MONTENEGRO
MINISTRY OF FINANCE
Directorate for economic policy and development

MONTENGRO PRE-ACCESSION ECONOMIC PROGRAM 2013-2016

January 2014

CONTENT

I ECONOMIC FRAMEWORK

In order to improve the quality of life of its citizens, Montenegro is demonstrating the increasing political and economic seriousness and readiness to accept the European values and standards in the process of approximation of the country to the Euro-Atlantic integration.

The negotiations for the EU membership, as the last, but also the most challenging integration phase of the process which will result in the full EU membership, are developing as planned. During 2013 the screening process was completed as the first negotiation phase, two chapters have been temporarily closed, and at the end of the year negotiations for five chapters were opened. In this regard, activities have been intensified aimed at harmonizing the legal order of the country with the *acquis communautaire*, as well as the activities in the field of their implementation. In order to accede to the process of harmonization and implementation of the *acquis communautaire* in its legal system in the most quality manner, Montenegro has enacted "Montenegro Pre-Accession Economic Program 2014-2018" (PPCG).

In the global economic situation, which is characterized by a relatively low level of economic growth, unconsolidated public finances and vulnerable banking sector as well as high unemployment, current economic policy is focused on creating opportunities for the growth and development of the Montenegrin economy, and consequently, for a higher standard of living.

The priority objective of economic policy in 2014 is consolidation of public finances and creation of conditions for rapid economic development, through the improvement of business environment, and preparation and initiation of significant development projects. Final demand, with a slight increase in household consumption and government spending and significantly increased investments in gross fixed capital formation will be major growth drivers. In the medium term increased investments in energy and tourism are expected, as well as the implementation of major infrastructure projects. Total value of the announced investments for the next five-year period is approximately €4.0 billion, which is above the annual amount of GDP. Achievement of these goals will contribute to the increasing macroeconomic stability and stabilization of the fiscal sector will be the result of the balancing public spending balance and debt levels.

The GDP contraction in 2012 from 2.5% in the first three quarters of 2013 was followed by a 3.1% growth. Starting from the available indicators, with the expectations that the established trends will be preserved by the end of the year, it is estimated that the Montenegrin economy will have the real growth of 2.6% in 2013, which is at the level of the last year's PEP projections (2.5%).

Base macroeconomic scenario, for the period 2014-2016, provides for continued economic growth of the Montenegrin economy. The expected increase in investments will have a dominant influence on the overall flow of economic activity in Montenegro. Real GDP growth is projected at the level of 3.6% in 2014, 3.5% in 2015 and 3.8% in 2016.

Low-growth macroeconomic scenario is based on the assumption of significant investments which would occur only in 2016 as a result of adverse global developments and structural weaknesses of the Montenegrin economy. According to this scenario, the projected rates of real GDP growth amount to 1.6% in 2014, 2.0% in 2015 and 4.0% in 2016. In addition to the above, potential macroeconomic and fiscal risks, both internal and external risks, have been identified which may lead to realization of the low-growth scenario.

Special attention in the second Chapter is dedicated to the analysis of competitiveness of the Montenegrin economy, that is, the analysis of the level of real wages, labour unit costs and analysis of tourism industry as one of the most important generators of economic growth.

Macroeconomic and fiscal framework

Macroeconomic and fiscal framework (in% of GDP)		Outturn	Estimate	Base scenario			Low-growth scenario		
		2012	2013	2014	2015	2016	2014	2015	2016
Macroeconomic indicators	GDP nominal growth	*-2,6*	*5,2*	*6,2*	*6,1*	*6,4*	*3,1*	*3,5*	*6,1*
	GDP real growth	*-2,5*	*2,6*	*3,6*	*3,5*	*3,8*	*1,6*	*2,0*	*4,0*
	Deflator	*-0,1*	*2,5*	*2,5*	*2,5*	*2,5*	*1,5*	*1,5*	*2,0*
	Inflation	*4,1*	*2,5*	*2,9*	*2,5*	*2,5*	*1,5*	*1,5*	*2,0*
	Employment	2,1	2,1	1,3	0,9	0,6	0,1	0,1	0,9
	Current account deficit	-18,7	-15,4	-14,6	-13,6	-12,3	-13,6	-11,8	-12,0
Fiscal indicators	Current public revenues	41,3	41,8	40,5	39,1	38,1	41,1	40,0	39,1
	Public spending	47,4	45,8	41,9	38,9	37,2	43,1	41,0	39,4
	Deficit/Surplus	-6,1	-4,0	-1,3	0,2	0,9	-2,0	-1,0	-0,3
	Interests	1,9	2,1	2,3	1,9	2,1	2,3	2,0	2,2
	Primary deficit/surplus	-4,2	-1,9	0,9	2,1	3,0	0,3	0,9	1,9
	Government debt	54,0	56,5	56,9	55,3	52,7	58,9	58,7	58,2

The objective of fiscal policy is consolidation of public finances whose priority is to reduce budget deficit and public debt. In this regard, measures, although socially heavy and politically unpopular, of restricted spending have been introduced which relate to the most relevant positions of budgetary expenditures and refer to stopping the growth of wages and pensions in 2013. In order to improve the revenue side of the Budget, the Law on Personal Income Tax has been amended based on which gross salaries exceeding the national average of €720.00 are taxed by additional 6% rate. In the middle of the year basic rate of value added tax increased from 17 to 19%.

Simultaneously with the policy of fiscal adjustment, activities in the fight against grey economy have been intensified. Bearing in mind the crisis context and liquidity problems of a large number of tax debtors, significant efforts have been focused on the collection of residual tax debt.

All these measures have been aimed at the introduction of more order and tax discipline, which will, according to estimates result in an increase in public revenues by 6.5% compared to last year. After a long period, tax debt was reduced, for approximately €25.0 million compared to the end of 2012.

The reduction of public deficit from 6.1% of GDP, as it was at the end of 2012, to 4% of GDP, as is estimated to be at the end of 2013, is a great success, given that we had an unplanned expense of €102.5 million (3.4% of GDP) caused by the activation of guarantees for KAP in July this year. If it was not for these unforeseen circumstances, deficit in 2013 would be less than 1.5% of GDP. Despite such significant extraordinary expenditures, fiscal 2013 ends with the total indebtedness defined by the Budget Law for this year. In this regard, government debt is estimated at €1,870.4 million, or 56.5% of GDP, which is within the limits of the Maastricht criteria.

When medium-term revenues were planned, there were some reserves towards the expected economic growth. In fact, as early as next year primary surplus of 1% of GDP is planned, while in 2016 public finances would transfer into surplus. Expenditures are planned according to the needs of consumer units, with the retention of counter-cyclical spending policy, which for the following period means the retention of austerity measures for all discretionary expenditures. At the same time, attention was paid to providing higher support to the development (capital budget) i.e. that its share in GDP in each subsequent year is above 3%.

The achieved results inspire realistic optimism that Montenegro has a serious chance to continue with further growth and accelerated development. In addition to consolidation of public finances and improving business environment, efforts will be focused on structural reforms in all spheres of economic system, as a precondition for ensuring long-term sustainable economic growth and development of the country.

In this regard, in the current period, significant progress has been made in structural reforms of the real, financial and government sector. The effects of the global economic crisis have slowed down, but not stopped their further implementation. In this regard, in the forthcoming period, activities will be conducted in the direction of:

- Completing privatization process (implementation of failed tenders from previous years, projects for which planning documentation has been adopted including the tenders for long-term lease of several military and tourist complexes);
- Directing state aid for research, development and innovation, aid for training, efficient use of energy, investment in environmental protection, aid to small and medium size enterprises (soft loans, share in interest rates, lower taxes or tax exemption);
- Reduction of costs of participants in the public procurement procedures (original-certified document shall not be submitted. This will be the bidder's obligation with which contract will be signed);
- Improvement of business environment - reduction/elimination of costs related to construction land, reorganization of public sector, improving the pension system, introduction of public-private partnerships in health care, as well as the introduction of modern information technologies in the education system; further improvement of legislation in the area of issuing building permits or creating one-stop-shops for issuing licenses etc;
- Development of a knowledge society (education, science) - alignment of education with labour market needs (reduction of the number of students in certain study programs, establishment of the system of continuous monitoring of careers of persons with acquired university education, improving mobility of students and teaching staff, defining a new model of financing higher education, stimulation of certain occupations for which the practice has shown to be in short supply - high school staff (building industry);
- Linking science and economy (establishment of technology parks, centres of excellence, investments in research, grants, etc) ;
- Implementation of important infrastructure projects, primarily in the sectors of transport, energy, tourism, etc;
- Solving the problem of non-performing loans as the key problem of banking industry;
- Harmonization of employment policies with education system;
- Active attitude towards the employment of working age beneficiaries of social benefits;
- Improving the health care system (implementation of measures of prevention programs, optimization of the secondary and tertiary levels of health care, investing in health care infrastructure, rationalization of the network of health care institutions, the establishment of eight health centres);
- Optimization of the number of employees in the public sector, reduction of labour costs and better concentration of human, financial and material and technical resources.

II MACROECONOMIC DEVELOPMENTS

The priority objective of economic policy in the period 2014-2016 is stabilization and consolidation of public finances, with foreign and domestic investments growth, which will have multiplicative effects on the entire economy, primarily on the sectors of construction, trade, transport (supply) and continuation of the process of stabilization of the financial sector. As for demand, main growth driver is final demand, with a slight increase in household consumption and government spending, with a strong growth in investments in gross fixed capital formation. In the medium term, strong growth in investments in the sectors of energy, tourism and implementation of the major infrastructure projects is expected. Total value of announced projects in the five-year period is €3.95 billion, which exceeds the GDP value.

The achievement of the set goals will contribute to the growth of macroeconomic stability, along with stabilization of the fiscal sector as a result of balancing the balance of public spending and debt levels.

The GDP contraction in 2012 of 2.5% was followed in the first quarter of 2013 by a 1.1% growth, in the second quarter by a 3.4% growth and in the third quarter by a 4% growth so that the nine-month growth in 2013 was 3.1%. Starting from the available indicators, with expectations that the established trends will be preserved by the end of the year, it is estimated that the Montenegrin economy in 2013 will have the real growth of 2.6% in 2013, which is at the level of the last year's PEP projections (2.5%).

Base macroeconomic scenario, for the period 2014-2016, foresee continued economic growth of the Montenegrin economy. The expected increase in investments will be a significant growth factor which will in a medium run have a dominant influence on the overall flows of economic activity in Montenegro. The real GDP growth in the medium term is projected at the level of 3.6% in 2014, 3.5% in 2015 and 3.8% in 2016.

Low-growth macroeconomic scenario is based on the assumption of the postponement of the beginning of the investments to 2016 as a result of adverse trends in the region and structural weaknesses of the Montenegrin economy, which would reflect in a weaker economic activity in the first years of the cycle. According to this scenario, the projected rates of the real GDP are as follows: 1.6% in 2014, 2.0% in 2015 and 4.0% in 2016.

Macroeconomic and fiscal risks (both internal and external) which may lead to realization of the low-growth scenario have been listed in a separate part.

Special attention in this Chapter is dedicated to the analysis of competitiveness of the Montenegrin economy given the importance of this issue for the position of Montenegro in relation to the international environment. The analysis of competitiveness relates to the level of real wages, unit labour costs and the analysis of tourism sector as one of the important sectors for economic growth.

2.1. Macroeconomic Developments in the Period 2012-2013

2.1.1. International Environment

The world economy is gradually recovering from the effects of the economic crisis[1]. In the second quarter of 2013, GDP growth rate amounted to 0.4% (the quarter compared to the previous one), which is the largest increase since the beginning of 2012. Growth impulse comes from the developed economies while emerging economies have achieved lower rates than projected. This decrease has influenced corrections of the growth projections, so that the projected growth of the world economy (excluding the EU) for 2013 of 3.5% in 2014 increases to 4.1% while in 2015 it increases to 4.5%. While confidence indicators for the developed countries are increasing, for the emerging economies they have been declining since 2010. The latest data on the GDP growth in the emerging economies are below expectations (Indonesia, Mexico, Russia and India). The Chinese growth is also reduced and its stabilization is expected at a level of 7.5% growth compared to 9% in the previous period. Reasons for the reduced growth in these countries are cyclical and structural. Normalization of monetary developments (reduction of monetary incentives in developed countries) are likely to cause pressure on the countries with structural weaknesses which particularly refers to Russia, Brazil, India and Indonesia, while a relatively closed capital market of China is an obstacle to the expansion of negative impacts. As for developed countries, the U.S. economy is 2013 was under the pressure of strong fiscal adjustments and a partial breakdown of budgetary operations (16 days). Stronger growth is expected in 2014 and 2015 driven by the increased household consumption and investments. Japan is expected to continue good results achieved in the first half of the year by the end of 2013 and 2014, encouraged by fiscal and monetary measures. The projections for the EU are predicting a slight increase in economic activity in 2014 - 2015 after a long recession in the previous period.

The following Table shows economic growth projections, share in the world economy and growth of imports and exports for major economies and regions:

Table 1 Projections of economic growth and trade for major world economies

	(a)	2010	2011	2012	2013	2014	2015
USA	19,9	2,5	1,8	2,8	1,6	2,6	3,1
Japan	5,8	4,7	-0,6	2,0	2,1	2,0	1,3
Asia (Japan excluded)	27,8	10,3	7,5	6,0	5,7	6,0	6,3
China	13,4	11,6	9,4	7,8	7,5	7,4	7,4
India	5,5	11,2	7,7	3,8	2,9	4,0	5,3
Latin America	8,6	6,1	4,5	2,9	2,6	3,1	3,5
- Brazil	2,9	7,5	2,7	0,9	2,2	2,5	3,1
MENA (Middle East and North Africa)	5,4	3,5	3,9	3,4	2,4	3,6	3,8
CIS (Community of Independent States)	4,2	4,9	4,8	3,3	2,3	3,3	3,6
-Russia	3,0	4,5	4,3	3,4	1,9	3,0	3,4
Sub-Sahara Africa	2,5	5,4	4,8	4,8	5,0	5,3	5,5
EU	19,2	2.0	1,7	-0.4	0.0	1,4	1,9
Euro area	13,6	1,9	1,5	-0,7	-0,5	1,1	1,7
Candidate countries		8,2	8,1	1,8	3,3	2,9	4,1
World (including EU)	100,0	5,2	3,9	3,1	2,8	3,6	3,9
World trade growth (import)		12,6	5,4	2,0	2,8	5,2	6,0
World trade growth (export- without internal trade in the U)		15,1	6,3	2,4	3,6	5,7	6,0

(a) relative share in GDP in% ,prices in 2009 in PPS (purchasing power standard)

[1] Data taken from the projections of the European Commission from November 2013

In the projected period Brent crude oil prices decline is expected as well as food prices decline and stable metal prices. So, as for Brent oil price decline is projected from the estimated $108.8/barrel in 2013 to $105.8/barrel in 2014 and $99.7/barrel in 2015. Although geopolitical risks may affect supply reduction, a high stock level acts as a stabilizing factor.

Increase in the prices of metals and raw materials by the end of 2013, is not expected. Certain price increase is expected in 2014 and 2015 as a result of the strengthening of demand caused by the growth of economic activity.

Inflation will also remain stable in developed countries below 2%, while in the emerging economies a stable level of 6% is expected as a result of lower prices of energy sources and food, and moderate growth is expected in economic activities.

2.1.2. Gross Domestic Product

Montenegro GDP contraction in 2012 of 2.5% was followed in the first quarter of 2013 by a 1.1% growth, 3.4% in the second quarter and 4% in the third quarter, so that the growth for nine months in 2013 amounted to 3.1%. Moderate growth was recorded in all sectors except in the sector of manufacturing industry and in the real estate sector.

Graph 1 Share of sectors in the real GDP growth in%-expenditure

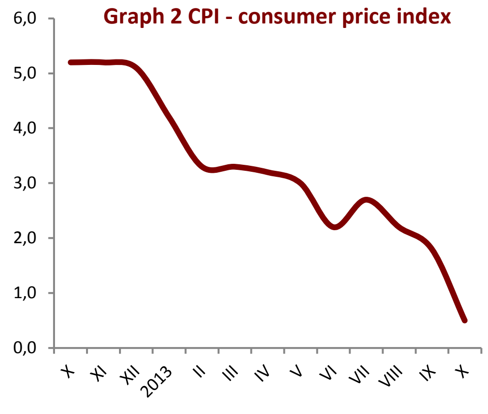
Available indicators for the period January-October indicate industrial production growth (9.0%) as a result of a significant growth in electricity production (51.9%), and a concurrent decline in the manufacturing industry of 12.3% and a decline in the mining and quarrying industry of 2.2%. Growth in tourism turnover for ten months is reflected in the increased number of arrivals (3.5%) and overnight stays (2.8%). Significant growth in the period January-October was recorded in the retail (10.9%). Construction sector in 2013 increased according to all indicators, whereby the value of construction works in the period January-September 2013 was higher by 2.6% (annual). A slight increase in economic activity influenced most aspects of transport in 2013 which recorded positive growth rates. In the period January-October 2013 there was a significant increase in taxes on goods minus subsidies for which the estimated growth was 14.3%.

Starting from the available indicators, with expectations that the established trends will be preserved by the end of the year, it is estimated that the **Montenegrin economy in 2013 will have a real growth of 2.6%,** which is at the level of the projections from the previous PEP (2.5%).

Graph 1 shows the share of individual components of GDP following the spending method for the period 2012 - 2013. Based on the available data, it is estimated that household consumption and gross investments will have negative share in the growth of GDP in 2013, while positive contribution will be the result of the increased export, lower imports and slightly higher government spending.

2.1.3. Inflation

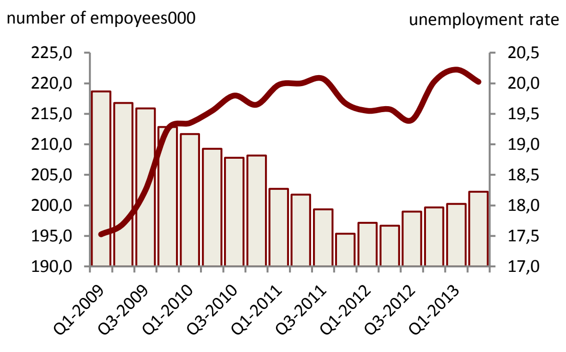
Average inflation rate in 2012 was 4.1% and ranged from 3.1% in January to 5.1% in December. Inflation growth was generated by the increase in the price of electricity, fuel, excise taxes (on tobacco, alcohol, soft drinks and coffee), as well as the introduction of the obligation to pay taxes on electric counters and SIM cards. After price increase during 2012, annual inflation rate in 2013 had a downward trend and was at a significantly lower level than last year. Inflation trends in January-October 2013 were predominantly connected with the growth of food and electricity prices, excise taxes on tobacco, the increase in the basic rate of VAT from 17 to 19%, and decrease in price of fuel and accommodation services. The annual inflation rate, as measured by the consumer price index, ranged from 4.2% in January to 0.5% in October. **Average inflation rate in the period January-October was 2.6%** which is below the level of inflation projected for the current year (3.0%). Producer prices in October 2013 recorded annual decline of 0.9%, primarily as a result of the price decrease in manufacturing industry of 1.4%. By the end of the year, a significant price increase is not expected, which makes the latest projections of the Ministry of Finance certain, according to which it is estimated that **average inflation rate in Montenegro in 2013 will amount to about 2.5%.** The previous PEP projected inflation rate for 2013 at 2.7%.



2.1.4. Labour Market

Developments in the labour market in 2012 despite the economic activity downturn show an increase in average employment by 2.1% annually, but also the decline in average unemployment by 2.2%. The number of the employed in October 2013 amounted to 169,044, while in the period January-October 2013 it increased by 3.6% compared to the same period last year. The increasing employment is a result of grey economy reduction, primarily in the sectors of: accommodation and food services (1,400 or more employees or 10% (which partly represent tourism), administrative and support services2 (1,200 more employees or 35%), state administration (770 more employees or 4%),3 transport (600 more employees or 6,9%), agriculture (300[4] more employees or 13%), education (250 more employees or 2%) and the like. Primarily, this refers to the larger coverage of employees, but also the economic activity growth. During this period, according to Monstat, the number of unemployed increased by 5.6% compared to the same period in 2012. In

Graph 4 Labour market –survey on workforce – four quarters moving average



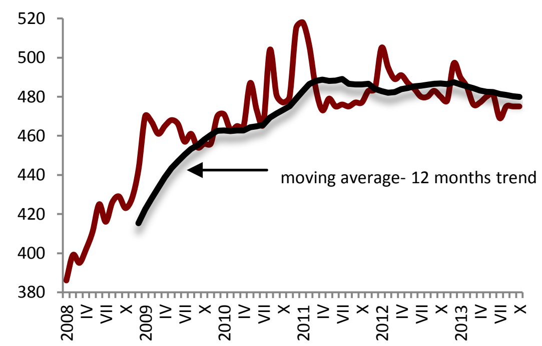
[2] This includes: tourist agencies, renting and leasing etc.

[3] Although the number of employees in the public sector has formally increased, in reality this number decreased. Namely, a significant number of employees has been laid off so that a certain number of the laid off workers could be hired if there is the need.

[4] According to the Register of agricultural producers, the number of employed in agriculture increased by 462.

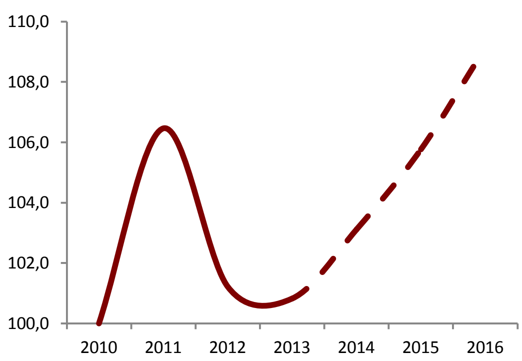
October the number of unemployed was 33,271, which makes a monthly increase of 7.6%. This increase is a result of the completion of the summer tourist season, but also the completion of a nine-month Professional Training Program of the persons with acquired university education. The unemployment rate in October 2013 was 14.3%, and it increased compared to October 2012 when it was 12.7%. The unemployment rate (LFS) decreased from 21.6% in the first quarter to 19.2% in the second quarter of 2013, while in 2012 it was 19.7%.

Graph 5 Net salaries zarade



Average gross salary in October 2013 amounted to €721.00, while average net salary was € 475.00 and remained at the same level as in the previous two months of 2013. In the period January-October 2013 compared to the same period in 2012 salaries were reduced by 0.4%, net salaries by 1.8%, while real net salaries were reduced by 4.3%. The trend in average nominal salaries shows their stagnation as of the first quarter 2011. Average pension in October amounted to €276.5 or 58.2% of average net salary and necessary funds for their payment in October amounted to €32.1 million.

Graph 6 Productivity measures by GDP /the employed - 2010=100



Labour productivity in the broadest sense measured by gross domestic product per worker[5] shows a decrease in the period 2011-2013 with regard to the increased employment with the GDP contraction in 2012 and faster growth of employment compared to the estimated economy growth in 2013. With the projected GDP and employment growth we are expecting productivity growth in the period 2014-2016. Graph 6 shows an overview of productivity in the period 2010-2016.

2.1.5. External Sector

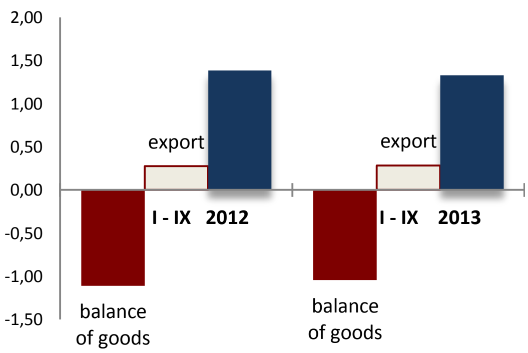
Current account deficit of balance of payments in 2012 recorded the increase of 2.5% compared to the previous year and amounted to €587.6 million or 17.7% of GDP. Deficit increase on the current account was generated by a relatively high growth of the foreign trade deficit of 6.3% and a slight increase in the positive balance of services by 3.9%. Current account deficit is largely financed by a net inflow of foreign direct investments.

[5] There are no needed data on the effective hours that are taken instead of the number of employees for the calculation of productivity in the broadest sense.

Table 2 Balance of payments of Montenegro 2010-2013

	2010	2011	2012	2013-estimate
A. CURRENT ACCOUNT (1+2+3+4)	-710.2	-573.4	-587.6	-512.8
1. Goods	-1.267.2	-1.306.2	-1.389.2	-1.434.6
1.1. Export, f.o.b.	356.6	476.5	391.9	418.6
1.2. Import, f.o.b.	1.623.8	1.782.8	1.781.1	1.853.3
2. Services	464.3	589.3	612.3	741.5
3. Income	-21.7	26.3	53.8	54.5
4. Current transfers	114.4	117.3	135.5	125.8
	0.0	0.0	0.0	0.0
B. CAPITAL AND FINANCIAL ACCOUNT	512,1	416,4	344,2	330,3
B1. Capital account	-0.5	-3.0	7.4	-3.2
B2. Financial account	512.6	419.4	336.8	333.5
1. Direct investments	552.1	389.1	461.6	469.0
2. Portfolio investments	188.2	163.6	-24.7	-27.5
3. Other investments	-211.2	-247.7	-55.5	-58.0
B3. Changes in CBM reserves	-16.6	114.3	-44.6	-50.0
C. NET ERRORS AND OMISSIONS	198.1	157.0	243.4	182.4

Graph 3 Foreign Trade Balance



Current account deficit for nine months of 2013 amounted to €231.7 million and decreased by 29.1% compared to the same period last year, primarily due to the reduction of foreign trade deficit by 6.3% and positive balance on other accounts. For nine months of this year it amounted to €994.4 million and was by 6.3% lower compared to the same period in 2012. Foreign trade exchange for nine months of 2013 amounted to €1,605.1 million, which is by 2.7% less compared to the same period in 2012. The increase in exports of goods by 3.8%, followed by reduced imports by 4.1%, influenced the trade deficit reduction on annual level. Total export of goods was €305.4 million, or it was by 3.8% higher, while import of goods amounted to €1,299.7 million and was by 4.1% lower. Exports growth was mostly influenced by the export of electricity which amounted to €79.6 million or 197.0% more compared to the same period last year. The decline in imports was mostly influenced by reduced import of electricity by 60.0% compared to the same period last year. Exports to the EU- 28 countries, once main source export market of aluminium, was reduced by 20.2% while exports to CEFTA countries increased by 38.5% compared to the same period last year. **Service account surplus** amounted to €625.5 million, which is at the approximately same level as in the previous year. Balance of services is predominantly influenced by developments in tourism industry. Revenues from travel and tourism amounted to €642.6 million and recorded an increase of 2.9%, which were influenced by relatively good indicators that is the growth of foreign tourist arrivals by 4.1% and overnight stays by 2.8%.

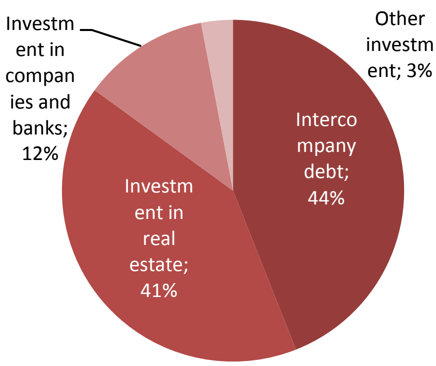
Balance of income recorded a surplus of €42.3 million or twice as much as last year which is a result of the increasing inflow based on compensations for employees and a small outflow coming from interests and dividends. Surplus on current transfers account amounted to €94.8 million, which is

1.9% lower than in the same period in 2012, where the largest inflow was generated from remittances, gifts and foreign aid aimed for individuals.

It is estimated that balance of payments position will be more favourable than last year, due to the growth of electricity exports but decrease of aluminium exports, growth in revenues from services export (foreign tourist spending) while maintaining the downward trend in imports, so that the deficit by the end of 2013 will amount to about 15.4% of the estimated GDP. Assessment of the elements of balance of payments is based on data on exports and imports trends.

In the capital and financial account in the first nine months of 2013 there was a net inflow as a result of net inflows to the direct investments subaccount, while on the portfolio and other investments subaccounts net outflow was recorded.

Graph 4 FDI structure



In 2012 foreign direct investments increased. The realized net inflow was in the amount of €453.6 million. **In the period January - September 2013 a FDI net inflow in the amount of €275.6 million was recorded which is by 14.8% less on the annual level**. Total FDI inflow in the same period amounted to €351.0 million which is by 15.8% less. In the FDI structure of inflows, equity investments account for 53.0% and are lower by 34.2% compared to 2012. Investments in companies and banks participated with 12.2% and are lower by 60.8%, while investments relating to investments in real estate make 40.8% (lower by 17.4%). Total outflow of foreign direct investments in the period January - September 2013 amounted to €75.4 million which is by 19.3% less than in 2012. In the structure of outflow most of it referred to the reduction of liabilities arising from intercompany debt (€46.1 million or 61.1%). The analysis of foreign direct investments shows that in the previous period about 35% of FDI was invested in real estate which is the least desirable form of investments inflows as it reduces the available fixed capital which is one of the components of future growth.

2.1.6. Banking Sector

The situation in the banking sector in 2012 was favourable in terms of liquidity and deposit growth, but there was also a high level of non-performing loans. This has affected the implementation of restrictive credit policy which was insufficient to initiate economic growth.

Banking sector in first ten months of 2013 was characterized by stability, growth in deposits, and growth of the level of liquid assets and capital with a high level of non-performing loans. Interest rates are still high, so that the spread of interest rates in October was over 6%. The following Table shows an overview of monetary indicators:

Table 3 Main monetary indicators for the period 2010-2013 in €mill.

	XII 2010	XII 2011	XII 2012	X 2013
Total bank assets	2943,7	2809,7	2808,3	2992,7
Cash and deposits with depository institutions	332,4	270,1	308,9	336,6
Total loans and other receivables	2517,9	2359,2	2342,0	2474,5
Loans and other economy receivables	1228,1	979,8	930,4	951,1
Loans and other retail receivables	863,6	833,7	809,1	886,8
Total deposits	1789,9	1817,1	1980,7	2104,3
Company deposits	439,1	477,8	526,5	572,8
Household deposits	951,9	1033,5	1146,8	1218,1
Total capital	310,9	305,2	288,7	428,8
Solvency coefficient%	15.85	16.51	14.71	n/a
Liquid assets	n/a	323,9	448,9	569,3
Liquid assets/total assets%	n/a	19,7	15.98	41,3
Non-performing loans and other receivables	461,3	303,8	327,8	438,6
Non-performing loans and other receivables%	20,97	15,53	17,6	17,72
Return on assets (ROA)	-2,76	-0,11	-2,01	n/a
Return on equity (ROE)	-27,27	-1,08	-18,32	n/a

Total deposits in October amounted to €2,104.3 million and for ten months they achieved growth of 6.2%, or €123.6 million. In the structure of deposits a dominant position is still occupied by retail deposits with a share of 53.0% and an increase of 9.3% per year. Total loans and other receivables in October amounted to €2,474.5 million and they decreased by 2.4% compared to the previous month, while on the annual level they recorded growth of 4.8%. In the loans structure 74.3% relates to companies and household, while 25.7% relates to loans granted to financial institutions, public enterprises and the Government. Growth in total loans and receivables is largely a result of the amended regulations whose implementation began on 1 January 2013 (banks have paid back part of written-off loans and other receivables coming from out-of-balance records). In September there was a decline in the share of non-performing loans to 17.40% of total loans, which is the lowest since the beginning of the year.

In addition to the significant results that banks have achieved in improving the quality of loan portfolio, vulnerability of the banking sector will be a key challenge in the year to come. Therefore, the Central Bank, in cooperation with the World Bank and the Ministry of Finance, worked intensely in 2012 and 2013 on creating a legislative framework for voluntary extrajudicial restructuring of debts of legal entities and individuals - beneficiaries of mortgage loans from the banking sector and other creditors, which will encourage the recovery of debtors and access to new means of financing in order to stimulate economic recovery and growth.

In contrast to a satisfactory liquidity of the banking sector, illiquidity in the real sector is still worrying. Total amount of debt amounted to €432.9 million, and it increased on the annual level by 8.6%.

In the forthcoming period, activities of the Central Bank will be focused on improving the quality of assets that is reducing non-performing loans, which represent one of the major risks for financial stability, as well as harmonization of legislation with the relevant EU regulations.

2.2. Base Macroeconomic Scenario for the Period 2014-2016

Macroeconomic projections for the period 2014-2016 show that the Montenegrin economy in 2014 will record a GDP growth rate of 3.6% in 2015 3.5% and 3.8% in 2016. As a result of GDP data revisions for 2012, positive trends in macroeconomic indicators for ten months and the announcement of investments, primarily in tourism, energy and infrastructure projections given in the Guidelines for macroeconomic and fiscal policy for the period 2014-2016 have been revised. In addition, domestic economy will be affected by a weak growth in economic activity in the countries of the European Union and the Western Balkans as well as by inherited structural weaknesses.

While projecting macroeconomic sizes a quite conservative stance was taken. Namely, the expected increase in investments will be an important growth factor, although projections for 2014 include only investments whose implementation is underway, those whose implementation will be started during the year, as well as those whose implementation is certain. Although the growth model of the Montenegrin economy, which is based on the investment activity of foreign owners, is not sustainable in the long run, it will have in the medium term a dominant influence on the overall flows of economic activity in Montenegro. After the implementation of the announced investments, Montenegro will have better prerequisites for a dynamic growth, since the number of offers will be increased in tourism and energy sectors, in addition to solving problems relating to the existing infrastructure. The Table below provides an overview of the announced investments in the period 2014-2018.

