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From: Secretary-General of the European Commission,  
signed by Mr Jordi AYET PUIGARNAU, Director

date of receipt: 18 April 2018

To: Mr Jeppe TRANHOLM-MIKKELSEN, Secretary-General of the Council of  
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PROGRAMME OF MONTENEGRO (2018-2020) COMMISSION  
ASSESSMENT

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Delegations will find attached document SWD(2018) 131 final.

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**COMMISSION STAFF WORKING DOCUMENT**

**ECONOMIC REFORM PROGRAMME**

**OF**

**MONTENEGRO**  
**(2018-2020)**

**COMMISSION ASSESSMENT**

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## 1. EXECUTIVE SUMMARY

**The medium-term macroeconomic scenario projects a deceleration of growth.** This would be the result of the impact of fiscal consolidation on both private and public consumption in addition to a fading contribution of investment after some large construction works are completed. Net exports are expected to continue strengthening, supported by tourism and the decline of investment-related imports. However, the still large trade deficits and external debt will remain an important risk for the country's external position. The banking system is regaining strength, improving its solvency and liquidity position, but the burden from non-performing loans continues to challenge the profitability of banks.

**The government introduced a rather ambitious fiscal adjustment plan.** Since December 2016, a series of measures are being adopted to increase budget revenue, contain spending and rebalance the public debt structure in more favourable terms. The 2018 budget relies on strong growth, the increase of VAT and excise rates, savings resulting from the reform of a costly benefits scheme for mothers as well as a public sector wage freeze to reduce the deficit. The fiscal strategy relies on achieving strong primary surpluses as of 2020 (following completion of the first section of the Bar-Boljare highway), to set public debt on a clear downward path. However, recurrent contingent liabilities and the overestimated performance of local government budgets risk derailing the medium-term fiscal targets.

The main challenges in these respects include the following:

- **Stabilising and reducing a high debt level require sustained fiscal efforts.** So far, the fiscal consolidation measures have helped strengthen tax collection and contain current spending to some extent. Additional measures to contain consumption-related spending and increase overall spending efficiency could further strengthen the credibility and sustainability of public finances. Moreover, budget allocations seem at present insufficient to cope with contingent liabilities from previous periods related to unfavourable court judgments. Overall, there is room for strengthening fiscal oversight and compliance with budget targets and fiscal rules.
- **The position of financial institutions is improving but smaller banks still lag behind.** The Central Bank of Montenegro is revamping the financial sector's legal framework for both banking and non-banking operations. Meanwhile, the resolution of non-performing loans (NPLs), in particular those related to the corporate sector, remains essential if banks are to expand credit to the economy.
- **A healthy entrepreneurial sector is necessary to improve Montenegro's competitiveness and help reduce external imbalances.** Too many inactive and indebted companies represent a burden for the economy, distorting the real situation of banks' exposure while impacting on public finances with irrecoverable tax arrears. A swift removal of inactive companies from the business registry would help establish a sounder and more trustworthy business environment.
- **Regulatory reform in rail transport and public-private partnerships/concessions should contribute to practical rail market opening and mobilisation of private sector expertise and investments.** Setting up an efficient and independent rail

regulatory and safety authority will increase competition and improve quality of service. At the same time, Montenegro lacks an effective regulatory and institutional framework for public private partnerships and concessions in line with EU rules.

- **Boosting investment in research and innovation (R&I) and rolling out the deployment of fixed high-speed broadband networks can become drivers of future growth.** In order to achieve its ambitious target of 100% high-speed broadband coverage by 2020, Montenegro needs to prepare an implementation plan. Montenegro should also increase the gathering of R&D (research and development) and Innovation statistics and advance plans to introduce fiscal incentives for R&I in line with EU state aid rules.
- **The skills mismatch and the lack of job creation remain a key obstacle to growth and competitiveness; nonetheless, both employment and activity have been improving.** The skills mismatch manifests itself at secondary and higher education levels; it stems from high transitions from vocational education and training (VET) to higher education and to programmes less relevant for labour market needs. Provision of employment services and active labour market policies continues to be weak, affecting their outreach and effectiveness. Further efforts are needed to strengthen linkages between the labour market and social protection and reduce disincentives to work. Some important actions with the potential to improve social inclusion were started, but progress has been slow.

### **The policy guidance jointly adopted at the Economic and Financial Dialogue of 23 May 2017 has been partially implemented.**

Substantial improvement was recorded with the adoption and prompt implementation of the new consolidation package and of fiscal and public debt strategies. Moreover, expenditure slippages were contained as no new legislative measures were adopted in 2017 without a fiscal impact assessment. However, there was no progress to provide with a detailed overview of the erosion of budget revenue due to tax exemptions. The Economic Reform Programme (ERP) announces an analysis to consider setting up a Fiscal Council but does not propose any clearly specified measure.

Good progress was made in opening the energy market. More needs to be done to ensure that the rail regulatory authorities have the capacity and independence to achieve this. Some efforts have been made to improve the financial and non-financial support for businesses and further steps are planned in the programme. The modernisation of school programmes is ongoing, but further efforts are needed. After a stall in discussions, the preparation of the new labour law has resumed. Active labour market policies were not strengthened, and they continue with low financing, coverage and targeting. Relevant actions have been initiated to establish cooperation between employment offices and social work centres and enhance the social protection information system. Overall, the structural reform measures planned in last year's ERP were only partially implemented.

The medium-term macroeconomic scenario is well articulated with the ERP's fiscal framework being sufficiently comprehensive and integrated with the overall fiscal policy objectives, the state budget and fiscal strategy. On structural reforms the focus of structural reforms is on the one hand on regulatory reform in the energy and transport markets and on the other, private sector development with as many as 11 measures on industry, services, business environment and R&I. Education, employment and social policy measures are not sufficiently developed and prioritised in the programme given the many challenges. Both reforms in the field of education focus on vocational education and training and there is no reform in the social inclusion and poverty area.

## 2. ECONOMIC OUTLOOK AND RISKS

**The economic reform programme (ERP) presents a prudent macroeconomic scenario.** Real growth was expected to gradually slow from 4 % in 2017 to 2.6 % in 2020. Private and government consumption is set to decelerate (by 2 and 3 percentage points respectively in 2018 compared to their growth rate in 2017) due to the negative impact of fiscal consolidation measures. Fixed capital formation is not expected to contribute to growth beyond 2019 after the completion of the works on the first section of the Bar-Boljare highway and the power interconnection cable with Italy. The contribution of net exports is expected to continue strengthening, in particular in the two outer years, supported by robust tourism activity and the decline of investment-related imports.

**The ERP's baseline is plausible but might overstate the negative impact of fiscal consolidation and the completion of some investment projects.** The ERP projects average real growth at 2.8 % over the period 2018-2020, slightly lower than the Commission forecast and the IMF and consensus projections. The ERP assumes a larger negative impact of the fiscal policy on private and government consumption beyond 2018, even though no major fiscal consolidation measures are planned thereafter. Also, the ERP seems to underestimate the contribution of investment to growth once the main section of the highway is completed, which does not appear consistent with the large number of investments presented in the programme (Annex 3). The ERP also projects lacklustre labour market performance, which does not appear fully justified considering employment's elasticity to GDP growth.

