insurance

4.3.1. Labour market

<u>Implementation and deviations from measures implementation and reasons for deviations</u>

Activities anticipated in the EFP 2009-2011 in the area of labour market, primarily related to the improvement in the legal framework and the response to the crisis, are implemented. At the end of 2009 and the beginning of 2010 following laws are passed: the Law on Employment and Securing Rights from Unemployment, the Law on the Union Representation, the Law on the

Labour Fund. As a response to the crisis a set of socio-economic and fiscal measures have been implemented, which have contributed to fact that the situation on the labour market has not deteriorated significantly. Within the active labour market measures emphasis was on the preparation for employment (training and prequalification), support to creation of the new jobs and incentives for employment of hard-to-employ individuals (long-term unemployed, persons with disabilities). The Law on Employment and Securing Rights from Unemployment has increased the unemployment benefit for those who become eligible after the law was passed to 40% of minimal wage as determined in the General Collective Agreement (currently 55€), while maximum duration is reduced to two years.

Within the process of strengthening labour market institutions, in the beginning of 2010 two new institutions have been established – the Agency for Peaceful Resolution of Labour Disputes and the Labour Fund. The main objective of the Agency for Peaceful Resolution of Labour Disputes is simplification of the process for resolution of disputes, as compared to the process in the courts, as well as the reduction of costs. The Labour Fund is established as institution which protects rights of the redundant workers, and provides payments of wage and other arrears to workers which became redundant due to technological, economic or reasons related to the restructuring of companies. The Fund is financed from the special contribution amounting to 0.2% of gross wage which is compulsory for all employed individuals. Since establishment until the beginning of November 2010 the Labour Fund received 16,707 claims for payment wage and other arrears, while 1,224 claims were processed among which 967 were approved.

Assessment of the current situation

According to the data from MONSTAT and Employment Agency of Montenegro, as anticipated in the last year's EFP, impact of crisis on the labour market was more present on 2010 than in 2009. Employment Agency data indicate that the unemployment rate has increased during 2010 and amounted to 11.74% in September 2010 , which is by 1.4 pp higher as compared to the same period in 2009, while the number of unemployed reached 30,967 which is by 13.6% higher as compared to the same period in 2009. Labour Force Survey data indicate further decrease in economic activity of population aged between 15 and 64; from 59.2% in the first quarter of 2010 to 57.6% in the second quarter (2009 activity rate was 60.2%). Employment rate has decreased from 47.4% to 46.1% in the second as compared to the first quarter 2010 (48.8% in 2009). Data on the number of registered employed are available only for the first quarter of 2010 due to introduction the system of joint registration, which caused lack of more complete data on the labour market dynamics.

Despite the lack of the timely and complete data on the labour market in Montenegro, the presence of structural misbalances is obvious, primarily as a consequence of the process companies restructuring. Misbalance in the labour supply and the labour demand is still present in the same degree, since the number of work permits issued to the foreigners (roughly 11,000 until October 2010), although lower as compared to the last year, is still significant. Reduction in the number of issued work permits is rather consequence of decrease in the economic activity in Montenegro, than the better matching of the labour supply and demand in Montenegro.

Likewise, lack of restructuring of companies, where the most characteristic example present aluminium and steel companies, makes that situation in these two companies present constant threat to situation on the Montenegrin labour market, despite the fact that statistically their share in employment is low (2-3% of overall registered employment). Also, observed in the context of insufficient restructuring, although the Labour Fund is established, its activities are mainly focused on solving issues and payment of arrears to employees from companies that were closed through insolvency procedure during last 20 years. On this way, Labour Fund as institution which would eventually support restructuring of the companies, is in great measure burdened by the problems and claims for severance payments and wage arrears for companies which do not exist for a while.

Current and future programs and economic policy measures

Planned activities in the area of labour market anticipate further improvements in the legal framework, which would increase opportunities for employment and increase degree of flexibility on the labour market. Despite relatively flexible labour regulations, labour market and especially its formal part is rather inflexible and does not allow for rapid adjustments of companies to the changes in the economic activity and especially to the decreases in activity. In that sense changes to the General Collective Agreement are adopted and during 2011 amendments to the Labour Law as well as to the Law on Employment and Work of Foreigners will be passed. New General Collective Agreement, and after that branch collective agreements, should contribute to changes in the concept and improvement in the process of wage formation as well as other compensations to employees. Anticipated changes in the Labour Law are related to the regulating and enabling the work of temporary work agencies. Work of these agencies will contribute to better matching of the labour supply and labour demand, on the manner which will enable employers' facilitated adjustments in employment to changes in the economic activity, while job seekers will be able to find job faster through intermediation of agencies.