Table 5 Announced investments in the period 2014- 2018

No	NAME OF THE PROJECT	Value of the investment
1	Kumbor	570.0
2	Plavi horizonti	250.0
3	HVDC undersea cable Montenegro – Italy	305.0
4	Luštica bay resort	1100.0
5	Port of Montenegro	100.0
6	Coal mine "Maoče", TE Pljevlja	500.0
7	2nd block of TE Pljevlja	280.0
8	Cable wire Kotor -Lovćen Cetinje	47.0
9	1st section of the highway Bar – Boljare	800.0
10	Other investments (tourism, agriculture, energy	
	Total	3952.00

Macroeconomic scenario for the period 2014-2016 is based on the following assumptions:

- When it was designed a realistic approach was taken according to which the value of investment projects in the medium term will increase the investment activity to 5% of the estimated GDP per year;
- Net foreign direct investments in the period 2014-2016 will significantly rise as a result of the announced investment activity so that they will amount on average to 15.7% of GDP, along with continuation of the existing projects. Because of the uncertainty of hodogram of investments and their structure it is difficult to project with certainty trends of investment activities and foreign investment inflows in the medium term, and deviations in their values by years is possible. According to the investors' announcements, the investment structure will move in the direction of green-field investments, while the part that relates to the real estate investments will decrease.

- Due to the economic activity growth banks will boost lending activities;
- Bank loans will rise, but slightly slower than nominal GDP growth.
- Share of deposits will be stable;
- Deflator is projected at 2.5%, during the entire period.
- Projections of inflation trends foresee a slight rate reduction compared to 2013, as a result of stable or lower prices of petroleum products and stable food prices. On the other hand, price increase will be impacted by the announced increase of electrical energy prices, increased excise taxes on tobacco and inflationary pressures caused by the increasing demand due to the increased investment activity. Projected inflation rates for the period 2014-2016 are 2.9, 2.5 and 2.5%.

Table 6 BASE MACROECONOMIC SCENARIO

	2014	2015	2016
Nominal GDP in €mill.	3,516	3,730	3,968
Nominal growth	*6.2*	*6.1*	*6.4*
Real growth	*3.6*	*3.5*	*3.8*
Deflator –growth	*2.5*	*2.5*	*2.5*
Inflation	*2,9*	*2,5*	*2,5*
Main characteristics:			
Current account deficit	-14.6	-13.6	-12.3
Export	44.4	43.9	43.4
Import	64.3	62.5	60.3
Other	5.3	5.0	4.7
Deposits	60.7	60.7	60.7
Banking loans	58.3	58.4	58.4
Household consumption	78.0	75.7	74.1
Gross investments	20.1	21.3	21.6
Government spending	21.7	21.6	21.2
Real growth rates in%			
Real GDP growth	3.6	3.5	3.8
Household consumption	0.3	0.4	1.6
Gross investments	11.8	9.4	5.4
Government spending	3.9	3.0	2.1
Net export	-1.6	-3.3	-5.3
Export	1.7	2.3	2.7
Import	0.7	0.6	0.3
Share in the real GDP growth			
Real GDP growth	3.6	3.5	3.8
Household consumption	0.2	0.3	1.2
Gross investments	2.2	2.0	1.2
Government spending	0.8	0.7	0.4
Net export	0.3	0.6	0.9
Export	0.8	1.0	1.2
Import	-0.5	-0.4	-0.2
in% of GDP if not indicated otherwise			
Major prerequisites:			
Employment growth	1.3	0.9	0.6
Unemployment (ARS)	19.2	19.0	18.8
FSDI% of GDP	14,8	16,6	15,6
Bank loans	5.3	6.3	6.3
Export growth	4.3	4.9	5.2
Import growth	3.2	3.1	2.8

Projected GDP growth includes the following components on the expenditure side:

- **Household consumption** will, as the most important factor in the formation of GDP, record a mild growth which will be caused by two divergent factors: stagnant income from wages and pensions - a real drop in disposable income with regard to the projected inflation rate of 2.9%. Increased spending on the basis of new employment, caused by the increased investment activity, will have an incentive effect on the growth of household consumption. Based on the Household Budget Survey data, disposable income from salaries and wages account for about 62% of the total disposable income, while income from pensions, accounts for approximately 26% of the total disposable income (Household Budget Survey). An additional correction factor of household consumption comes from the increase in credit indebtedness of this sector. In the period from 2014 to 2016 decrease in the share of household consumption in GDP is expected given that the real growth in household consumption will be lower than the real GDP growth rate.

- **Gross fixed capital formation** in this period will grow high rates (average 8.9%), due to the increased purchases of investment equipment and facilities necessary for the performance of investments. Increased spending in this segment is a sign that investors anticipate and plan increased activity in the future, because purchase of equipment and facilities related to the investments is a necessary precondition for their realization. In the period 2014-2016, share of this component is increasing, which for 2013 is estimated at 18.7% of GDP. At the end of the medium-term period share of gross fixed capital formation will reach the level of 21.6% of the projected GDP.

- **Government spending** will grow as a result of expenditures for financing first section of the highway from Smokovac to Mateševo, which will be implemented through the capital budget, but multiplicative effects of investments will have an impact on the budget revenues growth, which, combined with cutbacks in the current budget spending will have a positive impact on the budget deficit. It is planned that share of government spending in this period will be stable, and at the end of the period will reach 21.6% of GDP.

- **Export** of goods and services will gradually grow in this period because in 2014 and will be influenced by high-base in the accounts of goods in 2013, which apart from the reduction in exports of non-ferrous metals, recorded a significant growth by exports of electricity. The increase in exports of services, through the foreign tourist spending, will have a dominant influence on the growth of total exports of goods and services in the medium term. Participation of foreign tourist spending (exports of services) makes 20.4% of GDP in 2013. When this component was developed the average annual growth of 6% was taken into account. Current and future investments in tourism facilities and infrastructure will enhance tourist offer, which will change the growth model of tourism from the mass tourism destination to the elite tourist destination.

- •**Imports** will have weak growth which will be influenced by the increased import of investment equipment and substitution of food import with domestic production (reduction of imports). Average growth rate of imports is projected at the level of 3.3%, while imports of services will stagnate.

- •**Employment** will grow in line with the increased demand for labour in the construction industry but also in related industries such as trade, transport, manufacturing services, finance and insurance (0.9% annually).

- **Unemployment** will decrease, as inversely proportional to the size of employment, so that the 19.7% rate, recorded in 2013, will decrease to 18.8%. The limiting factor in reducing unemployment is structural unemployment, conditioned by mismatched supply. The expected investment cycle in the next five-year period will have an impact on tourism, transport and energy industry, which will cause the increased demand for specific profiles in these areas, which have also been in short supply so far.

- After a significant reduction in the **current account deficit** in 2013 in the period 2014-2016 a slight decrease has been projected, and at the end of the period deficit would be 12.3% of the estimated GDP. This trend will be the result of export growth higher than the growth of import of goods and services. Other components of the current account, relating to transfers and income balance, will reduce their participation and it will change from 5.4% in 2013, at the end of the period to 4.7% of GDP.

The projected GDP growth includes the following components on the production side:

- Projected growth in **agriculture** sector in the period 2014-2016 will amount an average to 2.0%. Growth is projected on the basis of the assumptions on the increased investments in agriculture and increased lending support to this sector in the period 2014-2016, as well as the gradual substitution of imports with the increased domestic production.
- **Mining and quarrying industry** will grow on average by 5.3% per year over the medium term.
- **Manufacturing industry** will have a weak growth in the following period of 1.5%, assuming that KAP production will be held at the 2013 level.
- **Electricity** production in this period will record a slight increase, while production from hydropower plants will record a decline due to the high base in 2013, while the production from thermo-power plant will be above the last year's production. Production of electricity from thermo-power plants will impact the increase in the mining production (coal mining).
- •**Construction industry** will have the largest growth of about 14% on average under the influence of the announced investment boom. Engaging domestic construction capacities will have a multiplicative effect on industries related to the functioning of this sector: **trade, transport, financial and insurance services, small production services** and the like. The increase in these sectors will be on the level of the overall economic activity growth (3.6%).
- According to this scenario, growth of 5.5%. in **accommodation and food** services sector is foreseen, which partly covers tourism sector with

The following Table provides an overview of the real growth rates, contributions to the growth and share in GDP in the medium term under aggregate production sectors:

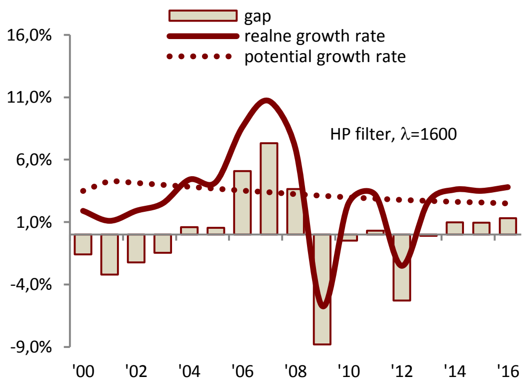
Table 7 Real growth rates of GDP- aggregate production sectors

	real growth rate in%	contribution to growth in%	share in GDP in%	real growth rate in%	Contribution to growth in%	Share in GDP in%	Real growth rate in%	Contribution in growth in%	Share in GDP in%
Agriculture, forestry and fishing	1.8	0.1	7.2	2.0	0.1	7. 1	2. 2	0. 2	7. 0
Industry	1.8	0.2	10.0	3.0	0.3	10. 0	3. 0	0. 3	9. 9
Construction industry	15.0	0.7	5.1	13.5	0.7	5. 6	14. 0	0. 8	6. 1
Services	3. 1	1. 9	60. 1	2. 8	1.7	59. 7	3. 0	1. 8	59. 2
Taxes –subsidies	4. 0	0. 7	17. 6	4. 0	0. 7	17. 6	4. 2	0. 7	17. 7
GDP		3. 6	100. 0		3. 5	100. 0		3. 8	100. 0

2.2.1. Real Sector

The Montenegrin economy has recently gone through a boom period (growth in the period from 2006 to 2008 - an average increase of 8.7%) and double recession caused by the financial crisis (in 2009 - a decline of 5.7%) and consequences of the crisis in the Euro area and the spillover to peripheral countries (2012 - a decline of 2.5%). These unstable movements in a relatively short period of time make it difficult to position economy in the business cycle precisely. These limits have been reinforced by short series or lack of data, so the results of this analysis should be taken with a grain of salt, even though they reflect core developments. This year, calculation of the position in business cycle has been made based on the HP6 - filter because disadvantages of CD7 - production functions for the assessment of the value of fixed capital have been reinforced by divergent trends in employment and economic activity in 2012. The Montenegrin economy in the period 2014-2016 with a projected growth rates will slowly approach potential GDP, after the contraction in 2009 and 2012 and moderate growth rates in 2010 and 2011. On that road a negative impact of the weak economic activity in the Euro area and the countries in the Region as well as the inherited structural weaknesses and fiscal adjustment needs can occur and activate.

Graph 5 GDP-Potential and real growth rates



Business cycle began in 2005 and had sharp fluctuations, which is shown by a top-down gap which was about 15% of GDP. After the boom in 2007 and 2008 there was an abrupt adjustment in 2009, and after that there was certain stabilization in 2010 and 2011. In 2012 delayed effects of the crisis occurred marked by repeated decline of economic activity (W - double bottom recession). Economy growth in line with projected rates will bring the achieved GDP closer to its potential level at the end of this cycle (2016). Average potential growth rate was around 3.2%, but its downward trend is noticeable, which is a result of both technical deficiencies of calculations but also the fundamental weakness of economy. Growth rates projected by the base scenario are higher than potential and somewhat higher inflation rate is the result of a slight overheating of economy, which by definition occurs in case where economic activity is growing faster than the potential rates. Potential and real GDP are not independent of one another, because longer periods of recession reduce production capacity and productivity, and it affects the reduction in the potential of economy. In case of Montenegro, this statement refers to the problem with failed privatizations - hotel facilities which have been privatized and which are still not operational, closure of unsuccessful production companies or a problem with the functioning of the KAP's production chain. Another important factor of the potential reduction is drop of funding sources especially those from the parent banks from the EU. Reduction of funds for financing in parent banks is reflected immediately in the reduction or withdrawal of capital from branches or banks subsidiaries. Reducing funding for financing can be manifested through difficult or rigid financing conditions.

Base macroeconomic scenario 2014-2016 is based on the projection of growth in production factors, primarily in the construction sector (the beginning of the investment cycle) and multiplicative effects on the sectors of retail, tourism, transportation, information and communications and the financial sector. Growth is expected in the agriculture sector, stimulated by the announced credit support and investments in this sector.

[6] Hodrick Prescott
[7] Cobb-Douglas

2.2.2. Inflation

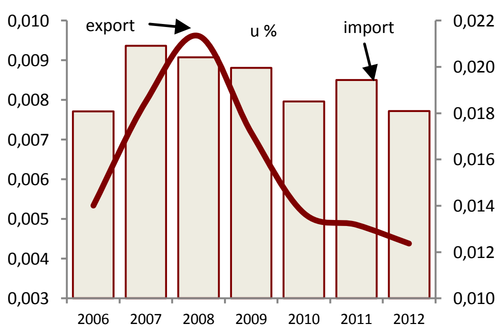
Projections of inflation trends in the base macroeconomic scenario are based on external assumptions which predict the fall in prices of oil in 2014 and 2015, stable food prices on international markets in 2014, with a tendency to fall in the next period and a slight increase in metal prices in 2014 and 2015, as a result of the increased demand caused by the growth of economic activity. On the other hand, inflationary pressures are expected from internal market, through the announced increase in electricity prices and an increase in excise duties on tobacco in 2014 and growth of aggregate demand throughout the entire period, as a result of the increased investment activity.

Starting from these assumptions, it is predicted that average inflation rate in the period 2014-2016 will amount to 2.9, 2.5 and 2.5%, while according to the European Commission projections inflation in Montenegro in 2014 and 2015 will amount to 2.1 and 2.9%.

2.2.3. External Sector and Its Medium-Term Sustainability

Current account balance of a country essentially shows competitiveness that economy of a country has in international trade. Current account deficit indicates weak competitiveness of the Montenegrin economy as export-import ratio shows that goods of foreign origin is either cheaper than Montenegrin or there is no such production in Montenegro. A corrective item in the current account of Montenegro is an inflow from transfers and income which in 2012 amounted to 10.9% of GDP. It is anticipated that in the future they will be at that level. Also the possibility of obtaining transfers from the EU funds should be mentioned, based on the implementation of various projects. As for expenditures on the factor income account, growth is expected in the following period, primarily due to maturity of obligations in terms of foreign borrowings. Also, the intensity of foreign direct investments will directly impact the trends in expenditures arising from dividend payments in the medium term. Major financial account shows how such deficit is financed and sources of funding. Macroeconomic scenario 2014-2016 anticipates the improvement of the balance of payments position in 2013 so that the estimated deficit would amount to 15.4% of GDP, caused by the increase in exports of electricity, reduction in metal industry goods exports, growth of revenues from services and a slight increase in the position which includes net income transactions and current transfers. Although the balance of payments position is improved, it is primarily the result of cyclical movements conditioned by record production of electricity, due to favourable hydro conditions and at the same time reduced need for electricity import.

Graph 6 Share of Montenegro in world trade



Source:database WTO and calculation of MiF Montenegro

In the period from 2014 to 2016 further improvement of the balance of payments position is foreseen based on the assumption of average export growth of 4.8%, conditioned primarily by the growth in revenues from tourism and a smaller increase in exports of goods. At the same time imports would grow at a 3% rate and would be conditioned by depreciated household consumption and substitution of imports with domestic production (agricultural products and electricity) and increased import of the investment equipment for the needs of investment spending. Current account deficit would have a downward trend, so that at the end of the period it would amount to 12.3% of GDP.

Major financial account shows that high deficit of current account is financed through a high level of foreign direct investments and indicates unsustainability of such a model in the long run. Although the level of net errors and omissions is constantly high (unrecorded revenues from tourism), in 2012 it amounted to 7.4% of GDP, it is still very high compared to international comparisons. Dependence of the growth of economic activity on constant inflow of foreign investment and financing of high deficit of balance of payments with this influx, clearly show the danger of a sudden outbreak of balance of payments crisis.

Certainly that balance of payments position of Montenegro shows that it is necessary to meet all these challenges as soon as possible. Export of goods accounts for only 12% in the formation of GDP, while export of services accounts for almost 34% (2012), where export of tourist services makes 20% of GDP. This indicates the importance that certain sectors have and in which direction efforts should be focused in order to overcome balance of payments imbalances.

Base macroeconomic scenario 2014-2016 predicts strong inflow of FDI, which will in the medium term amount to an average of 15.7% of GDP, which will be enough to cover the current account imbalance. Sources of such strong inflow of investments are the projects in the sectors of energy, tourism and infrastructure.

Graph 7 Real effective courses 2009=100

Source:World bank, Oanda, Monstat ,MiF calculation

The issue of external position of Montenegro is the issue of its competitiveness in relation to the external environment. The crisis in the Euro area underlined vulnerability of peripheral economies through deterioration in competitiveness, and thereby the increase in borrowings, because trade exchange deficits must be financed either by the influx of foreign investments or by increased borrowing. The analysis of competitiveness based on REER (real effective exchange rate) and unit labour costs show a decrease in competitiveness in 2012, but also growth in the medium term (ULC). The REER analysis was weight-based and it was conducted for 25 countries with which Montenegro has foreign trade exchange and which encompass 93.9% of foreign trade exchange and represents a real value of the basket of currencies with which Montenegro has foreign trade exchange. A model which uses weighted geometric mean to calculate the Nominal effective exchange rate (NEER) and weights for the CPI (inflation) was used where[8] :

$$REER = \frac{NEER_t * CPI_t}{CPI_t(strani)}$$

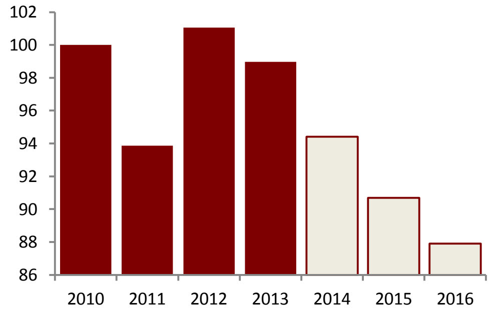
$$NEER = \prod_{i=1}^{N} S(i)_t^{w(i)}$$

$$CPI = \prod_{i=1}^{N} CPI_t^{w(i)}.$$

Since the increase in competitiveness cannot be reached through currency devaluation (use of the common currency) necessary adjustments must be achieved through a slow process of internal

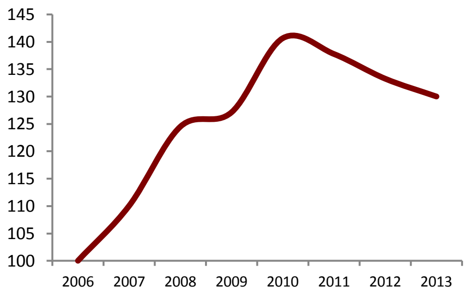
[8] w=weight that individual country has in foreign trade with Montenegro; S(i) Nominal course of the euro expressed in that country currency

Graph 8 Unit labor cost 2010=100



Izvor: Monstat i kalkulacije Ministarstva finansija

Graph 9 Real wages trends 2006=100



Izvor: Monstat and MiF calculation

devaluation through decreased wages and structural reforms. This Graph which shows the share of Montenegrin exchange in the world (this share is minor having in mind the size of the economy) a decrease in import of goods and services as well as the export of goods is noticeable. Having in mind the decrease in import of goods in 2013, we expect further decrease in the share of import of goods and services and stable share of export due to the export of goods and services in line with the growth of the world export (estimation of 3-4% growth for 2013).

The Competitiveness Analysis which was developed based on the unit labour cost (ULC) shows that price competitiveness increases although reliability of the analysis is limited because the source of data on the number of employees changed (2010) and because of the fight against grey economy which has led to the increase in the number of employees which is not in correlation with economic activity (2012-2013).

Real salaries trend is another indicator which shows that internal devaluation is conducted through the real salaries cuts. It is clear that stagnation of salaries along with inflation growth (consumer prices index) generates the decrease of real disposable income. Based on the calculations of the Ministry of Finance real salaries decreased by 7.6% from 2010 till the end of 2013. Although the decrease in salaries increases competitiveness, it has a negative impact on disposable income, and thus on the level of aggregate demand.

One of the sectors in which Montenegro can increase competitiveness which can be one of the sources of faster growth in the future is tourism. Previous results and their analysis show that Montenegro does not use sufficiently comparative advantages it undoubtedly has in natural beauties and geographical position.

Table 4 Indicators in tourism sector

	2006	2007	2008	2009	2010	2011	2012	2013
					In Euros			
Real growth rate of revenues from tourism	18.6	62.3	8.6	-6.0	4.5	8.8	-0.3	0.4
Tourist spending nominal amount	**285**	**405**	**455**	**435**	**437**	**451**	**447**	**444**
Tourist spending in 2006 prices	285	389	403	373	372	373	355	344

Source: Balance of payments CBM, Monstat and calculations of the Ministry of Finance

Data in the Table indicate that average tourist spending has been falling since 2008. Fall in 2009 is a result of the financial crisis while the decline in 2012 and 2013 is the result of the repeated recession or the reduction in disposable income in generating markets for Montenegrin tourism. Only improved supply in qualitative and quantitative terms can reverse the aforementioned trend. Improved supply refers to the construction of new attractive facilities, reconstruction of the existing and construction of infrastructure with better complementary tourist services. The current downward trend of average income and its level indicates that Montenegro is a mass tourism destination and that such orientation cannot bring significant improvements in the forthcoming period without changing the growth model. Measures and policies towards changing the growth model from mass to elite are a necessary condition for strengthening the share of this sector in economic activity.

Undertaken reforms that relate to the ease of starting and conducting business have yielded results so that the position of Montenegro in the publication Doing Business (World Bank) has improved. The Table shows that disadvantages to which foreign and local entrepreneurs had most complained (obtaining construction permits and registering property) have largely been eliminated and Montenegro progressed for 6 places and came to the 44th position of 189 countries.

Table 5 Simplicity of doing business – the World bank Report

	2014	2013	Change of positions
	Position		
	44	50	6
Business start-up	69	57	-12
Obtaining building permits	106	174	68
Using electricity (permits and the like)	69	68	-1
Property registration	98	114	16
Obtaining loan	3	3	No change
Protection of investors	34	32	-2
Paying taxes	86	85	-1
Foreign trade	53	51	-2
Contracts enforcement	136	134	-2
Insolvency resolution	45	45	No change

2.2.4. Financial Sector

Base macroeconomic scenario 2014-2016 predicts steady growth in deposits and moderate lending activity growth (somewhat lower than the nominal GDP growth). Lending activity growth is a necessary prerequisite for the real sector growth. For the whole period a stable share of deposits is projected (around 61% of GDP - with an average growth of 6% over the period). This projection is based on the deposit growth in the previous period, which is an indicator of restoring confidence in the financial system. Stable share of loans of around 58% of GDP is predicted.

2.2.5. Medium-Term Risks

Base macroeconomic scenario is based on estimates and information on the beginning of a strong investment cycle which will accelerate economic activity growth in the medium term. The Montenegrin economy is facing a reduction in foreign demand caused by the crisis and is inevitably suffering the consequences which are reflected in all sectors of the economy. Macroeconomic and fiscal risks (deterioration or improvements), which can be materialized in the forthcoming mid-term period are as follows:

1) Risks that may affect the reduction of economic activity and fiscal crisis in relation to the base scenario:

a. The risk that may materialize in the future relates to the possibility of reducing the inflow of funds due to the announcement that the U.S. Federal Reserve will start in the next year reduction of monetary incentives through the so-called quantitative easing[9], which have reached this year the amount of $1,000 billion which have had effects on the entire world economy. There is a consensus among analysts that elimination or reduction of these incentives, which have been introduced to encourage and stabilize economic growth in America , will have some negative impacts that will affect the withdrawal of funds from the emerging economies and among other countries of Eastern, Central and South-Eastern Europe. Reducing sources of cheap funds would increase borrowing rates and would reduce funding sources. This scenario was seen in June 2013 when rates on sovereign borrowings of the CESEE countries increased substantially after the story about reduction of quantitative easing that has not materialized so far. This risk is important for Montenegro because in 2015 and 2016 repayment of Eurobonds is due which were issued in 2010 and 2011 in the amount of €380 million and such a scenario could prevent or significantly raise the price of debt refinancing.
b. Previous risk can affect the confidence and heightened investor's caution that can reduce or delay the announced investment projects. The decrease in foreign direct investments could cause balance of payments crisis through the need to adjust the high current account deficit.
c. Decline in lending activities due to the problems in the banks of the countries from which owners of daughter banks in Montenegro come. The ECB is currently conducting stress testing of banks in the Euro area to assess capital adequacy. Requirements for the increase in capital can reflect in the reduction of lending activities primarily in daughter banks.
d. Further deepening of the crisis in KAP, through the further reduction of production or liquidation, would affect the further decline in exports and reduction of budgetary revenues. Current aluminium price is $1,750/t, and is at the lowest level since the beginning of 2013. Montenegro is in the process of finding a strategic partner for KAP, but if it is not found under the current market conditions, functioning of KAP is unsustainable by economic parameters.
e. Additional fiscal obligations may arise from activating the given government guarantees, which would produce an additional pressure on the budget and achieving the set fiscal goals.
f. Decrease in charging budgetary revenues due to the high illiquidity of the real sector would further aggravate the issue of fiscal adjustments, since it would require either further reducing expenditures or raising taxes. Need to restructure sovereign debt or its repayment in 2015 and 2016 makes these adjustments urgent due to the confidence of potential investors.

2) Macroeconomic and fiscal risks - probability of positive deviations:

a) Positive risks relate to the possibility that all the announced investment projects are activated immediately, which would strengthen economic activity above the rates projected by the base scenario and would have multiplicative effects on all sectors of the economy.

[9] Quantitative easing is implemented through the purchase of government bonds with the new dollar print. This is not the only quantitative easing, but instead similar measures have been applied by the Central Banks of Japan, England and Switzerland.

2.3. Macroeconomic Low-Growth Scenario for the Period 2014-2016

Macroeconomic low-growth scenario is based on the assumption of a delay of the beginning of the investment cycle for two years due to the investor caution because of the risks mentioned in the previous section. This scenario is based on the assumption that tourism sector will generate positive results at the level from the base scenario, and that energy sector cannot have a significant growth due to the limited production capacities. Under this scenario, the following growth rates of real GDP in Montenegro are projected: 1.6% in 2014, 2.0% in 2015 and 4.0% in 2016.

Table 6 Macroeconomic low-growth scenario

	2014	2015	2016
Nominal GDP in € mill.	3,415	3.535	3.750
Nominal growth	*3.1*	*3.5*	*6.1*
Real growth	*1.6*	*2.0*	*4.0*
Inflation	*1.5*	*1.5*	*2.0*
Deflator –growth	*1.5*	*1.5*	*2.0*
Major characteristics:			
Deficit of the current account	-13.6	-11.8	-12.0
Export	44.0	43.3	42.0
Import	63.0	60.3	58.9
Other	5.4	5.2	4.9
Deposits	59.0	58.0	58.0
Banking loans	57.1	56.6	57.3
Household consumption	78.9	77.2	75.5
Gross investments	18.7	18.7	20.8
Government spending	21.4	21.1	20.6
	(real growth rates% of GDP)		
Real GDP growth	**1.6**	**2.0**	**4.0**
Household consumption	-0.5	-0.2	1.7
Gross investments	1.8	2.0	15.4
Government spending	0.5	0.5	1.8
Net export	-7.4	-8.6	3.4
Export	-1.1	0.3	0.9
Import	-3.1	-2.4	1.6
	Share in the real GDP rate in%		
Real GDP growth	**1.6**	**2.0**	**4.0**
Household consumption	-0.4	-0.1	1.3
Gross investments	0.3	0.4	2.9
Government spending	0.1	0.1	0.4
Net export	1.6	1.6	-0.6
Export	-0.5	0.1	0.4
Import	2.0	1.5	-1.0

Real Sector

Macroeconomic low-growth scenario 2014-2016 is based on the projection of the production factors of low growth in the sectors of tourism, retail, transport and financial sector. Growth is expected in agriculture sector, stimulated by the announced credit support and investments in this sector. Given that this scenario is based on the assumption on the delay of the investment cycle, in 2016 a strong growth in the construction sector is expected with multiplicative effects on the entire economic activity.

In this scenario the worst scenario (for KAP) was taken into account as the baseline which foresees liquidation of KAP due to the lack of interest of investors to buy it as a result of adverse developments the commodity market and estimation that further extension of subsidies for electricity is not profitable which is a necessary condition for KAP's continuation of production.

Employment stagnates during the first two years of the period, as a result of a weak economic growth and in 2016 it would start a mild increase. Projected rates of employment growth are 0.1, -0.1 and 0.9%.

Inflation

Projections of inflation in the low-growth scenario are based on the same external assumptions as in the base scenario, while internally milder inflationary pressures are expected as a result of increase in electricity prices and excise taxes on tobacco and a lower growth of the investment activity compared to the base scenario.

Starting from these assumptions, it is projected that average annual inflation rate in the period 2014-2016 will be 1.5, 1.5 and 2.0%.

External Sector

Balance of payments projections predict current account deficit decrease as a result of the slight increase in exports and decrease in imports. This scenario predicts a decline in exports of goods and moderate growth in exports of services (tourism). The low-growth scenario foresee a decline in imports of goods and services in the first two years and in 2016 imports growth would occur stimulated by the beginning of a stronger investment activity. In the period 2014-2016 FDI are lower and amount to 11% of GDP, where first two years of approximately 9% and at the beginning of the investment cycle in 2016 they would significantly increase and amount to about 14% of GDP.

Financial Sector

Low-growth scenario 2014 - 2016 foresee stagnation of lending activity in the first two years of the cycle and a significant growth would occur in 2016 (investments). Share of deposits decreases because disposable income for consumption is decreasing, so that saving is one of the sources of correction. This scenario does not take in consideration materialization of the risks associated with high level of non-performing loans and high illiquidity of economy.

III PUBLIC FINANCES

This chapter presents long-term and medium-term commitment of public finances of Montenegro. Also, this chapter gives an overview of the basic fiscal parameters which have marked 2013 that is the period after the publication of the last Program. Special attention in this Chapter is paid to fiscal consolidation measures which have been implemented during 2013 and their financial and macroeconomic effects. Also, fiscal measures planned for the next period are presented, which in addition to fiscal consolidation measures include fiscal incentive measures that will contribute to achieving higher rates of economic growth in the forthcoming period.

Medium-term fiscal projections, as in the previous program, are based on two fiscal scenarios, “base fiscal scenario” and “low-growth scenario” based on which the scenarios of government debt developments have been prepared. “Base fiscal scenario” is the central scenario which is based on the base macroeconomic scenario (presented in Chapter 2) and which is in accordance with the annual 2014 Law on Budget. “Low-growth scenario” represents an estimate of fiscal categories if economic growth envisaged by macroeconomic low-growth scenario is achieved. In subsection Government Debt, debt development in 2013 is presented and projections of debt development based on two fiscal scenarios and structure as well as the condition of issued government guarantees.

In subsection Public Finances structural balance is shown which excludes effects of business cycle and all the measures that have been implemented in the last couple of years as a result of fiscal adjustment measures but also the gradual harmonization of legislation with the EU regulations.

Bearing in mind that the Montenegrin economy is a small and open system, susceptible to changes and influences from the region, along with its own inner vulnerabilities, potential risks that could be manifested in the future have been identified, which is represented by sensitivity analysis. In addition to the risks that could affect deterioration, i.e. implementation of the alternative low-growth scenario, risks that could lead to the achievement of better fiscal performance than those provided for in the base scenario have been recognized.

This Chapter points to the fiscal implications of the basic structural reforms (which are presented in Chapter 4) and the elements which have impact on the long-term sustainability of the public finances system of Montenegro. Consequently, changes made in terms of quality strengthening and institutional framework of public finances are presented.

3.1. Strategy and Medium-Term Goals of Fiscal Policy

High rates of economic growth in the years before the crisis, accompanied by expansionary fiscal policy resulted in the country's significant structural deficit during the crisis. The result of a high deficit was accompanied by the rapid growth of the level of government debt, which in nominal terms was more than doubled, from less than €900 million in 2008 to €1,845 million at the end of September 2013, and as a share of GDP, in the same period debt increased from less than 30 to over 55 (while with guarantees it exceeds 63% of GDP). The increasing public debt reflected in an increase in interest costs that before the crisis amounted to less than 1% of GDP, and now they amount to over 2% of GDP.

Montenegro as a small and open economy is very susceptible to external shocks, and therefore the need to establish financial stability is imposed as a basic prerequisite for development. Specificity of the Montenegrin economic system is reflected in the use of the euro as a currency, which for the Euroized economy means that focus of economic policy is put on fiscal policy instruments. In order to achieve fiscal sustainability, Montenegro is running a prudent and responsible fiscal policy, focused primarily on consolidation of public finances, but also the creation of basic preconditions for dynamic growth and development in the future. An additional argument supporting the necessity of running a stable public finance policy is reflected in the need to maintain the best possible quality of access to international financial markets. A significant reason for running a prudent fiscal policy in the next mid-term period is reflected in the fact that we are at the stage of negotiations for the EU accession. In this context it is necessary to find a specific solution concerning the euro as currency, and the solution will be easier to find and negotiate if Montenegro ensures stable public finances, stressing a stable level of public debt.

A key long-term objective of public finances of Montenegro is stabilization of the public debt, that is, decrease level of public debt relative to GDP.. The success of achieving this strategic goal will be to a large extent depending on the economic growth that the country will pursue in the forthcoming period, and on the other hand, the multi-year process of fiscal consolidation. The introduction of the fiscal rule and its efficient implementation in this context becomes even more important. In terms of government debt development, long-term goal of public finances is to reduce public debt to a pre-crisis level in 2008, that is, to about 30% of GDP by 2023.