*Table 1:*  
**Comparison of macroeconomic developments and forecasts**

	2016		2017		2018		2019		2020	
	COM	ERP	COM	ERP	COM	ERP	COM	ERP	COM	ERP
Real GDP (% change)	2.9	<b>2.9</b>	3.9	<b>4.0</b>	3.0	<b>3.0</b>	3.3	<b>2.7</b>	n.a.	<b>2.6</b>
<i>Contributions:</i>										
- Final domestic demand	10.0	<b>9.5</b>	5.9	<b>5.4</b>	3.2	<b>3.6</b>	3.0	<b>1.7</b>	n.a.	<b>1.0</b>
- Change in inventories	0.8	<b>-0.5</b>	-0.5	<b>-0.6</b>	-0.5	<b>0.0</b>	0.0	<b>0.0</b>	n.a.	<b>0.0</b>
- External balance of goods and services	-7.9	<b>-6.5</b>	-1.5	<b>-1.3</b>	0.4	<b>-0.6</b>	0.4	<b>1.1</b>	n.a.	<b>1.6</b>
Employment (% change)	1.1	<b>1.1</b>	2.6	<b>1.5</b>	2.3	<b>0.7</b>	2.0	<b>0.4</b>	n.a.	<b>0.3</b>
Unemployment rate (%)	18.0	<b>18.0</b>	17.2	<b>17.0</b>	16.7	<b>16.7</b>	16.0	<b>16.6</b>	n.a.	<b>16.6</b>
GDP deflator (% change)	n.a.	<b>5.1</b>	n.a.	<b>2.1</b>	n.a.	<b>1.6</b>	n.a.	<b>1.1</b>	n.a.	<b>0.9</b>
CPI inflation (%)	0.1	<b>0.4</b>	2.5	<b>2.5</b>	2.2	<b>2.6</b>	2.0	<b>1.9</b>	n.a.	<b>1.5</b>
Current account balance (% of GDP)	-17.9	<b>-17.6</b>	-18.0	<b>-18.5</b>	-16.7	<b>-18.8</b>	-16.0	<b>-17.4</b>	n.a.	<b>-15.7</b>
General government balance (% of GDP)	-3.7	<b>-3.6</b>	-6.2	<b>-3.1</b>	-5.6	<b>-1.6</b>	-2.7	<b>0.1</b>	n.a.	<b>5.4</b>
Government gross debt (% of GDP)	67.2	<b>63.4</b>	69.5	<b>65.5</b>	73.2	<b>66.5</b>	74.9	<b>66.1</b>	n.a.	<b>59.7</b>

*Sources: Economic Reform Programme (ERP) 2018, Commission Autumn 2017 forecast (COM)*

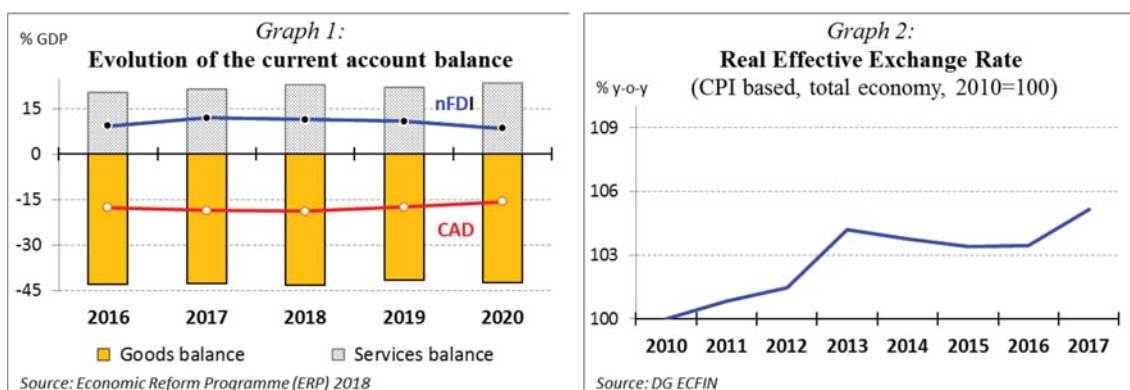
**The baseline scenario faces downside risks stemming from external shocks on tourism or investment.** Like in previous years, these risks are assessed in an alternative low-growth scenario which assumes a mild decline in tourism compared to the baseline and further stagnation of investments. The consideration of a modest negative shock on these two key drivers of growth helps to illustrate linkages within the economy. Along these lines, a negative impact on tourism would result in a fall in employment and private consumption, and consequently, in fiscal revenues. This would broaden the budget deficit and therefore public debt. An investment shock would further reinforce these negative

consequences, but also reduce the trade deficit given the country's high reliance on imports.

**Montenegro is a price taker on global markets given its relative size and trade openness.** This condition is further reinforced by Montenegro's import of the euro area monetary stance through its unilateral adoption of the euro as sole legal tender. Overall, the inflation scenario remains largely driven by international commodity prices, in particular of petroleum products and food, while domestic price pressures remain modest as average nominal wage growth is set to remain below the inflation rate in the medium-term due to labour market slack. Increases to the value added tax rate and excise duties would generate temporary inflationary pressures in 2018, estimated between 0.5 and up to one percentage point. Inflation would decline from 2019 as the impact of previous year's tax hike fades out, to reach an average rate of 1.5 % in 2020. However, the ERP's expected inflation rate in 2020 might be slightly underestimated considering the effects on Montenegro of imported inflation from a stronger global economy increasing external demand pressure on commodity import prices.

**A high and persistent current account deficit remains driven by a structurally large trade imbalance.** Robust tourism growth, remittances from a large diaspora, and pension transfers from abroad result in continuing surpluses in the balances of services, primary and secondary income. However, the merchandise trade balance displays chronic high deficits, exacerbated by large infrastructure investments and a narrow production base. There is scope to relieve imports by further developing domestic resources, like agriculture, food processing, construction materials, or electricity production. External competition remains very challenging for domestic companies. However, the real effective exchange rate has been appreciating again after 2016 while productivity growth remains weak (estimated in the ERP at some 1.5 % to 1.8 % per year). Therefore, the outlook is for some weak cyclical reduction of the external deficit, reflecting the investment trend and the demand for construction materials generated by ongoing major investments.

**External competitiveness and the current account**



**Investment and consumption needs result in a high reliance on foreign financing.** Foreign direct investment inflows and external debt remain key elements to finance Montenegro's growth model. The baseline scenario foresees net FDI to cover some 60 % of the external gap; the rest of the deficit being financed by private loans and sovereign debt. External debt totalled 158 % of GDP in 2016, increasing by EUR 432 million compared to 2015, and it is estimated to have further increased in 2017. This increase



was largely driven by government borrowing (accounting for 32 % of total external debt) as a result of Eurobonds emissions and foreign loans to finance the budget deficit. The ERP does not provide data on the net international investment position (NIIP). Overall, the strong dependence on foreign financing implies risks to the country's external position and also to public finances if financing conditions tighten or investors' confidence weakens.

*Table 2:*  
**Financial sector indicators**

	2013	2014	2015	2016	2017
Total assets of the banking system, mEUR	2,959	3,136	3,472	3,791	4182
Foreign ownership of banking system	83.5	82.7	80.4	79.4	80.4
Credit growth	3.1	-1.9	0.8	1.3	11.8
Bank loans to the private sector %	91.4	93.2	93.8	93.6	91.8
Deposit growth	5.9	10.0	13.7	9.4	13.8
Loan to deposit ratio	1.2	1.0	0.9	0.8	0.8
<b>Financial soundness indicators</b>					
- non-performing loans	17.5	15.9	12.6	10.3	7.3
- net capital to risk weighted assets	14.4	16.2	15.5	16.0	16.4
- liquid to total assets	20.0	22.2	24.8	24.5	25.3
- return on equity	0.5	5.4	-0.9	1.2	7.0
- forex loans to total loans %	1.6	1.6	1.6	1.1	0.7

*Sources: National Central Bank, Macrobond*

**Although the financial sector's contribution to the economy is recovering, lending to the corporate sector remains subdued.** The banking system is regaining strength, improving its solvency and liquidity position. Credit risk has been reduced, and lending to private owned companies started recovering, growing by 4.8 % year-on-year at the end of 2017, albeit still in clear contrast with the much faster two-digit expansion of households and general government credit. One key reason is the high level of indebtedness of local companies. Although the ratio of NPLs has been declining since 2013, reaching 7.3 % of total loans at the end of 2017, these impaired loans are largely concentrated in the corporate sector and challenges the profitability of banks.