Also, besides improvements in the legislative framework, policy measures on the labour market in the next year will be focused on further alleviation of structural misbalances, through improvement in the adjustment of the education system to the labour market needs, as well as active labour market measures. Activities of the IPA project Labour Market Reform and Workforce Development, which implementation started in first half of 2010 are in great measure aimed at better connection of the education system and the labour market. Active labour market measures implemented by the Employment Agency will focus, in line with the

National Action Plan for Employment, on the problem of misbalance in the labour supply and demand, regional differences as well as on the long-term unemployment.

Expected effects of listed measures are in first line alleviation of structural misbalances, improvement in the labour market flexibility and decrease in unemployment. According to available data on the level of economic activity and labour market dynamics, further deterioration of situation is expected in the second half of 2010 and first half of 2011, while from the second quarter of 2011 labour market will show the signs of recovery, i.e. the increase in activity and employment with decrease of unemployment are expected.

Budget effects of the programs and measures

Table 34: **Fiscal impact of the labour market economic policy measures**[21]

	2010	2011	2012	2013
Measure/program – Active labour market policies				
Net fiscal impact (in € million)	7.77	4.79	5.40	5.12
Direct impact on budget revenues(in € million€)	3.82	3.21	3.30	3.38
Direct impact on budget expenditures(in € million€)	11.59	8.00	8.70	9.5
	2010	2011	2012	2013
Measure/program – Provision of social security to unemployed individuals				
Net fiscal impact (in € million€)	13.86	12.22	12.22	12.22
Direct impact on budget revenues(in € million€)	1.34	1.28	1.28	1.28
Direct impact on budget expenditures(in € million€)	15.2	14.5	14.5	14.5
	2010	2011	2012	2013
Measure/program – Legislation – Labour Law				

[21] Assessment of the fiscal impact is preliminary. Impact of measures except for the Agency for Peaceful Resolution of the Labour Disputes, does not include operational expenditures for daily operations of a body.

Net fiscal impact(in € million€)		0.16	0.82	0.25
Direct impact on budget revenues(in € million€)	-	0.16	0.82	0.25
Direct impact on budget expenditures(in € million€)	-	0.00	0.00	0.00
	2010	2011	2012	2013
Measure/program – Labour Fund				
Net fiscal impact(in € million€)				
Direct impact on budget revenues(in € million€)	1.443	2.0	2.0	2.0
Direct impact on budget expenditures(in € million€)	3.150	2.350	2.350	2.350
	2010	2011	2012	2013
Measure/program – Agency for Peaceful Resolution of Labour Disputes[22]				
Net fiscal impact(in € million€)		0.29	0.29	0.29
Direct impact on budget revenues(in € million€)	-			
Direct impact on budget expenditures(in € million€)	-	0.29	0.29	0.29

Table 35: Assessment of the requirements for the new staff

	2010	2011	2012	2013
Measure/program – Active labour market policies				
Required new staff	-	-	-	-
Measure/program – Provision of social security to unemployed individuals				
Required new staff	-	-	-	-
Measure/program – Legislation – Labour	-	-	-	-

[22] Expenditures relate to the operational expenditures of Agency for Peaceful Resolution of Labour Disputes.

Law				
Required new staff	-	-	-	-
Measure/program – Labour Fund[23]				
Required new staff	8	-	-	-
Measure/program – Agency for Peaceful Resolution of Labour Disputes[24]				
Required new staff	-1	5-	-	-

4.3.2. Education and research

Implementation and deviations from measures implementation and reasons for deviations

After defining vision and direction for reform of the education system in Montenegro on all levels and comprehensive preparation and phased implementation of reform measures in individual education institutions, in the school 2010/11 all primary and secondary schools in Montenegro in the starting grades have enrolled students/pupils which are educated in accordance to the new education programs, while tertiary education institutions offer students education process adjusted to the principles of Bologna process.

Along with the implementation of reform solutions, during 2010 Parliament of Montenegro has adopted set of 6 laws in the area of education, which provisions enable further structural reform measures: introduction of the public-private partnership, possibility for financing private tertiary institutions from the budget, etc.