Fiscal Policy of Montenegro for the period 2014-2016 is aligned with a long-term strategy of stabilization which is followed by a reduction in public debt. Specifically, the elements of fiscal consolidation for the next three-year period are focused on:

1. Decrease of grey economy;
2. Decrease of tax receivables;
3. Continuation of austerity measures particularly in non-productive expenditures;
4. Creating regulatory framework for business development and new investments;
5. Rigorous issuance of guarantees (predominantly for the projects that are fostering economic and social development);
6. Fiscal incentives aimed at harmonious and equitable development.

For achieving these goals, a set of systemic measures has been prepared and will implemented in the forthcoming period and they are related to: regulation of the reward system in public sector, finding a model for a higher level of sustainability of the pension system, harsher penalties for offenders, granting discounts to regular payers of taxes, interest write-off for one-off debt repayment, tax debt paid by debtor's property, rationalization of public procurement, additional taxes on property that is not operational, illegally constructed buildings, unsold flats and property which does not serve to acquire additional revenues from property and property rights, etc .

By accomplishing these elements of fiscal consolidation prerequisites for higher economic growth are created, which along with better revenue collection and prudent spending contributes to the reduction of public deficit and consequently the level of public debt.

3.2. Public Finances in 2013

The previous, 2012, was one of the lowest performing years in economic terms in the recent Montenegro's history (GDP contracted by2.5%), and particularly in the area of public finances. External factors, combined with activated state guarantees for KAP and structural weaknesses of its economy caused lower public revenues and increased public spending while increasing deficits to €193.4 million (€68.9 million more than forecasted in the previous PEP). Originally estimated GDP for Montenegro in 2012 amounted to €3,338.0 million, while the final data of the Statistical Office - Monstat show that in 2012 there was a decrease in the real GDP of 2.5% and in nominal terms it amounted to €3,149 million. The very GDP contraction has influenced the increase in public expenditures which increased deficit from 5.8% to 6.1% of GDP i.e. by 0.3 percentage points.

At the beginning of 2013, Montenegro has introduced a set of crisis measures of fiscal adjustment with the aim to halt the trend of fiscal parameters deterioration, primarily the fall of revenues collection and, consequently, deficit and public debt growth. A set of fiscal measures aimed at increasing budgetary revenues, meant the introduction of tax rate on salaries above the national average of 15% and increased base rate of value added tax (from 17% to 19%). As of the signing of the Stabilization and Association Agreement with the European Union, the excise policy has been gradually harmonizing, so in this year there was an increase in excise rates, due to the harmonization of excise rates with the European regulations. On the revenue side, there was a collection of fees and taxes introduced in mid-2012 which encompassed SIM cards, electricity meters, smoking areas and cable television. During the whole year there was a high commitment to the implementation of measures aimed at combating grey economy, which had impact on the expansion of tax base and improving fiscal discipline. Thanks to the successful implementation of these measures in 2013 revenue collection was higher than planned and also compared to 2012, which has positive effects on fiscal consolidation and stabilization of public finances.

On the expenditure side of the Budget, a set of measures of fiscal adjustment was reflected in the freezing of pensions, balancing earnings in the public sector, the cancelling fees for engagement in committees and working groups of the Government of Montenegro, reduction of all spending in the companies in which the Government has majority shares and reduction of costs in local self-governments. Good results of implemented measures were decreased by the activation of guarantees for the Aluminium Plant Podgorica (KAP) in the amount of €102.7 million or 3.1% of GDP. This meant the activation of all the guarantees given to KAP, which significantly reduces the fiscal risks in the medium term. By the end of the year, it is estimated that the total amount of paid guarantees will be around €111.6 million which increases the deficit in relation to GDP by 3.4 percentage points. It should be mentioned here that payment of guarantees is included in expenditures, and without that negative "one-off" effect, deficit in 2013 would be around 0.6% of GDP.

Overview of fiscal measures introduced in this year as well as their budgetary implications, are presented in Table 7.

Table 7. Most important fiscal measures introduced in 2013 and their effects

<table>
<tr><th>No.</th><th>Measure</th><th>Description</th><th>Date of adoption/coming into force</th><th>Revenues/expenditures of the Budget</th></tr>
<tr><td>1</td><td>Increasing VAT rate</td><td>Basic VAT rate is increased from 17% to 19%, while the zero and lower VAT rate remained unchanged (0% and 7%). Effects of this measure by the end of 2013 are estimated as revenues increase in the amount of €25 mill.</td><td>July 2013</td><td>Revenues</td></tr>
<tr><td>2</td><td>Freezing pensions growth</td><td>In 2013 and 2014 pensions will not be adjusted to the inflation and salaries increase. The estimated effect of this measure is about €12 mill.</td><td>January 2013</td><td>Expenditures</td></tr>
<tr><td>3</td><td>Crisis tax on salaries</td><td>Additional taxation of the salaries exceeding the national gross average (€720) by 15% rate. It is estimated that Budget will earn revenues from this taxation in the amount of €7.5 mill.</td><td>February 2013</td><td>Revenues</td></tr>
<tr><td>4</td><td>Increasing minimum wage</td><td>Minimum wage is increased from 30% to 40% of average salary in the country. This measure has a minor impact on budgetary revenues but has positive effects on the standard of citizens with minimum wage.</td><td>April 2013</td><td>Revenues</td></tr>
<tr><td>5</td><td>Activities focused on the reduction of the citizens' tax debt</td><td>Adopted the Decree which provides that payment of tax debt exceeding €100,000 can be compensated with property. Until November, thanks to this and other measures aimed at the reduction of tax debt this type of receivables was reduced by about € 25 mill.</td><td>June 2013</td><td>Revenues</td></tr>
<tr><td>6</td><td>Reduction of costs in public sector</td><td>Local self-government - plan of consolidation of local budgets.</td><td>June 2013</td><td>Expenditures</td></tr>
<tr><td>7</td><td rowspan="3">Reduction of costs in public sector</td><td>State administration – abolished fees for working in commissions and working groups for performing work that is in their job description.</td><td>January 2013</td><td>Expenditures</td></tr>
<tr><td>8</td><td>State owned companies – reduction of managerial staff salaries, deprofessionalization of Management Boards and reduction of fees for being in MBs.</td><td>January 2013</td><td>Expenditures /Revenues</td></tr>
<tr><td>9</td><td>Regulatory agencies – adjusting salaries to the level of salaries in public administration as well as rationalization of other expenditures.</td><td>January 2013</td><td>Expenditures /revenues</td></tr>
<tr><td>10</td><td>Transfers of public institutions revenues</td><td>Surplus in balances of regulatory agencies, companies in which the government is majority owner will be transferred to the Budget of Montenegro. Estimated effect of this measure is about €1mill.</td><td>January 2013</td><td>Revenues</td></tr>
</table>

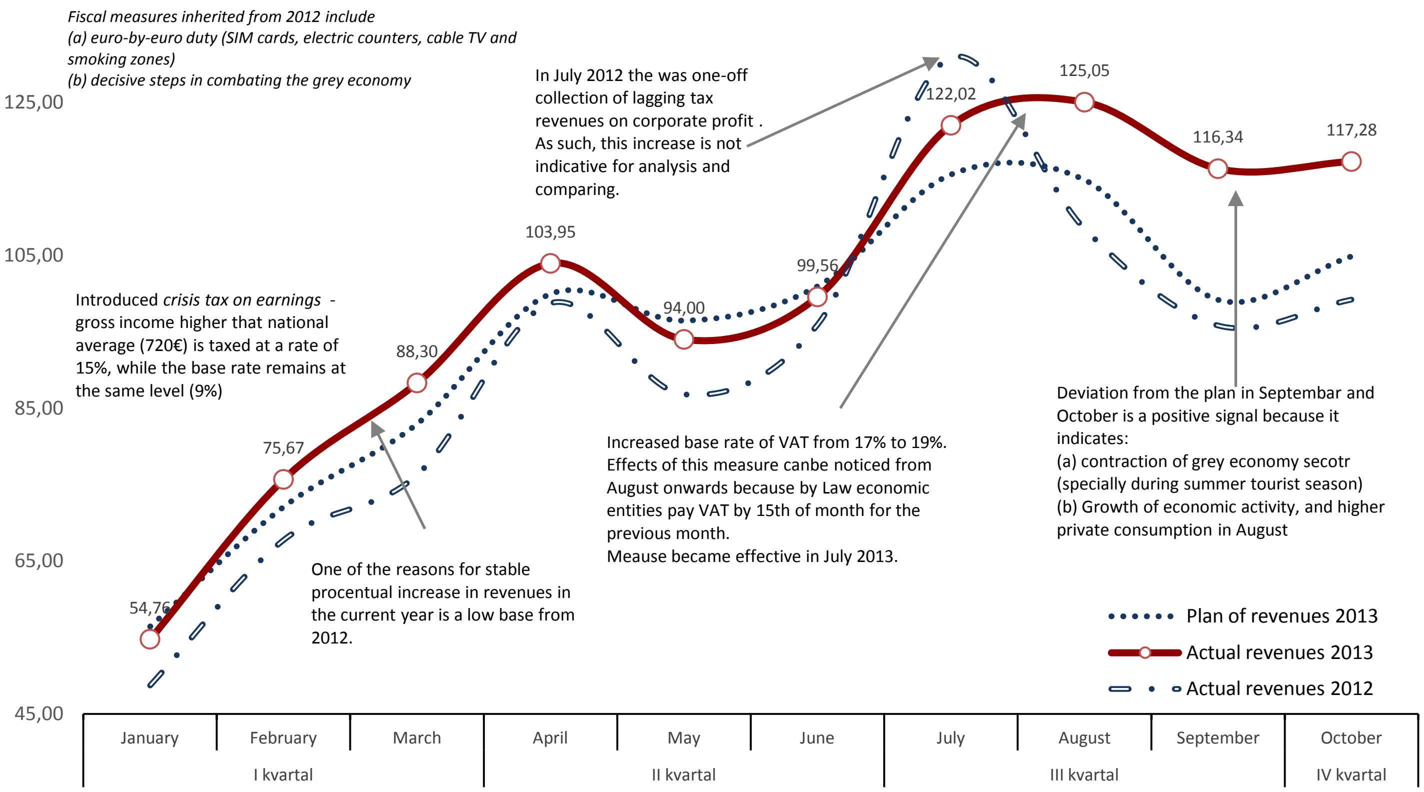
Public Revenues

Implementation of the set of measures of fiscal adjustment and intensifying the fight against grey economy halted the trend of deterioration of fiscal parameters, while revenues increased and tax discipline improved. Based on the revenues generated in the period of nine months projection was made for 2013 which shows that total revenues in this year will be €1,384.5 million, which is by €90.4 million more compared to the original plan (which was presented in the last year's PEP), and 6.5% more compared to last years execution. The most significant growth compared to last year will be in terms of contributions (€45.8 million, 12.6%) and value added tax (€68.5 million, close to 19.3%). These two types of public revenues have the largest share in public revenues which is about 25% of the projected GDP for 2013.

Collection of public revenues cumulatively for nine months of 2013 increased by €65.7 million compared to the same period last year and amounted to €993.7 million or 30.0% of estimated GDP (€3,311.0 million). The most significant deviation was observed within the item value added tax of €51.9 million which is a result of the application of a higher VAT rate and intensification of economic activity.

Since local self-governments are obliged to submit quarterly reports on their financial flows, monthly data on revenues and expenditures are available only for the Central Budget, which makes about 90% of public finances of Montenegro. The first quarter, traditionally, records cyclically conditioned lower budgetary revenues compared to the second part of the year. Compared to the previous year, as of January, with the exception of July, there was an increase in revenues. In the third quarter, revenues earned in every single month exceed the plan for this period. Graph 6 shows for the sake of the simplest comparison of the results achieved, revenues generated in 2012 and 2013 as well as the revenue plan for the current year.

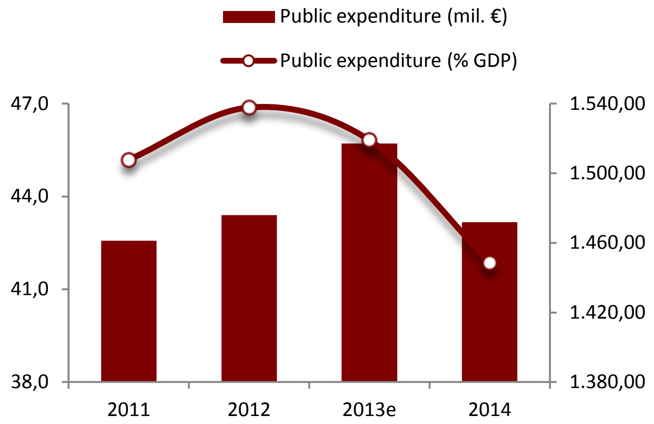
Graph 6 Overview of generated income in 2013



Public Expenditures

As of 2002 public expenditures records decreased as a percentage of the share in gross domestic product and it is expected that this trend will continue in the medium term. In particular, on average in the period 2011-2013, public spending accounts for about 46.1% of GDP. However, as shown in the Graph 7, its continuous fall is obvious despite the high level of spending in 2013 of about 45.8% of GDP.

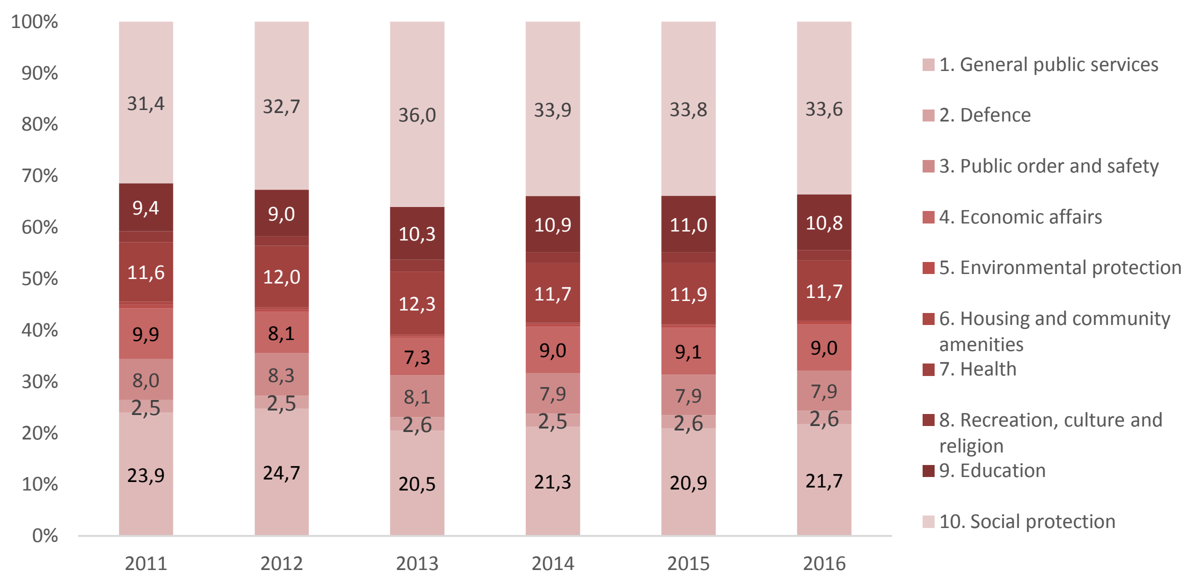
Graph 7 Public expenditure



In fact, public spending reaches its greatest nominal level in 2013 in the amount of approximately €1.5 billion (€111 million represent payment of activated government guarantees) and this level of public expenditure in nominal terms will not be reached in the medium term, which indicates a rapid decline in the share of public expenditure in GDP.

The graph below shows public expenditure allocated by functional (COFOG) classification for the period 2011-2016.

Graph 8 Public expenditure by functional classification (% of total spending)



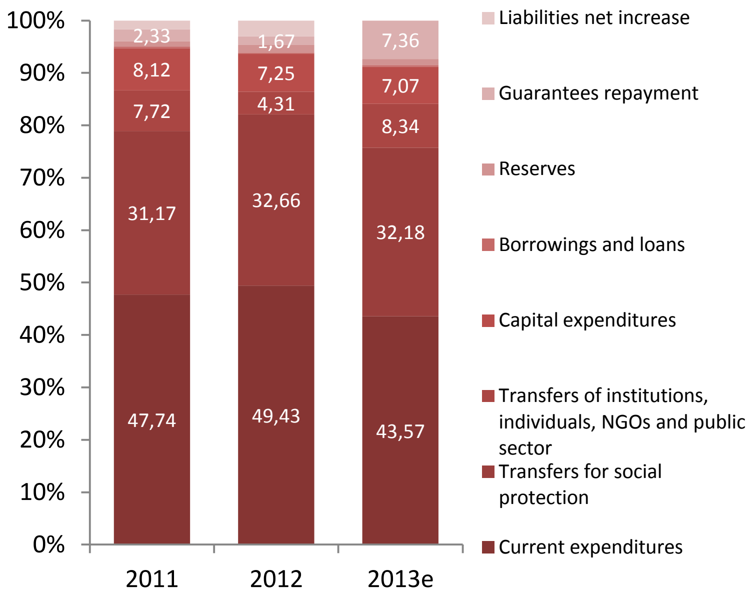
The Graph shows that social protection is the most important expenditure in the total spending ranging from 31.4% in 2011 to a projected 33.6% in 2016. Social expenditures growth trend until 2013 was caused by the constant increase in pension and disability insurance expenditures, which is the most important item among the social protection expenditures, while based on the 2014-2016 projection it can be concluded that in the future they will be in decline. Considering the importance and participation of the pension system in the system of public finances, in early 2014 preparation of solutions was planned which will, on one hand, improve the standard of the most vulnerable category of the population which makes up about 17% of the total population, and on the other hand improve sustainability of the pension system.

Expenditures for general public services have a significant share in the total expenditures. These include local self-governments expenditure which is the most important item of general public services expenditures. These expenditures have a stable share in the total spending which ranges from 24.7% in 2012 to 21.7 in 2016.

Compared to the previous PEP, where public expenditure for 2013 under the base scenario was projected in the amount of €1,375.8 million, or 41.6% of the estimated GDP, according to the latest estimates in 2013 it will amount to €1,517.1 million, or 45.82% of GDP.

If we take a look at the public expenditure by economic classification, Graph 9 shows an overview of expenditures by basic economic categories.

Graph 9 Public expenditure by economic classification (*% of total spending*)



In fact, as presented, the most important expenditures in the total public spending in the last three years goes to Current Expenditures, which account for an average of 47% of total expenditure, then Social Protection Transfers 32%, Capital Expenditures 8%, Transfers to Institutions, Individuals, NGOs and Public Sector 7% and other expenditures ranging from 0.2% to 2.3% of the total public expenditure. Trend of these expenditures shows that that there are certain changes in the percentage participation in the period to 2013.

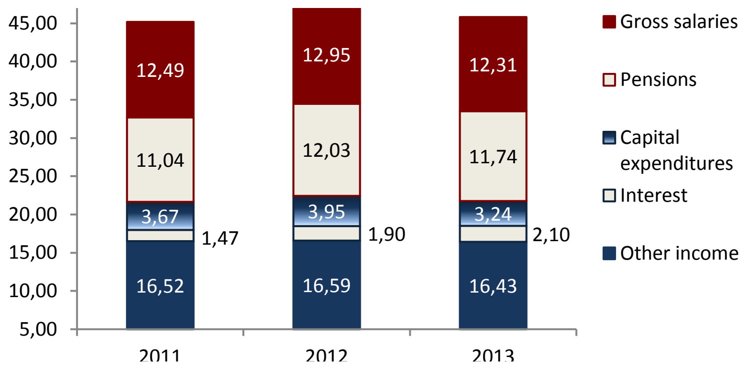
There is an evident decline in spending in 2013 noticeable in capital expenditures. However, it is important to mention that for the following period the increase in expenditures for capital projects is planned, bearing in mind the fact that such measures of economic policy have positive effects on economic growth and development.

Transfers for social protection in the current period recorded growth in the total expenditure. However, in 2013, primarily due to the implementation of pensions "freezing" measures, these expenditures are maintained at approximately the same level as last year. Within these expenditures, the most important item are expenditures for pension and disability insurance, which on average amount to about 25% of the total expenditure. In addition to these, significant and relatively constant expenditures are the rights in the field of social welfare protection which are on the average level of 4.2% of the total spending.

Guarantees repayment expenditures in the previous period have had a significant share in the total expenditure, and largest spending of this kind was made in 2013 amounting to 7.5% of the total expenditure. Bearing in mind that, as a rule, these were unplanned expenditures, they had a significant impact on the overall structure of expenditures, reflecting in the form of additional consolidation of current expenditures and primarily discretionary spending.

Graph 10 presents an overview of public expenditures through a number of items of expenditures as a percentage relative to GDP. As you can see, the most important expenditure refers to gross salaries expenditures in the average amount of more than 12% of GDP. In the medium term, a relative decline in expenditures on this basis is expected due to the growth of the comparative basis (GDP). Nominally, a relatively stable level of this type of expenditure is retained.

Graph 10 Public expenditures in the period 2011-2013 (% GDP)

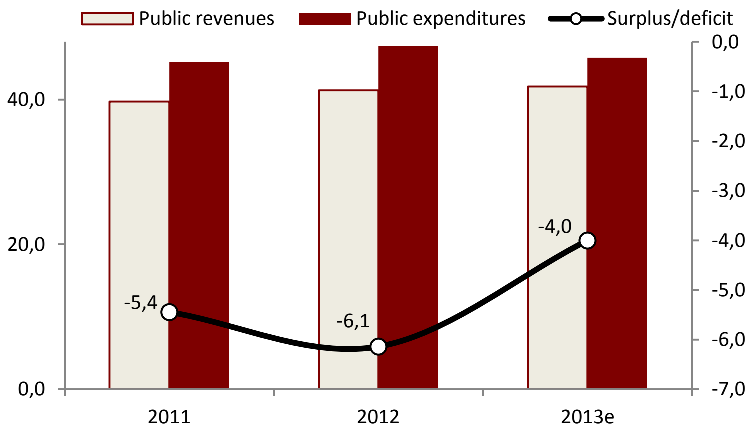


In addition to the expenditures for salaries, a significant level of public spending goes to expenditures for pensions, which nominally retain the level of over €350 million while every year there is a nominal increase of expenses. Expenditures for subsidies, presented in the graph within other expenses, have a decreasing trend and in 2013 it is expected that they will be realized in the amount of 0.5% of GDP, and account for about 1% of the total current expenditure.

In addition, significant expenditures annually are allocated for interests in the average amount of 4%. Expenditures on this basis are expected to vary during the period, depending on the level of borrowings and the cost of debt, and are in the upward trend in the observed period.

Capital budget is tried to be kept on a relatively high level relative to GDP and during the observed period (2011-2016) it is above 3% of GDP. Nominally, this means growth of capital expenditures, and, during this period, it will be ranging from 8-10% of the total public expenditure.

Graph 11 Public revenues, expenditures and deficit/surplus (% of GDP)



On the basis of public revenues and expenditures (Graph 11), since 2012 deficit of public spending is in decreasing trend. Having achieved a high level of deficit in 2012 of around 6% of GDP, in 2013 deficit of around 4% of GDP is expected. However, as previously stated, a significant contribution to the deficit in 2013 comes from expenditures arising from the activated state guarantees which amounted to 3.4% of GDP. Excluding extraordinary expenditures deficit of public spending in 2013 was around 0.6% of GDP, and would be lower than planned by almost 75%.

The following Table provides a detailed overview of public revenues and expenditures, deficit, debt repayment, and sources of financing presented by economic categories.

Table 8 Public expenditures for 2012 with the plan and estimation for 2013

Public expenditures	2012		Plan 2013		Estimation 2013	
	€mill.	% GDP	€mill.	% GDP	€mill.	% GDP
Primary source revenues	1299.91	41.28	1294.10	39.08	1384.46	41.81
Taxes *of which:*	**785.99**	**24.96**	**773.23**	**23.35**	**838.02**	**25.31**
Personal income tax	109.68	3.48	115.04	3.47	117.37	3.54
Corporate profit tax	64.02	2.03	41.93	1.27	42.88	1.30
Taxes on real estate transactions	14.41	0.46	15.22	0.46	15.41	0.47
VAT	354.71	11.26	373.05	11.27	423.22	12.78
Excise	151.77	4.82	157.45	4.76	161.13	4.87
International trade and transactions tax	28.97	0.92	31.19	0.94	23.04	0.70
Local taxes	50.96	1.62	34.94	1.06	50.00	1.51
Contributions	**362.25**	**11.50**	**384.22**	**11.60**	**408.05**	**12.32**
Duties	**23.50**	**0.75**	**35.62**	**1.08**	**30.51**	**0.92**
Fees	**73.75**	**2.34**	**54.16**	**1.64**	**55.29**	**1.67**
Other income	**48.92**	**1.55**	**42.07**	**1.27**	**45.65**	**1.38**
Revenues from loan repayment and funds transferred from the previous year	**5.50**	**0.17**	**4.81**	**0.15**	**6.94**	**0.21**
Public expenditures	1493.34	47.42	1375.77	41.55	1517.07	45.82
Current public expenditures	1368.98	43.47	1280.13	38.66	1409.82	42.58
Current expenditures *of which:*	**729.68**	**23.17**	**646.27**	**19.52**	**661.04**	**19.97**
Gross salaries and contributions at employer's expense	**407.75**	**12.95**	**397.57**	**12.01**	**407.65**	**12.31**
Other personal income	**13.27**	**0.42**	**13.28**	**0.40**	**15.98**	**0.48**
Expenditures for material and services	**167.22**	**5.31**	**96.66**	**2.92**	**101.83**	**3.08**
Current maintenance	**27.39**	**0.87**	**25.16**	**0.76**	**25.61**	**0.77**
Interests	**59.72**	**1.90**	**74.32**	**2.24**	**69.37**	**2.10**
Rent	**7.43**	**0.24**	**8.24**	**0.25**	**8.15**	**0.25**
Subsidies	**26.61**	**0.84**	**14.93**	**0.45**	**15.42**	**0.47**
Capital expenditures of the Current Budget and State Funds	**13.39**	**0.43**	**9.32**	**0.28**	**9.71**	**0.29**
Transfers for social protection, *of which:*	**482.09**	**15.31**	**498.26**	**15.05**	**488.17**	**14.74**
Rights in the area of social protection	**65.64**	**2.08**	61.40	1.85	64.07	1.94
Funds for redundant workers	**16.13**	**0.51**	15.36	0.46	14.78	0.45
Rights in the area of pension and disability insurance	**378.96**	**12.03**	400.90	12.11	388.78	11.74
Transfers of institutions, individuals, NGOs and public sector	**63.61**	**2.02**	**121.01**	**3.65**	**126.52**	**3.82**
Capital expenditures	**124.36**	**3.95**	**95.64**	**2.89**	**107.25**	**3.24**
Capital Budget of Montenegro	**76.04**	**2.41**	65.64	1.98	72.25	2.18
Capital Budget of the local self-government	**48.32**	**1.53**	30.00	0.91	35.00	1.06
Borrowings and loans	**2.96**	**0.09**	**3.73**	**0.11**	**4.58**	**0.14**
Reserves	**21.54**	**0.68**	**10.86**	**0.33**	**17.91**	**0.54**
Guarantees repayment	24.72	0.79	0.00	0.00	111.60	3.37
Liabilities net increase	**44.39**	**1.41**	**0.00**	**0.00**	**0.00**	**0.00**
Surplus/deficit	-193.43	-6.14	-81.67	-2.47	-132.61	-4.01
Primary deficit	-133.71	-4.25	-7.35	-0.22	-63.24	-1.91
Debt repayment	173.09	5.50	160.68	4.85	274.34	8.29
Repayment of principal to residents	**66.13**	**2.10**	27.80	0.84	109.03	3.29
Repayment of principal to non-residents	**59.87**	**1.90**	66.70	2.01	71.06	2.15
Repayment of arrears	**47.09**	**1.50**	66.18	2.00	94.26	2.85
Shortfall financing needs	-366.52	-11.64	-242.35	-7.32	-406.95	-12.29
Financing	366.52	11.64	242.35	7.32	406.95	12.29
Borrowings and loans from domestic sources	71.27	2.26	8.00	0.24	133.33	4.03
Borrowings and loans from foreign sources	258.13	8.20	205.99	6.22	190.00	5.74
Donations	7.92	0.25	2.00	0.06	10.74	0.32
Revenues from privatization and property sale	14.02	0.45	19.00	0.57	14.42	0.44
State deposit use	**15.18**	**0.48**	**7.35**	**0.22**	**58.44**	**1.77**

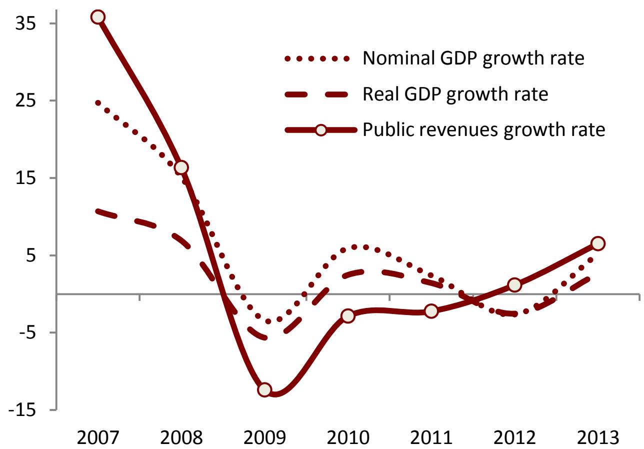
Source: Ministry of Finance of Montenegro

3.3. Public Finances in the Period 2014-2016

Medium-term projection of public finances of Montenegro is based on two fiscal scenarios – base scenario and low-growth fiscal scenario. Both scenarios take assumptions from the respective scenarios of the macroeconomic environment, and they are described in Chapter 2. Base fiscal scenario was adopted within the Law on Budget of Montenegro for the fiscal 2014 and is the central scenario of the public spending in the medium - term. Low-growth fiscal scenario is based on the low-growth macroeconomic scenario, which assumes that (a) the beginning of the investment cycle, due to instability in the regional and European market will be delayed, (b) the situation on the financial market will deteriorate in the sense that banks will not provide credit support to the growth of economy, (c) weak growth in all sectors, except in tourism, due to internal and structural weaknesses of the economy and (d) worse budgetary impact of fiscal consolidation.

Aware of the price of borrowings on the international market, the amount of government debt and credit rating of Montenegro by the Agency for Credit Risk Assessment *Standard & Poors* (BB-), public revenues (central budget revenues with funds and local self-government) have been predicted according to the conservative method. Practically, this means that in both. the base scenario and low-growth scenario, revenues growth rate is below the rate of the real GDP growth. Real growth rate is taken as referential because in the conditions of great instabilities and the influence of external factors on the indicators that are assessed in an already short series of data, there is a greater degree of the correlation between the growth rate of public revenues and real growth rate of GDP than with the nominal (which is, theoretically, usually the case). Graph 12 shows that in the lower part of the cycle which began to be felt in 2008, growth rate of public revenues correlates more with the real growth rate and that difference between the growth rate of public revenues and the real growth rate of GDP is smaller than it is the case with the nominal growth rate.

Graph 12 Growth rates of the real and nominal GDP and growth rate of public revenues



This method by itself emphasizes exceptional caution in the projection because it excludes the impact of inflation on budgetary revenues. General attitude of the Ministry of Finance of Montenegro is that it is better to adjust budgetary revenues for more, that is, to exceed the forecasts, because revenues generated in this way are in majority of cases budgetary surpluses that will be utilized for anticipated repayment of debt principal, which will reduce debt in relation to the current forecast of public debt management.

In addition, in relation to the rate of the real growth a certain percentage is left as a buffer that is the zone of revenues adjustments. According to the low-growth scenario lower growth rate of GDP is taken as a referential rate which at the same time reduces public revenues. Graph 15 generally presents the difference in revenues and expenditures balance in public spending between these two scenarios based on which it can be concluded that there is a little difference in revenues which is the consequence of a conservative approach when planning the base scenario.

In order to achieve fiscal sustainability, Montenegro is running extremely cautious and responsible fiscal policy focusing primarily on the consolidation of public finances, which contributes to reducing biggest fiscal vulnerabilities (deficit and debt) on one hand and the expansion of the room for further strengthening of competitiveness. Guided by this principle, the Government of Montenegro has implemented or is in the process of implementation of measures which can be divided into two groups as follows:

Consolidation measures which will primarily be focused on the following:

1.Continued implementation of *measures to combat grey economy and increase tax discipline* through:
More severe sanctions for re-offenders – by tightening the penalty policy for re-offenders and introduction of more rigorous measures against these entities in the form of the introduction of multiple large fines and prohibition of work for the specified period of time or, in the extreme, license revocation. There are three basic principles in the fight against grey economy (a) zero tolerance, (b) non-selective approach, and (c) the transparency that will create incentive to the loyal competition in the market.
At the same time it is planned to strengthen institutional and human resource capacity of the state administration bodies responsible for the control and collection of revenues.

2. Continuation of implementation of *measures aimed at tax debt reduction through the following*:
One-time repayment of debt principal – allows tax debtors to repay one-time principle debt with interest write-off for liabilities from the previous period.
Tax debt paid by debtor's property - in the previous period invitation was published via the Tax Administration services aimed for all tax debtors whose debt amounts to over €100,000 announcing that they have the right to reduce their debt in the amount of the appraised value of debtor's assets.

3. *Improving the tax system of Montenegro, through the following*:
The increase the taxes on real estate transactions rate is planned for certain categories of real estate (property not placed in service; illegally constructed buildings; unsold flats and taxes on real estate transactions increase is planned for facilities that are not generating any revenues based on property and property rights).

4. *Harmonization of legislation with the EU legislation through the following*:
Harmonization of excise rate - the amount excise rates is gradually adjusting to the European level. In order to increase transparency and predictability of this part of the tax system, introduction of the excise calendar is planned which would allow legal entities to adapt their business operations to the dynamics of increasing excise rates.
Harmonization in the area of value added tax.