### 3. PUBLIC FINANCE

**In 2017, the new government started implementing a relatively ambitious fiscal adjustment programme.** A plan was adopted for redressing public finances in parallel with the 2017 budget law. This plan was complemented by a rather ambitious medium-term fiscal strategy adopted in July, which frontloaded additional increases of excise duties, contained further cuts in public sector wages and revision of the mothers' benefit scheme. However, despite the consolidation measures already implemented, the general government deficit increased to 5.4 % of GDP in 2017, or 1.2 % of GDP higher than the revised plan, and 2.3 % of GDP higher than the ERP projection. This overrun was largely driven by capital spending, while unexpected payment obligations (i.e. repayment of liabilities from past years related to unfavourable court judgments, not projected in the ERP) added 1.7 % of GDP to the deficit. The wage bill ratio to GDP was contained due to restrictive wage policies, while the revision of a costly benefits scheme for mothers led to savings in social transfers by one percentage point of GDP as some beneficiaries of these mothers' benefits returned to the pension system. Strong economic growth and some further increases in excise rates helped boost tax collection, which surged by 9 %



year-on-year in line with the budget plan. Social security contributions also grew strongly, supported by the new recovery programme of tax arrears.

**The increase in indirect taxes is expected to lead to some reduction of fiscal imbalances in 2018.** On 26 December 2017, the parliament adopted the central government budget for 2018, envisaging a 1.5 percentage points reduction of the fiscal deficit over the year to 2.6 % of GDP. Budget consolidation would be mainly revenue driven. Tax revenues are planned to increase by 1.6 % of GDP in 2018, driven by higher VAT and excises rates from the beginning of the year. Current expenditure is projected to fall by 1.5 percentage points of GDP in 2018, contributing to the adjustment effort. The main drivers of spending reflect the priorities of the government: further capital investment and transfers to public institutions (in particular to health and education), all increasing strongly by some 16 % over the year. The public debt profile will enable a 10 % year-on-year reduction in interest payments in 2018. Some savings are also planned on social security transfers. However, part of the reduction on these transfers would be offset by a rise in pensions as most of the former benefits to mothers of three children or more, which previously benefited from pension rights, are converted again into pension rights.

The net consolidation effect of the original budget is estimated at 1.5 % of GDP in 2018 in the ERP. However, while this revenue target seems attainable thanks to the increase in total budget revenue (expected to raise by 2.6 percentage points of GDP), the impact of the consolidation measures on the expenditure side appear less certain, like the optimistic projection of 1 % of GDP surplus expected from municipal budgets. Moreover, the budget remains exposed to contingent liabilities from previous years (which averaged 2.6 % over the last three years), while budget reserves are planned to be further reduced to 0.4 % of GDP in 2018. Overall, while the current primary deficit is projected to improve by 4 percentage points of GDP, in the absence of additional consolidation measures the revised budget risks missing its deficit target.

***Box: The budget for 2018***

- \* The draft state budget for 2018 was approved by the government<sup>1</sup> on 14 November 2017 and adopted by the parliament on 26 December 2017. However, by the end of February, 9 municipalities out of 23 had not yet adopted their budgets for 2018.
- \* On 7 March 2018, the government presented a bill to increase expenditure by EUR 82 million and revenue by 57 million, with the EUR 25 million gap being covered by additional borrowing. As a result, the central government deficit would climb to 3.2 % of GDP, up from the original target of 2.6 %. On the expenditure side, EUR 70 million are earmarked for the buyback of shares<sup>2</sup> from the electric power company EPCG, while EUR 6.5 million set to cover public companies' debt, and EUR 4 million for the implementation of public administration reform. The revenue increase would be largely driven by the collection of EPCG's dividends worth EUR 43 million, while VAT revenue was revised upwards by additional EUR 10 million.
- \* The consolidation measures of the 2018 budget are a sequel to the 2017 Fiscal Strategy. On the revenue side these concern an increase of the standard VAT and excises rates, and some positive fallout on municipalities' budget from the legalisation of informal construction. In the same way,

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<sup>1</sup> Every year the government prepares the State budget while each of the 23 local self-government assemblies adopts its own budget after approval of their draft budget by the Ministry of Finance.

<sup>2</sup> This is a financing transaction which does not affect the deficit because involves the purchase of financial assets.

the expenditure side will continue with further implementation of 2017's reforms, like the reduction of wage coefficients and salaries for several categories of public sector workers, the completion of the revision of the benefits scheme for mothers' and a marginal reduction in discretionary spending. Some new liabilities (already committed), or some new tax incentives for tourism facilities would add some marginal drag to the budget.

- \* The budget is drawn up on a cash basis and not on an accrual principle. Therefore, some items like payments of commitments from previous years might derail the deficit target.

Table: Main measures in the budget for 2018

Revenue measures*	Expenditure measures**
<ul style="list-style-type: none"> <li>• Increase of the standard VAT rate from 19 % to 21% (0.97 % of GDP)</li> <li>• Increase of excise duties on tobacco, alcohol and carbonated drinks (0.7 % of GDP)</li> <li>• New utilities connection fee after regularisation of informal constructions (0.10 % of GDP)</li> <li>• Recovery and restructuring of tax arrears (0.55 % of GDP)</li> <li>• Reduced VAT rates (from 21 % to 7 %) for high-category hotels (- 0.08 % of GDP)</li> </ul>	<ul style="list-style-type: none"> <li>• Public sector wage reduction (-0.12 % of GDP)</li> <li>• Revision of the former benefit for mothers of three or more children (-0.31 % of GDP)</li> <li>• Reduction in discretionary spending (-0.09 % of GDP)</li> </ul>

\* Estimated impact on general government revenues.

\*\* Estimated impact on general government expenditure.

Source: ERP

**The ERP envisions further spending reduction in the outer years.** As most of the measures included in the 2017 strategy have been already implemented, except for a new (albeit still symbolic) excise on coal along with some further increases in other excise duties to be introduced in 2019, the budget consolidation impact would be half a point of GDP that year, and zero in 2020. At the same time, the finalisation of the first section of the Bar-Boljare highway would enable the budget to swing into a very strong surplus of more than 5 % of GDP in 2020. This would contribute significantly (together with moderate inflation and growth rates) to bring the public debt below the fiscal rules' threshold of 60 % of GDP (unless further contingent liabilities derail the deficit targets).