Ministry of Education and Sports during 2010 has prepared and Government adopted following documents: Plan for Implementation of the Strategy for Development of Vocational Education in Montenegro (2010-2011), the Plan for Education of Adults (2010-2014), the Strategy of Early

[23] Labour Fund has in total 15 employees, out of which 6 are hired from another state body while 8 is engaged through the public vacancy announcement.

[24] Total number of staff in Agency is 5, out of which 4 persons are hired from another state body and 1 employed through public vacancy announcement. In 2011 Agency is planning/has need for five more employees.

and Preschool Upbringing and Education and the Strategy for Introduction of the ECDL Standard. On this way further activities in certain segments of the system have been determined.

Current and future programs and economic policy measures

Set of the reformed law has established the foundation for passing the long-term plans, so next step will be work on the Strategy of Tertiary Education and it's financing. In the area of improving quality of teaching and evaluation of pupils' knowledge legal frameworks is set, so its implementation follows as well as continuation of improvement of legislative in the education system in Montenegro. During 2011 modalities for application of public-private partnership in the establishment and management of educational institutions, conducting study programs and outsourcing will be defined.

Parliament of Montenegro has adopted the Law on the Scientific-Research Activities, which is aimed at improving this area, especially having in mind commitment to include research and scientific institutions in European research area and international scientific programs. In that sense, increasing participation of Montenegrin research institutions in European programs in the area of science, research and technological development, is one of the measures whose implementation is planned in the following period, which is in line with the changes in the Government of Montenegro and establishment of Ministry for Science.

With the goal of further development of overall education system in the next period following is planed:

- Prepare and adopt Strategy for Development and Financing of Tertiary Education and corresponding Decree on Normative and Standards for Financing of Tertiary Education;
- Collect data and Prepare Action Plan for Optimisation of the Existing Primary Schools Network, by which the savings within system will be secured as well as unification in the quality of education in schools;
- In June 2011 external graduation and expert exam will be conducted, which will ensure objectivity in measuring achievements of students and will have impact on admission policy of tertiary education institutions;
- Ensure involvement of local self-governments in financing of education and start with the financing of institutions per student, in order to generate savings and enhance responsibility of school management in planning and spending of available funds;
- Strengthening links between the labour market and education through: defining adequate admission policy, improving quality of practical teaching in vocational schools, application of modulation of educational programs and establishment of the system for functioning of higher vocational schools,
- Fully apply quality assurance model in education on all levels, which will be combination of external graduation and internal assessment in accordance with the clear previously determined standards;

- Increase existing level of mobility of Montenegrin students, especially taking into account unconstrained recognition of the periods of studies abroad.

<u>Budget effects of the programs and measures</u>

Table 36a: **Fiscal effects of programs and measures in the area of education (in €)**

	2010	**2011**	**2012**	**2013**
Measure/program	Preparation and adoption of the Strategy for Development and Financing of Tertiary Education and Bylaw on Normative and Standards for Financing of Tertiary Education			
Net fiscal impact	20.000			
Direct impact on budget revenues	Document submitted for consideration and adoption will be amended by the table for assessment of fiscal impact and rationale which would partly cause savings in the budget.			
Direct impact on budget expenditures	20.000			
Measure/program	**Conducting external Graduation and Expert Exam**			
Net fiscal impact	20.000	450.000	450.000	450.000
Direct impact on budget revenues	Conducting Graduation and Expert Exam will not have direct impact on revenues, but will have impact of overall quality of education and thus to further economic growth by providing incentives to development of labour force in accordance with the labour market needs.			
Direct impact on budget expenditures	20.000	450.000	450.000	450.000 000
Measure/program	**Involving local self-governments in financing education and starting with application of the financing institutions by pupil**			
Net fiscal impact		10.000		
Direct impact on budget revenues	Involving local self-governments in the financing of education will ensure savings in the budget, but it is not possible to project these savings, since the consensus on the model which will be applied is still not reached with the local self-governments.			
Direct impact on budget expenditures		10.000		
Measure/program	**Strenghtening links between labour market and education**			
Net fiscal impact		14.000		
Direct impact on budget revenues	Positive impact on revenues is expected, since the labour force which will have skills, knowledge and competences necessary for efficient work, will contribute to development of overall economy of Montenegro.			
Direct impact on budget expenditures		14.000		