5. Continued *implementation of fiscal measures introduced in 2012 and 2013*:
Applying "crisis tax" - on the basis of the Analysis of the Model of Taxation of Citizens it was established that in 2014 crisis tax will apply and in the next medium-term getting back to the proportional model of taxation is planned.
Application of "duties" – for 2014 application of duties on smoking zones and use of acoustic devices is planned. Also, duties on smoking zone will change in the sense that catering facility must be categorized as a smoking or a non-smoking zone, and in case of choosing to continue operations as a facility in which consumption of tobacco products is allowed they will have to pay per month €1/m^2 for the facility, in its entirety. Given the significant deviation in the collection of this type of duty in relation to what was planned, future steps will be focused on identification of these facilities and debt collection arising from these duties.

6. Continued implementation of *austerity measures* through the following:

Rationalization of the costs in public administration by reducing expenditures on salaries and benefits, official vehicles, lease and all other forms of discretionary spending.
Arranging the reward system in the public sector – underway are the activities aimed at the preparation of the Draft of this Law which will apply to the entire public sector and which among other things introduces a correlation between the amount of gross salaries and financial results. Aim of the adoption of this Law is to achieve a greater level of transparency in salaries as well as to achieve the principle of equality in salaries according to responsibilities of the public sector.
Freezing pensions and increasing the level of sustainability of the pension system - Pensions will remain frozen in 2014 that is there will be no adjustments with inflation rate and salaries growth. Also it is necessary to find new sources of funding of the pension system with the aim to achieve a higher level of protection of pensioners and secure deficit reduction of Pension and Disability Insurance Fund (*PIO Fond*) and thus the government deficit.
Rationalization of public procurement - In addition to the improvement of regulatory framework, focus will be put on economic aspects i.e. justification of public procurement.

Incentive measures will in the first place be focused on the following:

1. Stimulation of employment and balanced regional development - with the aim to encourage growth in less developed municipalities of Montenegro, giving tax incentives to new businesses and new jobs in the northern municipalities of Montenegro (including Nikšić and Cetinje) will be proposed in terms of the exemption from income and profits tax payment for a period of five years.

2. Granting discounts to taxpayers who pay a one-time debt arising from profits tax in the amount of 6% if they pay profits until 31st March.

3. Recognition of standard costs in a higher amount (from 30% to 70%) to the providers of private accommodation in tourism sector thereby reducing the risk of operating in a grey zone.

4. Subsidies for production and job creation – the 2014 Budget committed resources to stimulate production and agriculture.

5. Issued guarantees for development – The 2014 Budget issued guarantees for the development projects valued at €25 million of which €20 million relates to the Undersea Cable Project, which is one of the priority projects aimed at improving and strengthening electricity supply both in Montenegro and the region.

6. Increased allocations in the Capital Budget – €25 million more than last year have been planned by the 2014 Budget.

7. Empowering payment operations instruments – payment instruments (bills of exchange etc.) are planned to be strengthened as security and execution institutes with the aim to provide greater protection to creditors and thus reduce liquidity in the real sector.

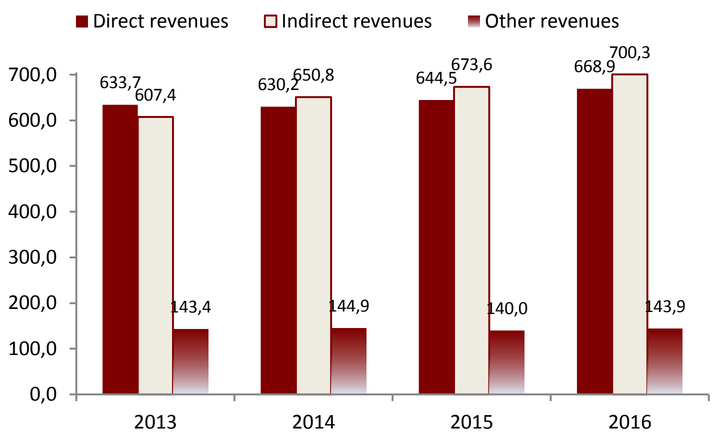
8. *Podgorica approach* - with the aim to increase stability in the banking sector, voluntary restructuring of the banks portfolio (non-performing loans) is planned, with expected implementation of specific strategies and adoption of *lex specialis*, which will contribute to the revival of lending activity and consolidation of the real economy.

The aforementioned measures of writing off interest to one-off repayment of the tax debt principal is also an incentive measure since it contributes to a healthier interaction between economic entities with no debts owed to the state.

Base Scenario

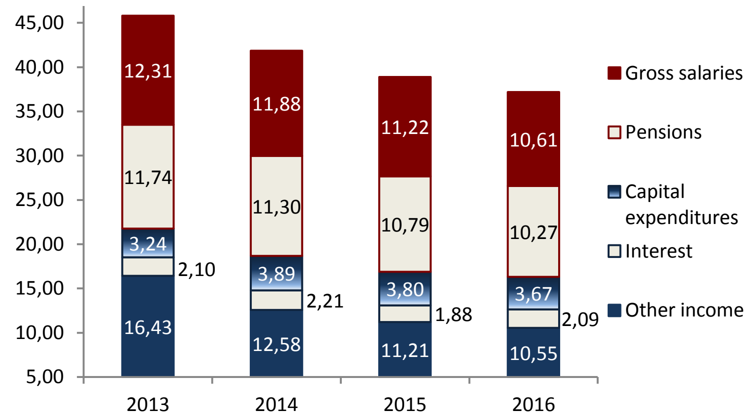
Base scenario predicts that the announced investment cycle will begin during 2014, which will cause nominal GDP growth of 6.2%, while the real growth will amount to 3.6%, with an increase in lending activity, continued recovery of economic framework in the region and Europe. Base macroeconomic scenario and preconditions for its implementation are explained in more details in Chapter 2.

Graph 14 Public revenues 2013 - 2016 (nominal)



Total revenue sources in the forthcoming medium-term period, although they will grow in nominal amount, will reduce their share in GDP from 40.5% in 2014 to 38.1% in 2016. Significant deviations compared to the last year's PEP are the result of adjustments in the assessment the GDP growth rate, which has subsequently corrected growth rate of public revenues. In relation to 2012 positive deviation is attributed to the previously described measures of fiscal adjustments, reduction of informal economy, but also the increase in economic activity. Graph 13 shows distribution of revenues by categories - direct (taxes on income, profits, real estate and contributions), indirect (VAT, excise and customs duties) and other revenues (fees, duties, other revenues etc). In the current year, which is not the case for the rest of the revenues time series, direct taxes/revenues will be greater than revenues derived from indirect taxes. The result of this is collection of part of tax debt within this type of revenues. Tax debt was reduced by about €25 million and it is assumed that largest part of it relates to debt reduction based on contributions and taxes on earnings. Within indirect taxes, there was a change in the fiscal framework with the regular increase in excise rates, because of harmonization of rates with the European by increasing the base value added tax rate from 17% to 19% in mid-2013, but also by reducing customs tariffs and trade liberalization, which decreased revenues on this bases from year to year all in accordance with the adjustment and the process of accession to the European Union.

Graph 13 Public expenditures in the period 2013 - 2016 (% of GDP)



In the medium term, revenues will grow at an average annual rate of 2%, with implementation of fiscal measures. All paid debts, planned privatizations; implementation of investment plans at full capacity will represent a positive momentum of public finances and provide additional revenues that will be allocated to finance development projects and/or reduction of government debt.

As for **public expenditures**, according to the base scenario, a policy of restrictive and counter-cyclical budgetary policy will be implemented in the area of spending and there will be an average annual growth of only 0.3% in the period 2014-2016. Traditionally, the largest share of public spending goes to mandatory expenditures for gross salaries of employees in the public sector and pension benefits, as presented in Graph 14. Spending in this segment in cumulative terms (gross salaries and pensions) is 23.2% of GDP in 2014 with a tendency to decrease to 20.9% of GDP in 2016 and mainly as a result of state administration rationalization measures, whereas, the effect of pension reform because of its long-term nature is impossible to achieve in the short term. Due to the suspension of adjustment of pensions in 2014, the increase in pension expenditures occurs due to an increase in the number of pension beneficiaries.

At the same time, capital budget of public spending during the medium-term period, and under the current plan, will be close to 4% of GDP in all years (3.9% in 2014, 3.8% in 2015 and 3.7% in 2016).

The aforementioned distribution of revenues and expenditures, in the base scenario, will result in **public expenditures deficit** of 1.3% of GDP in 2014. Combination of these measures for stabilization of public finances, together with rationalization of public spending will result in public finance transferring from the deficit zone to the slight surplus zone of 0.2% of GDP in 2015 and after that generation of surplus of 0.9% in 2016.

In addition to the original public revenues in 2014 revenues from privatization are planned in the amount of €17 million, and a conservative approach has been applied in this projection as well. For the next year several state-owned sites are planned to be brought to their purpose within almost the same plan for privatization of state enterprises. Apart from this, the plan of privatization and sale of non-financial assets in the local self-governments will be around €12 million. In the next three-year period, spending and debt repayment will be in addition to primary source revenues and revenues from privatization financed from borrowing and credits. The largest portion of these revenues will be used to repay debt and debt restructuring, while trying to replace loans of short -term maturity and higher interest rate loans with longer maturity loans with lower interest rates, which would result in lower expenditures for debt servicing, that is, lower annual repayment of principal and lower interest rates.

The following table shows development of basic fiscal parameters in the medium term, according to the base scenario:

Table 9 Medium -term public expenditures plan – base scenario

Public expenditures	Plan 2013		Estimation 2013		Plan 2014		2015		2016	
GDP (in € mill.)	3,311.0		3,311.0		3,516.0		3,730.0		3,968.0	
	Plan according to the 2013 Law on Budget									
	€ mill.	**% GDP**	**€ mill.**	**% GDP**	**€ mill.**	**% GDP**	**€ mill.**	**% GDP**	**€ mill.**	**% GDP**
Primary source expenditures	**1,294.10**	**39.08**	**1,384.46**	**41.81**	**1,425.85**	**40.55**	**1,458.09**	**39.09**	**1,513.01**	**38.13**
Taxes *of which:*	**773.23**	**23.35**	**838.02**	**25.31**	**888.21**	**25.26**	**911.57**	**24.44**	**946.32**	**23.85**
Personal income tax	115.04	3.47	117.37	3.54	121.15	3.45	118.02	3.16	122.35	3.08
Corporate profit tax	41.93	1.27	42.88	1.30	44.40	1.26	45.95	1.23	47.79	1.20
Taxes on real estate transactions	15.22	0.46	15.41	0.47	15.79	0.45	16.27	0.44	16.68	0.42
Value added tax	373.05	11.27	423.22	12.78	455.95	12.97	471.90	12.65	490.78	12.37
Excise	157.45	4.76	161.13	4.87	171.11	4.87	177.10	4.75	184.18	4.64
International trade and transactions tax	31.19	0.94	23.04	0.70	23.74	0.68	24.57	0.66	25.30	0.64
Local taxes	34.94	1.06	50.00	1.51	51.00	1.45	52.53	1.41	53.84	1.36
Contributions	**384.22**	**11.60**	**408.05**	**12.32**	**397.82**	**11.31**	**411.75**	**11.04**	**428.22**	**10.79**
Duties	**35.62**	**1.08**	**30.51**	**0.92**	**28.28**	**0.80**	**20.82**	**0.56**	**21.37**	**0.54**
Fees	**54.16**	**1.64**	**55.29**	**1.67**	**58.74**	**1.67**	**60.04**	**1.61**	**61.71**	**1.56**
Other revenues	**42.07**	**1.27**	**45.65**	**1.38**	**45.75**	**1.30**	**46.66**	**1.25**	**47.91**	**1.21**
Revenues from loan repayment and funds transferred from the previous year	**4.81**	**0.15**	**6.94**	**0.21**	**7.05**	**0.20**	**7.26**	**0.19**	**7.48**	**0.19**
Public expenditures	**1375.77**	**41.55**	**1517.07**	**45.82**	**1471.84**	**41.86**	**1450.88**	**38.90**	**1475.88**	**37.19**
Current public expenditures	**1280.13**	**38.66**	**1409.82**	**42.58**	**1335.02**	**37.97**	**1309.25**	**35.10**	**1330.09**	**33.52**
Current expenditures	**646.27**	**19.52**	**661.04**	**19.97**	**687.67**	**19.56**	**668.61**	**17.93**	**682.69**	**17.20**
Gross salaries and contributions at employer's expense	**397.57**	**12.01**	**407.65**	**12.31**	**417.63**	**11.88**	**418.62**	**11.22**	**421.19**	**10.61**
Other personal earnings	**13.28**	**0.40**	**15.98**	**0.48**	**14.42**	**0.41**	**13.06**	**0.35**	**11.86**	**0.30**
Expenditures for material and services	**96.66**	**2.92**	**101.83**	**3.08**	**105.06**	**2.99**	**102.63**	**2.75**	**103.74**	**2.61**
Current maintenance	**25.16**	**0.76**	**25.61**	**0.77**	**26.82**	**0.76**	**27.74**	**0.74**	**27.86**	**0.70**
Interests	**74.32**	**2.24**	**69.37**	**2.10**	**77.87**	**2.21**	**70.23**	**1.88**	**82.96**	**2.09**
Rent	**8.24**	**0.25**	**8.15**	**0.25**	**8.57**	**0.24**	**8.54**	**0.23**	**8.55**	**0.22**
Subsidies	**14.93**	**0.45**	**15.42**	**0.47**	**19.65**	**0.56**	**12.75**	**0.34**	**12.17**	**0.31**
Other expenditures	**6.78**	**0.20**	**7.34**	**0.22**	**7.15**	**0.20**	**6.57**	**0.18**	**6.32**	**0.16**
Capital expenditures of the Current Budget and State Funds	**9.32**	**0.28**	**9.71**	**0.29**	**10.50**	**0.30**	**8.47**	**0.23**	**8.04**	**0.20**
Transfers for social protection *of which:*	**498.26**	**15.05**	**488.17**	**14.74**	**498.81**	**14.19**	**496.87**	**13.32**	**502.01**	**12.65**
Rights in the area of social protection	61.40	1.85	64.07	1.94	59.23	1.68	60.13	1.61	60.27	1.52
Rights in the area of pension and disability insurance	400.90	12.11	388.78	11.74	397.32	11.30	402.32	10.79	407.32	10.27
Transfers of institutions, individuals, NGOs and public sector	**121.01**	**3.65**	**126.52**	**3.82**	**131.48**	**3.74**	**120.43**	**3.23**	**121.77**	**3.07**
Capital Budget of Montenegro	65.64	1.98	72.25	2.18	101.82	2.90	105.63	2.83	108.80	2.74
Capital Budget of the local self-government	30.00	0.91	35.00	1.06	35.00	1.00	36.00	0.97	37.00	0.93
Borrowings and loans	**3.73**	**0.11**	**4.58**	**0.14**	**4.35**	**0.12**	**4.34**	**0.12**	**4.58**	**0.12**
Reserves	**10.86**	**0.33**	**17.91**	**0.54**	**12.71**	**0.36**	**19.00**	**0.51**	**19.04**	**0.48**
Guarantees repayment	0.00	0.00	111.60	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Surplus/deficit	**-81.67**	**-2.47**	**-132.61**	**-4.01**	**-45.99**	**-1.31**	**7.22**	**0.19**	**37.13**	**0.94**
Primary deficit	**-7.35**	**-0.22**	**-63.24**	**-1.91**	**31.88**	**0.91**	**77.44**	**2.08**	**120.08**	**3.03**
Debt repayment	**160.68**	**4.85**	**274.34**	**8.29**	**220.43**	**6.27**	**478.27**	**12.82**	**425.10**	**10.71**
Repayment of principal to residents	27.80	0.84	109.03	3.29	34.51	0.98	38.60	1.03	33.50	0.84
Repayment of principal to non-residents	66.70	2.01	71.06	2.15	112.58	3.20	372.77	9.99	336.90	8.49
Repayment of liabilities from the previous period	66.18	2.00	94.26	2.85	73.34	2.09	66.90	1.79	54.70	1.38
Shorfall/financing needs	**-242.35**	**-7.32**	**-406.95**	**-12.29**	**-266.42**	**-7.58**	**-471.05**	**-12.63**	**-387.97**	**-9.78**
Financing	**242.35**	**7.32**	**406.95**	**12.29**	**266.42**	**7.58**	**471.05**	**12.63**	**387.97**	**9.78**
Borrowing and loans from domestic sources	8.00	0.24	133.33	4.03	6.00	0.17	6.00	0.16	6.00	0.15
Borrowing and loans from foreign sources	205.99	6.22	190.00	5.74	227.98	6.48	438.26	11.75	370.79	9.34
Donations	2.00	0.06	10.74	0.32	10.00	0.28	2.00	0.05	2.00	0.05
Revenues from privatization and sale of property	19.00	0.57	14.42	0.44	17.00	0.48	22.00	0.59	12.00	0.30
Use of government deposits	**7.35**	**0.22**	**58.44**	**1.77**	**5.44**	**0.15**	**2.80**	**0.07**	**-2.82**	**-0.07**

Source: the Ministry of Finance of Montenegro

Low-Growth Fiscal Scenario

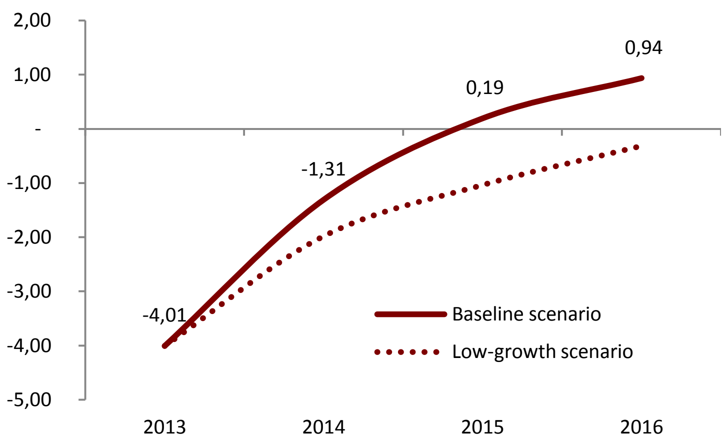
The Low-growth fiscal scenario was developed based on the appropriate macroeconomic scenario. Macroeconomic assumptions in implementation of this scenario are a lower growth in economic activity, delayed beginning and significantly slower dynamics of the announced investments, as well as instability in the international market which will affect Montenegro in a way that parent banks will withdraw funds from their daughter Montenegrin banks, which will further increase interest rates and/or credit support to the economy will stagnate, which will certainly slow down investments and economic activity, and thus public revenues.

Despite conservativeness in estimating GDP growth in this scenario, as for fiscal projections, as in the base scenario, the Ministry of Finance was even more rigorous in assessing revenues. The decline in economic activity is mostly reflected through a decline in indirect taxes (VAT, excise and customs duties), which, along with contributions, are major revenue components in the Montenegrin budget. In case of realization of this scenario, fiscal pressures would be significantly higher, so, in this scenario growth of public revenues by 1.3% is foreseen for 2014.

This scenario, with a constant level of consumption, foresees deficit growth in 2014 to 2% of GDP, which would be financed by a slightly larger borrowing from foreign sources and the use of government deposits. According to the low-growth scenario deficit of the central budget would rise to 2.5% of GDP, compared to below 2% according to the base scenario, which represents about €20 million difference in the nominal amount. Revenues from local self-government will also be exposed to a lower revenue growth, but due to the relatively low share in public expenditures, the effect of this decrease is not reflected sufficiently in public spending.

Relying on the assumption of liquidation of the Aluminium Plant, which is elaborated in the low-growth macroeconomic scenario, repercussions in the state budget are also planned. A rough estimate of the Government is that the social program for workers of the Aluminium Plant and Bauxite Mine will cost around €17 million, of which €3 million are already planned in the base fiscal scenario within budget item *funds for redundant workers*. This is done so that, once again, cautiousness of the Government in running fiscal policy is shown, and more specifically in order to reduce public finances deficit and risks.

Graph 15 Comparison of scenarios – public spending deficit (%of GDP)



According to the low-growth scenario, as seen in the Graph, Montenegro will not leave the zone of public finances deficit in the medium term, although it will significantly reduce it to around -0.3% of GDP in 2016. In case of realization of such scenario, additional reduction of discretionary costs would be needed.

A positive indicator according to this scenario is that already in 2014 and in the years to come public expenditures will achieve primary surplus of 0.3% in 2014 to 1.9% of GDP in 2016.

The following table shows development of the basic fiscal parameters in the medium term under the low-growth scenario:

Table 10 Medium-term public expenditures plan – low-growth scenario

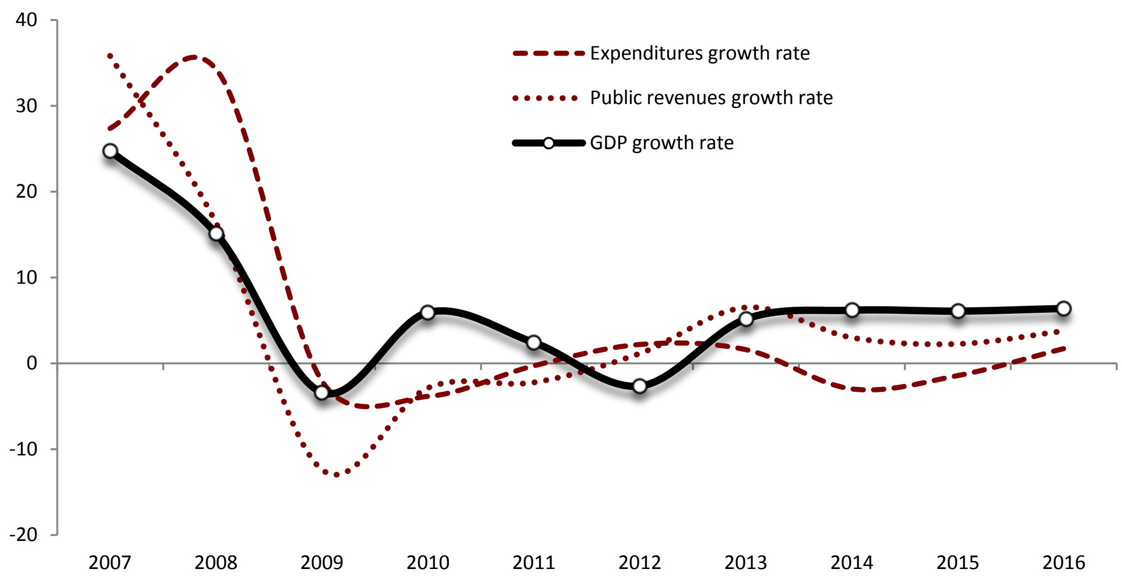
GDP (in € mill.)	3311.0		3311.0		3415.0		3535.0		3750.0	
	Plan according to the 2013 Law on Budget									
Public expenditures	**Plan 2013**		**Estimates 2013**		**Plan 2014**		**2015**		**2016**	
	€mill.	**% GDP**	**€mill.**	**% GDP**	**€mill.**	**% GDP**	**€mill.**	**% GDP**	**€mill.**	**% GDP**
Primary source revenues	**1,294.10**	**39.08**	**1,384.46**	**41.81**	**1,402.83**	**41.08**	**1,414.19**	**40.01**	**1,465.00**	**39.07**
Taxes, *of which:*	**773.23**	**23.35**	**838.02**	**25.31**	**873.95**	**25.59**	**884.37**	**25.02**	**916.96**	**24.45**
Personal income tax	115.04	3.47	117.37	3.54	119.69	3.50	114.84	3.25	118.84	3.17
Corporate profit tax	41.93	1.27	42.88	1.30	43.79	1.28	44.58	1.26	46.14	1.23
Tax on real estate transactions	15.22	0.46	15.41	0.47	15.64	0.46	15.92	0.45	16.46	0.44
Value added tax	373.05	11.27	423.22	12.78	447.35	13.10	455.40	12.88	471.34	12.57
Excise	157.45	4.76	161.13	4.87	168.38	4.93	173.10	4.90	180.89	4.82
Tax on international trade and transactions	31.19	0.94	23.04	0.70	23.37	0.68	23.79	0.67	24.62	0.66
Local taxes	34.94	1.06	50.00	1.51	50.70	1.48	51.61	1.46	53.37	1.42
Contributions	**384.22**	**11.60**	**408.05**	**12.32**	**392.40**	**11.49**	**399.46**	**11.30**	**413.44**	**11.03**
Duties	**35.62**	**1.08**	**30.51**	**0.92**	**27.76**	**0.81**	**20.04**	**0.57**	**20.65**	**0.55**
Fees	**54.16**	**1.64**	**55.29**	**1.67**	**56.07**	**1.64**	**57.08**	**1.61**	**58.97**	**1.57**
Other earnings	**42.07**	**1.27**	**45.65**	**1.38**	**45.62**	**1.34**	**46.08**	**1.30**	**47.57**	**1.27**
Revenues from loan repayment and funds transferred from the previous year	**4.81**	**0.15**	**6.94**	**0.21**	**7.04**	**0.21**	**7.17**	**0.20**	**7.42**	**0.20**
Public expenditures	**1375.77**	**41.55**	**1517.07**	**45.82**	**1470.44**	**43.06**	**1450.74**	**41.04**	**1476.74**	**39.38**
Current public expenditures	**1280.13**	**38.66**	**1409.82**	**42.58**	**1333.62**	**39.05**	**1309.11**	**37.03**	**1330.95**	**35.49**
Current expenditures	**646.27**	**19.52**	**661.04**	**19.97**	**687.49**	**20.13**	**668.50**	**18.91**	**683.22**	**18.22**
Gross salaries and contributions at employer's expense	**397.57**	**12.01**	**407.65**	**12.31**	**417.45**	**12.22**	**418.51**	**11.84**	**421.41**	**11.24**
Other personal earnings	**13.28**	**0.40**	**15.98**	**0.48**	**14.42**	**0.42**	**13.06**	**0.37**	**11.86**	**0.32**
Expenditures for material and services	**96.66**	**2.92**	**101.83**	**3.08**	**105.06**	**3.08**	**102.63**	**2.90**	**104.05**	**2.77**
Current maintenance	**25.16**	**0.76**	**25.61**	**0.77**	**26.82**	**0.79**	**27.74**	**0.78**	**27.86**	**0.74**
Interests	**74.32**	**2.24**	**69.37**	**2.10**	**77.87**	**2.28**	**70.23**	**1.99**	**82.96**	**2.21**
Rent	**8.24**	**0.25**	**8.15**	**0.25**	**8.57**	**0.25**	**8.54**	**0.24**	**8.55**	**0.23**
Subsidies	**14.93**	**0.45**	**15.42**	**0.47**	**19.65**	**0.58**	**12.75**	**0.36**	**12.17**	**0.32**
Other expenditures	**6.78**	**0.20**	**7.34**	**0.22**	**7.15**	**0.21**	**6.57**	**0.19**	**6.32**	**0.17**
Capital expenditures of the Current Budget and Government Funds	**9.32**	**0.28**	**9.71**	**0.29**	**10.50**	**0.31**	**8.47**	**0.24**	**8.04**	**0.21**
Transfers for social protection, *of which:*	**498.26**	**15.05**	**488.17**	**14.74**	**498.81**	**14.61**	**496.87**	**14.06**	**502.01**	**13.39**
Rights in the area of social protection	61.40	1.85	64.07	1.94	59.23	1.73	60.13	1.70	60.27	1.61
Rights in the area of pension and disability insurance	400.90	12.11	388.78	11.74	397.32	11.63	402.32	11.38	407.32	10.86
Transfers of institutions, individuals, NGOs and public sector	**121.01**	**3.65**	**126.52**	**3.82**	**130.27**	**3.81**	**120.40**	**3.41**	**122.07**	**3.26**
Capital expenditures	**95.64**	**2.89**	**107.25**	**3.24**	**136.82**	**4.01**	**141.63**	**4.01**	**145.80**	**3.89**
Capital Budget of Montenegro	65.64	1.98	72.25	2.18	101.82	2.98	105.63	2.99	108.80	2.90
Capital Budget of local self-government	30.00	0.91	35.00	1.06	35.00	1.02	36.00	1.02	37.00	0.99
Borrowings and loans	**3.73**	**0.11**	**4.58**	**0.14**	**4.35**	**0.13**	**4.34**	**0.12**	**4.61**	**0.12**
Reserves	**10.86**	**0.33**	**17.91**	**0.54**	**12.71**	**0.37**	**19.00**	**0.54**	**19.04**	**0.51**
Repayment of guarantees	0.00	0.00	111.60	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Surplus /deficit	**-81.67**	**-2.47**	**-132.61**	**-4.01**	**-67.61**	**-1.98**	**-36.54**	**-1.03**	**-11.75**	**-0.31**
Primary deficit	**-7.35**	**-0.22**	**-63.24**	**-1.91**	**10.26**	**0.30**	**33.68**	**0.95**	**71.21**	**1.90**
Debt repayment	**160.68**	**4.85**	**274.34**	**8.29**	**220.43**	**6.45**	**478.27**	**13.53**	**425.10**	**11.34**
Repayment of principal to residents	27.80	0.84	109.03	3.29	34.51	1.01	38.60	1.09	33.50	0.89
Repayment of principal to non-residents	66.70	2.01	71.06	2.15	112.58	3.30	372.77	10.55	336.90	8.98
Repayment of liabilities from the previous period	66.18	2.00	94.26	2.85	73.34	2.15	66.90	1.89	54.70	1.46
Shorfall/financing needs	**-242.35**	**-7.32**	**-406.95**	**-12.29**	**-288.03**	**-8.43**	**-514.81**	**-14.56**	**-436.85**	**-11.65**
Financing	**242.35**	**7.32**	**406.95**	**12.29**	**288.03**	**8.43**	**514.81**	**14.56**	**436.85**	**11.65**
Borrowing and loans from domestic sources	8.00	0.24	133.33	4.03	6.00	0.18	6.00	0.17	6.00	0.16
Borrowing and loans from foreign sources	205.99	6.22	190.00	5.74	247.38	7.24	477.12	13.50	414.91	11.06
Donations	2.00	0.06	10.74	0.32	10.00	0.29	2.00	0.06	2.00	0.05
Revenues from privatization and sale of property	19.00	0.57	14.42	0.44	17.00	0.50	22.00	0.62	12.00	0.32
Use of government deposits	**7.35**	**0.22**	**58.44**	**1.77**	**7.66**	**0.22**	**7.69**	**0.22**	**1.94**	**0.05**

Source: the Ministry of Finance of Montenegro

3.4. Structural Balance

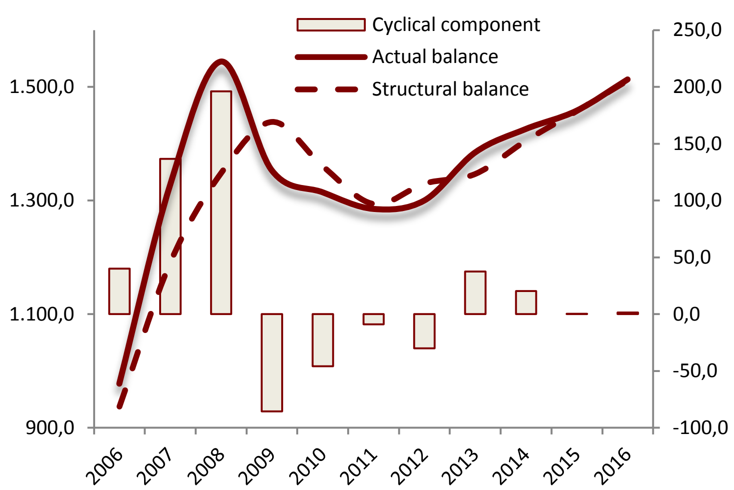
Based on the assumptions about the value of fixed capital based on the comparison with the European countries (the ratio of fixed capital formation/GDP) the potential GDP has been calculated, which was the basis for calculating structural deficit. This estimate is quite unstable due to (a) short series of data which does not allow a large degree of correlation between fiscal and macroeconomic parameters (nominal GDP in the first place) and (b) significant fluctuations in growth rates, as shown in the Graph 16. Instability in economic growth caused a large number of measures of fiscal adjustment and one-off events whose exact effect should be assessed and excluded from the calculation of structural deficit, because they represent a cyclical and one-off event component, which is by definition exempted in the calculation of the structural deficit.