Table 3:  
Composition of the budgetary adjustment (% of GDP)

	2016	2017	2018	2019	2020	Change: 2017-20
<b>Revenues</b>	42.6	42.6	44.2	44.2	43.9	1.4
- Taxes and social security contributions	35.1	38.4	39.6	39.7	39.6	1.2
- Other (residual)	7.5	4.1	4.6	4.5	4.3	0.2
<b>Expenditure</b>	46.2	45.7	45.8	44.1	38.6	-7.1
- Primary expenditure	44.0	43.3	43.7	42.0	36.6	-6.7
<i>of which:</i>						
Gross fixed capital formation	2.7	7.1	8.0	7.8	3.3	-3.8
Consumption	16.3	15.6	15.8	15.2	14.8	-0.8
Transfers & subsidies	14.8	14.1	13.2	12.7	12.4	-1.7
Other (residual)	10.2	6.5	6.8	6.3	6.1	-0.4
- Interest payments	2.2	2.4	2.0	2.1	2.0	-0.4
<b>Budget balance</b>	-3.6	-3.1	-1.6	0.1	5.3	8.4
- Cyclically adjusted	-2.5	-2.7	-2.6	-0.2	6.1	8.8
<b>Primary balance</b>	-1.4	-0.8	0.4	2.2	7.3	8.1
<b>Gross debt level</b>	63.3	65.5	66.5	66.1	59.7	-5.8

Sources: Economic Reform Programme (ERP) 2018

**Structural reforms to strengthen the sustainability of public finances are not well detailed and their fiscal impact remains unclear.** The ERP briefly presents a series of reforms which are under way, including tightening the conditions for early retirement,

reshaping the social protection system by amending the Social and Child Protection Law, a review of the cost of medicines, and optimizing the number of employees in the public administration. However, the programme does not present any fiscal estimates for these.

**Contingent liabilities appear to be the main risk for attaining fiscal adjustment targets.** These liabilities have been a regular occurrence in the past, but have not been included in the ERP's medium term budget projections as they are part of the financing side of the budget (i.e. 'below the line'). The ERP assumes strong budget surpluses after 2020 due to the completion of the first section of the Bar-Boljare highway. This assumption could be at risk in case new debt-financed sections of the highway are launched before Montenegro adopts a law on public private partnerships and concessions to help mobilise private capital to support public sector investment (*see also Chapter 4, Public finance management*). Finally, one more risk would be an economic downturn triggered by external shocks on commodity prices or tourism, the latter pondered in the ERP's alternative scenario<sup>3</sup>.

**The basis for improving the quality of public finances is being gradually set up.** The regular occurrence of contingent liabilities, spending overruns, and budget rebalances indicate budgeting planning weaknesses. Several activities are under way to strengthen the budget regulatory framework. In October 2017, amendments to the Law on budget and fiscal responsibility formally introduced three-year budgeting (to be put into effect starting from the 2019 budget). The ERP provides for the establishment in 2019 of a new payroll management system to centrally pay out wages for public servants. In November 2017, the government adopted a decision to introduce programme budgeting by the end of 2020. Meanwhile, work on implementing ESA2010 accounting standards for government finance statistics is making slow progress.

<b>Box: Debt dynamics</b>					
<i>Table 4:</i>					
Composition of changes in the debt ratio (% of GDP)					
	2016	2017	2018	2019	2020
<b>Gross debt ratio [1]</b>	<b>63.4</b>	<b>65.5</b>	<b>66.5</b>	<b>66.1</b>	<b>59.7</b>
Change in the ratio	-1.8	2.1	1.0	-0.4	-6.4
<i>Contributions [2]:</i>					
<b>1. Primary balance</b>	<b>0.7</b>	<b>0.4</b>	<b>-0.4</b>	<b>-2.2</b>	<b>-7.4</b>
<b>2. "Snow-ball" effect</b>	<b>-2.7</b>	<b>-1.2</b>	<b>-0.8</b>	<b>-0.3</b>	<b>-0.2</b>
<i>Of which:</i>					
Interest expenditure	2.2	2.4	2.0	2.1	2.0
Growth effect	-1.7	-2.4	-1.9	-1.7	-1.7
Inflation effect	-3.2	-1.2	-1.0	-0.7	-0.6
<b>3. Stock-flow adjustment</b>	<b>0.3</b>	<b>2.9</b>	<b>2.3</b>	<b>2.1</b>	<b>1.2</b>
<i>Memorandum item</i>					
Gross financing needs	16.8	9.3	7.1	12.7	11.8
Highway loan [3]	<b>0.2</b>	<b>4.1</b>	<b>4.8</b>	<b>5.6</b>	<b>0.0</b>
<b>Notes:</b>					
[1] End of period.					
[2] The snow-ball effect captures the impact of interest expenditure on					
[3] Includes loan and government own contribution.					
<i>Source: Economic Reform Programme (ERP) 2018, ECFIN calculations</i>					

**Sustained GDP growth and deflators are helping to contain public debt stock.** The combined effect of GDP growth, and a moderate but positive inflation are set to override debt interest costs, resulting in a negative contribution from the 'snow-ball effect', eroding the nominal increase in debt. This, coupled with the end of the work on the highway in 2019, would set the public debt into a clear downward trajectory as of 2020. The debt analysis presents some stock-flow adjustment, which could be explained by the way the authorities account for the US dollar based highway loan, which is recorded in euros using the exchange rate applied at the time of subscribing the contract, whereas each year's debt stock is recorded at the current exchange rate.

<sup>3</sup> See sensitivity analysis box below.

The resumption of the highway works in 2017 brought new debt, increasing the debt stock by 2 percentage points to 65.1 % of GDP by the end of the year. The structure of the debt is largely dominated by external liabilities, which make up 81.2 % of the total. Debt volatility is limited as 80 % of it presents fixed interest rates, with an average rate of 3.1 % and an average time to maturity of 4.7 years. Overall, currency risk is also limited, as some 87 % of the debt is denominated in euros. To reduce interest and exchange rate risks, the government adopted in March 2018 a decision enabling the possibility of purchasing derivatives to hedge against such risks. State guarantees accounts for 7.4 % of GDP at the end of 2017, below the fiscal rules threshold of 15 %.

**Authorities adopted a new Public Debt Management Strategy in March 2018.**

Overall, given the high level of public debt, its repayment profile (surging from 5.5 % of GDP in 2018 to 17.1 % in 2020) and the tightening of global financial conditions, it is essential to rebalance the debt structure and to minimise borrowing costs by developing a sound market strategy. Some measures of the new medium-term debt strategy have started to be implemented to facilitate the re-financing of debt, including long-term debt arrangements with financial institutions to pre-finance outstanding Eurobonds and to extend their average maturities and reduce rollover risks. The challenge represented by the sizeable budget financing needs is expected to be contained by the financing proposal for a loan received from a consortium of international banks, by the Chinese loan to finance the highway, and by an EUR 500 million Eurobond emission in April 2018. Altogether, these would cover financing needs until 2020.

**Box: Sensitivity analysis and comparison with previous ERP**

The ERP's low-growth scenario's assumes stagnating investment combined with a 2 % contraction in tourism revenue, weakening the fiscal position as a result. Budget revenue would contract while expenditure remains at the same level as in the baseline due to the high level of non-discretionary spending of the budget, resulting in some 0.5 % of GDP annual deterioration of budget balances each year until 2020. This higher deficit would also feed into the public debt stock, which is expected to peak at 69.5 % of GDP in 2019, instead of 66.1 % as projected in the baseline, before dropping back to 63.8 % of GDP in 2020.

The ERP 2017 baseline fiscal projections were much worse than the ERP 2018 because the fiscal strategy had not been implemented yet, projecting substantially higher budget deficits and debt (see below). In addition, the revision of nominal GDP numbers in 2017 also improved the debt-to-GDP ratios, contributing to improve the current ERP fiscal projections.