Measure/program	Application of model for quality assurance on all levels of education			
Net fiscal impact	223.439	262.000	250.000	250.000
Direct impact on budget revenues	Application of quality assurance model will not have direct impact on revenues but will increase quality of the education system.			
Direct impact on budget expenditures	223.439	262.000	250.000	250.000
Measure/program	**Increase of mobility of Montenegrin students**			
Net fiscal impact	70.000	120.000	120.000	120.000
Direct impact on budget revenues	Increase in the mobility of students will ensure budget revenues, which could be quantified after implementation of the program for mobility that are financed for Montenegrin students through bilateral support and European programs, and for which in the case of non-participation should be provided from own sources.			
Direct impact on budget expenditures	70.000	120.000	120.000	120.000

Table 36b: **Fiscal effects of programs and measures in the area of science (in €)**

Measure/program	Increase participation of Montenegrin researchers and research and scientific institutions in European programs in the area of science, research and technological development			
Net fiscal impact	287.964	388.000	496.000	620.000
Direct impact on budget revenues	Increase in participation of Montenegrin researchers and research and scientific institutions in European programs will ensure budget revenues which could be quantified after realisation of projects which are financed from the European program funds in terms of funds allocated for participation of Montenegro, which should be provided from own funds in the case on non-participation.			
Direct impact on budget expenditures	287.964	388.000	496.000	620.000

4.3.3. Reform of the pension system

Implementation and deviations from measures implementation and reasons for deviations

Montenegro has initiated pension reform with the parametric reform of the system of current financing (I pillar) in 2003, when the legal foundations for development of the three pillars pension system have been set. New solutions had positive impact on decrease of Pension Fund expenditures and increase in the revenues from contributions. The Law on Voluntary Pension Funds in 2007 has created institutional base for the new form of pension savings and entrance of the institutional investors on Montenegrin market, as well as possibility for custody services of banks.

Having in mind unfavourable indicators as compared to the countries in the region and the EU, such as demographic trend of population aging, low activity on the labour market and low employment rate, as well as high replacement rate as a result of pension adjustment to the increase in average wage and inflation, financial sustainability of the pension system in Montenegro is endangered. Situation has been additionally worsened by the negative impact of global economic and financial crisis. Current number of beneficiaries of rights from the pension and disability insurance is roughly 110 thousands individuals, while pension expenditures have increased from € 199 million in 2006 to €321 million in 2009.

Introduction of compulsory capitalized pension savings based on individual accounts (II pillar) is delayed in medium term due to already high deficit in the system of current financing and inability to finance the transition cost.

Compulsory capitalized savings for old age is a concept which Montenegro will apply when the financial stability and sustainability of state pension system is achieved.

Current and future programs and economic policy measures

Result of negative demographic trends and rigidity of the pension system reflected in inability to adjust to new conditions on the labour market, is increase in pension expenditures from 8.6% of GDP in 2008 to 12.2% of BDP in 2009. Although it was planned that the pension expenditures amount to 10.5% of GDP in 2010, projections based on the budget execution data indicate that expenditures will make 11% to 12% of GDP.

As optimal solution to overcome PIO deficit in the short term and set foundations for creating adequate, sufficient and safe pensions in the long run, pension reform is continued through parametric reform of system of current financing, delaying introduction of II pillar in medium term and regulatory changes in the area of voluntary pension insurance. Parliament of Montenegro has adopted Law on Changes and Amendments to the Law on the Pension and Disability Insurance, which implementation will start in 2011.

Parametric reforms of the system of current financing are in great measure continuation of the parametric reforms from 2003, and relate to following changes in the Law on the Pension and Disability Insurance:

- Gradual increase of retirement age to 67 years of age for males until 2025 and females until 2041;

- Introducing possibility for retirement with completed 40 years of working experience regardless to age;
- Pension adjustment will be done once a year using modified “Swiss formula”, where rate of pension change is calculated as a sum of 75% of the CPI change and 25% of average wage in Montenegro change;
- Revision of the jobs for which the working experience is calculated with the increased duration by the special regulation;
- Increase of age limit for eligibility to survivors pension from 50 to 52;
- Increase of age limit for child beneficiary of the survivors pension from 15 to 19 and decrease in the age limit for students beneficiaries of the survivors pension from 26 to 24;
- Compulsory payment of pension and disability contributions for additional jobs.

Adopted changes and amendments to the law do not change provisions that relate to approved rights.