Graph 16 Comparative overview of development of revenues, expenditures and GDP (growth rates)



On the revenue side, after exclusion of cyclical components which, in this case, represent all the previously described measures of fiscal adjustment on the side of direct and indirect, as well as other revenues. Corrections in indirect revenues should be emphasized because this is the category in which biggest changes occurred - changes in excise rates every year, VAT rate changes, and along with the aforementioned reduction in grey economy, which was primarily effectuated through the increase in revenues from VAT. The structural revenues Graph shows that revenues during the period of economic growth were higher than structural, while during the so-called underside of the business cycle they were lower, which is the

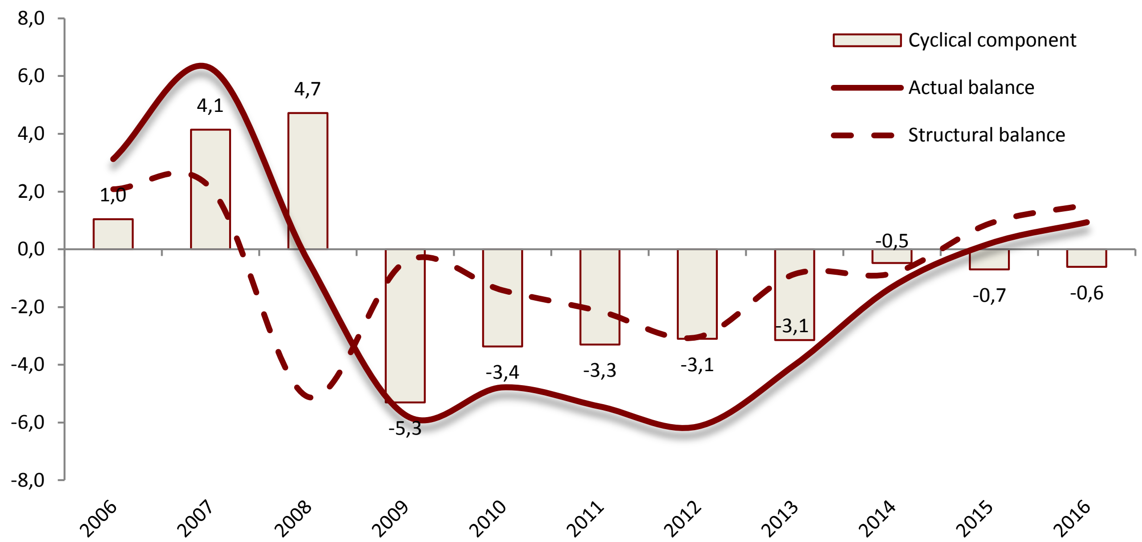
Graph 17 Structural revenues (in €mill.)



expected result, given the current trends that public revenue in the periods of economic expansion grow more than economy growth rates. The only deviation was in 2013 when measures of fiscal adjustment were applied whose full effect was almost impossible to assess. In addition, grey economy was reduced that is the number of regular taxpayers increased, which is certainly, excluding the slow economic growth, had a positive impact on public revenues. In the med-term, the projected revenues will be at the level of structural revenues.

When expenditures are subtracted from income, corrected for one-off budget events such as payment of guarantees, but also other cyclical components (subsidies, transfers, unemployment benefits, etc.)a picture in which the structural deficit lower than the realized is obtained, which corresponds with appropriate macroeconomic projections which show that since 2008 the economy is below its potential impact. Cyclical component on the Graph shows the difference between the actual and structural deficit and shows that after a period of adjustment balance of public finances is approaching its structural level.

Graph 18 Structural deficit (% of GDP)



3.5. Government Debt 2013-2016

3.5.1. Government Debt in 2013

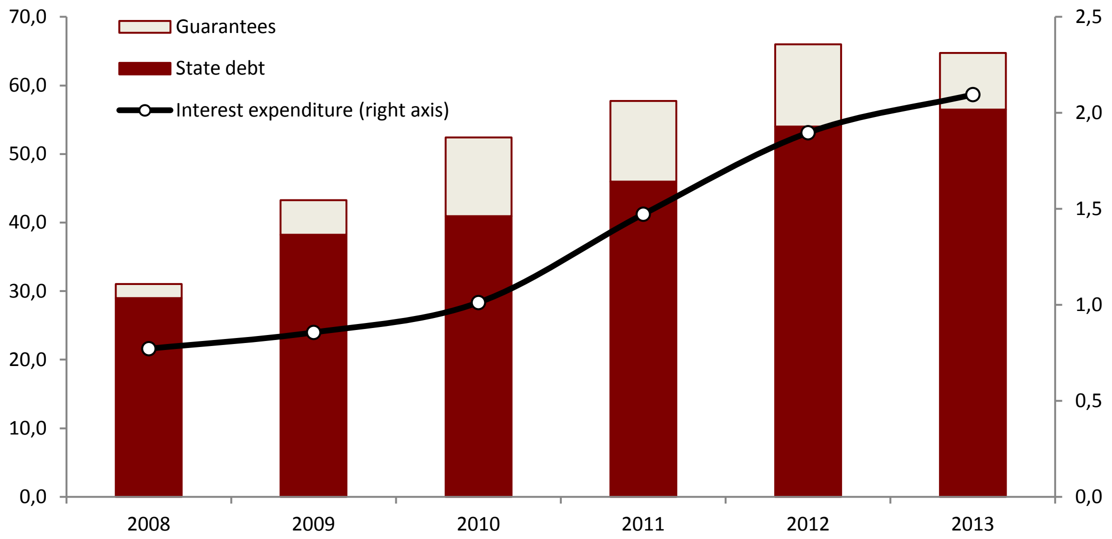
During 2013, public finances in the EU countries have partially stabilized, but there is still a rather high level of public debt present as well as high budget deficit. Also, bearing in mind development of economic growth and deficits in the forthcoming period, further increase of the government debt is expected.

At the end of 2012 the Montenegrin government debt amounted to €1,699.5 million or 54% of GDP[10]. Having regard to the withdrawals in the first three quarters of 2013, as well as debt repayment, state of government debt on 30 September 2013[11] amounted to €1,844.8 million or 55.7% of GDP, so that debt in the announced period increased by about €140 million or 8.5%.

Based on debt trends and tendencies of its change as of 2002[12] , it can be concluded that in 2013 debt growth rate significantly decreased which depicted the previous period and which will, given the projection of debt trends by the end of the year remain at a similar level.

Graph 19 provides an overview of the Montenegrin debt in the previous period. The Montenegrin government debt records an increase in the period since 2008 to 2013, in the period of the occurrence of economic and financial crisis. One of priority objectives of the Government in the forthcoming period will be provision of public debt sustainability, that is, its reduction. Debt sustainability is significantly contributed by the fact that about 94% of the total debt is in Euros, which significantly reduces the risk of potential exchange rate changes, which could lead to an increase in liabilities.

Graph 19 Public debt, guarantees and interests trends in the period 2008 - 2013 (% of GDP)



The 2013 Law on Budget provides for borrowings amounting to €250 million, so that borrowing in the current year is realized within the set limits despite the activated guarantees for credit arrangements between KAP and foreign creditors. The total paid guarantees for KAP amounted to

10 After Monstat had published final data on GDP trends in 2012 government debt as percentage of participation was increased from 51.1%to 54%.

11 See Table D1 in Annex

12 See Table D2 in Annex

€102.7 million. On the basis of better effects in revenue collection[13], the need for additional borrowings for the needs of financing of budget spending caused by the activation of guarantees has been reduced.

At the same time, during 2013, funds in the amount of about €36 million, for a variety of infrastructural projects have been withdrawn, which are financed from the loan arrangements with international financial institutions (EBR, EIB, KfW, WB). These amounts have been used for the improvement of water supply and other municipal infrastructure, then road infrastructure, agriculture and energy efficiency.

During 2013, credit arrangements14 amounting to €248.5 million have been concluded and realized. Part of the funds was provided from the international market, through the issuance of bonds and signing of bilateral agreements, while part of the funds was provided from domestic sources. Majority of credit arrangements concluded in 2013 will be repaid in the period 2014-2016.

In the period 2013-2017, repayment of a significant portion of liabilities for credit arrangements15 concluded in the last few years is foreseen , which will significantly reduce the burden in the form of payment of interest and principal. Bearing in mind the anticipated repayment a significant increase of obligations relating to the interest repayment is not expected.

The analysis of credit arrangements concluded in 2013 shows an evident decline in interest rates to 5.75% which represents an improvement in credit conditions compared to those that were concluded in the previous period, and it can be concluded that a certain progress has been made in providing better financing conditions as well as the improvement of the position on international market.

In the forthcoming period, systemic measures will be implemented which are presented in details in Chapter 3.1 and 3.3 which will contribute to reducing spending, increasing revenues and reducing deficit which will cause a reduction in the need for borrowings and thus the level of public debt.

In addition to these measures, in the area of public debt management follow-up activities are planned which relate to obligations cost analysis and undertaking measures that would lead to a reduction of costs arising from debt servicing. The subject of special attention will be lending arrangements entered into in the previous period, with high interest expenditures, as well as for issued bonds. In this regard Ministry will consider possibility, in the course of 2014, of issuing bonds in a higher amount than the planned for the purpose of budget financing (€240 million), under favourable terms of repayment, in order to partially meet the obligations arising from previous bonds, which were issued in 2010 and 2011. The aforementioned bonds were issued in the amount of €200 million and €180 million for the maturity period of five years, with the interest mounting 7.875% and 7.25.%, respectively.

In particular, bonds would be issued in the amount to cover financing needs in 2014, and part would be used to reprogram part of the previously issued bonds. Bond issuance in a higher amount is aimed to provide more favorable terms of financing, that is lower interest rates, as well as placement of bonds that would be more liquid, that is, more interesting for investors. In this way, a better position of Montenegro would be provided at the international capital markets and, consequently, the easier and cheaper access to funding sources. Also, pressure to repay obligations in 2015 and 2016 would be reduced, because the debt repayment reprogramming, amounting to 50% of the existing obligations would reduce debt repayment by €100 million in 2015 and €90 million in 2016.

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[13] See Chapter Public Finances in 2013 – Public Revenues.

[14] See Table D4 in Annex

[15] See Table D3 in Annex

Box 1 Detailed information on infrastructural projects and announced investments

The long-term goal of public finances is to reduce the level of public debt to about 30% of GDP by 2023. In particular, negotiations about the construction of the priority sections of the highway Bar – Boljare have been initiated with the first-ranked bidder CRBC. Negotiations concern the commencement of the construction, the model of financing and investment dynamics. In this regard, the 2014 Law on Budget designates funds for the costs of land expropriation and also through the position of the capital budget of the Directorate for Transport. At the same time, the aforementioned Law in a separate article allows the possibility of the additional borrowing for the commencement of the construction of the priority section Smokovac - Uvač - Mateševo. Having in mind the value of the project and its importance to the overall economy in the forthcoming months capacities to implement the project will be discussed, with minimal burdening of the public finances, and the level of public debt. One of the possibilities is the financing of Highway by selling its commercial function, which would reduce the need for borrowing. After the construction of the priority section, preconditions for financing construction of the part towards Bar and Serbia ceding concessions are created.

In the period 2014-2018 beginning of the implementation of several large investments is expected whose total value is around U.S. $4 billion. Most projects will be realized by foreign investments in, first of all, the field of tourism, energy and transport. Implementation of these projects will, through the increased economic activity and employment, have a significant positive impact on economic growth, and the country's public finances. In addition, their implementation does not increase public debt which is in the function of implementing a long-term strategy for the reduction of the share of public debt in GDP.

In this context, public debt will fall based on three grounds:
• increased investments,
• increased public revenues,
• GDP growth .
Based on these assumptions, it is evident that growth generated by these investments will exceed projections from the base macroeconomic and fiscal scenarios.

Base Scenario for Government Debt 2014-2016

Based on the Proposal for the 2014 Law on Budget, the projected deficit and debt, for the year 2014 borrowing in the amount of €240 million is planned, which will cause an increase in debt to the level of around €2,000 million or about 57% of the estimated GDP. Additional borrowing refers to the need of financing budget deficit, servicing obligations and creating fiscal reserves. Internal debt at the end of 2014 will be reduced by about €38 million, while the external debt will be increased by some €170 million.

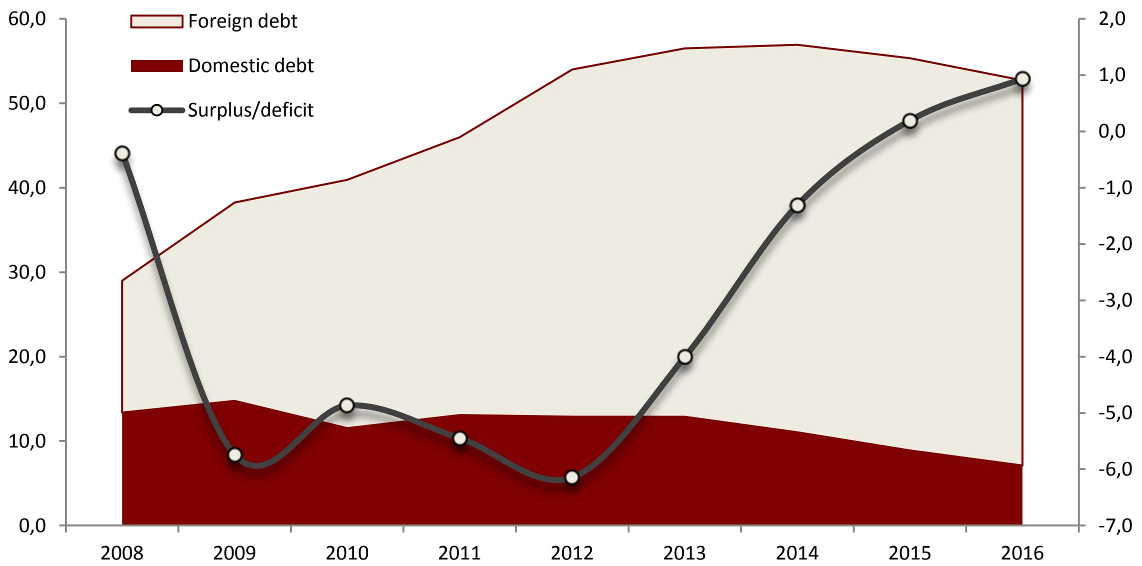
In the course of 2014 withdrawal of about €30 million funding for infrastructure and other projects is planned, while the repayment of principal of domestic and foreign debt is planned in the amount of about €150 million.

Table 11 Government debt trend in the period 2013 - 2016 –base scenario

Type of debt	30 September 2013	2013	2014	2015	2016
GDP	**3,311**	**3,311**	**3,516**	**3,730**	**3,968**
foreign debt	1,363.9	1,443.5	1,612.7	1,731.9	1,809
% GDP	**41.19**	**43.60**	**45.87**	**46.43**	**45.59**
domestic debt	480.9	426.9	388.6	332.1	282.6
% GDP	**14.52**	**12.89**	**11.05**	**8.90**	**7.12**
Total	1,844.8	1,870.4	2,001.3	2,064	2,091.6
% GDP	**55.72**	**56.49**	**56.92**	**55.34**	**52.71**

Due to the evident deficit in the period of crisis, there was a rapid growth in government debt, whose continuation of growth is expected by 2014. Graph 20 shows the tendency of changing the structure and the amount of government debt in the period 2008-2016.

Graph 20 Structure of public debt and deficit for the period 2008 - 2016 (% of GDP)



At the end of 2014 a slight increase in debt to 56.9% of GDP by around 0.5% of GDP is expected, after which their decline in projected. In nominal terms, debt will increase from €1,870.4 million in 2014 to €2,091.6 million in 2016 due to the need of financing the Budget. In particularly, withdrawal of almost €226 million is foreseen in 2014 for the financing of government spending, while the Proposal for the Law on Budget for 2014 established the possibility of borrowing amounting to €240 million. In 2015, the necessary funds for financing debt and deficit repayment amount to approximately €450 million, while that amount for 2016 is foreseen to be around €380 million.

At the same time, in the abovementioned period of time withdrawal of funds under other financial arrangements is planned which will amount to approximately €30 million per year.

In the course of 2014 funds for budget financing will be provided, as already mentioned, through the bond issuance on international market.

Government Debt Trends for the Period 2013 – 2016 – Low-Growth Scenario

In case of low-growth scenario, a decline in economic activity and revenues would occur, which would cause an increase in deficit, that is, the increase of the need for its funding. Table 13 shows debt trends for the period 2014-2016 under the low-growth scenario. In case of low growth in the medium-term framework of 2014-2016 the increase in total debt is expected. Thus, at the end of 2014 public debt would amount to 58.9% of GDP, 59.7% of GDP in 2015 while in 2016 there would be a decrease to 58.2%. In the medium term there would be an increase in foreign debt in 2014 to 47.5% of GDP, in 2015 to 50.3% of GDP, and finally in 2016 to 50.7% of GDP.

Table 12 Government debt trends for the period 2013 - 2016 – low-growth scenario

Type of debt	30 Sept 2013	2013	2014	2015	2016
GDP	**3.311**	**3.311**	**3.415**	**3.535**	**3.750**
Foreign debt	1363.9	1443.5	1622.7	1776.9	1899.9
% of GRP	**41.19**	**43.60**	**47.52**	**50.27**	**50.66**
Domestic debt	480.9	426.9	388.6	332.1	282.6
% of GDP	**14.52**	**12.89**	**11.38**	**9.39**	**7.54**
Total	1844.8	1870.4	2011.3	2109	2182.5
% of GDP	**55.72**	**56.49**	**58.90**	**59.66**	**58.20**

In the course of 2014 an increase in debt of some €140 million is predicted that is total debt will amount to about €2,011.0 million or 58.9% of GDP. The increase in debt in the course of 2014 will be most affected by the increase of the external debt, in the amount of €180 million which will mostly be contributed by the additional borrowing for the needs of finance the budget in the amount of €250 million. In the course of 2014 repayment of the principal foreign debt in the amount of approximately €108 million is predicted.

In the course of 2015 the increase in external debt by about €154 million is expected compared to 2014 mainly due to financing of the budget where for the mentioned year borrowing of about €495 million is predicted. During 2015 about €370 million of foreign debt will be repaid.

In 2016 there will be an increase in foreign debt for €117 million where for the budget needed additional €425 million will have to be borrowed while €332 million of debt will be repaid.

In the period 2014-2016 withdraw of €30 million for funding infrastructure and other projects in Montenegro is predicted.

At the same time, when internal debt trends for the period 2014 -2016 are observed decline in domestic debt is expected from 12.9% of GDP in 2013 to 7.5% of GDP at the end of 2016. There will be a significant reduction in domestic debt based on the established repayment that is projection of certain obligations that will arise in the coming period which will in the next three years that is by 2016 reduce by about €144 million.

Government Guarantees

Total government guarantees[16] amounted to € 272 million as at 30 September 2013, representing 8.2% of GDP. Of this amount, some € 239.9 million (around 7.2% of GDP) referred to foreign guarantees, while domestic guarantees amounted to € 31.9 million (around 0.96% of GDP).

Montenegro's foreign guarantees amounted to around € 347.5 million or 11% of GDP at end-2012. The decline in foreign guarantees during the first three quarters 2013 resulted from the calling upon of guarantees issued for loan facilities concluded by the Aluminium Plant *(Kombinat aluminijuma Podgorica - KAP)* with the financial institutions. During 2013, guarantees in the amount of € 102.7 million were paid off. Of this amount, € 60 million was paid to VTB Bank and € 42.7 million to OTP Bank. For the purpose of providing funds for repayment of these guarantees, two facilities were signed, one with Deutshce Bank and Erste Bank, in the amount of € 60 million for the guarantee issued to VTB Bank, while the second facility was signed with Crnogorska Komercijalna Bank - OTP Group for repayment of € 42.5 million.

After the repayment of these guarantees, the risk of calling upon of the guarantees for the facilities including foreign creditors has been substantially reduced. There is a certain risk for the guarantees issued to the Railway Infrastructure of Montenegro *(Željeznička infrastruktura)*. Total funds withdrawn based on the facility for which the Government issued guarantees amounted to € 19 million or 0.6% GDP (Risk guarantees are indicated in the Table D1 in Annex - *Foreign Guarantees as at 30 September 2013*).

The loan facilities of the Railway Infrastructure are long-term credit lines signed with the international financial institutions (the European Bank for Reconstruction and Development - EBRD) or soft loans (Czech Export Bank). These are favourable facilities with repayment period of 10 years and favourable interest rates (in the case of EBRD facility – 6M Euribor + 1%; Czech Export Bank – 6M Euribor + 1.95%).

In the case of the guarantees issued to the Railway Infrastructure, this company will be obliged to meet all of the outstanding obligations to foreign creditors. In that respect, if there is a risk that certain obligations will not be met, the company will have to take measures to reduce its operating costs (reduction in the number of employees, reduction in wages), which would provide funds needed to meet all obligations. A respective request is forwarded also to the Railway Infrastructure with the initiative to take reorganisation and fiscal adjustment measures that would lead to the cost reduction.

As for the domestic guarantees[17], certain guarantees were called upon in the last quarter 2013 in the amount of € 3 million (guarantee of MI RAI Group Ltd Nikšić – in the amount of around € 1.5 million; guarantee issued to the Electrodes Factory Plužine *(Fabrika elektroda Plužine - FEP)* – in the amount of € 1.5 million), while one guarantee in the amount of € 3.5 million was taken over by the Government of Montenegro (guarantee for the facility signed between Railway Transport JSC *(Željeznički prevoz AD Podgorica)* Podgorica and Erste Bank AD Podgorica), which was planned in the 2013 Budget Law. Based on the repaid and assumed guarantees, and certain repayments and withdrawals, guarantees amounted to € 26 million as at end-November of the current year.

With regard to the risk of further calling upon of guarantees, there are still certain risks of calling upon of some domestic guarantees. In that respect, the guarantee issued to the Bauxite Mines JSC Nikšić *(Rudnici Boksita AD Nikšić)* in the amount of € 5 million should be mentioned. The guarantee was issued for the loan facility signed between the Bauxite Mines and NLB Montenegrobanka.

[16] See Tables G1 and G2 in Annex.
[17] See Table G2 in Annex.

Bearing in mind that the bankruptcy proceedings have been introduced in the company, the calling upon of the guarantee is expected soon. This guarantee will be paid by the end of the current year. Similarly, guarantee issued for the company "Lenka" JSC Bijelo Polje in the amount of € 0.52 million was submitted and it will be paid by the end of the year (risk guarantees are marked in the Annex in the Table: Domestic Guarantees).

Taking into account the existing risk of their calling, the repayment of guarantees for Bauxite Mines and guarantees to FEP and MI-RAI, the repayment of these obligations has been already envisaged in the table Public Spending in the part concerning the estimate for 2013 – repayment of guarantees, where it is mentioned that total amount of repaid guarantees will be € 111.6 million at end-2013.

There is a risk of calling upon of certain guarantees in the following period, where the highest risk bears the guarantee issued for loan facility signed between Melgoni – Primorka Ltd Bar, in the amount of € 4 million, and the possibility of calling upon of certain portion of the guarantees for Pobjeda JSC Podgorica. Guarantees issued to Montenegro Airlines have not been compromised for the time being, as this company rescheduled the existing obligations and postponed the repayment period. Bearing in mind the aforesaid, it is likely calling upon of guarantees in the following period could amount to € 10 million.

Moreover, it is estimated that domestic guarantees will amount to around € 20 million or 0.6% of GDP by the end of 2013, while the increase in foreign guarantees by some € 8 to 10 million is expected (based on certain withdrawal and repayment of funds), whereby foreign guarantees could amount to about € 250 million or 7.5% of GDP.

Pursuant to the above mentioned, total amount of disbursed guarantees could amount to about € 270 million or 8.1% of GDP at end-2013.

Simultaneously, agreements on guarantees were signed in 2013 in the amount of € 66.2 million for the following facilities:

- *for the loan facility signed between Chinese Exim Bank and Montenegro Lines (Barska Plovidba) for the project of purchase of cargo ships in the amount up to € 40.000.000.00;*
- *for the loan facility signed between Montenegrin Electrical Transmission System (Crnogorski elektroprenos) and the European Bank for Reconstruction and Development or German Development Bank (KfW) for the project of cable construction Tivat – Pljevlja in the amount up to € 25.000.000.00;*
- *for the loan facility for Montenegro Airlines in the amount of € 1.200.000.00.*

New foreign guarantees are planned to be issued in 2014 in the amount of € 25 million, out of which the amount of € 20 million is planned for the loan facility between Montenegrin Electrical Transmission System and the European Bank for Reconstruction (EBRD) for the project of the cable construction between municipalities Tivat and Pljevlja, while the amount of € 5 million is envisaged for the loan facility signed between EBRD and Montenegrin Fund for Solidarity Housing Development for the project of housing construction.

The Government of Montenegro carried out, as it has been announced, a strict control of further issuing of government guarantees, aimed at better management of government guarantees and risk reduction. The policy of issuing guarantees for infrastructural projects will be carried out in this segment, as well as for loan facilities for which the assessment is that they contribute to the economic development of the country, as in the case of two above-mentioned projects, as well as for those where the evaluation is that there are no risks that they will be called on.

3.6. Budget Implications of Structural Reforms

Table 14 contains an aggregate overview of quantified fiscal effects of those structural programmes and measures presented in more detail in Chapter 4. In methodological terms, the table is compiled based on the inputs received for particular segments of the structural reforms that are contained in some of the subsections of Chapter 4[18].

Structural reforms affect both revenues and expenditure side of the public finances. Expenditures mostly refer to the expenditures for designing and implementing reforms covering training of employees, changes in organisation and processes. Estimated net effect of structural reforms in 2013 is the expenditure of € 378.3 million. The most important portion of this amount referred to the pension system reforms, showing an expenditure of about € 139 million for net effect. This amount was used for financing Pension and Disability Insurance Fund deficit and providing undisturbed pension payout. No pension reform effects are expected in medium-term. Therefore, the design of new model of financing pension system is planned in the following period.

Transport sector, social benefits, employment policies and the like have significant impact on negative net effect of structural reforms.

Structural reforms also affect the revenue side of public finances, predominantly in the form of the revenue increase. Positive effects of public finances on the revenue side are estimated to € 248.5 million in 2013, whereby the highest impact will be from the pension system reform.

Table 13 Budget implications of structural reforms 2013 - 2016 (€)

Year	2013	2014	2015	2016
Total	-378.325.438.59	-151.958.472.97	-138.740.286.15	-115.142.479.77
Total effect on Budget revenues	248.467.921.45	274.536.173.57	241.412.173.57	268.004.173.57
Total effect on Budget expenditures	626.793.360.04	426.514.646.54	380.152.459.72	383.146.653.34

[18] Annex to this document contains an overview of all structural reforms, as well as those for which fiscal effect is quantified and those for which the exact effect could not be estimated. Tables in the Annex also state years in which these structural reforms have or will have financial effect.

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

In the case that any of the aforesaid risks would materialise, it would have either positive or negative effect on the sustainability of public finances, precisely on the level of deficit and government debt.

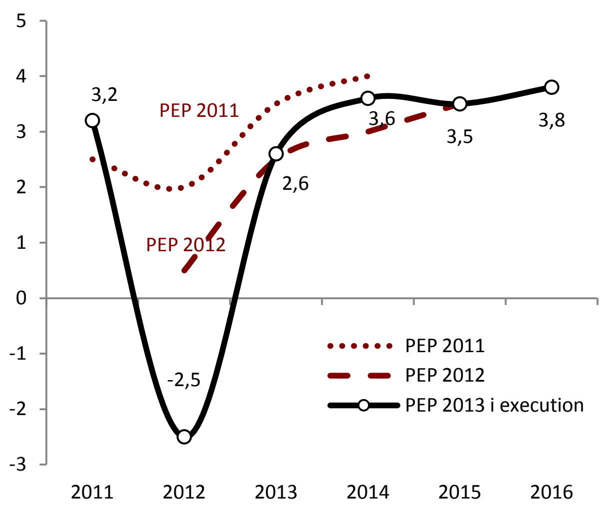
Factors representing fiscal and macroeconomic risks for the presented plans and projections are as follows:

1. Foreign direct investments – although a conservative approach is in fact paradigm of medium-term macroeconomic and fiscal projections, the announced investments and dynamics of their implementation is taken into consideration with significant reserve, which resulted in taking the conservative approach in the planning process. Discrepancies from the announced dynamics of projects' implementation may occur in the following period, which will directly influence the GDP growth and thus public revenues.
2. Effects of developments in the EU economies – since the slowdown economic growth in the EU countries is expected, it is certain that the recession processes from immediate and wider Euro area environment will be spilt over, and the decline in demand and available profit in these countries may have negative effect on Montenegrin economy through the reduction in demand for our export products, including tourism.
3. Companies in the restructuring process – KAP, Bauxite Mines Nikšić, and several others in the restructuring process, and also with regard to the social dimension of the country, Montenegro may opt for renouncing a portion of its receivables and/or to support financially the restructuring process so that these companies would be more attractive for the investors. The possible solution of termination of the KAP will pose expenditure for the State Budget in the form of the support to the social programof employees.
4. Banking system – bearing in mind that the Montenegro's banking sector is fully privatised largely by foreign banks, further decline in lending activity may occur as a result of reduction in available lending funds (crisis of the banking sectors in home countries – Italy, Slovenia, Austria, Hungary). Similarly, one of the risks is also the decline in demand for loans caused by the decline in economic activity. Such situation and withdrawal of capital from Montenegrin market reduces lending activity, jeopardizes the conditions for growth and additionally increases unemployment rate. Growth in illiquidity of economy poses special risk which may reflect on the increase in the share of non-performing loans in total loans.
5. Decline in public finances deficit – has been accomplished by, inter alia, the decline in public spending which may have adverse effects on the aggregate demand and thus on tax revenues. The average fiscal multiplier is 0.5, which means that 1% of deficit decline results in the decline of 0.5% of GDP. The IMF experts (WEO) estimate that this ratio is significantly higher being 0.9-1.7, which in particular refers to the economic crisis periods. On the other hand, the Government of Montenegro aims to reduce only non-productive spending, which in essence generates deficit, while the trend is to maintain the productive spending embodied in the capital budget at the level of more than 3% of GDP, thus creating the assumptions for the generation of economic growth.
6. Tax pressures – the introduced fiscal measures, although mostly having temporary character, may increase the pressure on the economy in the following year which will reduce available funds of legal entities thus indirectly reducing the possibility for new investments in the technology and the expansion of the capacities. At the same time, a model of progressive taxation combined with the increased tax rates, in theory, is challenging for tax evasion (avoidance of paying tax arrears), which directly affects the increase in the appearance of the informal economy. In the medium term, such defined risk is significantly

reduced, because the intention is that the fiscal adjustment measures have only a temporary character until the establishment of stability of public finances.

7. Inflation – the implementation of the announced investments will result in an increase in aggregate demand, which would lead to the increase in prices (inflation). In the medium and long term, significant growth in economic activity is expected, which implies also to an increase in the income of citizens, thereby neutralising the effects of price increases.
8. Infrastructure projects – the dynamics of their implementation and models of investments in the announced infrastructure projects (thermal power plant, highway, hydro power plants, etc), in terms of government debt and budget expenditure, represent significant fiscal risk, but, at the same time, they represent a precondition of the development through the removal of bottlenecks and strengthening the capacities which creates an environment for more dynamic economic growth and development. Also, the implementation of investments in the private sector will affect opening of new job positions and greater economic activity, which has a positive effect on the revenue side of public finances.
9. Weather conditions – non-diversification of Montenegrin economy makes the economy dependant on weather conditions because they affect the agricultural sector and the energy sector, but also the dynamics of the implementation of infrastructure projects and the length of the tourist season.
10. Developments at the Mediterranean – political instabilities in the southern and eastern Mediterranean may have positive effects on the tourist season in Montenegro, as Croatian accession to the EU and establishment of the visa regime with Russia had a positive impulse to Montenegrin tourism.
11. Invitation to the NATO membership - economic effect of this political decision has not been quantified yet; however, based on the positive experience of other countries, accession to this military and political organisation can be considered as a positive economic event. The Invitation to the NATO membership represents a positive signal to international investors by increasing the level of security in the country and the region, which brings additional economic benefits.

Graph 21 Real growth of gross domestic product (%)



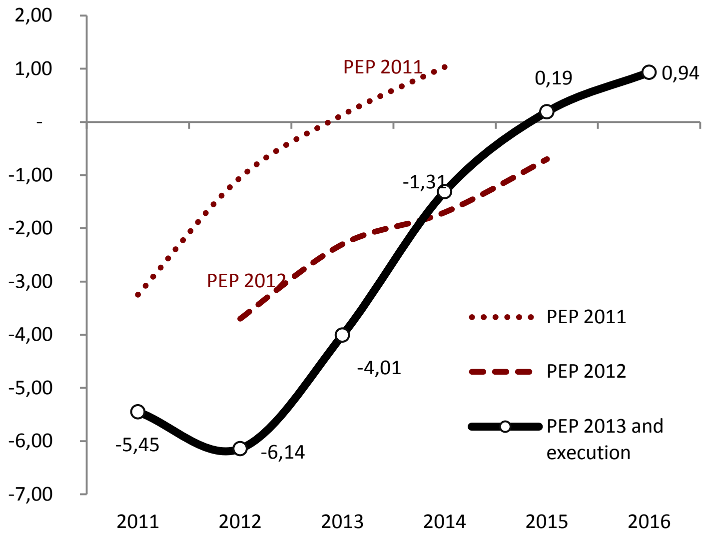
The elasticity of macroeconomic and fiscal scenarios compared to exogenous factors, despite the reservations expressed in their design, is relatively large. Announced investments and the stability of the financial markets, which constitute an important factor of stability and growth of the entire system, are under the influence of external factors. This means that the realisation of these two scenarios will depend on the situation on the international financial market. The basic scenario has higher probability of the accomplishment due to the prudential approach to the level and the dynamics of the implementation of large investments in the next three-year period.

According to the final data of the Statistical Office – MONSTAT, the real growth rate generated in 2012 was -2.5, which was lower than the one projected by 2012 PEP.[19] Graph 21 shows the difference in projections from the previous two documents. The most important deviation is evident

[19]Explained in details in Chapter 2.

in 2012, when in spite of the expectations of Montenegrin and international institutions, the economic downturn of 2.5% occurred. Other projections remained at the level of the prior-year's projections.

Graph 22 Public spending deficit (% of GDP)

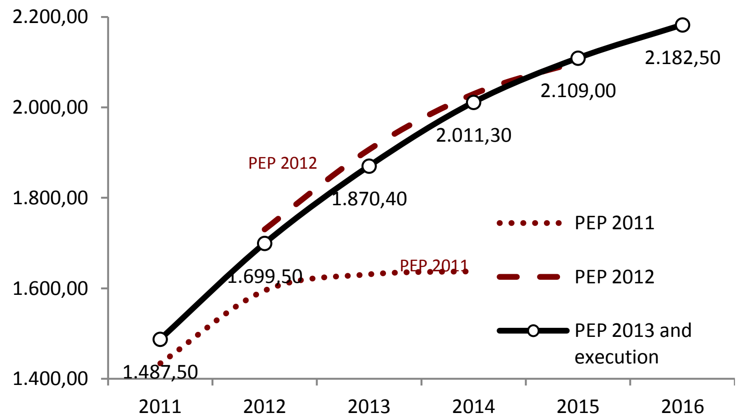


Due to lower GDP growth rates, and considering conservative projection of revenues, they are also at considerably lower level if compared to the previous programme. Moreover, developments in the period following the preparation of the previous program have also influenced the level of projected revenues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

Graph 22 shows significant differences in annual projections, largely as a result of creating outstanding obligations by spending units, which is almost impossible to estimate, and increasing significantly the expenditures of the public sector at the end of the year they also increase the deficit, which is estimated after three quarters for the current year. In addition to the aforesaid, significant discrepancies were due to changes in the value of the final GDP compared to the estimate of the Ministry of Finance, so that for example, the deficit in 2012 increased just on that basis by 0.3 percentage points.