<i>(in % of GDP)</i>		2017	2018	2019	2020
<b>ERP 2017</b>	General Government balance	-6.1	-5.5	-3.8	--
	General Government debt	71.6	74.9	77.5	--
<b>ERP 2018</b>	General Government balance	-3.1	-1.6	0.1	5.4
	General Government debt	65.5	66.5	66.1	59.7

**4. STRUCTURAL REFORMS**

**Structural reform needs remain concentrated on the labour market, and human and physical capital.** Labour market performance is poor, characterised by high youth unemployment, low participation of women and high long-term unemployment. Active labour market policies are ineffective. More progress is needed to align education and skills with the labour market needs. There are significant transport bottlenecks, but they need to be addressed in a fiscally sustainable and transparent manner, with due attention

given to network maintenance and regulatory reform. The high price and low availability of high-speed broadband is not supportive of economic growth and innovation. Local companies have poor export performance or are only focused on the local market and non-tradable sector, as well as being insufficiently integrated in international production processes. Despite ongoing work, challenges to the rule of law remain. Corruption continues to be a serious problem and the informal sector is large, creating unfair market conditions. The ERP's analysis of the bottlenecks to growth and competitiveness is broadly consistent with this.

**The majority of the reform measures are appropriate to foster growth and competitiveness.** Out of a total of 20 measures, 8 are new measures and 12 are rolled over. The measures that were dropped were justifiably excluded following the Commission's assessment of their relevance for competitiveness and long-term growth in 2017 or, as regards infrastructure, as a consequence of the revised ERP guidelines. The ERP 2018-2020 prioritises several regulatory and administrative measures in the area of the labour market, transport, energy, and financial services, in place of large infrastructure measures that were dropped this year. This new focus responds to a general need to develop the country's institutional and economic framework. Similarly, the focus on private sector development and innovation, including strengthening industry and services and improving the business environment, is good as it targets key binding constraints to competitiveness and long-term growth. The two proposed measures on education and skills, while relevant, are limited to VET, and basic and higher education are not considered. The labour market and employment measures are relevant, but their implementation –according to the ERP timeline– bears risks. The area of social inclusion, poverty reduction and equal opportunities does not contain any measure, despite clear challenges. Several 2017 reforms are delayed, underlining the need for more realistic planning, risk mitigation, and close monitoring of the implementation of the structural reform agenda.

### **Public finance management**

**Weaknesses in public finance management (PFM) continue, including the lack of an effective regulatory framework for public private partnerships and concessions in line with EU rules.** Several reforms foreseen in the 2016-2020 PFM reform programme are progressing on schedule, but there are considerable delays in areas requiring technical assistance. There is ongoing work on improving strategic planning, internal control, and reforming the debt management division. Significant efforts are still needed to ensure the alignment of macroeconomic and business statistics. In the area of the priority reform - public procurement – major work remains to be done, such as establishing an effective regulatory framework for public private partnerships and concessions in line with EU rules. This is delayed for several years, even though it is considered a means to potentially help finance future investments. Moreover, the June 2017 amendments to the Law on public procurement represent backsliding in terms of alignment with the EU *acquis* and hinder the smooth functioning of the system. The ERP correctly identifies the PFM challenges, which are primarily discussed in Chapter 3.

**The measure to introduce e-procurement will have a positive impact on the level of competition and transparency in the use of public funds, but implementation has been delayed for the second year.** The Montenegrin administration faced capacity constraints when preparing the tender documents for e-procurement. The envisaged switch to e-procurement - mandatory under EU rules - represents a major change. This needs to be well planned, efficiently implemented, and accompanied by adequate training and communication activities.



## **Energy and transport market reform**

**Montenegro has small electricity and transport markets, characterised by a significant infrastructure gap and high investment costs. They can be important drivers for economic growth to the extent that they can be fully integrated into a regional context.** For this reason, the need to complete the practical opening of the markets is rightly identified as a key priority for both sectors. The priority reforms in this area are well-aligned with the connectivity reform agenda promoted by the EU. Montenegro has made considerable progress, especially in the energy sector, by implementing connectivity reforms. However, investments in renewable energy and energy efficiency are not sufficiently targeted through the ERP. Likewise, in the transport sector, inter-modality projects and improving border-crossings procedures (on the basis of the good practice established with Albania at the Hani i Hotit/Tuzi border) remain of paramount importance.

**The measure to improve the regulatory and institutional framework for Montenegro's integration with the regional electricity market is directly linked to the connectivity reform agenda agreed at the 2015 Vienna Summit (under the Berlin process).** It should be noted that the activities foreseen for 2018 are focused on aligning national legislation with the relevant EU *acquis*. Implementation activities are planned for 2019 and 2020, but detailed information is missing. The focus should be on the implementing legislation under the third energy package, including the auction rules for granting support to producers of renewable energy. However, it seems realistic that this measure can be achieved given both the timeline and the allocated budget.

**The measure setting up a single window for maritime transport will lead to a safer and more efficient management of port activities, making the ports more competitive.** The expected impact is conditional on the successful implementation of the required IT project; this is planned to be achieved by 2023. The relevant EU Directive 2010/65, which is currently under revision with the aim to establish a European Maritime Single Window Environment, also needs to be taken into account.

**The measure establishing an efficient and independent regulatory and safety authority for rail transport is a necessary pre-condition for the practical opening of the market.** This reform measure consists of amendments to the Law on the Railways, which are compliant with the relevant provisions of Directive 2012/34 (recast) on a single European rail area. Responding to the May 2017 joint policy guidance, the measure will support the full opening of the rail market. The expected impact is to create a level playing field for new entrants, which in turn should increase competition, improve quality of service and sector productivity. While the measure does not have a significant budgetary incidence, the functional reorganisation, the necessary trainings and the overall strengthening of the administrative capacities are major undertakings.

## **Sectoral development**

**Montenegro's economy is dominated by services,** which account for 71.9% of gross value added, while industry and agriculture make up 12.3% and 8.8% respectively in 2016. This is a consequence of the country's fast growing tourism sector and de-industrialisation.

### **Agricultural sector development**

**Agricultural development continues to be constrained by a number of challenges.** These include fragmented and small parcels with high production costs, limited export opportunities, weak sector organisation, limited access to credit, and a lack of qualified

labour, adequate equipment, and infrastructure. Montenegro managed to secure support of about EUR 120 million to the sector, including for food production and processing. The effectiveness of this support will need to be closely monitored and any overlap of funding programmes avoided.

**The measure to invest in the food production sector to help companies achieve EU standards is essential for the agricultural sector to become more competitive.** The level of public support in this area is steadily increasing, and Montenegro has prepared measures to provide more farmers with access to credit, which will help the support scheme to be effective. Montenegro is also encouraged to make faster progress in obtaining EU export accreditation for exports of animals, products of animal origin and food products. While it is important to reduce import dependency and increase exports, Montenegro identified tourism as an important market for its agricultural products.

### **Industry sector development**

**Key bottlenecks for further industrial development are low product diversification and labour productivity, underinvestment in modernisation and weak linkages between private companies and science.** The production of competitive higher value added products remains limited and local industry is characterised by marginal participation in global supply chains, and low digitisation. As a first step in order to support an increased diversification and industrial modernisation, Montenegro adopted a comprehensive industrial policy. The ERP is broadly aligned to the above-mentioned obstacles to industrial development. Given the current steel and aluminium production overcapacity on world markets, the objective for base metals should be to shift towards higher quality, niche markets, and material efficiency, including metal recycling. Non-energy resource efficiency and circular economy policy planning should be considered as part of Montenegro's efforts to support industrial modernisation.

**The two measures to boost industrial modernisation address a key constraint through the promotion of investments linked with job creation and the installation of new equipment.** Since the introduction of the scheme in 2016, industrial investments amounting to EUR 7.2 million were supported by about EUR 1 million in subsidies. Another EUR 1.25 million financial support is included in the 2018 budget. The pilot scheme to support the purchase and installation of new industrial equipment is still receiving little interest, with only one grant provided in 2016 and four grants in 2017. Its impact on competitiveness is therefore so far limited.