Positive impact of new legislation on the budget through decrease of pension expenditures will be effectuated in the long run, primarily due to gradual transition from the previous law. Although the planned expenditures for pension amounted €321 million in 2010, based on execution in the first nine months of 2010, projected amount is by €10 higher and amounts €331 million. Increase in pension expenditures is a result of continuation of negative influences on the pension system from the previous periods and planned payment of €6 million for military pensioners and persons with disabilities.

The main idea behind changes in the system of voluntary pension savings is to decrease barriers for entrance of new members and integration of Montenegrin market of voluntary pension insurance into larger markets. In that sense the Law on Voluntary Pension Funds will allow for cross border payment of contributions, decrease amount of founding capital, remove lower limit on the number of members, regulate work of closed pension schemes and adjust legislation in accordance to the EU standards.

<u>Budget effects of the programs and measures</u>

Table 37: **Fiscal effects of programs and measures**

	2010	2011	2012	2013
Measure/program – Legislation	**Impact of contribution revenues and pension expenditures with gradual application of legal provisions**			
Net fiscal impact (in mil €)	-132.36	-124.65	-116.73	108.73

Direct impact on budget revenues(in mil €)	198.64	218.35	230.90	244.90
Direct impact on budget expenditures(in mil €)	331.00	343.00	347.63	353.63

Source: Fund PIO and the Budget Law 2011

4.3.4. Health protection

Implementation and deviations from measures implementation and reasons for deviations

2010 is marked by realisation of planned investment projects in the health institutions as well as changes in the legislation and measures of health policy. Master Plan for Development of Health Sector in Montenegro (2010-2013.) aligns development of health system in accordance to overall development of a country and follows recommendations of the EU health strategy "Together for health". In line with the implementation of the Law on Health Protection the Government of Montenegro has adopted Decision on the Network of Health Institutions (public and private) in Montenegro through which the level and efficiency in the provision of health services is improved. The following laws are adopted: Law on the Rights of Patients, the Law on Changes and Amendments of the Law on Medicines and the Law on Protection of the Genetic Data. The following strategies are drafted and adopted: Strategy for Improvement of Health of Employees and the Protection at Work 2010-2014 with the Action plan for Implementation, Action Plan for Safe Food and Nutrition, Action plan for Implementation of International Health Rulebook, as well as National Program for Early Discovery of the Breasts Cancer. Also the health informational systems are improved.

In 2010 planned activity of introducing integral hospital informational system (IBIS), as very advanced tool for improvements and the management of the system, is not implemented. The reason for this is legal nature of the public procurement system, due to which the deadline until which the favourable financing (draw a credit line with the Austrian control bank) should been secured is elapsed.

Current and future programs and economic policy measures

The main current and future activities of the Government in the area of health system relate to continuation of the systematic changes and realisation of investment activities in the area of health infrastructure.

Preparation of model for public-private partnership is ongoing, while in the following period its implementation is expected. Model for partial or full privatisation of some public health institutions will be prepared in the following period. In 2011 the possibility of introducing voluntary health insurance, from which individuals will be able to finance certain products and services, will be reconsidered.

4.3.5. Social protection

Implementation and deviations from measures implementation and reasons for deviations

Implementation of strategies in the area of social protection adopted in previous period has continued during 2010: Strategy for Alleviation of Poverty and Social Exclusion 2007-2011, Strategy of Development of Social and Child Protection 2008-2012, Strategy for Integration of Persons with Disabilities 2008-2016 and Strategy for Development of Social Protection of Elderly 2008-2012. In the area of infrastructural support to the system of social protection preconditions for care for children with special needs are created, while work on accommodation for elderly is started.

Current and future programs and economic policy measures

Analysis of the system of social protection in Montenegro, whose realisation is expected in mid 2011, will be base for design of the new Law on Social and Child Protection, while Social Card[25]project will enable availability of valid data on personal status, property and income of individuals, in order to secure better targeting of the social protection rights to vulnerable individuals and families.

Budget effects of the programs and measures

For programs of social, veterans and disability protection in 2011 budget plan anticipates expenditures amounting to €54.6 million, in 2012 €56.3 million and in 2013 € 58 million (expenditures for child allowances, veterans and disability protection, family material support, maternity leaves, other person care and attendance, nutrition of children in kindergartens, and accommodation in residential institutions).

Table 38: **Fiscal effects of programs and measures**

	2010	**2011**	**2012**	**2013**

[25] The costs of implementation of the Social card project have not been jet specified.