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

Graph 23 Government debt (in nominal terms)



As expected, with lower level revenues the need to borrow also grows, and consequently the level of the government debt as well. However, as it can be noted in the Graph 23, in nominal terms, the government debt is planned at approximately the same level compared to last year's PEP. Compared to the 2011 PEP, the discrepancy exists because it was assumed that the economy in 2012 will continue the trend of recovery, so the burden of the crisis spilled over first to the state budget through the increased expenditures due to calling upon of guarantees, reduced revenues due to a slowdown in economic activity and unfavourable weather conditions, causing an increase in the deficit and thus the government debt. Compared to last year's PEP, the government debt is slightly below the projections for this year.

3.8. Public Finances Quality and Institutional Framework

Fiscal policy in 2013 was aimed at consolidating public finances, reducing fiscal risks and at continuing public finances alignment with the legislation and practice in the EU. With a view to achieving fiscal sustainability, measures of fiscal consolidation have been applied during 2013. Current year was marked by the improved collection of budget revenues, while insisting on austerity measures, which influenced that, in addition to unplanned fiscal events, deficit was at the level of sustainable and legally acceptable one.

Set of fiscal measures that have been introduced, and thus marked the current year, in order to strengthen the quality of public finances, include:

- **Measures to suppress grey economy** are one of the priorities of the Ministry of Finance in 2013 and are directed to the improvement of tax discipline and broadening of the tax base. To that end, the Ministry of Finance has established a Coordination Team for monitoring the implementation of grey economy suppression measures. Control measures are increased, in particular in the segment of trade in excisable goods, labour market and employment of non-residents, issuing of fiscal receipts, and registration of legal entities and natural persons engaged in economic activities. Better exchange of information was achieved, and more efficient inspection controls together with more severe penalty policies have influenced improvement of the taxpayers’ fiscal discipline. Within legislative measures aimed to reduce grey economy, the Law on Excise Taxes was amended, improving the existing solutions concerning the use of gas oils and liquid petroleum gas used for heating for users of public interest, and introducing the system for the excise tax payment and refund in order to introduce more efficient control and narrow down a room for misuse. Moreover, the Law on Misdemeanours was amended in 2013 thus increasing fines for the offenders. The Government of Montenegro adopted in March 2013 the Action Plan for Combating Grey Economy for 2013, which envisages stricter penalty measures, zero tolerance rate for grey economy, non-selective approach, increase of the transparency in the work of government bodies, and passing of a set of new measures for suppressing grey economy including those necessary for the strengthening of staffing and institutional capacities of the authorities, and rigorous penalties. Also, in order to improve the transparency in combating grey economy, a campaign "Stay prone grey zone is gone" *(Siva zona na sva zvona)* was launched for the purpose of greater involvement of citizens in the process of implementing a unified project organised by the Government's Bureau of Public Affairs and the Faculty of Electrical Engineering. Special emphasis is placed on the revision of the current legislation (Law on Value Added Tax and the Law on Excise Taxes), which leaves room for irregular operations, and the adoption of the Law on the Prevention of Illegal Business Operations was proposed. With regard to further suppression of grey economy, the inclusion of certain sectors is envisaged (health care, lawyers, architects, auditors, accountants, etc.) in the tax system according to the real income (i.e. the abolition of lump sum taxation), which will allow for better and more efficient control of their business and, finally, contribute to the reduction of the shadow economy in these sectors.
- **Adjustment of the level of excises** - in January 2013, amendments to the Law on Excise Taxes, increased excise taxes on beer, while in July 2013, excise taxes on tobacco products were increased in order to harmonise regulations with the EU regulations. Revenues from excise taxes grew by € 13.7 million y-o-y in the first 10 months of 2013.
- The amendments to relevant regulations enabled the transfer of the **excess of revenues over expenditure** achieved by the regulatory agencies to the State Budget. This amount is estimated to about € 1 million.

- As a result of the activities aimed at **reducing the tax debt**, according to the latest data from the Tax Administration, tax debt has been reduced from € 354 million as at the beginning of 2013 to around € 330 million. The Decree on the Procedure of Collection of Tax Liabilities through Taxpayer's Property affected certainly the aforesaid reduction and enabled that the companies whose tax debt exceeds € 100,000 can offer their property for debt settlement.
- **Consolidation of finances in local self-governments** initiated by the adoption of plans for consolidation of local public finances, which envisage the rationalisation of the number of employees, lowering of wages, payment of tax liabilities and reduction of indebtedness of municipalities.

With a view to improving the overall system of public finances in Montenegro and harmonisation of regulations relating to public finances area with the relevant regulations of the European Union, the Government of Montenegro adopted in July 2013 the **Proposal of Law on Budget and Fiscal Responsibility**. It is anticipated that the law will be passed by the Parliament of Montenegro at the beginning of 2014. In accordance with the EU's a*cquis communautaire*, numerical fiscal rules are introduced which are envisaged by the Maastricht criteria relating to the level of the deficit and debt, as well as the introduction of medium-term budget framework. The proposal of the Law on Budget and Fiscal Responsibility envisages further improvement of the system of public finances by strengthening fiscal responsibility, transparency and medium-term and long-term sustainability of public finances. To wit, Fiscal strategy passed by the Government at the beginning of its mandate is established as the main strategic document and it relates to the duration of the mandate of the Government. This document identifies the main fiscal targets to be achieved in the medium term and it is the basis for planning of the medium-term and annual policies. In addition to the fiscal strategy, the Government adopts also Fiscal Policy Guidelines, which are based on the Fiscal strategy and reviewed annually, and determine three-year macroeconomic projections, objectives of economic and fiscal policy, spending limits, etc.

In addition to the strategic documents, elements of fiscal responsibility are based on the introduction of criteria on the basis of which planning and implementation of fiscal policy is performed, as well as planning of the annual spending and borrowing. The criteria are primarily reflected on the need of achieving primary surplus on an annual basis, which represent a basic fiscal anchor and a general indication of the quality of public finances management. Moreover, the need for harmonisation of current expenditures and transfers with total current revenues is established, as well as pursuing prudent debt policy in order to provide fiscal sustainability. Furthermore, in accordance with the established Maastricht criteria, the limit of the maximum deficit at the level of 3% of gross domestic product is established and/or the limit the maximum level of indebtedness at 60% of GDP, and in the event that the debt and deficit exceed the established limits, the Government proposes their rehabilitation.

In accordance with best practice, the assessment of respecting the elements of fiscal responsibility gives an independent body, the State Audit Office Senate, which acts as the fiscal council and reports to the Parliament on the implementation of the abovementioned criteria of fiscal responsibility and respecting of fiscal rules.

Special attention in the Law was paid to the control of spending. Specifically, in order to empower the budget expenditure control during the fiscal year, the institute of the budget inspector is defined, as well as scope of work, and the powers that are additionally determined by the Law on Inspection Supervision. Also, liability of authorised persons in government bodies is prescribed and penalties to be applied in the case of acting contrary to the provisions of this Law.

These objectives are in line with the commitment of the Government of Montenegro to further continue working on the improvement of public finances management and harmonisation of regulations governing the area of public finances with the relevant regulations of the European Union.

Montenegro continued to strengthen the legal framework and staff capacities in 2013 in order to manage effectively **IPA funds** in accordance with the European Commission requirements. The First Level Control Office for trans-national programmes was established within the Sector for Finance and Contracting of the EU Assistance Fund, which will reduce costs and increase the efficiency in the implementation of IPA projects.

In accordance with the obligations laid down an action plan, the Ministry of Finance (National Fund) forwarded to the European Commission in March 2013 a set of documents necessary for the establishment of decentralised management of **IPA components** III (Regional Development) and IV (Human Resources Development). The delivery of the accreditation package to the European Commission represents the finalisation of one of the most important phases in this process which confirms the capacity to fully meet the accreditation criteria defined in the IPA regulation, which shows the willingness of national institutions to take responsibility and manage the EU funds earmarked for the regional development and human resource development. The next step in this process will be the arrival of auditors of the European Commission which will, on the spot assess the established institutional and legal framework developed for the purpose of transferring the management of pre-accession funds from the European Commission to Montenegro institution, i.e. independent programming, contracting and financing, as well as the monitoring of these funds.

Montenegro, as a candidate country for EU membership, has an obligation to establish a vision of social and economic development, with individual investments and development measures necessary for their implementation. The Government of Montenegro adopted the document **Montenegro Development Directions 2013-2016 (NDP)**, which suggested the solutions for the harmonisation of the objectives of sectoral and national strategies in various areas of development. By identifying areas of policy and sub-policies, authentic development interests of Montenegro are determined under the directions of the development of "smart growth", "sustainable growth" and "inclusive growth" together with a proposed investment / development measures.

With a view to accessing more qualitatively the harmonisation process of the legislation, drafting of **Montenegro's EU Accession Program for the period 2014-2018**, which will be used as an effective mechanism for planning strategies, programmes and action plans in the field of public finances of Montenegro. Also, it will include legislative framework with an overview of the planned legislation which transposes the EU's *acquis communautaire* in this field. This extremely complex process of legislative, administrative and institutional harmonisation of the country with the EU rules will have also significant financial / fiscal implications. This program will identify costs that will be incurred in the accession process, on the basis of which the decision will be made on the amount of funds needed for its realisation.

In the segment of **regulatory reform** and improvement of the business environment, the Government established an **e-registry of business licenses** in 2013. E-Registry of Business Licenses enables the increase of transparency and reduces regulatory risk for legal entities. E-Registry provides a favourable environment for the efficient conduct of business and creating greater confidence in the government bodies.

The Ministry of Finance and Tax Administration of Montenegro introduced in 2013 the practice of **publishing so called White List**, i.e. a list of taxpayers whose highest degree of fiscal discipline was noted and with which the Tax Administration has a successful cooperation in terms of respecting tax legislation and settlement of tax liabilities. The criteria for the selection of taxpayers on the White List included accuracy of tax calculation and submission of tax returns, regularity in payment of tax liabilities. The publishing of the White List is another step forward in encouraging taxpayers to comply with tax rules and cooperate with the Tax Administration, thus contributing to the achievement of budget revenues, and improving the business and investment climate in Montenegro.

Simultaneously with the publication of the *White List*, the publication of the so-called **Black Lists** of the Central Bank and the Tax Administration has begun, which publish respectively a list of companies whose accounts are frozen and those who do not regularly meet their obligations to the state. In this way, the liquidity of the real sector has been trying to improve in a way that doing business with companies that are on the "black" lists will become non-stimulating for other operators in the market.

Drafting of the **Strategy for Public Sector Transition to ESA 95 system** is planned in 2014 within the negotiation Chapter 17 - Economic and Monetary Union. it is planned to develop the Strategy for the transition of the public sector in the ESA 95 system The adoption of the European System of Accounts, ESA 95 is one of the requirements of the Economic and Monitory Union to achieve comparability of results of EU Member States, i.e. to define the methodology of common standards, definitions, classifications and accounting rules. The Strategy will define the plan of transition to ESA 95 system, the objectives to be achieved by the accounting and reporting reform, as well as the timeframe for transition.

The Ministry of Finance has proposed the implementation of systemic set of measures **for 2014 and for the following period**, which are listed in Chapters 3.1 and 3.3, and they will contribute significantly to the process of fiscal consolidation and long-term sustainability of public finances.

3.9. Long-term Sustainability of the Public Finances System

In order to ensure long-term sustainability of the public finances system, reforms were implemented in the previous period which will give results in the long run. One of the most important reforms implemented in Montenegro is the state pay-as-you-go pension system. Longevity, low population growth rates, as well as the low labour force activity rate, have conditioned a need for the retirement age limit to be gradually moved to 67 years of age. Moreover, the formula for pension adjustments was also changed. A growing number of pensioners threatened to put in serious jeopardy sustainability of public finances of Montenegro. The actual situation shows that this trend continued also in 2013, where there has been a growth in the number of pensioners, which combined with rising inflation led to an increase in the cost of pension benefits. With this in mind, as an interim measure, the Law on Pension and Disability Insurance was amended, prescribing that the pensions will not be adjusted during 2013. Given the high deficit of the Pension and Disability Insurance Fund, a model that will provide greater level of sustainability of the pension system will be found in the coming period.

With a view to further improving fiscal discipline and creating long-term sustainable wage system, the amendment of the regulatory framework that defines wages in the public sector was initiated. The new law would define the method of determining wages for all employees in the public sector which will be conditioned by developments in the level of deficit or financial results of public companies and state companies, while at the same time it will provide unified method of calculating wages for the performance of the same jobs.

The implementation of the "social card" will also affect public finances in long run, as it was mentioned in the previous PEP. Specifically, in order to improve the focusing of funds for social and child protection and achieve greater fairness and efficiency, and reduce the costs of administering the system, the Government has initiated the project "Social Card – Social Welfare Records." During 2013, all of the activities planned for the implementation of the project were successfully completed, and the project should be, in accordance with the Agreement on the Project Implementation signed between the Government of Montenegro and UNDP office in Montenegro, completed by the end of 2014. This will ensure that social assistance get those who really needs it.

All fiscal consolidation measures introduced in the previous period, which will be implemented in the coming period, were aimed at establishing long-term sustainability of the public finances system.

IV Structural Reforms

The reforms in all spheres of economic systems are a prerequisite of ensuring long-term sustainable economic growth and development. The structural reforms that have been carried out in 2013 are presented in this Chapter, those that have not been implemented, with the reasons for deviations from the one planned in the last year's PEP, as well as reforms that Montenegro will implement in the coming medium-term period. Chapter III gave table overview of the budget effects that will produce structural reforms by individual policies.

4.1. Major Obstacles to Economic Growth and Key Structural Reforms Agenda

The effect of the global economic crisis slowed down the implementation of structural reforms. In such conditions, systemic solutions aimed at strengthening the competitiveness of the economic system have been implemented in 2013 in the field of structural policies. In this regard, the following activities stand out: the improvement of the business environment, encouraging the development of entrepreneurship and/or SMEs sector; assessment of the situation in the labour market and, in this regard the improvement of labour legislation, and the necessary harmonisation in the education sector, ensuring sustainability pension system in terms of increasing number of the pensioners; improvement of the health system, and achievement of greater efficiency and productivity of state administration. At the same time, activities were intensified to improve infrastructure, primarily in the transport, energy and tourism sectors. Structural reforms are also, in addition to the above, response to requests from the EU accession process.

Montenegro is faced with many challenges at the global and national level:

- Prolonged duration and/or new effects of the economic crisis have led to an increase in illiquidity of the economy, increase in social pressure due to the loss of jobs, with reduced investors' interest for new investments;
- Lending activity, as a key activity of banks, is still not at the level that would meet customer expectations and boost the economic growth and development, and high interest rates on the loans granted mostly from the deposits gathered not only discouraged economic activity, but encouraged growth in deposit interest rates;
- Structural unemployment and unemployment of young persons with acquired university education is evident;
- The need to increase the competitiveness of the economy, together with strengthening the role of science and, in this respect, innovations and technological changes;
- Climate changes, as a part of the global challenges, as well as other challenges affecting the long-term development of the country.

In order to create conditions for faster growth and development, an active relationship was established and the work on addressing the identified key problems has begun. Along with fiscal consolidation, ambitious structural reforms are implemented that are aimed at establishing a functional market economy, increasing productivity and enhancing the competitiveness of the domestic economy, as the basis for maintaining macroeconomic stability and ensuring long-term sustainable economic growth.

Corporate and Financial Markets - Reduced investment activity in international environment had an adverse impact on corporate and financial markets in Montenegro. Systemic changes are by and large aimed at strengthening competitiveness of the country and at its harmonisation with the EU legislation. Public resources will be directed towards the establishment of long-term competitiveness, i.e. so called "good" state aid will be given.

Business environment enhancement - as one of priorities of the Government of Montenegro is implemented through activities directed to the provision of additional incentives for business development. *Tax policy* is focused on stabilisation and consolidation of public finances. The realisation of a set of measures of fiscal adjustment and intensification of the fight against the grey economy halted the trend of deteriorating fiscal parameters, revenues increased and tax discipline improved. In accordance with the fundamental principles of tax policy, the competitiveness of the tax system will be improved in the coming period, which includes attractive tax rates, efficient administration and procedures, good taxpayers' culture and reduction of the grey economy.

Financial sector - Banking sector is stable, solvent, liquid and supervised on a continuous basis by the regulator. Basic characteristics of the banking sector are: high level of non-performing assets, growth of deposit potential, and slight growth of lending activity. The regulatory framework has been improved, whereby attention was paid to its harmonisation with the relevant EU directives.

Labour market - Inconsistent and inadequate statistical base for analyses have been identified, which has been reflected primarily through unsatisfactory quality of data on labour market, both from survey and administrative sources. Labour market is still characterised by high long-term unemployment and high youth unemployment rates. Taking into consideration the mismatch between the education system and labour market needs, the Law on Vocational Education of persons with acquired university education has been adopted, based on which the implementation of the Program for employment of persons with acquired university education has commenced. With a view of increasing flexibility of labour market and decreasing labour costs, negotiations on the General Collective Agreement are in the final stage.

Administrative reforms - In order to optimise the public sector, and/or to establish a balance between reducing the budget expenditure, and servicing obligations arising from the EU accession process, on the other hand, in accordance with the *Plan for internal reorganisation of the public sector* for the period 2013-2017, the appropriate measures and activities are implemented. In the area of administration system, the implementation of the new Law on Civil Servants and State Employees has started since the beginning of 2013. At the same time, a significant number of secondary legislation has been adopted which will enable more efficient implementation of the reform solutions contained therein. More detail criteria for defining the tasks of state bodies and their segregation by level of complexity were established. In order to create the preconditions for the provision of qualitative services to citizens, entrepreneurs and other entities by public administration bodies, a new Law on administrative procedure was drafted, which adoption is expected the beginning of 2014.

4.2. Corporate and Financial Markets

4.2.1. Privatisation

Implementation and Divergences: Privatisation process in 2013 was carried out in line with the Privatisation Plan for 2013. The Decision on Privatization Plan for 2013 ("Official Gazette of Montenegro", no. 10/13) defined privatisation activities with the main objectives, methods and manners of privatisation, determined list of companies and the percentage of share capital for privatisation. The criteria for making decisions on individual privatisations increased also the competitiveness and efficiency of functioning of companies in the current economic and financial conditions, encouraging foreign investments and entrepreneurship, increasing employment and improving the living standards.

The tender procedure was carried out successfully and Agreement on sale of 62.1% of capital of the company Container terminal and general cargo, Ltd Bar (*AD Kontejnerski terminal i generalni tereti Bar*) was signed with the Turkish company Global Ports Holding. Based on the agreement, the buyer will pay the purchase price of € 8.1 million, provided that, among other things, invests € 13.5 million in the reconstruction of the Company within three years. Similarly, by selecting the Belgian company BESIX Group, the conditions were created for the implementation of the first phase of the construction of the apartment complex in the marina Luštica Bay. The Agreement on purchase of 64.2% of share capital of the company "Polimka" ltd Berane was implemented, whereby the buyer- "KIPS" Ltd Podgorica fulfilled all obligations necessary for closing the said contract.

In this period, the Privatisation Council declared unsuccessful tenders for New Tobacco Company JSC (*Novi duvanski kombinat AD – Podgorica*), Institute Dr Simo Milosevic Igalo, and NIG Pobjeda - Podgorica. The Council obligated the relevant Tender Commission to commence, after examining interests of investors, the activities on the implementation of the repeated tender procedure.

Current and Future Economic Policy Programmes and Measures: The privatisation process in 2014 will be directed to the realisation of failed tenders from previous years, and projects for which the planning documents are adopted including tenders for long-term leasing of several military-tourist complexes. The implementation of these plans will depend, primarily on the interests of potential investors.

Budgetary Effects of Programmes and Measures: Total nominal value of the company and the assets for privatisation in 2014 amounts to € 186.3, while the projected revenue from the valuation of tourist sites is estimated at about € 10.0 million. The amounts of budget revenues are uncertain, given that the implementation of projects directly depends on the interests of investors, which is not possible to predict given the current circumstances.

4.2.2. Competition, State Aid and Public Procurement

Competition

Implementation and Divergences: On the basis of the Law on Protection of Competition from 2012, the Agency for Protection of Competition was established. After its establishment, the Agency has adopted all necessary internal documents and three (3) secondary legislation documents.

The Administrative Court confirmed one decision of the Agency for Protection of Competition (former Administration) on the abuse of a dominant position. Furthermore, in July 2013, the Administrative Court partially confirmed the decision of the Agency for Protection of Competition on the abuse of dominant position due to the misapplication of substantive law. The adoption of the decision on the enforcement of the judgment of the Administrative Court is pending. At the same time, several decisions on determining the abuse of dominant positions were passed that are pending before the competent court for confirmation purposes.

The Agency launched, ex officio, three investigation procedures, of which **one** proceedings was initiated due to the suspicion of the existence of a prohibited agreement in the market for publishing and transporting daily newspapers in the territory of Montenegro, **the second** was initiated because of the suspected abuse of dominant position in the market of services provision to access to the necessary infrastructure and broadcasting signals for mobile telephony in the Montenegro market, while **the third** proceedings was initiated because of suspicion of the existence of a prohibited agreement (the acts the object or effect of which is or may be to prevent, restrict or distort competition).

Some 20 requests for issuing the approval for the implementation of a concentration were filed to the Agency for the assessment in the current year, of which 12 concentrations were approved, one was rejected and others are pending.

Current and Future Economic Policy Programmes and Measures: With a view to creating complete legal framework governing this matter, the activities on drafting and adoption of the seven secondary legislation documents are underway.

Budgetary Effects of Programmes and Measures could not be estimated in the area of competition.

State Aid

Implementation and Divergences: All the measures and activities from the last year's Pre-Accession Economic Program concerning the improvement of legal framework have been fully implemented. Amendments to two secondary legislation documents were adopted, thereby contributing to the further harmonisation of national legislation with the EU's a*cquis communautaire*, as well as strengthening the activities of the Commission for state aid control. In 2012, the Commission adopted thirteen decisions, of which eleven referred to the compliance of measures. It was concluded in one case that the aid reported in accordance with the provisions of the Law on State Aid Control does not constitute state aid. In November 2013, the Commission adopted two conclusions and seven decisions on the state aid compliance with the Law. Except in the case of the KAP, the Commission paid special attention to the restructuring of Montenegro Airlines, which the Commission assessed in its Decision No. 01-36/1 of 20 June 2012 as compliant with the Law. Based on comments of the European Commission on the Restructuring Plan of Montenegro Airlines, the Commission for state aid control adopted the Conclusion No. 01-22/1 of 02 April 2013 on the amendment to the previously mentioned decision.

Table 14 State Aid in period 2010 - 2012

Indicator	Unit of measure	2010	2011	2012
State aid	*€ million*	71.9	66.4	41.9
State aid share in GDP	*%*	2.3	2.0	1.3

Total state aid granted in Montenegro in the 2012 amounted to € 41.9 million, accounting for 1.3% of GDP. Thus, compared to 2011, total state aid granted decreased by 36.9%, or € 66.4 million, and therefore the share of state aid in GDP significantly reduced (in 2011 it was 2.0%). Of total state aid granted in 2012, some € 32.8 million or 78.3% was given for horizontal aid, while 18.0% or € 7.5 million referred to sectoral state aid. Of total state aid granted in 2012, 3.7% or € 1.5 million referred to the regional aid.

The Commission for state aid control monitors developments in KAP with special attention. The Commission assessed in its Decision No. 01-35/1 of 24 November 2009 that the Financial Restructuring Program of the KAP was harmonised with the Law on State Aid Control. Specifically, each payment of state aid or equivalents of subsidies thereof, are recorded through annual reports of the Commission on state aid granted on the basis of data on state aid granted delivered by the line ministry. However, after identifying irregularities in the implementation of the Financial Restructuring Program of the KAP, i.e. calling upon of guarantees by Deutsche Bank in the amount of € 22.0 million, the Commission for state aid control ordered the State aid provider by the Decision 01-33/1 of 1 June 2012 to take all legal actions to refund non-compliant state aid granted, as well as to suspend the possible further allocation of state aid to the KAP. In this regard, the Ministry of Finance submitted on 14 June 2013 request for initiating bankruptcy proceedings over this company, which was initiated by the Commercial Court on 8 July 2013. In this regard, the Government reported all its receivables to this company in the bankruptcy pool of assets, which amounted to € 148.1 million. Due to the inability to conduct reorganisation through programmed bankruptcy, the Commercial Court declared bankruptcy of the KAP on 9 October 2013. After declaring bankruptcy, the conditions for the sale of the bankruptcy debtor as a legal entity have been created, i.e. its entire property, which is estimated at approximately € 52.5 million. In that respect, an Announcement was published on 6 December for bids for the purchase of property of Aluminium Plant JSC under bankruptcy.

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

Budgetary Effects of Planned Programmes and Measures: During 2013, guarantees for loan facilities concluded between KAP and financial institutions in the amount of € 102.7 million were called upon for payment, which had a direct negative impact on the budget, given that these obligations were serviced from the state budget.

Public Procurement

Implementation and Divergences: In order to improve certain normative solutions and more complete harmonisation with the EU legislation, the activities on drafting the amendments to the Law on Public Procurement are underway. The project "Strengthening of the public procurement system in Montenegro" was fully implemented. It was aimed at providing, based on an analysis of the current situation in this area, guidelines for drafting amendments to the Law on Public Procurement, for implementing centralised procurements, monitoring and better use of statistical data presented on the website of the Administration, as well as for preparing technical specifications for the future process of the introduction of the public procurement system. In accordance with the Action Plan for implementation of the strategy for the development of the public procurement system in Montenegro for the period 2011-2015, significant activities have been carried out on raising awareness about the importance of control of public procurement procedures in all entities that are, directly or indirectly, related to the procurement procedure.

Current and Future Economic Policy Programmes and Measures: The authorisation of the Administration for Public Procurement are expanded by the adoption of this Law in the part relating to the monitoring and inspection of the implementation of regulations in the area of public procurement, which requires the provision of adequate implementation capacities.

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

There are no budgetary effects of planned programmes and measures.

4.2.3. Business Environment

Business Environment Improvement

Implementation and Divergences: Reforms in the area of improving business environment carried out during the 2013 included the measures planned in the last year's PEP, primarily, in the part relating to the issuance of building permits, creating of one-stop shop principle of licensing, based on obtaining the consent of the relevant authorities, ex officio, with significantly shorter deadlines. An analysis of fiscal policy at the local level was prepared including recommendations relating to the improvement of business environment at the local level and, among other things, changes to one of the most significant fiscal burdens in the realisation of investments and obtaining building permits, so called utility fees for residential land. Other activities related to:

- Preparation of the Plan of internal reorganisation of the public sector, with the aim of creating an efficient, economical and effective public administration that is based on the best international standards and practices;
- Preparation of analysis of the structural reforms, with special focus on the pension system, the introduction of public-private partnerships in health care, as well as the introduction of modern information technologies in the education system;
- The adoption of the necessary legislation for the introduction of public enforcement officers in the system of execution of judicial decisions;
- implementation of RIA (Regulatory Impact Assessment) on laws and secondary legislation acts, as well as the preparation of opinions of the Ministry of Finance regarding the validity of RIA, as well as the impact of the same on business environment;

Efforts made in the implementation of these reforms were recognized by the World Bank through its Doing Business Report 2014. Montenegro advanced by 7 places, from 51st to 44th, in terms of global rating of business climate, with the most significant progress within the indicator "issuing building permits" where it advanced from 68th place, as well as within the indicator "registration of immovable properties, where it advanced by 16 places.

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

- implementation of accepted “Regulatory Guillotine” recommendations;
- implementation of the activities within the public sector reform;
- introduction of public enforcement officers,
- reduction of the cost of obtaining building permit, as a step for further improvement of these procedures,
- implementation of the recommendations of the fiscal analysis at the local level;
- overcoming the problem of illiquidity of the economy and the adoption of new legislation on voluntary financial restructuring.

Sector of Small and Medium-sized Enterprises

Implementation and Divergences: Measures to support the SMEs sector are implemented through annual action plans for the implementation of the SMEs Development Strategy 2011-2015, the Strategy to boost the competitiveness at the micro level 2011-2015, and Strategy for Lifelong

Entrepreneurial Learning 2008-2013. Loan support of the Investment and Development Fund (IRFCG) resulted in 140 loans granted to entrepreneurs, farmers and SMEs by 4 December 2013. Resources of the Investment and Development Fund committed for these purposes amounted € 23.9 million, while the banks allocated additional € 0.25 million for their realisation. The SMEs sector was further supported by 21 factoring facilities, whereby receivables were purchased in amount of € 22.3 million, and three guarantees were issued totalling € 2.9 million. In addition, the activities on the establishment of the centres of excellence were carried out, as well as on the implementation of regional business centres and incubators depending on the provision of financial sources, strengthening competitiveness and stimulating export orientation[20]. The implementation of the project "Internationalisation of Mentoring System for SMEs in Montenegro" has begun on the basis of the cooperation agreement signed with the Japanese International Cooperation Agency-JICA for period of three years.

It is evident that the priority is given to the measures of financial support, thus greater attention will be paid in the coming period to strengthening measures of non-financial support, which is closely related to the financial support, especially when it comes to the support to the start-up businesses.

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

- Development of Strategy of development of lifelong learning 2014-2018 and continuation of the projects initiated for the development of entrepreneurial competencies and educational projects and training;
- Development Strategy for Women's Entrepreneurship 2014-2015 and implementation of measures to foster female entrepreneurship;
- Continuation of the initiated projects "Internationalisation of Mentoring Systems for SMEs in Montenegro", on-line SMEs portal, internationalisation, activities in terms of improving competitiveness, promotion, social responsibility and other activities that will be defined by the action plans on these strategies for 2014.

4.2.4. Knowledge Society Development

Montenegro, in addition to its natural resources, possesses significant human potential for the realisation of more dynamic economic growth and development and higher competitiveness of domestic products and services in the global market.

Knowledge society is in direct correlation with the quality of human resources, so that education becomes even more important in our society. The quality of the education system determines the innovation capacity and is the basis for economic competitiveness. Investing in people and skills is vital for Montenegro. Therefore, lifelong learning has become an imperative for public policies, which stresses the mutual importance of economic and social standards for the successful development of knowledge society. Using digital technologies, willingness to adopt new skills and work of knowledge-based companies has become crucial to support innovation and sustainable economic development. In return, the knowledge society will create new and better jobs and higher

[20] Evaluation of the use of voucher schemes under the project "Assessment of the implementation of specific incentive measures for SMEs", which was awarded by the European Association of projects for winning the first prize for the best project completed in 2013. The activities to establish *on-line SME portal* have begun. The promotion of Montenegrin enterprises in international trade fairs was also supported. The establishment of a visual identity for 9 companies was enabled, which will provide visibility and better positioning in the market. As a part of the Program for encouraging the development of clusters in the Northern region and less developed municipalities of Montenegro for 2012-2016, the financial support was provided in 2013 in the form of a grant for 2 clusters in the amount of € 14 thousand.

living standards. Therefore the support and enhancement of education that supports and accelerates the adoption of the current changes is an imperative.

Education

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

Current and Future Economic Policy Programmes and Measures: In 2013, the activities on passing strategic documents continued, with the aim of further improving the overall education system, particularly in the enrolment policy at the University of Montenegro, as well as improving the links between the education system and labour market. In addition, the activities continued to develop Models of education financing, which will be determined in the coming period, as well as activities to improve the capacities for student accommodation (reconstruction of the existing and construction of new student dormitories, according to the public-private partnership).

Activities are planned to develop National Qualifications Framework and defining learning outcomes (innovation of existing legislation, the creation of a methodology for defining learning outcomes, etc). Grants for the implementation of reform activities will be awarded to the institutions of higher education in which, through a process of external evaluation "room for improvement" is recognized. During 2014, the establishment of a system for continuous monitoring of careers of graduates was planned with the aim of objective and standardised monitoring of the degree of success in the career of graduates, as support for future students, the academic community, employers and decision makers in designing educational programs and decisions on registration.

Research and Development

Implementation and Divergences: All the activities planned by the last year's PEP have been implemented.

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

- The status of the first Centre of Excellence in Montenegro will be granted within the "Higher Education *and* Research for Innovation *and* Competitiveness Project (HERIC)" by March 2014, (the procedure is pending). At the same time, in order to strengthen the exceptional research teams, internationalisation and linking of research and industry, large research grants will be allocated (€ 150-400 thousand), starting from April 2014.
- The implementation of the project of establishing the first "Scientific and Technological Park" (STP) is underway. The project is designed as a networked structure based in Podgorica and the decentralised units - impulse centres in Nikšić, Bar and Pljevlja, which will create the conditions for establishing closer cooperation of scientific and research institutions and the private sector, in order to strengthen innovative activities and their generating into specific product or service. **Innovative Entrepreneurial Centre "Technopolis" was founded in Nikšić (the activities related to remodelling of the building**

for its accommodation is underway). In 2016 and 2017, entrepreneurial centres in Bar and Pljevlja will be established.