### **Service sector development**

**The service sector contributes over 70 % of Montenegro's gross value added (GVA) and employs nearly three-quarters of the workforce.** Of this, tourism alone provides a fifth of GVA and employs over 15 % of the workforce. One of the most important challenges is the diversification of the service sector and the dependency on tourism. The ERP does not contain an analysis of the service sector as a whole but is limited to the identification of obstacles in the tourism and banking sectors. In the tourism sector, Montenegro's effort to become a high-end tourism destination is hampered by infrastructure and accommodation issues, limited accessibility of destinations, high seasonality, and regional disparities. A number of high-end hotel facilities were put into operation in the last few years. A reduced 7 % VAT rate was introduced in January 2018 for high-end hotels' food and beverage preparation services - such reduced VAT rates are more often granted for basic consumption products, for the purpose of inclusive economic growth.



The banking sector improved its solvency and liquidity position, but corporate sector borrowing remains below pre-crisis levels. The level of non-performing loans in the banking sector has gradually declined to 7.3 % of total loans at the end of 2017, down from its peak of close to 26% in 2011. A credit registry was set up in 2008, but its scope and usage remain limited. Lending interest rates fell and private sector credit grew moderately.

**The measure that seeks to diversify the tourism offer is formulated as an objective rather than as a reform with targeted activities.** There is no correlation with the expected impact, which depicts tourism employment trends as a whole. However, the responsible ministry clarified its plans during a Commission fact-finding mission: it is seeking to implement a regular grant scheme to mobilise local level initiatives to make tourism in the north of the country more attractive.

**The measure on strengthening the regulatory framework for prudential control and bank resolution is an accession priority that requires careful planning.** The strengthened framework could foster the further resolution of NPLs by reducing systemic risks and enhancing the intermediate role of financial institutions in the economy. It should be prepared in close cooperation with relevant stakeholders.

### **Business environment and reduction of the informal economy**

**Recent progress in improving the business environment has been more incremental than qualitative, as shown by different international rankings, partly due to implementation delays.** Businesses complain about the poor implementation of laws and delays in obtaining information and services. Challenges remain in SMEs access to finance and in construction, notably high permit costs, and lengthy procedures for paying taxes and property registration. Enhancing the efficiency and effectiveness of public administration and the further roll-out of e-government are important to ensure business-oriented public services. Moreover, further efforts are needed to strengthen the rule of law, including by reducing the informal sector and fighting corruption. Investors also complain about the inconsistency of case law, non-enforcement of court decisions and interferences with property rights. The ERP diagnostic recognises most of these obstacles. However, it does not identify a broader set of measures on reducing the informal economy.

**The measure that introduces e-services to the land registration system seeks to speed up the issuing of land and property registration documents.** The need to improve the land registry is frequently stressed by business representatives. This is also reflected in the World Bank Doing Business report, where Montenegro is ranked in 76<sup>th</sup> place on this indicator.

**The measure that introduces e-fiscal invoices remains relevant for reducing the informal economy.** This reform, which has been postponed for the second time, has the potential to create a better level-playing field for registered businesses and improve revenue collection. Montenegro expects a significant revenue increase of some EUR 30 million annually, but it is now expected to materialise only as of 2020 due to delays.

**The two SME measures foreseen represent ongoing efforts to expand the available financial and non-financial support.** In 2018, the Montenegrin Investment and Development Fund (IDF) plans to set up a guarantee and micro-credit scheme, which will help facilitate SMEs' access to finance. Montenegro also plans to build up the capacity of the seven existing SME clusters and continues to provide small grants to support them. The IDF's activities are scaled up, reaching EUR 176 million in loans and factoring arrangements in 2017 (approx. 4 % of GDP), but they continue to depend

largely on external funding. The IDF's activities should be externally reviewed for their effectiveness, and impact. At the same time, only limited budgetary resources are dedicated to non-financial support. Increasing the rate of SMEs' use of regional funding instruments, such as COSME and Enterprise Development and Innovation Facility (EDIF), remains a significant challenge.

**The upgrade of ICT systems for issuing construction permits has the potential to significantly shorten the time needed to issue such permits.** The measure seeks to improve the functioning of one-stop shops introduced in 2012 by establishing e-services as part of the wider e-government agenda. This addresses another of the World Bank Doing Business indicators, on which Montenegro is underperforming. The measure was first presented 2 years ago, but was not implemented pending a reform of the Law on spatial planning, which was eventually adopted in October 2017. Implementing legislation for this law, which should also provide for procedural safeguards, is pending.

### **Research, development and innovation and the digital economy**

**Montenegro's low number of researchers per capita - only 20% of the EU average – is a key contributing factor to the country's lack of competitiveness in research and innovation (R&I).** With a current rate of only 0.38 % of GDP invested in R&I, serious efforts are needed to reach the 2020 target of 0.6 %. Investment in higher education and university science education is particularly needed to develop a higher skilled workforce. Further key constraints that continue to hamper the country's progress in this area are: insufficient integration of the private sector, a low number of domestic innovative enterprises, and limited commercial and legal expertise in research institutions, such as on IP rights. Furthermore, the lack of part of the R&D and Innovation statistics impedes access to reliable data.

Montenegro is already taking steps to address these shortfalls, and has initiated plans to participate in the EU Innovation Scoreboard. Along with the envisaged introduction of fiscal incentives to support R&I, the development of a smart specialisation strategy will be an essential tool for identifying key measures to support competitiveness and growth. The ERP diagnostic correctly identifies some of the bottlenecks.

**Montenegro needs to speed up broadband access so that its citizens can benefit from a digitalisation of the economy.** Montenegro's information society strategy sets an ambitious goal of 100 % household coverage with speeds above 30 Mbit/s by 2020, whereas the current coverage is 26.5 %. It remains challenging to set conditions for meeting this goal and delivering an action plan that is implementable. Broadband alone will not provide for the economic benefits of digitalisation. It needs to be accompanied by skills development, cyber security and a conducive regulatory environment. On the latter, Montenegro is advised to take a pro-active approach on issues such as cross-border data transfers and data protection, and to closely follow the EU digital agenda. The ERP diagnostic correctly identifies some of the bottlenecks, but falls short of identifying regulatory reforms.

**The measure establishing a science and technology park in Podgorica focuses on infrastructure.** Design and tendering have been delayed, as was the case with the Technopolis (a former ERP measure). This is now operational (although its labs are still to be equipped). Along with its infrastructure plans, Montenegro has an action plan, which is already budgeted, to: i) set up a centre of excellence; ii) develop a policy programme to support start-ups; and iii) boost the activity of researchers and link it to private sector needs. The action plan covers the period 2018-2020. Funding for expert

support in developing a sound management structure for the science and technology park has been secured, while funds for training and equipment are taking longer to ensure.

**The measure to apply a cost reduction framework for electronic communication networks will not be sufficient to achieve the targets of Montenegro's strategy in this area.** In line with last year's policy guidance, Montenegro advanced its preparations for legislative alignment with Directive 2014/61/EU to reduce the cost of high-speed broadband deployment. However, a discrepancy remains between the planned entry into force of the respective national law in January 2021 and Montenegro's 2020 goal of 100% broadband availability, even if partial implementation could be envisaged earlier. An analysis of the broadband market and the existing regulatory framework to identify funding needs and tools is planned for 2019 only. The ERP does not detail any further activities in order to translate the findings of the analysis into an action plan.

### **Trade-related reforms**

**While the export of services is steadily increasing, the export of goods remains hampered by a narrow export base, a low level of diversification, and a predominance of low value-added products.** There are significant gains expected from greater intra-regional economic integration. Efforts on this should include streamlining customs procedures and greater use of trade facilitation tools, such as the authorised economic operators programme. The ERP acknowledges these weaknesses, but it does not include a detailed discussion of customs procedures and trade facilitation.