Measure/program	Social protection transfers			
Net fiscal impact (in mil €)	-47,929,388.97	-53,262,238.48	-54,860,105.63	-56,505,908.80
Direct impact on budget revenues(in mil €)				
Direct impact on budget expenditures(in mil €)	47,929,388.97	53,262,238.48	54,860,105.63	56,505,908.80

4.4. ADMINISTRATIVE REFORMS

At the end of June 2010, the Government of Montenegro adopted the Draft Agenda for Public Administration Reform in Montenegro for the period 2010-2015 „Aurum“, and the final text of the Strategy of Public Administration Reform along with the Action Plan for its implementation is in final phase. These documents should ensure continuation of the process which has begun with the adoption of the Strategy for Administrative Reform 2002-2009. The main objective of the Public Administration Reform Strategy for the period 2010-2015 is efficient, professional and service-oriented public administration as a service to citizens and other social and economic subjects. Key areas in the reform of public administration system are: national government, local authorities and organizations exercising public authority.

4.4.1. Public administration

Implementation and deviations from measures implementation and reasons for deviations

Based on the adopted Information and materials in the field of public administration, medium-term budgetary framework, certain sectoral policies, as well as analysis conducted within Regulatory reform, the Government iof Montenegro s determined to continue reforms in public administration in six main directions:

- structural adjustment of the public administration system;
- stabilization of public financing system;
- Improvement of civil service system by measures of depoliticization and professionalization;

- measures to strengthen quality of strategic documents as well as regulation;
- improvement of administrative procedures;
- reforms of the inspection system.

Public administration system in Montenegro[26] consists of 53 bodies (17 ministries, one secretariat, 17 administrations, 10 institutes, six directorates and two agencies). In the previous period, instead of integrating new activities into the existing institutional framework, a trend towards the establishment of new bodies was present, which had its effect on the increasing costs of state administration. According to data from the Ministry of Finance, the number of employees in public administration, health and education sector in 2009 was about 42.5 thousand, including trainees and employees on a contract of service.

So far, the implementation of relevant policy documents achieved significant results in the establishment and implementation of e-government. Key legislation governing electronic commerce has been passed. Projects related to the establishment of key information systems are either realized or are in the final phase.

<u>Current and future programs and economic policy measures</u>

Direction of future activities on the improvement of public administration are aimed at establishment of an efficient public administration with a clear division of responsibilities, which will consist of responsible and professional employees. Also, in order to achieve the desired fiscal effects, cost rationalization is needed. Future activities include:

- Rationalization of public administration, as unification of certain agencies, institutes and other administrative agencies and their merger to relevant ministries, in order to successfully integrate Montenegro into the European administrative system;
- Streamlined operations and enhancement of wage system in the civil service, which will lead to a reduction in wage fund by 1% of GDP (the new Law on Wages will contribute to the improvement in the wage system);
- In 2010 Montenegro has arranged the civil service system with the Law on Civil Servants (Official Gazette of MNE, no. 49/10). This area, however, remains subject to further improvements from the standpoint of a more precise definition of rights and obligations of civil servants, as well as conditions of their choice. The goal is improved civil service system, which will be based on the merit system and which will produce competent personnel interested in working in government agencies. This will lead to rationalization of the budget expenditures determined for financing of public administration;
- The implementation of the so-called Guillotine of existing regulation (under the authority of Government and the Council for Regulatory Reform and Improvement of Business Environment), which will abolish or amend regulation that is outdated and / or harmful to the economy. Also, the implementation of regulatory impact assessment

[26] On its session held on 27th January 2011 Government of Montenegro has adopted decree on organization and manner of work of Public administration, with regards to the election of new Government on Parliamentary session held on 29th December 2010.

(RIA) will be introduced, as a quality control system in their adoption and implementation, which implies an obligation for everyone who writes legislation to respond to standardized questions. Based on the current effects in Bijelo Polje, Bar and Niksic, the implementation of Guillotine and removal of business barriers at the local level will bring savings of around 20 €million;

- Unification of administrative procedures, which, while reducing their cost, will lead to capacity building of the employees working on administrative procedures as well as simplification of those procedures (one-stop-shop). This includes promotion of development of a single window, where the interested party will be able to obtain all necessary information and documents;
- In the upcoming period, the Law on License Center will be passed, which will improve the speed of access to services and information, its reliability, while reducing the cost of information resources of government agencies;
- Establishment of a system of electronic document management in public administration bodies (public communication network), which will provide the connectivity of the government bodies at the horizontal level;
- Functional reorganization of inspections in the upcoming period, i.e. concentration of all inspections in the unified body which would exercise only inspection operations. This will lead to more adequate, efficient and rational assurance in performance of inspection control;
- The Law on Wages Financed Under the Budget of Montenegro.