- International scientific and technological cooperation shall be carried out through:
  - multilateral cooperation (Program FP7, EUREKA programme, COST, NATO's The Science for Peace and Security Programme; cooperation with the International Atomic Energy Agency (IAEA), the International Centre for Genetic Engineering and Biotechnology (ICGEB), as well as cooperation through Joint Research Centre - JRC). Furthermore, the preparatory activities for the new EU Framework Program for Research and Innovation "Horizon" 2020, as well as the IPA are underway.
  - the bilateral science and technological cooperation (S&T Cooperation) - the implementation of 76 projects is pending in accordance with agreements with other countries on the S&T cooperation (12 agreements).
  - regional cooperation - the Declaration on Regional Research and Development (R&D) Strategy for Innovation was signed.
- The implementation of the national programmes will continue, including:
  - Implementation of the second research year for 104 national research projects;
  - Promotion of science in society and among the youth;
  - networking of local and international scientific community will be continued within the project "Scientific Network" and a uniform database for research capacities will be established.

4.2.5. Network Industries

Energy

Implementation and Divergences: Energy represents one of the pillars of economic development of the country, which has been recognized in numerous strategic documents. In order to clearly direct the development of the country in this area, drafting of the Energy Development Strategy of Montenegro by 2030 is in its final stage. The drafting of the National Renewable Energy Action Plan by 2020 is underway. This plan will determine the dynamics and incentives for the achievement of national objectives in terms of participation of renewable energy in overall final energy consumption.

As for the large projects, the preconditions are being created based on which the potential investors would deliver the bids for the construction of the hydro power plants on the river Morača and hydro power plant on the river Komarnica. Bids for the implementation of the project Block II of the thermal power plant "Pljevlja", in which bidders are supposed to present also the financial structure for the project implementation, have been already submitted. The projects for the construction of small hydro power plants are being implemented in accordance with the previously concluded agreements on concessions, and the process of implementation of tender procedures continued. Thus, in March 2013, small hydro power plant "Jezerštica" in the municipality of Berane started with operations, and 10 companies applied to the public notice for the granting concessions for the use of watercourses for the construction of small hydropower plants in Montenegro, which included eight watercourses in the basin of the rivers Lim, Komarnica and the Piva Lake. The possible total installed power of the present watercourses is 12.3 MW, with an estimated total annual electricity production of 54.8 GWh. The project of building the wind farms on the site Krnovo has been implemented according to the scheduled dynamics, and although certain phases of the project Možura are delayed, not all deadlines determined in the Annex to Agreement were breached. The project of the construction of the submarine interconnection power cable between the electric power systems of Montenegro and Italy is carried out in accordance with the envisaged schedule. In August 2013, a public invitation to tender has been announced for awarding the Concession Agreement for the production of hydrocarbons in the offshore of Montenegro, with the deadline for submission of applications by the end of February 2014.

Montenegro continues with activities in the area of energy efficiency. The Second National Energy Efficiency Action Plan by 2015 was passed in 2013. It envisaged the following: the continuation of the activities to raise public awareness and implementation of good practices in the field of energy efficiency, especially in public sector institutions, local self-governments, large consumers, professional organisations and other stakeholders; continuation of the activities to improve statistical and monitoring systems in the field of energy efficiency, as well as the continuation of the measures and energy saving projects with recognisable results. The Methodology for Calculating Energy Savings is being drafted. The conditions for energy savings (3.957.530 kWh or € 332.206) were created through the implementation of the energy efficiency measures of the reconstruction in the public sector (eight schools and five hospitals) within the Montenegro Energy Efficiency Project (MEET). Loan facility for the continuation of the implementation of MEET in health care facilities (€ 5.0 million) was signed.

Oversight of the energy sector in Montenegro is the responsibility of the Energy Regulatory Agency. In addition to the passing of the legislation, the Agency gave approval, in accordance with its statutory authorisations, to several secondary legislation documents passed by energy entities in carrying out the obligations laid down by the Energy Law. Rules on the minimum standards for the quality of electricity supply were drafted among other things. Bearing in mind that the Agency, under the applicable Energy Law, does not have adequate powers to effectively monitor the implementation of standards of quality, the setting up of this act is possible only after the adoption of the new Energy Law and its alignment with the EU Third Energy Package.

The customers connected to the transmission system (KAP, Steel Mill, Railway Infrastructure) have not been supplied with the electricity under regulated tariffs since 1 January 2013, which contributes to the acceleration of the process of creating and strengthening the electricity market in Montenegro. A licence was issued to the energy entity “Montenegro Bonus” Cetinje for the activity of electricity supply. This is the first example of electricity supply in the market, outside the public supplier.

Current and Future Economic Policy Programmes and Measures: In the coming period the realisation of the initiated activities will be continued. The activities related to the current tender procedures will be carried out, the activities arising from appropriate action plans and programmes, as well as those arising from the international treaties and agreements, which are, at the same time, project tasks of the Government of Montenegro in the energy sector.

The Energy Regulatory Agency will increase its activities in the field of renewable energy in the coming period, in line with the announced higher use of these resources in Montenegro. In addition, the Agency will: continue to control the operations of the energy entities, especially in the realisation of investment plans and respecting the conditions from licenses for performing operations; amend the methodology for determining regulatory revenues and tariffs for which certain deficiencies are determined in the process of implementation; monitor the harmonisation of the Energy Law with the EU Third Energy Package (the Agency submitted the relevant proposal to the line ministry) and after its adoption, work on the harmonisation of secondary legislation which is under its responsibility; monitor the implementation of regulations on minimum standards of quality, which will be applied as a test document from 1 January 2014 until the end of the regulatory period 31 July 2015; begin the implementation of activities within the competence for the regulation of the gas sector adopting the secondary legislation in accordance with the law; continue to take further measures and activities for reviving the energy market, as well as prepare tariff customers and the market as a whole for transfer of these categories of customers to the supply in the energy market, in accordance with the appropriate programme, etc.

Transport

Road infrastructure and road traffic: Activities directed to improvement of the road infrastructure have been implemented in continuity (regular maintenance of state roads that is financed from the current budget funds; the implementation of the program for elimination of bottlenecks in the traffic network of Montenegro, the program of reconstruction of intersections on state roads of Montenegro and the program of reconstruction and rehabilitation of critical points on state roads of Montenegro).

Highway Bar – Boljare, which is currently in the preparation phase, is the largest infrastructure project, i.e. priority section Smokovac-Uvač-Mateševo. On the basis of three bids, the Government decided in July 2013 to continue negotiations only with the first-ranked bidder, i.e. Chinese companies *China Communications Construction Company Ltd. (CCCC) and China Road and Bridge Corporation (CRBC)*.

Other means of transport: In the field of **air transport**, pursuant to the Master Plan for development of airport by 2030, the public enterprise Airports of Montenegro (*JP Aerodromi Crne Gore)* continued with the implementation of infrastructure projects in order to create preconditions for further development of air transport and increase the availability of Montenegro as cheap tourist destination by air transport. International tender for the development of Main project of the construction of terminal building 2 at Tivat Airport was announced, which will be financed from the funds of the public enterprise Airports of Montenegro.

With regard to the **railway transport**, the second phase of the railway restructuring is close to its finalisation, and it implies segmentation of already established joint stock companies, and it will be completed by the privatisation of some parts of the railway system. The Law on Railway was passed and the proposal of the Law on Combined Transport was determined. The Law on Safety and Interoperability of Railways is in the Parliament procedure. For the purpose of dividing authorities and improving business environment for business entities created by the restructuring process of the Railways of Montenegro JSC, and, above all, increasing the level of safety of traffic, secondary legislation acts were adopted.

The implementation of a series of infrastructure projects (railway modernisation, rehabilitation of landslides, tunnels, road crossings, railway stations) is underway that are funded from the loan facilities and pre-accession funds (EIB, EBRD, IPA10). In 2013, two projects were completed, which were financed from IPA 10 (overhaul of the railway lines Mijatovo Kolo - Mojkovac and the repair of the railway station tracks in the station Trebešica).

In the area of **maritime transport**, activities were carried out on the reconstruction and extension of the Montenegrin naval fleet. The construction of two ships for the purpose of the company Montenegro Lines, JSC is underway, which signed an agreement with Poly Technologies Inc. from Beijing and Exim Bank. The completion of the construction is expected by the middle of 2014.

Telecommunications

The telecommunications sector has an important place in the economy of Montenegro, which is confirmed by the data on its share in GDP (about 5%).

Electronic communications: According to the number of mobile phone users, which has been increasing (in October 2013, there were 1.097.574 users or 177.02%), Montenegro ranks high in the world (it was ranked second in 2011, according to the International Telecommunication Union). Number of fixed line phone connections reported a slight y-o-y decline (in October 2013, there were 168.987 or 0.7% less than in October 2012), which indicates that fixed-to-mobile substitution is present in Montenegro. Observed by the number of connections, the number of Internet users trended up (it amounted to 90.144 in October 2013, i.e. 8.2% more than in October 2012). The number of active connections for television and radio programmes distribution to end users amounted to 145.756. This represented an increase of 11.53% compared to October 2012.

Bearing in mind the situation in the market of electronic communications, the infrastructure resources available to the State which are unused or less used, as well as the significant amount of funds from the budget allocated for the payment of various services to the existing operators, drafting of the Study on the collection and putting into operation state resources of electronic communications is underway.

The work on the establishment of the national internet exchange point (IXP) in Montenegro will continue aimed at lowering the cost of services, relieving the links of the global internet access and security of communications.

The new Law on Electronic Communications was passed, which is harmonised with the EU Telecom Package from 2009. The conditions were created for, among other things, accelerating the development of electronic communication networks and services, healthy competition in the market, open and equal access to networks and electronic communications services, encouraging the efficiency and cost-efficiency, and introducing new technologies and services in this sector, as well as for more efficient protection of interests of users of electronic communication services.

The Agency for Electronic Communications and Postal Services will, in accordance with the new Law on Electronic Communications, in addition to further legislative regulation of the area of electronic communications: analyse relevant markets of electronic communication services and monitor the implementation of established regulatory obligations; regulate retail prices of fixed telephony services; implement a model for accounting unbundling and cost accounting for operators of public electronic communication networks. Georeferenced database of electronic communication infrastructure is being developed and implemented. In accordance with the responsibilities regarding radio frequencies, a number of rulebooks and decisions were passed. The international coordination of radio frequencies in different bands will continue with neighbouring countries.

Radio-broadcasting: The first phase of digitalisation was completed. The tender procedure for the procurement of transmitters and repeaters, as a part of the 2nd phase of the digitalisation financed by the state of Montenegro is underway.

4.2.6. Financial Sector

The financial system in Montenegro is bank-dominated, i.e. the banking system has a dominant position as opposed to the insurance and capital market sectors, not only with regard to its assets but also from the aspect of overall influence on the economic development.

Macro prudential supervision of the financial system functioning - financial intermediaries, markets and market infrastructure was carried out by the Financial Stability Council, which was established in October 2010. Its task is to monitor, identify, prevent and mitigate potential systemic risks in the financial system of Montenegro as a whole, in order to ensure the maintenance of the financial stability and avoid episodes that may lead to widespread financial distress.

Banking Sector

With a view to preventing spreading of the spiral of illiquidity in the real sector and better informing the business entities, the Central Bank has acted preventively and amended the Payment System Law, and since July 2012, it started to publish on its website monthly overview of legal entities and entrepreneurs whose accounts over € 10.000 were continuously frozen in period for more than 30 days. Higher level of transparency of operating results of a number of business entities that are in financial difficulties was provided at the same time, which resulted in good reception by the public and was positively rated by business entities. However, the number of judgment debtors - legal entities and entrepreneurs in the blockade continued to grow, as well as the amount of the debt. In that respect, in October 2013, the accounts of 12.561 judgment debtors were frozen, with the amount of debt of € 432.9 million. Since the illiquidity of real sector has taken a systemic proportions the situation in the banking sector inevitably worsened, reflecting on the deterioration of all indicators of asset quality and profitability.

Non-performing loans represent an acute problem of Montenegrin banking system, with a worrying share of 17.7% in total loans and receivables at the end of October 2013. Despite many years of efforts to address this issue (transfer and/or sale of non-performing loans to parent banks and factoring companies, write-off and rescheduling of debt of legal entities and natural persons), the problem appeared again with not less intensity and complexity, taking on systemic proportions. Total amount of assets sold, since the outbreak of the crisis to date, amounted approximately to € 650.0 million. It turned out that the individual approach in debt restructuring, which was mainly based on debt rescheduling, gave positive effects only in cases where the debtor was faced with temporary problems. During 2012 and 2013, the activities for strengthening the regulatory and supervisory framework for the systemic resolution of not only non-performing loans, but also growing financial debt, in a broader sense have been intensified. To that end, through the project for financial debt restructuring, i.e. through "Podgorica Approach", the Central Bank, in cooperation with the World Bank, obliged the banks at the end of November 2013 through the amendments to the regulations, to develop a comprehensive strategy for NPL resolution for a period of three years, determine annual operational objectives related to reducing the level of non-performing loans and submit quarterly reports on the implementation of operational objectives. Draft Law on Voluntary Financial Restructuring was developed within the same project and which created a stimulating normative framework that supports and encourages real restructuring of economically viable business entities in out-of-court proceedings, thereby eliminating the reasons for their bankruptcy, which, as a rule, places creditors and debtors in difficult position. The Law regulates the conditions and manner of voluntary debt restructuring, and/or loans classified in categories "B" and "C" with banks, MFIs and leasing companies based in Montenegro. In addition to financial institutions, all other domestic and foreign creditors including foreign banks can participate in the financial restructuring. The implementation of the solutions adopted will contribute to: encouraging of the recovery of the debtors and/or users of housing loans that are in financial difficulties, maintaining stability of the financial system and providing access to new sources of financing in order to stimulate economic recovery and growth. The Law will apply two years after its entry into force. The next phase of the Project involves the development of new supervisory techniques and key performance indicators that will be used in the on-site and off-site supervision and monitoring of the process of voluntary financial restructuring in business entities.

Lending activity, as a key activity of banks, is still not at a level that would meet customer expectations and foster the economic growth and development, whereas high interest rates on loans granted mostly from the deposits gathered not only discouraged economic activity, but encouraged growth in deposit interest rates. Therefore, in November 2012, the Central Bank passed a decision temporarily limiting lending interest rates for period of six months, i.e. until the middle of May 2013, and the amount of deposit rates is linked to the amount of additional regulatory capital.[21] Despite certain positive results achieved in reducing the level of the weighted average effective interest rate (WAEIR) and interest margin between WAEIR and weighted average nominal interest rate (WANIR), which had negative implications on banks' lending activities, the implementation of this decision was not extended. Since the establishment of the level of interest rates is however the result of free market competition, the opinion prevailed that this issue in the long run can be resolved only in cooperation with the Government, which is responsible for prescribing the maximum contractual interest rate at the system level. Therefore, one of the recommendations of the Central Bank addressed to the economic policy makers is to implement this solution through amendments to the Law on Contracts and Torts[22].

Thanks to continuous recapitalisations, which reached the amount of about € 300 million in the post-crisis period, either at the initiative of the banks or ordered by the Supervision Department of the Central Bank, solvency of the banking sector is preserved and, therefore, both its stability and the stability of the financial system as a whole. This was confirmed also by the fact that the capital adequacy ratio was continuously above the statutory minimum requirement of 10%, i.e. it accounted for 14.99% at end-September 2013. Furthermore, due to the weakening trend of deleveraging to parent banks and external creditors, the continuous growth in deposits since June 2009 and implementation of restrictive credit policy for several years, banks' liquidity has been constantly trending up, and the prescribed day and ten-day liquidity indicators were significantly above prudential requirements.

After five years of negative operations, banks reported positive financial result at the aggregate level in 2013, indicating that they survived the most difficult period of their operations. Most of small and medium-sized banks have shown satisfactory degree of adaptability and resilience during the crisis, while systemic banks recorded multimillion-dollar losses. The deterioration in the quality of the loan portfolio and the growth in past due loans affected the banks' profitability at the system level.

In 2013, supervision of banks and micro-credit financial institutions (MFIs) was intensified in the segment of monitoring the level of risks the financial institutions are facing in operations and strengthening the system resilience. Nine on-site examinations of banks and MFIs were carried out, and based on the results supervisory measures were imposed against some of the banks in order remove disclosed irregularities and poor practices in their operations. With a view to analysing the overall risk profiles of international banking groups, business strategies and their impact on the operations of banks in Montenegro, the CBCG supervisors participated in the work of supervisory colleges contributing to the establishment of effective cross-border cooperation with supervisors of

[21] Maximum interest rates on bank loans in the amount of 14% were prescribed for a single loan that the bank grants to a legal person or entrepreneur, i.e. 15% for a single loan that the bank grants to a natural person. Although the deposit interest rates were also extremely high because the banks have focused mainly on domestic sources of financing as the most accessible sources, the Central Bank did not limit their level, but prescribed a condition of providing additional level of regulatory capital to discourage the banks in the race for attracting deposits of legal entities and natural persons.
[22] This solution was implemented by Croatia, Macedonia and some of the EU countries.

parent banks, whose subsidiaries operate in Montenegro, which was the preventive action to preserve the stability of not only banking sector, but the financial system as a whole.

Regulatory Activities

Implementation and Divergences: In 2013, activities to improve the regulatory framework and its harmonisation with the relevant EU directives were undertaken. In this regard, the Payment System Law was adopted, as well as implementing decisions for the Law on Consumer Loans, and the Decision supplementing the Decision on the Methodology for Calculating Country Risk in Banks, which additionally harmonised the applicable decision with the relevant EU directive.

The implementation of International Accounting Standards (IAS 39) in 2013 affected the change of chart of accounts for banks in 2013 and the system of banks' reporting to the Central Bank, which is a step forward on the path towards the harmonisation with the EU regulations. The implementation of IAS positively reflected on the key balance sheet positions (loans, deposits, capital) and therefore, on the banks' operating results. In order to objectify this effect, prudential filters were embedded in the regulatory framework as supervisory instruments in the area of credit risk management in banks and as the element for establishing additional responsibilities for maintaining the stability of the banking sector.

Current and Future Economic Policy Programmes and Measures: Based on the analytical results of the bilateral screening for Chapter 9 - Financial Services, and starting from the new regulatory framework in the EU, which entered into force in July 2013 (Basel III), the activities on further harmonisation of the laws and regulations with the relevant EU regulations will continue in the coming period. Priority activity will be drafting of the new Banking Law and supporting secondary legislation, particularly the regulations on capital adequacy of banks, as well as the development of secondary legislation in the field of payment system.

Capital Market

Capital market is still characterised by low level of liquidity, which resulted from high level of securities placed as collateral with banks, and lead to the situation where an important part of the most liquid securities were temporarily out of trade. Moreover, the transformation of collective investment funds into closed and open-ended investment funds influenced their lower market activity.

New capital invested in companies and banks (primary market) amounted to € 19 million in the first nine months 2013, while turnover at stock exchange market (secondary market) amounted to € 17 million. Both stock exchange indices declined (MONEX20 of 4.80% and MONEXPIF of 18.16%). Market capitalisation declined by 4.73% compared to the beginning of the year.

Securities and Exchange Commission drafted the Law on Capital Market which will be harmonised with the MIFID directive.

In the area of alternative investment funds, the Securities and Exchange Commission signed with ESMA (European Securities Market Authority) and 24 regulatory authorities of the Member States the Memorandum of Understanding with the aim of improving cooperation, exchange information and experiences related to the supervision of alternative investment funds, together with the implementation of confidentiality rules and sharing of information applicable to the EU competent bodies, the ESMA and the European Systemic Risk Board (ESRB).

Insurance

Montenegrin insurance market is characterised by continuous stability with the present upwards trend. However, according to the structure and level of premiums earned, it still significantly lags behind the European average. A slowdown in the growth of Montenegrin economy has reflected, to a certain degree, on the results in the insurance sector, through a moderate growth of the written premium value generated on the market in 2012. Gross insurance premiums increased in 2012, with a declining trend in market concentration and achieving positive financial operating results at the level of the overall insurance market. Gross written premiums in the insurance market of Montenegro in 2012 amounted to € 66.922 million and recorded a slight increase of 3.29% compared to the previous year. Gross written premiums per capita in 2012 amounted to € 107.93, which was still significantly below the average of EU member states in 2011 (according to estimates it amounts to € 2,137). A more detailed overview of the insurance market indicators is provided in the tables below.

Table 15 Overview of the situation in the insurance sector for 2011 and 2012

Insurance class	2011		2012		Index 2012/2011
	Premium (€)	Share (%)	Premium (€)	Share (%)	
Life insurance	9.056.856	13,98	9.474.403	14.16	104.61
Non-life insurance	55.734.843	86.02	57.447.618	85.84	103.07
TOTAL	64.791.699	100	66.922.021	100	103.29

Table 16 Overview of the situation in the insurance sector in Q3 2012 and 2013

Insurance class	Q3 2012		Q3 2013		Index
	Premium (€)	Share (%)	Premium (€)	Share (%)	
Life insurance	6.360.279.28	12.45	7.325.274	13.63	115.17
Non-life insurance	44.710.594.71	87.55	46.427.917	86.37	103.84
TOTAL	51.070.874	100.00	53.753.191	100	105.25

Regulatory Activities

Implementation and Divergences: The Agency has successfully implemented the activities planned on the adoption of secondary legislation in the field of insurance in 2013.

Current and Future Economic Policy Programmes and Measures: Activities of the Insurance Supervision Agency will be directed to amendments of existing and adoption of new enabling regulations, aimed at further harmonisation with the EU standards. Passing of the new Law on Bankruptcy and Liquidation of Insurance Companies was planned within the aforesaid activities. One of the core priorities of the Agency in the coming period is the development of professional and administrative capacities and the development of necessary infrastructure, with a view of improving the insurance supervision quality. At the same time, the Insurance Supervision Agency will intensify the cooperation with international institutions, aimed at ensuring technical assistance, advisory and expert missions and training, necessary for administrative and capacity development.

It is not possible to estimate ***budgetary effects of planned programmes and measures*** in the financial sector.

4.3. LABOUR MARKET

4.3.1. Employment Policy

Implementation and Divergences: In terms of economic recovery in 2013, labour market is still characterised by problems inherent in the markets of the region and beyond, and the most dominant reflects in high long-term unemployment and high rate of the unemployment of young population. According to data from the Employment Agency of Montenegro, unemployed persons whose unemployment exceeds one year accounted to 58% of total number of unemployed persons as at 30 September 2013. The Labour Force Survey shows that the rate of unemployment of young population remains still high at 34.4% in the second quarter 2013, but it was significantly lower compared to Q2 2012, when it was 44.6% for the population between 15 and 24 years of age. This was the result of an active stance towards the challenge of high rate of young population unemployment (the Project “Subsidised employment of young population for seasonal jobs”, Decree on subsidies for employment of certain categories of unemployed persons, etc.).

Based on the implementation of the Law on Professional Development of Persons with acquired University Education, until 10 October 2013, over 4.200 persons with acquired university education performed work practice with employers in the public and private sectors. For the purpose of implementation of this Programme, some € 10 million was allocated in the Budget of Montenegro for the 2013, and the continuation of its implementation is also planned in 2014 with certain modifications. In this regard, in terms of reducing the scope of employment in state administration bodies, the budget for the coming year will allocate € 7 million for this purpose, and the program will be mainly implemented in cooperation with the private sector.

In 2013, significant activities were aimed at improving the legal framework regulating labour market, primarily focusing on the amendments to the Labour Law and amendments to the Law on Social Council, which were submitted to the Government of Montenegro for its consideration and determination of the Proposals of these laws. The new law on Health and Safety at Work is in the drafting procedure and it is in the process of gathering opinions from the competent institutions. Draft Law on Strike is forwarded to the Parliamentary procedure for consideration and adoption.

The planned adoption of the Law on Inspection Affairs was withdrawn due to the changes made in the organisation and status of labour inspection in the Administration for Inspection Affairs under the Decree on the Public Administration Organisation and Manner of Work and the Law on Civil Servants and State Employees.

Negotiations for the conclusion of the General Collective Agreement are in the final stage. The signing of the Agreement is expected after reaching an agreement between two representative trade unions on the clauses relating to the amount of 0.2% of the wage of an employee, at the account of the special Fund of such trade union, and which will be used for the prevention of work disability and recreational holiday of employees. With respect to all other provisions of the General Collective Agreement, an agreement was reached between social partners.

Current and Future Economic Policy Programmes and Measures: The activities will be primarily focused on the following in the future period:

- further harmonisation of labour markets with European legislation;
- implementation of a New Model for the implementation of the Program for professional training of persons with acquired university education in 2013/2014;

- implementation of the Decree on subsidies for employing certain categories of unemployed persons, which allow subsidies for employers who employ persons with acquired university education after completion of the professional training;
- further implementation of active employment policy in line with labour market needs.

4.3.2. Reform of the Social Protection System

Pension System Reform

Implementation and Divergences: The number of users of rights from pension and disability insurance increased by around 1.8% compared to the previous year. This resulted in an increase of expenditure for pensions. In that respect, a measure was introduced in 2013 by which the pensions are not harmonised with the inflation and wages trends. This measure will also apply in 2014.

Current and Future Economic Policy Programmes and Measures: The activities of the pension system reform will be focused in the coming period on monitoring of the implementation of the law, its effects and on defining the directions of further pension and disability insurance reform in Montenegro. Revision of the law was planned in 2014 with the aim of further improving of the system indicators, primarily formula for harmonisation of pensions, as well as finding new sources of financing the pension system.

Budgetary effects of programmes and measures: Based on freezing of the pensions in 2013, savings of approximately € 12 million were made.

Health Care

Implementation and Divergences: Activities planned under the last-year's PEP for the area of healthcare were implemented. The adoption of the Law on Health Care Insurance created opportunities to rationalise the network of health care institutions, which will allow the optimal spatial distribution of the capacities of health care institutions, established by the state or a natural person or legal entity. The decision was made on the establishment of health care centres. In June 2013, the realisation of screening for early detection of colorectal cancer started, and the screening for early detection of cervical cancer will begin by the end of the year.

Current and Future Economic Policy Programmes and Measures: The activities aimed at the implementation of the third screening, i.e. early detection of breast cancer in women, as well as activities related to the reform of the secondary and tertiary levels of health care will continue in the coming period. The secondary health care needs to be aligned with international guidelines together with the improvement of services of specialised out-patient facilities, acute and non-acute hospital-based care, and transfer of activities into day-care hospitals with a transparent system of patient classification as bases for the system of financing, which needs to be ultimately linked with the system for improving quality and safety. The tertiary activity is of significant national importance, since it covers the most complex procedures, scientific and research work, thus the tertiary status needs to be verified periodically (every 5 years).

In the coming period:

- Activities will continue on the implementation of the preventive programmes and strategic documents, in particular the Strategy for Optimisation of the Secondary and Tertiary Healthcare Level, as well as of the strategies adopted in the previous period;

- Investments in the health care infrastructure will continue;
- Network of healthcare institutions will be rationalised;
- Eight healthcare centres will be established.

Social Protection

Implementation and Divergences: Law on Social and Child Protection (Official Gazette of Montenegro, 27/13), which represents the basis for improving the focusing of social benefits, engaging of beneficiaries of the social and child protection capable of work, improvement of social services and child protection, the establishment of Institute for social and child protection, organising inspections for social and child protection, etc.

The Strategy for the development of social and child protection for the period 2013-2017 was passed aimed at undertaking necessary actions to improve social and economic status of citizens, particularly persons who are in need of services and support in the areas of social and child protection. Furthermore, the Strategy for the development of the social protection of old persons was adopted for the period 2013-2017 in order to undertake the necessary actions to improve social and economic status of elderly citizens, particularly those who are in need of services and support in the area of social protection. At the same time, in order to define the general policy of the State towards children, National Plan of Action for Children (NPA) 2013-2017 was passed. The plan identified the main problems in achieving, protecting and advancing the rights of the child in the country, as well as the basic directions for their solution.

Current and Future Economic Policy Programmes and Measures: In the coming period, in accordance with the Law on Social and Child Protection, enabling regulations will be adopted in the area of social and child protection. The activities will be focused on the implementation of strategic documents, in accordance with the supporting action plans for the period for which they were issued.

In order to improve channelling of funds for social and child protection, achieve greater fairness and efficiency and reduce the costs of administering the system, the implementation of the project "Social Card (Social welfare records)" has commenced. All activities planned for the implementation of the project were completed successfully in 2013, and development of software is underway which is performed according to the planned schedule.

4.4. Administrative Reforms

Implementation and Divergences: In the process of the public sector optimisation, the *Plan for the Public Sector Reorganisation* 2013-2017 is adopted. The balance between the reduction of budgetary expenditure, on one hand, and servicing obligations arising from the EU accession process, on the other hand will be established through the implementation of measures and activities envisaged by the Plan.

In the area of civil service system, the new Law on Civil Servants and State Employees has been implemented since the beginning of 2013. A significant number of secondary legislation was adopted at the same time that will allow more efficient implementation of the reform solutions contained in the law (employment in state bodies, performance evaluation of civil servants and state employees, the criteria for the internal organisation and job position scheme in the state authorities, etc.). More detail criteria for defining operations of state bodies and their separation by level of complexity are defined.

In order to create preconditions for the provision of more quality services to citizens, entrepreneurs and other entities by public administration bodies (simplification and shortening of administrative procedures, higher level of legal protection of the customers, the introduction of e-government), new Law on administrative procedure was drafted, whose adoption is expected at the beginning of 2014.

Montenegro does not have a unique legal framework for the system of public services i.e. entities (except for the state authorities) empowered with public authorisations, which results in extensive differences in their status and functioning, as well as in insufficient control of legality of work and purposefulness of their work. The Strategy for Public System Reform 2011-2016 and Framework Action Plan for its implementation served for drafting, among other things, of the analysis of the position of organisations exercising public authority, on the basis of which Law on Public services and Funds and the Law on Public Agencies will be passed, taking into account the solutions of the European practice.

An analysis of functioning of local self-government in Montenegro was prepared, which reviewed and evaluated the situation of the local self-government in a comprehensive manner in the area of legislation and implementation of regulations in the established system of local self-government. There are ongoing activities on amendments to the Law on Local Self-Government, with the aim of improving the legal framework for the successful functioning of the local self-government and/or more complete and more precise regulation of normative assumptions for exercising citizens' rights to local self-government.

With a view to more adequate positioning of communal police in the local community and more precise definition of its responsibilities, powers, organisation and other important issues, passing of the new Law on Communal Police is underway.

Local self-government units are obliged, in accordance with the Law on Regional Development of Montenegro, to develop plans for economic development which are approved by the Ministry of Economy. Fourteen local self-government units have fulfilled this obligation so far.

Financial management and control: During 2012, activities to improve financial management have been continued or commenced in the public sector institutions for whose functioning over 90% of the budget of Montenegro is allocated, through the development of action plans, business analysis, and establishing clear rules and procedures in business processes. In this regard, operations in 25 institutions, whose spending exceeds 90% of total budget expenditures, are formalised through the introduction of internal books of procedures.

Internal audit: Coverage of the budget spending by internal audit increased in 2012 from approximately 75% to over 90% of the total budget spending, while the number of internal auditors engaged increased by 50%.

Current and Future Economic Policy Programmes and Measures: In order to optimize the number of employees in the public sector, reduce labour costs and better concentration of human, financial and material and technical resources, the activities shall be performed in the coming period in accordance with the decisions of the *Plan of internal reorganization of the public sector.*

Based on the analysis of the position of the organization with the public authorities, systemic and regulatory framework will be determined for the establishment and operation of public agencies and services, which will define clear and uniform rules for their establishment, functioning, accountability, monitoring of their work, job classification, status of employees and methods of financing.

Amendments to the Law on Local Self-Government shall specify the system solutions for improving the work of local self-governments (public work of local self-governments, financial sustainability, human resource management, etc.). The Law on Communal Police will be adopted, whose implementation will provide more efficient implementation of regulations under the competence of municipalities, or provide more efficient operation of communal police. Local self-governments that default in establishing plans for economic development will adopt their development plans, with a view to their rapid development and use of IPA funds.

Taking into consideration the share of wages in total budget expenditures, as well as significant differences in the levels of wages of employees in the public sector and in accordance with the Reorganisation Plan, drafting of a single legislative framework for the calculation of wages of employees in the public sector is underway. The new policy of wages refers to all direct and indirect beneficiaries of the state budget and local self-government budget, legal entities established in accordance with the law, as well as companies owned by state or municipalities. The main principles that would serve as the basis for the law include: transparency of wages, the principle of equal wages for work in similar positions, titles and functions, determining of wages in accordance with accountability and fiscal sustainability of the wage system.

Future activities in the area of internal financial control will focus on strengthening of managerial responsibility, improving of the financial management and further strengthening of internal audit units, in terms of the number of auditors and their professional competence.

4.5. Information on Specific Structural Reforms

The implementation of a series of **infrastructure projects** is in different stages, with expected significant effects both in the construction phase and exploitation phase, which will ultimately reflect on economic growth, employment, regional development, foreign and internal trade, manufacturing, tourism, agriculture and transport, as well as strengthen the competitiveness of the business entities and/or economy of Montenegro.

Block II of the thermal power plant "Pljevlja" of 220-300 MW will be built on the location of the existing unit (thermal power plants "Pljevlja" - I) applying the latest technologies and in line with the latest EU regulations and Montenegro in the field of environmental protection. The project envisions heating of the town Pljevlja. It is planned that this project is realised on the basis of interstate agreements, whereby the bidder is obliged to provide specific loan facility or to offer, in a certain percentage with financing of the project, an option of joint ventures, or to be an industrial and financial partner of EPCG for the implementation of the project (as a shareholder or similar). The evaluation of bids for the project implementation is underway from the financial, technical and environmental aspects (9 offers were submitted). The beginning of works is scheduled for August 2014.