**The implementation of the Central European Free Trade Area (CEFTA) protocol 5 on trade facilitation will reduce transaction costs.** Montenegro ranks below the EU average in trading across borders indicators. The measure addresses this through further streamlining and harmonisation of customs procedures with neighbouring countries. Finalising the negotiations on CEFTA protocol 6 on service sector liberalisation has the potential to play an important role in Montenegro's economic development. The ERP does not mention any plans to develop a national trade facilitation strategy.

### **Education and skills**

**The key obstacle to growth and competitiveness remains the skills mismatch and weak inter-institutional cooperation between education and labour market.** The skills mismatch is manifested at secondary and higher education levels and stems from high transitions from vocational education and training (VET) to higher education, and to programmes that are less relevant for labour market needs. Weak performance in basic education and low investments in teacher training and transversal skills affect performance in the later stages of education. This link with basic education is not acknowledged in the ERP. Despite some initiatives – in particular at the higher education level - there are no systematic forecasting or student tracer mechanisms in place.

**Most progress has been achieved in improving the VET system.** Efforts were taken to integrate entrepreneurial learning as a key competence in the curricula from primary school and secondary education, including VET. New and revised curricula were introduced, accompanied by teachers training. In July 2017, the Law on VET introduced a dual education system, while promotional activities were carried out to attract and inform students. Higher education saw the introduction of 25 % practical training and the establishment of an agency for control and quality assurance. Limited progress has been made on enrolment policies to address the root causes of the skills mismatch. Improving pre-school enrolment and the quality of basic education received less focus.

**The two reform measures in the ERP in this area are relevant for improving VET and school-to-work transitions, but more efforts are needed to address the skills mismatch.** Modernisation of VET programmes with the support of sectoral committees will continue, and importantly, monitoring and evaluation should be established. The implementation of the newly introduced dual education system, especially to ensure the cooperation with employers and quality apprenticeships, will be crucial. Better inter-institutional cooperation is needed, as well as stronger focus on career guidance. Poor use and application of forecasting tools for future skills and employers' needs act as an additional obstacle to matching skills with labour market needs.

### **Employment and labour markets**

**Labour market dynamics remain volatile, partly because of legislative changes in social policy in recent years.** Nonetheless, both employment and activity have been improving, albeit at a slow pace. Young people, women and the long-term unemployed remain the most vulnerable to obstacles entering and remaining on the labour market. The ERP diagnostic insufficiently addresses the structural challenges, with no focus on labour demand (i.e. the lack of job creation) and deep-rooted inactivity and links with the informal economy. Further efforts are needed to strengthen linkages between the labour market and the social protection system.

After the legislative repeal of lifelong benefits for mothers with three or more children, new activation and employment support measures are yet to be outlined, in particular for young people and women. More decisive action is needed to activate the beneficiaries of social protection benefits who are able to work. This will involve in particular, investing in upskilling and reskilling, and better cooperation between employment services and social work centres to activate people.

**The reform measure foresees previously planned legislative amendments, but the timing of this implementation remains uncertain.** The measure consists of pursuing previously announced amendments to the Labour Law and the Law on employment intermediation and benefits during unemployment, but their full roll-out cannot be expected until 2019. The focus should also remain on reducing undeclared work and on further strengthening of labour inspection and on an incentive-based approach to formalising employment. The follow-up on previous measures is also weak. The traineeship programme for graduates seems to be having positive results. However, the implementation of other active labour market policies is not being followed up properly and there has still been no evaluation of their effectiveness. Effective counselling and employment intermediation are negatively affected by the presence of passive measures and lack of sufficient human and financial resources in employment services.

### **Social inclusion, poverty reduction and equal opportunities**

**Poor labour market outcomes are coupled with weaknesses in the social protection system, which suffers from weak services and targeting.** Poverty is significantly higher in the north, compared to other parts of the country. Poverty rates are also higher for Roma, pensioners, the long-term unemployed and people with disabilities. Young people and the low skilled are also among those who face more difficulties in accessing the labour market, putting them more at risk of social exclusion. The ERP analysis is not comprehensive, reflecting the need for stronger evidence-based policy planning and stronger social statistics.

**There is no specific measure on social inclusion in the 2018-2010 ERP.** Nevertheless, some important actions with the potential to improve social inclusion have begun. Among these is the project to improve the cooperation between the employment agency

and social welfare centres. This project's aims are to provide support for people that are hard to employ and to support their integration into the labour market. Furthermore, the Integrated Information System of Social Protection (the 'Social Card') aims to improve the efficiency and effectiveness of the administration, and the provision of social services. There are some plans to further pursue pension system reform focused on indexation and limiting early retirement, while there is less consideration on the adequacy of pensions along with prolonging working lives.

**ANNEX 1: IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2017**

2017 policy guidance	Summary assessment
<p><b>PG 1:</b></p> <p>Fully implement the 2017 consolidation package, and take additional fiscal measures if necessary to achieve the envisaged budget savings of around 3% of GDP.</p> <p>Adopt a comprehensive medium-term fiscal strategy with concrete revenue and expenditure measures with sustainable effects in order to stabilise public debt and reduce debt-related vulnerabilities.</p> <p>Consider establishing an independent fiscal council.</p>	<p>PG 1 has been <b>partially implemented</b>:</p> <ul style="list-style-type: none"> <li>• <b>Partial implementation:</b> The plan for redressing public finances was adopted and implemented. The 2017 consolidation package was implemented and produced in the current budget sizeable savings over the year worth 3.1 % of GDP, but the general government deficit significantly overshoot the rebalanced budget target, mostly due to one-off payment obligations.</li> <li>• <b>Full implementation:</b> A fiscal strategy with concrete revenue and expenditure measures was adopted and is being implemented according to plan. The strategy aims to stabilise the public debt ratio in 2019 and achieve a sizeable budget surplus in 2020.</li> <li>• <b>No implementation:</b> Analysis on the establishment of a fiscal council was launched but no clearly specified measure proposed.</li> </ul>
<p><b>PG 2:</b></p> <p>Gradually reduce public spending on wages and pensions as a share of GDP.</p> <p>Ensure the availability of adequate financial resources for the implementation of new legislative measures.</p> <p>Strengthen tax revenues and review tax exemptions with a view to a further reduction of tax exemptions.</p> <p>Adopt measures in order to facilitate debt servicing by tapping the local debt markets, extending maturities, and advancing the privatisation agenda.</p>	<p>PG 2 has been <b>partially implemented</b>:</p> <ul style="list-style-type: none"> <li>• <b>Partial implementation:</b> The 2017 budget execution and the 2018 budget medium term fiscal framework present each year an annual reduction of pension expenditure as a share of GDP. However, budget execution data for 2017 confirm wage expenditure (in percent of GDP) increased marginally above the plan.</li> <li>• <b>Full implementation:</b> No new legislative measures were adopted in 2017 without a fiscal impact assessment.</li> <li>• <b>Limited implementation:</b> Tax revenue has been strengthened by means of the measures contained in the plan for redressing public finances, the fiscal strategy, and the restructuring of tax arrears. However, the ERP provides a very succinct qualitative assessment of tax exemptions, and fails to present an analysis of the erosion of the tax base (in particular VAT) from foregone revenue compared to the benefits to the economy attributable to the subsidies.</li> <li>• <b>Substantial implementation:</b> Recourse to domestic borrowing for budget financing surged by 160 % in 2017 compared to the plan. Authorities subscribed a loan with the World Bank to cover the 2018 budget deficit, to repay maturing bonds in 2019, and a new Medium Term Debt Management Strategy was adopted</li> </ul>