Budget effects of the programs and measures

- STATE LEVEL: - Reducing the number of state administration organs and public services and agencies (merging several agencies into one, becoming integral part of the Ministry, etc.) and reduction in the number of employees in state administration and public services, by 5%. Reduction in the number of employees will be conducted on several grounds (moving to other jobs, retirement, use of some of the rights of the programs resolving redundancies on a voluntary basis with severance pay, etc.).

- LOCAL LEVEL: Reducing the number of employees in local government by 10% based on the rationalization program, on a voluntary basis with severance pay.

All these measures will reduce the share of earning fund in consolidated budget by about €30 million, which represents 1% of GDP, but it will be necessary to allocate at least €10 million for the settlement of redundancies.

Planned reform of the inspections and their more efficient performance will lead to a suppression of the underground economy and illegal work for about 25%, which will cause an increase in GDP as well as increase in government revenues by more than 3% or almost €100 million by 2015.

Raising the quality of legislation through modern instruments of regulatory reform in the field of economic legislation (guillotine of regulation, the introduction of regulatory impact assessment, one-stop shop reform, etc.) will cause decrease of regulatory risk, which will increase the inflow of foreign direct investment, increase the number of companies, and therefore the opening of new work places. Mentioned state-level reforms are aimed at reducing administrative costs to the economy in the amount of 25%, which is about €20 million (approximately 0.13% of GDP or €4 million annually).

Other reforms (administrative procedures, licensing - one stop shop, inspections, etc.) based on comparative experience and methodology of the World Bank are estimated that will lead to savings for the economy in the amount of €20 million by 2015 (about 0.17% of GDP or about €5 million per year).

4.4.2. Local government

<u>Implementation and deviations from measures implementation and reasons for deviations</u>

Recognizing the importance of further development of local government, government of Montenegro in December 2009 adopted an Information on the implementation of the reform of local government, as a document that presents an overview of the results in implementing administrative reform Strategy 2002-2009 and at the same time it is one of the elements on which basis the final text of the Strategy of Public Administration Reform for the period 2010-2015 is created.

<u>Current and future programs and economic policy measures</u>

The realization of this Strategy will provide the functional and fiscal decentralization, with the alignment of financial and material resources of local governments to operations they perform, as well as cost-effective and optimal functioning of local government in terms of personnel and material matters. Future activities include:

- Establishment of better cooperation between central and local authorities and strengthening of administrative capacities in this area;
- Optimization of the number of employees (about 10,500 employees in the local administration and public services) and the rationalization of the regular costs;
- Establishment and election of the Council for Development and Protection of Local Government, which will contribute to strengthen transparency and improve the operation of local government;

- Strengthen the capacity of the Union of Municipalities of Montenegro, within which will be established the unit for human resources development, which in future will coordinate and facilitate activities on the establishment of special units for human resources development in all local governments.

Budget effects of the programs and measures

Implementation of Guillotine and removal of business barriers at the local level will bring savings of around €20 million.

4.4.3. Organizations exercising public authority

Implementation and deviations from measures implementation and reasons for deviations

In the work of organizations exercising public authority, the following problems or risks have been identified: reduction in the level of control over these institutions, reduction in the level of ministerial responsibility, and there is possibility of certain dysfunctions in the operation of these institutions, when for example their interests are dependent on the interests of service users.

Current and future programs and economic policy measures

Future activities of the Government in the area of organizations exercising public authority will go towards improving the legal framework in the field of organizations with public authorities, more clearly defining the position of public services, public agencies and funds in the overall system, as well as the responsibilities of this segment of public administration towards other administrative, legislative or judicial authorities, which is aimed at ensuring the rule of law and the principle of legality.

In the area of strengthening the consistency of the system of public administration, future activities will be focused on: improvement of the system of concessions and other forms of public-private partnerships in the delivery of public services; continuation of the process of regulation, liberalization and privatization of public services and introduction of competition in the provision of public services.

Budget effects of the programs and measures

Budgetary effects of the above mentioned programs and measures for now is not possible to assess, because there are no relevant analysis.