The project of connecting Montenegro and Italy by submarine interconnection cable of direct current appraised at approximately € 860 million is realised according to the foreseen dynamics. Some € 305 million of this amount will be invested at the territory of Montenegro. The project also envisages the construction of submarine interconnection cable of direct current capacity of 1.000 MW between Italy and Montenegro and converter plants in Italy and Montenegro (the investment is over € 758 million, of which the around € 200 million is for the territory of Montenegro, which represents an obligation of the Italian company Terna) and construction of 400 kV substation on the Montenegrin coast with connecting transmission lines and power lines from the Montenegrin coast to Pljevlja, as well as the reconstruction of the substation in Pljevlja (the investment of around € 105 million is the obligation of the Montenegrin Electrical Transmission System - CGES). It is expected that this project will be completed by the end in 2016.

Within the framework of implementation of Montenegrin part of the project, Detail Spatial Plan for the project was passed; the expropriation of land required for the project is in the final stage; and a piece of equipment for the transmission line and substation was purchased. CGES has signed contracts on loan facilities with international financial institutions, so that the funds in the amount of € 85.00 million for the Project implementation (obligation of Montenegro) were allocated. The funds in the amount of €25.00 million (fixed interest rate of 2.4%, repayment in 18 semi-annual instalments; the first instalment matures in December 2016) were provided from the loan of Germany Development Bank (KfW) and guaranteed by the Government of Montenegro, and funds in the amount of € 60.00 million from the loan of the European Bank for Reconstruction and Development (EBRD), for which the state guarantees will be issued in the coming period, in instalments, as it will defined in the annual budget laws (floating interest rate – 6M EURIBOR + 1%; repayment over 12-year period, in semi-annual instalments, the first instalment matures in September 2016, and the last matures in September 2028).

The highway Bar - Boljare is the largest infrastructure project in Montenegro, which is currently under preparation. Bids were analysed (three bides) for the design and construction of priority sections of the Highway, Smokovac-Uvač-Mateševo, and the bidder was selected with which negotiations were continued - Chinese companies *China Communications Construction Company Ltd*. (CCCC) and *China Road and Bridge Corporation (CRBC*). Decisive factors in the decision making process were the construction costs, compliance of credit indebtedness with the budget of Montenegro, the start and completion of the works, as well as the engagement of domestic construction companies. The project will be implemented on the basis of interstate agreements and it should be funded from a special loan facility for Central and Eastern Europe, announced by the People's Republic of China.

According to the offer of the Chinese companies, the design and construction of the priority section would amount to € 809.57 million, where 85% of the funds would be provided from the loan from Exim Bank, with a fixed interest rate of 2%, a repayment period of 20 years and a grace period of 5 years. The government can borrow from Chinese Exim Bank or other financial institution up to € 800.00 million for financing the construction of priority sections of the highway, of which € 100.00 million will be effective in 2014. The remaining funds will become effective according to the dynamics of the construction of Highway, which will be defined in the annual budget laws.

Projects that are being implemented or will be implemented in the **tourism sector,** as one of the strategic priorities for the development of Montenegro, influence trends in Montenegrin economy. High class accommodation capacities, golf courses, marinas, and the like will be built through foreign investments among other things, thus creating conditions for improving the tourist offer of Montenegro.

Investment of around € 100 million was realised within the project “Port of Montenegro”, the most important project of nautical tourism in the region. The investment largely refers to the expansion of the marina and the construction of a luxury hotel, with supporting facilities and it will be completed in the 2014.

The company "Luštica Development" (90% owned by the Egyptian Orascom, and 10% by the Government of Montenegro) has invested € 35 million so far in the construction of an exclusive hotel and tourist complex on the peninsula Luštica. The construction of 10 residential buildings and the first of two marinas commenced within the tourist and residential and nautical complex. The completion of the documentation for the issuance of building permits for the construction of the golf course is underway. Moreover, total investment until 2018 should amount to € 1.1 billion.

Azerbaijan giant Socar initiated, through the newly established local company Azmont Investment, the implementation of the project in Kumbor, worth € 500 million. It is expected that the construction of the tourist resort (luxury hotel of 180,000 square meters of residential and office space, a marina and sandy beach) will be completed in 32 months. In the construction phase, employment of three thousand domestic workers was announced, mostly in civil engineering profession.

Qatar state investment fund "Qatari Diar" will invest € 250 million in building of a luxury tourist complex in the bay Pržno near Tivat, at the site of the former hotel "Plavi horizonti". In order to build condominium hotel and residential area, amendments to the urban plan Pržno will be made.

The tourist offer of Montenegro will be enriched with another new content: preparatory activities for the construction of the 15 km long cable car Kotor - Lovćen – Cetinje are underway, which will be the longest tourist cable car in the world. This investment is worth € 47 million.

Annex - Tables

BUDGET IMPLICATIONS OF STRUCTURAL REFORMS				
Year	**2013**	**2014**	**2015**	**2016**
Total	**-378.325.438.59**	**-151.958.472.97**	**-138.740.286.15**	**-115.142.479.77**
Total effect on Budget revenues	**248.467.921.45**	**274.536.173.57**	**241.412.173.57**	**268.004.173.57**
Total effect on Budget expenditures	**626.793.360.04**	**426.514.646.54**	**380.152.459.72**	**383.146.653.34**
State Aid				
Guarantees issued Aluminium Plant Podgorica (KAP)				
Net Budget effects	-102.700.000.00	0.00	0.00	0.00
Direct effect on Budget revenues				
Direct effect on Budget expenditures	102.700.000.00	0.00	0.00	0.00
Improvement of Business Environment				
Council for regulatory reform and improvement of business environment				
Net Budget effects	-120.000.00	-100.000.00	-100.000.00	-100.000.00
Direct effect on Budget revenues				
Direct effect on Budget expenditures	120.000.00	100.000.00	100.000.00	100.000.00
Small and Medium-sized Enterprises Sector				
Directorate for Development of Small and Medium-sized Enterprises				
Net Budget effects	-216.636.56	0.00	0.00	0.00
Direct effect on Budget revenues				
Direct effect on Budget expenditures	216.636.56			
Education				
Implementation of activities and measures under the Strategy of development and financing of higher education				
Net Budget effects	-2.500.000.00	0.00	0.00	0.00
Direct effect on Budget revenues				
Direct effect on Budget expenditures	2.500.000.00			
Implementation of external graduation and professional exams				
Net Budget effects				
Direct effect on Budget revenues*				
* Implementation of graduation and professional exams will not have direct effects on revenues, but it will affect overall quality of education and further economic development, thus providing incentive for the labour force development which is needed for the labour market				
Research and Development				
Participation fee for Montenegro in the FP7 Program (2008-2013) and HORIZONT 2020 (2014-2020)				
Net Budget effects	-608.019.08	-1.149.150.43	-1.215.429.56	-1.299.806.68
Direct effect on Budget revenues				
Direct effect on Budget expenditures	608.019.08	1.149.150.43	1.215.429.56	1.299.806.68
National scientific and research projects, other instruments of scientific and research industry, bilateral projects, science promotion programmes				
Net Budget effects	-900.000.00	-1.600.000.00	-1.800.000.00	-1.900.000.00
Direct effect on Budget revenues				
Direct effect on Budget expenditures	900.000.00	1.600.000.00	1.800.000.00	1.900.000.00
Linking science and economy by establishing the Centre of Excellence, Scientific-technological park, IPC Nikšić, IPC Bar, IPC Pljevlja, implementation of major research grants (INVO project), project implementation within the EUREKA program through financing scientific and research projects				
Net Budget effects	-272.000.00	-2.577.430.00	-7.239.980.00	-8.027.010.00
Direct effect on Budget revenues				
Direct effect on Budget expenditures	272.000.00	2.577.430.00	7.239.980.00	8.027.010.00
Energy				

Subsidies to electricity consumers				
Net Budget effects	-1.200.000.00	-1.500.000.00	0.00	0.00
Direct effect on Budget revenues				
Direct effect on Budget expenditures	1.200.000.00	1.500.000.00		
Development of the Strategy for Energy Development of Montenegro until 2030, Action Plan for implementation of the Strategy and Strategic impact assessment of the Strategy on environment				
Net Budget effects	-90.000.00	-20.000.00	0.00	0.00
Direct effect on Budget revenues				
Direct effect on Budget expenditures	90.000.00	20.000.00		
Projects of construction of wind farms at the locations Krnovo and Možura				
Net Budget effects	116.921.45	207.967.57	207.967.57	207.967.57
Direct effect on Budget revenues	116.921.45	207.967.57	207.967.57	207.967.57
Direct effect on Budget expenditures				
Projects of construction of small hydro power plants				
Net Budget effects	95.000.00	20.000.00	50.000.00	90.000.00
Direct effect on Budget revenues	115.000.00	30.000.00	60.000.00	100.000.00
Direct effect on Budget expenditures	20.000.00	10.000.00	10.000.00	10.000.00
Research project of wind potential and development of coastal wind farms at the Adriatic Coast				
Net Budget effects	0.00	-10.000.00	0.00	0.00
Direct effect on Budget revenues				
Direct effect on Budget expenditures		10.000.00		
Local energy plans				
Net Budget effects	0.00	-10.000.00	0.00	0.00
Direct effect on Budget revenues				
Direct effect on Budget expenditures		10.000.00		
Energy efficiency measures of public sector reconstruction (+ energy savings in public institutions; - loan repayment)				
Net Budget effects	-1.757.013.00	-1.294.808.00	-2.806.809.00	-2.010.560.00
Direct effect on Budget revenues		332.206.00	332.206.00	332.206.00
Direct effect on Budget expenditures	1.757.013.00	1.627.014.00	3.139.015.00	2.342.766.00
Transport				
Reconstruction of regional and main roads in Montenegro				
Net Budget effects	-12.900.000.00	-11.800.000.00	0.00	0.00
Direct effect on Budget revenues				
Direct effect on Budget expenditures	12.900.000.00	11.800.000.00		
Reconstruction and rehabilitation of critical spots				
Net Budget effects	0.00	-500.000.00	0.00	0.00
Direct effect on Budget revenues				
Direct effect on Budget expenditures	0.00	500.000.00		
Debt repayment for the road Risan -Žabljak				
Net Budget effects	-2.843.537.40	-11.373.684.13	-6.402.903.01	-259.234.93
Direct effect on Budget revenues				
Direct effect on Budget expenditures	2.843.537.40	11.373.684.13	6.402.903.01	259.234.93
Highway Bar – Boljari, section of the road from Smokovac to Mateševo				
Net Budget effects	100.000.00	-5.100.000.00	0.00	0.00
Direct effect on Budget revenues				
Direct effect on Budget expenditures	-100.000.00	5.100.000.00		
Program of reconstruction of intersections				
Net Budget effects	-1.000.000.00	-1.200.000.00	0.00	0.00
Direct effect on Budget revenues				
Direct effect on Budget expenditures	1.000.000.00	1.200.000.00		
Rehabilitation of bridges, landslides and slopes at main and regional roads				
Net Budget effects	-1.000.000.00	-1.500.000.00	0.00	0.00
Direct effect on Budget revenues				
Direct effect on Budget expenditures	1.000.000.00	1.500.000.00		
Resolution of bottle-necks in the transportation network of Montenegro				
Net Budget effects	-8.250.000.00	-4.700.000.00	0.00	0.00
Direct effect on Budget revenues				
Direct effect on Budget expenditures	8.250.000.00	4.700.000.00		

Investment maintenance of regional and main roads, surveillance, designing, expropriation, audits				
Net Budget effects	-2.300.000.00	-1.800.000.00	0.00	0.00
Direct effect on Budget revenues				
Direct effect on Budget expenditures	2.300.000.00	1.800.000.00		
Construction of the Tifran tunnel				
Net Budget effects	-1.000.000.00	-1.200.000.00	0.00	0.00
Direct effect on Budget revenues				
Direct effect on Budget expenditures	1.000.000.00	1.200.000.00		
Construction of third lines				
Net Budget effects	-1.450.000.00	-1.050.000.00	0.00	0.00
Direct effect on Budget revenues				
Direct effect on Budget expenditures	1.450.000.00	1.050.000.00		
Program of elimination of flood consequences on main and regional roads				
Net Budget effects	-2.000.000.00	-750.000.00	0.00	0.00
Direct effect on Budget revenues				
Direct effect on Budget expenditures	2.000.000.00	750.000.00		
Road crossings				
Net Budget effects	0.00	-2.000.000.00	0.00	0.00
Direct effect on Budget revenues				
Direct effect on Budget expenditures	0.00	2.000.000.00		
Program of development, maintenance, reconstruction and modernisation of railway infrastructure (ŽICG) - Budget				
Net Budget effects	-6.800.000.00	-10.500.000.00	0.00	0.00
Direct effect on Budget revenues				
Direct effect on Budget expenditures	6.800.000.00	10.500.000.00		
Program of passengers' transport (ŽPCG) – Budget				
Net Budget effects	-2.400.000.00	-2.900.000.00	0.00	0.00
Direct effect on Budget revenues				
Direct effect on Budget expenditures	2.400.000.00	2.900.000.00		
Railroad track Podgorica – Nikšić - outstanding loans				
Net Budget effects	-1.195.154.00	-1.150.007.00	-1.104.860.00	-1.059.714.00
Direct effect on Budget revenues				
Direct effect on Budget expenditures	1.195.154.00	1.150.007.00	1.104.860.00	1.059.714.00
Project VTMIS (oversight and monitoring of maritime transport and environment protection)				
Net Budget effects	0.00	-490.000.00	0.00	0.00
Direct effect on Budget revenues				
Direct effect on Budget expenditures		490.000.00		
Concession Contract between the Government of Montenegro and Adriatic Shipyard JSC (*Jadransko brodogradilište AD*) Bijela and Maritime Affairs, Ltd (*DOO »Pomorski poslovi«)*				
Net Budget effects	36.000+PDV	36.000+PDV	36.000+PDV	36.000+PDV
Direct effect on Budget revenues	36.000+PDV	36.000+PDV	36.000+PDV	36.000+PDV
Direct effect on Budget expenditures				
Telecommunications				
Implementation of the Law on Electronic Communications				
Net Budget effects	-29.000.00	0.00	0.00	0.00
Direct effect on Budget revenues				
Direct effect on Budget expenditures	29.000.00			
Implementation of the program „Support o digitalisation of the Public Broadcasting Service of Montenegro – equipment procurement"				
Net Budget effects	0.00	-500.000.00	0.00	0.00
Direct effect on Budget revenues				
Direct effect on Budget expenditures		500.000.00		
Employment policy				
Active employment policy				
A. Program of implementation				
B. Net Budget effects	-4.790.000.00	-2.390.000.00	-2.000.500.00	-2.000.500.00
Direct effect on Budget revenues	3.210.000.00	1.610.000.00	1.356.000.00	1.356.000.00
Direct effect on Budget expenditures	8.000.000.00	4.000.000.00	3.356.500.00	3.356.500.00
Ensuring social safety for unemployed persons				

A .Program of implementation				
B. Net Budget effects	-11.670.000.00	-8.190.000.00	-7.850.000.00	-7.850.000.00
Direct effect on Budget revenues	2.830.000.00	2.900.000.00	3.150.000.00	3.150.000.00
Direct effect on Budget expenditures	14.500.000.00	11.090.000.00	11.000.000.00	11.000.000.00
Program of professional development university students				
A. Program of implementation				
B. Net Budget effects		-7.280.000.00	-6.700.000.00	-6.700.000.00
Direct effect on Budget revenues		2.720.000.00*	2.500.000.00**	2.500.000.00***
Direct effect on Budget expenditures		10.000.000.00	9.200.000.00	9.200.000.00
Legislation – Labour Law				
A. Program of implementation				
B. Net Budget effects	160.000.00	820.000.00	250.000.00	250.000.00
Direct effect on Budget revenues	160.000.00	820.000.00	250.000.00	250.000.00
Direct effect on Budget expenditures				
Labour Fund				
A. Program of implementation				
B. Net Budget effects	-350.000.00	-350.000.00	-300.000.00	-300.000.00
Direct effect on Budget revenues	2.000.000.00	2.000.000.00	1.000.000.00	1.000.000.00
Direct effect on Budget expenditures	2.350.000.00	2.350.000.00	1.300.000.00	1.300.000.00
Agency for Peaceful Settlement of Labour Disputes ****				
A. Program of implementation				
B. Net Budget effects	-290.000.00	-290.000.00	-530.000.00	-530.000.00
Direct effect on Budget revenues				
Direct effect on Budget expenditures	290.000.00	290.000.00	530.000.00	530.000.00
* Includes revenues based on health insurance and revenues from VAT. ** Includes revenues based on health insurance and revenues from VAT. *** Includes revenues based on health insurance and revenues from VAT. **** Expenditures include operating expenditures of the Agency for Peaceful Settlement of Labour Disputes				
Pension System Reform				
Pension system impact on Budget				
A. Program of implementation				
B. Net Budget effects	-139.000.000.00	-137.020.000.00	-164.800.000.00	-145.928.000.00
Direct effect on Budget revenues [1]	240.000.000.00	263.880.000.00	232.520.000.00	259.072.000.00
Direct effect on Budget expenditures	379.000.000.00	400.900.000.00	397.320.000.00	405.000.000.00
[1] Revenues will be quantified after the implementation of projects financed or will be financed in the following two years from the funds of FP7 program and may be shown by total amount of funds spent by Montenegrin institutions through the participation in these projects				
Healthcare Protection				
Construction of the Polyclinic of the General Hospital Berane, Drugs Agency, Institute for Blood Transfusion, and reconstruction of some healthcare institutions in municipalities, Neurology Clinic, Psychiatric Clinic, and Genecology Clinic in the Clinical Centre of Montenegro				
Net Budget effects	-3.200.000.00	-6.742.637.25	-9.441.298.42	-9.574.176.62
Direct effect on Budget revenues *				
Direct effect on Budget expenditures	3.200.000.00	6.742.637.25	9.441.298.42	9.574.176.62
Strategy for optimisation of the secondary and tertiary healthcare level				
Net Budget effects				
Direct effect on Budget revenues **				
Direct effect on Budget expenditures				
Action Plan for Nutrition and Food Safety of Montenegro				
Net Budget effects	-563.000.00	-570.000.00	0.00	0.00
Direct effect on Budget revenues				
Direct effect on Budget expenditures	563.000.00	570.000.00		
National Program of Early Detection of Colorectal Cancer for the period 2012-2016				
Net Budget effects	-255.000.00	-355.000.00	-190.000.00	-230.000.00
Direct effect on Budget revenues				
Direct effect on Budget expenditures	255.000.00	355.000.00	190.000.00	230.000.00
National Program of Early Detection of Cervical Cancer for the period 2012-2016				
Net Budget effects	-100.000.00	-100.000.00	-220.000.00	-160.000.00
Direct effect on Budget revenues				
Direct effect on Budget expenditures	100.000.00	100.000.00	220.000.00	160.000.00
Action Plan for protection and improvement of children health by improving the environment quality in Montenegro				

Net Budget effects	-442.500.00	-516.500.00	-338.500.00	0.00
Direct effect on Budget revenues				
Direct effect on Budget expenditures	442.500.00	516.500.00	338.500.00	
National Strategy for Improvement of healthcare protection quality and safety of patients				
Net Budget effects	-57.300.00	-38.500.00	-55.300.00	35.300.00
Direct effect on Budget revenues				
Direct effect on Budget expenditures	57.300.00	38.500.00	55.300.00	-35.300.00
National Strategy of healthcare of persons with diabetes 2012 to 2016				
Net Budget effects	-5.000.00	0.00	-10.000.00	0.00
Direct effect on Budget revenues				
Direct effect on Budget expenditures	5.000.00		10.000.00	
National Strategy for control of antibiotic-resistant bacteria for the period from 2012 to 2016, with the Action Plan for 2012/2016				
Net Budget effects	-13.000.00	-10.000.00	-10.000.00	-10.000.00
Direct effect on Budget revenues				
Direct effect on Budget expenditures	13.000.00	10.000.00	10.000.00	10.000.00
National Strategy of prevention of harmful use of alcohol and alcohol-induced disturbances in Montenegro 2013-2020, with the Action Plan for 2013/2014				
Net Budget effects	-6.200.00	-21.800.00	0.00	0.00
Direct effect on Budget revenues				
Direct effect on Budget expenditures	6.200.00	21.800.00		
* Construction of clinics, Polyclinic, Agency and some healthcare institutions will not have direct effect on the Budget revenues but it will affect the improvement of the quality of providing healthcare services ** There is no direct effect on Budget revenues, it affects the improvement of the quality of providing healthcare protection and quality control, availability of healthcare protection and costs reduction. ***Funds are provided from Global fund for HIV/AIDS, tuberculosis and malaria				
Social Protection				
Implementation of the Law on Social and Child Protection				
A. Program of implementation				
B. Net Budget effects	-64.560.000.00	63.500.000.00	58.660.000.00	58.660.000.00
Direct effect on Budget revenues				
Direct effect on Budget expenditures	64.560.000.00	-63.500.000.00	-58.660.000.00	-58.660.000.00
Social Card				
A. Program of implementation				
B. Net Budget effects	0.00*	-378.250.00	706.000.00	0.00
Direct effect on Budget revenues				
Direct effect on Budget expenditures		378.250.00	-706.000.00	
* Funds for the potential implementation of Social Card in the said amount are envisaged in the current budget reserve, while their implementation depends on the decision on the manner and scope of the project				
Administrative Reforms				
Public Sector reorganisation plan				
A. Program of implementation				
B. Net Budget effects	0.00	14.465.326.27	14.465.326.27	13.517.254.89
Direct effect on Budget revenues				
Direct effect on Budget expenditures		-14.465.326.27	-14.465.326.27	-13.517.254.89

Table D1: Government debt as at 30 September 2013

Foreign debt		
Creditor	**Debt**	**Foreign debt/GDP**
		3.311
International Bank for Reconstruction and Development (IBRD)	239.6	7.24
International Finance Corporation (IFC)	0.65	0.02
Member countries of the Paris Club of Creditors	99.2	3.02
International Development Association (IDA)	63.1	1.91
European Investment Bank (EIB)	90.3	2.73
European Bank for Reconstruction and Development (EBRD)	19.7	0.59
Council of Europe Development Bank	9.1	0.27
European Community	5.5	0.17
German Development Bank – KfW	18.2	0.55
Hungarian loan	10.5	0.32
Polish loan	9.3	0.28
French loan	8.3	0.25
EUROFIMA - debt of the Railways company	20.8	0.63
Czech EXIM - debt of the Railways company	21.5	0.67
Steiermarkische Bank und Sparkassen AG	16.5	0.50
Erste Bank	34.5	1.04
Credit Suisse Bank	242.0	7.31
Spanish loan for construction of a landfill	4.9	0.15
Exim Bank Hungary	1.3	0.04
Austrian loan	8.6	0.26
EUROBOND	380	11.48
Deutsche Bank	60	1.81
TOTAL	**1363.9**	**41.24**
Domestic debt		
Creditor	**Debt**	**Domestic debt/GDP**
Foreign currency frozen savings	69.5	2.10
Local self-governments debt*	77.2	2.33
Obligations based on indemnifications	86.9	2.62
Loans with commercial banks	118.1	3.57
Loans of non-financial institutions	21.3	0.64
Pension arrears**	1.8	0.05
Treasury bills	101.5	3.07
Labour Fund obligations	4.6	0.14
TOTAL	**480.9**	**14.52**
TOTAL GOVERNMENT DEBT	**1844.80**	**55.71**

Table D2. Debt in period 2002-2012 and changes in debt

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
GDP	1.360.3	1.510.1	1.669.7	1.814.9	2.148.9	2.680.4	3.085.6	2.980.9	3.103.8	3.234.0	3.148.9
Internal debt (in € million)	255.6	249.7	254.1	187.1	197.1	275.1	413	440.3	358.3	423.5	404.5
Internal debt in% of GDP	18.78	16.53	15.21	10.3	9.17	10.26	13.38	14.77	11.54	13.09	12.9
External debt (in € million)	893.6	461.5	502.4	513.3	504	462.1	481.7	699.9	912.4	1.063.70	1295
External debt in% of GDP	65.69	30.56	30.09	28.28	23.45	17.23	15.61	23.46	29.39	32.89	41.1
Total (in € million)	1149.2	711.2	742.4	700.4	701.1	737.2	894.7	1140.2	1270.7	1487.5	1699.5
% of GDP	84.47	47.09	44.46	38.58	32.62	27.50	28.99	38.25	40.94	45.98	54.00
Debt decrease/increase		-38.11	4.39	-5.66	0.10	5.15	21.36	27.44	11.45	17.06	14.25

Table D3: Situation and condition of loans signed for the Budget financing purposes

Banka - Creditor	**Purpose**	Debt as at 30.09.2013 in EUR	**Date of signing**	**Maturity date**	**Terms and conditions**
ERSTE Banka		**7.500.000.00**			
Erste Banka -Austria	Budget	7.500.000.00	26.06.2009	2009-2014	Fixed 8.78%
Credit Suisse		**242.000.000.00**			
tranche 1	Budget	32.000.000.00	19.07.2012	2013-2017	12M Eur + 3.5%
tranche 2	Budget	60.000.000.00	19.07.2012	2019	12M Eur + 3.5%
tranche 1	Budget	120.000.000.00	11.04.2012	2014-2017	12M Eur + 6.5%
tranche 2	Budget	30.000.000.00	11.04.2012	2017	12M Eur + 6.5%
TOTAL		**249.500.000.00**			

Table D4: Loan facilities signed in 2013

Banka - Creditor	**Purpose**	Amount	**Date of signing**	**Maturity date**	**Terms and conditions**
ERSTE Banka		**61.000.000.00**			
Erste Banka - Austria	Budget	30.000.000.00	28.12.2012.	2013-2017	7.045%
Erste Banka - Podgorica	Budget	16.000.000.00	16.09.2013.	2014-2016	3M Eur + 6.5%
Erste Banka - Podgorica	Budget	15.000.000.00	20.12.2013.	2014-2017	am Eur + 5.75%
Deutsche Bank & Erste Banka - Austria		**60.000.000.00**			
Deutsche Bank & Erste Banka - Austria	Budget	60.000.000.00	11.07.2013	2015-2016	6.42%
Crnogorska komercijalna banka AD Podgorica- OTP Group		**42.500.000.00**			
Crnogorska komercijalna banka - OTP Group	Budget	42.500.000.00	07.08.2013.	2013-2016	3M Eur + 6.5%
Eurobond		**80.000.000.00**			
Eurobond	Budget	80.000.000.00	09.12.2013.	2014-2016	3M Eur + 5.95%
Societe Generale Montenegro		**5.000.000.00**			
Societe Generale Montenegro	Budget	5.000.000.00	11.04.2012.	2014-2017	6M Eur + 5.75%
KUOPIO		**248.500.000.00**			

Table G1: Foreign guarantees as at 30.09.2013

CREDITOR	LOAN	BORROWER	DATE OF SIGNING	AMOUNT (EUR)	AMOUNT (USD)	DISBURSED UNTIL 30.09.2013 (EUR)	Debt as at 31.09.2013
EIB	European roads Project	Monteput	17.05.2004	24.000.000.00		24.000.000.00	22.146.680.80
EIB	Reconstruction of the Electricity System	Electricity Company of Montenegro (EPCG)	15.08.2002	11.000.000.00		8.023.090.00	6.241.760.50
EIB	Modernisation of Airports	Airports of Montenegro	27.03.2004	12.000.000.00		11.000.000.00	8.866.666.67
EIB	Small and medium-sized enterprises credit line via commercial banks	Commercial banks	02.07.2009	90.000.000.00		90.000.000.00	81.241.144.30
EIB	Modernisation of the railways infrastructure	Railway Infrastructure of Montenegro	20.12.2010	7.000.000.00		0.00	0.00
Total EIB				**144.000.000.00**		**133.023.090.00**	**118.496.252.27**
EBRD	Modernisation of Airports	Airports of Montenegro	12.12.2003	11.000.000.00		10.235.127.00	4.685.699.70
EBRD	Construction of the regional water-supply system Project – southern branch – Phase I	PE Regional Water Supply – first tranche	09.11.2007	8.000.000.00		8.000.000.00	6.000.000.00
EBRD	Construction of the regional water-supply system Project – southern branch – Phase I	PE Regional Water Supply – second tranche	16.05.2008.	7.000.000.00		7.000.000.00	5.541.666.63
EBRD	Construction of the regional water-supply system Project – southern branch – Phase I - Annex	PE Regional Water Supply – expansion of the second tranche		3.000.000.00		3.000.000.00	2.375.000.00
EBRD	Project of reconstruction of the railways infrastructure– Phase III	Railway Infrastructure of Montenegro – third tranche	8.11.2010	4.000.000.00		3.506.879.60	3.506.879.60
EBRD	Project of reconstruction of the railways infrastructure - Phase III Annex	Railway Infrastructure of Montenegro	10.12.2012	10.000.000.00			
EBRD	Project of urgent reconstruction of the railways infrastructure II	Railway Infrastructure of Montenegro	11.12.2009	15.000.000.00		10.885.523.36	10.885.523.36
EBRD	Project of acquisition of electric-railcars and diagnostic equipment	Railway Transport JSC	8.11.2010	13.550.000.00		3.098.372.46	3.098.372.46
EBRD	Credit line for deposit protection	Deposit protection fund	8.11.2010	30.000.000.00		0.00	0.00
Total EBRD				**101.550.000.00**		**45.725.902.42**	**36.093.141.75**
KfW	EPCG-Perućica	EPCG	15.12.2003	3.580.000.00		3.422.387.66	1.036.388.00
KfW	EPCG-Piva	EPCG	28.12.2007	16.000.000.00		3.616.553.00	3.616.552.64
KfW	EPCG – sub-station Podgorica-Ribarevine	EPCG	20.07.2007	5.400.000.00		4.038.395.91	3.700.895.91
KfW	EPCG - Replacement of filters in the TPP Pljevlja and expansion of the substations Podgorica-Ribarevine	EPCG	11.12.2008	15.000.000.00		12.900.445.27	12.900.445.27
KfW	Erste bank	Erste bank		15.000.000.00		15.000.000.00	8.181.818.18
	NLB	NLB	26.10.2009.	16.000.000.00		16.000.000.00	10.545.456.56
Total KfW				**70.980.000.00**		**54.977.781.84**	**39.981.556.56**
OTP	KAP	KAP	20.11.2009.				0.00
Total OTP							**0.00**

EXIM China	Acquisition and overhaul of ships	Montenegrin maritime transport company (Crnogorska plovidba)	21.01.2010		47.396.000.00	35.812.417.60	35.812.417.60
Total EXIM				**35.812.417.60**		**35.812.417.60**	**35.812.417.60**
WTE Wassertechnik	Wastewater treatment Project	Municipality of Budva	16.03.2010.	29.250.000.00		**0.00**	0.00
Total WTE Essen				**29.250.000.00**		**0.00**	**0.00**
Abu Dhabi Fund	Water-supply Project	Regional Water Supply	07.04.2010.		11.870.405.66	4.854.905.18	4.854.905.18
Total Abu Dhabi				**8.969.278.52**		**4.854.905.18**	**4.854.905.18**
VTB	Support to KAP	KAP					0.00
Total VTB							**0.00**
Czech Export Bank	Completion of the railroad Podgorica- Niksic	**ZICG**	**12.12.2011**	**5.000.000.00**		4.978.101.65	4.729.196.70
Total Czech Export Bank X				**5.000.000.00**		**4.978.101.65**	**4.729.196.70**
TOTAL				**395.561.696.12**		**279.372.198.69**	**239.967.470.06**

Legend:

Risk guarantees

Guarantees of KAP paid off

Table G2: Domestic guarantees

CREDITOR	BORROWER	DATE OF SIGNING GUARANTEE	SIGNED AMOUNT (EUR)	Debt as at 30.09.2013	Debt as at 26.11.2013
NLB Montenegrobank	Bauxite Mines JSC Nikšič	09.06.2009	5.000.000.00	5.000.000.00	5.000.000.00
Podgorička banka	Pobjeda JSC Podgorica	10.07.2009	2.970.000.00	1.728.963.35	1.728.963.35
Hipotekarna banka	Montenegro Airlines	31.12.2009	2.700.000.00	2.700.000.00	2.700.000.00
NLB Montenegrobanka	Montenegro Airlines	25.02.2010	1.800.000.00	1.800.000.00	1.585.812.14
Erste banka Podgorica	Pobjeda JSC Podgorica	01.07.2010	3.500.000.00	3.500.000.00	3.500.000.00
Hipotekarna banka	MI-RAI GROUP Ltd NIKŠIĆ	27.07.2010	800.000.00	777.975.71	0.00
NLB Montenegrobanka	Melgonia-Primorka	22.12.2010	4.000.000.00	4.000.000.00	4.000.000.00
Hipotekarna banka	Montenegro Airlines	06.05.2011	2.000.000.00	2.000.000.00	2.000.000.00
Erste banka Podgorica	Electrodes Factory "Piva" Plužine	27.07.2011	1.500.000.00	1.500.000.00	0.00
Hipotekarna banka	MI-RAI GROUP Ltd NIKŠIĆ	13.09.2011	700.000.00	700.000.00	0.00
Erste banka Podgorica	Railway Transport of Montenegro	13.12.2011	3.500.000.00	3.500.000.00	0.00
NLB Montenegrobanka	Montenegro Airlines	13.12.2011	2.400.000.00	1.130.000.00	1.410.000.00
Investment and Development Fund JSC	Montenegrin maritime transport company JSC Kotor	30.12.2011	1.500.000.00	852.192.32	600.230.09
Crnogorska komercijalna banka Podgorica	Adriatic Shipyard JSC	19.01.2012	1.050.000.00	1.050.000.00	1.050.000.00
Hypo Alpe Adria banka	Lenka JSC Bijelo Polje	30.12.2011	525.000.00	525.000.00	525.000.00
Prva banka Podgorica	Montenegro Airlines	20.02.2013	1.200.000.00	1.200.000.00	1.200.000.00
TOTAL			**33.945.000.00**	**31.964.131.38**	**26.000.005.58**

Legend:

Guarantees paid off and assumed in period 30 September – 26 November 2013

Risk guarantees