	and implemented in order to extend debt maturities and lowering interest rates. However, there was no further advancement with the privatisation agenda.
<p><b>PG 3:</b></p> <p>Continue efforts to foster NPL resolution by developing a comprehensive strategy to that end, including participation by all relevant stakeholders, with the aim of reducing credit risks in the banking sector and removing impediments to credit extension in the economy.</p> <p>Consider to include corporate debt restructuring and tackle other underlying structural obstacles of resolution as part of the strategy.</p> <p>Enhance prudential and banking resolution frameworks to the end of buttressing financial stability.</p>	<p>PG 3 has been <b>partially implemented</b>:</p> <ul style="list-style-type: none"> <li>• <b>Partial implementation:</b> The central bank continued with determined actions aimed at NPL disposal and restructuring in the banking sector, which contributed to the decline of the NPL ratio. However, the impediments for NPL resolution outside the remit of the central bank as well as the high stock of NPLs held outside the banking sector have been largely unaddressed so far.</li> <li>• <b>Limited implementation:</b> Underlying obstacles to NPL resolution that remain outside the remit of the central bank (in the area of e.g. judiciary system, contract enforcement and bankruptcy procedures or obstacles to selling collaterals), have remained untouched. However, the factoring companies currently holding a large part of NPLs were incorporated into the scope of central bank supervision in late 2017, which will allow the central bank to undertake further actions aimed at the resolution of NPLs that are held outside the banking sector.</li> <li>• <b>Substantial implementation:</b> In 2017 the authorities strengthened the central bank's supervisory powers (through, inter alia, including factoring companies into the scope of the central bank's supervision) and advanced work on the framework for the recovery and resolution of credit institutions. The central bank intends to publish a macroprudential policy strategy document still in the first half of 2018.</li> </ul>
<p><b>PG 4:</b></p> <p>Harmonise national rules with Directive 2014/61 on cost reduction measures for the development of high-speed electronic communication networks.</p> <p>Ensure effective, efficient and independent rail regulatory and safety authorities to implement the full opening of the rail market.</p>	<p>There was <b>limited implementation</b> of PG 4:</p> <ul style="list-style-type: none"> <li>• <b>Limited implementation:</b> The drafting of a Law on measures to reduce the cost of setting up high speed electronic communications networks is at an advanced stage. The law remains to be adopted and the ERP foresees a delayed implementation by 2021 only.</li> <li>• <b>Limited implementation:</b> The Ministry established a working group in July 2017 to prepare amendments to the existing law on railways. The amendments relate to an independent regulatory and safety body. The adoption of the amended law is planned for 2018.</li> </ul>
<p><b>PG 5:</b></p> <p>Continue to strengthen financial and non-financial support services for SMEs.</p>	<p>There was <b>substantial implementation</b> of PG 5:</p> <ul style="list-style-type: none"> <li>• <b>Substantial implementation:</b> SME financial and non-financial support was expanded. Financial support channelled via IDF almost</li> </ul>



<p>Adopt legislation to ensure the operational independence of the state aid authority.</p>	<p>tripled since 2013, reaching EUR 176 million or approx. 4 % GDP in 2017. Non-financial support is being strengthened as a priority reform, but budgetary resources and activities should be further reinforced.</p> <ul style="list-style-type: none"> <li>• <b>Full implementation:</b> In February 2018, Parliament adopted amendments to the Law on protection of competition) along with amendments to the Law on state aid control. These changes provide a legal framework for the operational independence of the State Aid Authority.</li> </ul>
<p><b>PG 6:</b></p> <p>Reform the law on social protection to ensure cost-effectiveness, better targeting of assistance and the reduction of disincentives for women to work.</p> <p>Carry out a review of active labour market policies with a view to improving their coverage and targeting the long-term unemployed, women and youth.</p> <p>Improve school-to-work transitions through work-based learning and promoting the appeal of vocational professions.</p>	<p>PG 6 has been <b>partially implemented:</b></p> <ul style="list-style-type: none"> <li>• <b>Partial implementation:</b> Montenegro repealed benefits for mothers of three and more children (providing transitory solutions for women who left the labour market). The plan is (i) to redirect social funds to those mostly in need (i.e. an increase in child benefit and one-off benefits for new-borns, the merging of personal disability allowance and the allowance for providing care and assistance to other persons) and (ii) for active labour market policies. However, the plans are unclear and have not been properly designed yet.</li> <li>• <b>No implementation:</b> The Employment Agency has yet to demonstrate that a rigorous monitoring system is in place to trace users and anticipate needs and to ensure quality of the agency's action to help its users.</li> <li>• <b>Partial implementation:</b> Legislative amendments expanded the dual model of apprenticeship with the aim of ensuring a positive impact on the quality of training and of school-to-work transitions. Results of the implementation of the dual model are yet to materialise. It will crucial to ensure and carry out continuous and proper monitoring of this.</li> </ul>

## **ANNEX 2: COMPLIANCE WITH PROGRAMME REQUIREMENTS**

The Economic Reform Programme for the period 2018-2020 was adopted by the Government of Montenegro on 25 January 2018 and was submitted to the Commission on 31 January 2018. The programme is in line with the Medium-Term Budgetary Framework and the Budget Law.

### *Inter-ministerial coordination*

The preparation of the 2018 ERP was centrally coordinated by the Office of the Prime Minister and the Ministry of Finance. An inter-ministerial working group involving all relevant Ministries contributed to Chapter 4. Montenegro established a high-level competitiveness council, chaired by the Prime Minister, to monitor the implementation of the ERP priority reforms and of the joint policy guidance.

### *Stakeholder consultation*

The draft ERP was subject to an online public consultation between 15 December 2017 and 5 January 2018. A roundtable discussion with the stakeholders took place on 27 December 2017. The comments are included in the ERP, including how these were taken on board. The draft ERP was presented to the parliamentary committee for economy, finance and budget, attended however only by the deputies from the ruling coalition.

### *Macroeconomic framework*

The programme presents a clear and concise picture of past developments. Data coverage has improved and includes more detailed analysis on potential growth, external debt and productivity. However, data on the net international investment position is not yet available. The macroeconomic framework is sufficiently comprehensive and coherent. The baseline macroeconomic scenario is plausible, albeit slightly below the forecasts of international institutions. Major uncertainties and risks are not always clearly outlined and recognised or even absent as in the case of the possible continuation (announced by the government but not in the ERP) of the Bar-Boljare highway works beyond 2019. The programme also presents an alternative macro-fiscal scenario with a lower growth path.

### *Fiscal framework*

The fiscal framework is based on the presented medium-term macroeconomic scenario and is sufficiently comprehensive and integrated with the overall fiscal policy objectives, the state budget and fiscal strategy. Revenue and expenditure measures are explained clearly. However, important measures like the 40% buyback of the electric power company, or increasing the budget borrowing threshold were not included in the ERP. The programme does not present long-term projections of population trends and of the implications on health and pension systems. Further efforts would be needed to ensure ESA 2010 compatibility of fiscal data. Some discrepancies still remain between figures in the text and in some tables.

### *Structural reforms*

The structural reforms sections (4, 5 and 6) follow the guidance note. The reporting of the implementation of the policy guidance and the structural reform measures from the 2017-2019 ERP is both sufficient and up-to-date. The number of reform measures is limited to 20 and the page limit for section 4 is respected. The structure of the reform measures is good, in terms of scope and clarity of timeline and to some extent in terms of budget for activities planned in the three years of the programme. However, several measures have long implementation periods (e.g. measures 15, 16) spread over 5 to 6 years. Table 9 is lacking data, while tables 10-11 of the annex are filled in appropriately.