Public Disclosure Authorized

Public Disclosure Authorized

Document of The World Bank

FOR OFFICIAL USE ONLY

Report No.: 116690-ME

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

DOCUMENT FOR A PROPOSED FIRST FISCAL AND FINANCIAL SECTOR RESILIENCE POLICY-BASED GUARANTEE

IN THE AMOUNT OF EUR 80 MILLION

TO

MONTENEGRO

November 21, 2017

Macroeconomics and Fiscal Management Global Practice (MFM)
Finance and Markets Global Practice (F&M)
Poverty and Equity Global Practice (POV)
Western Balkan Unit (ECCWB)
Europe and Central Asia Region (ECA)

This document has a restricted distribution and may be used by recipients only in the performance of their official duties. Its contents may not otherwise be disclosed without World Bank authorization.

MONTENEGRO – GOVERNMENT FISCAL YEAR
January 1 – December 31

CURRENCY EQUIVALENTS
(Currency Euro, Exchange Rate Effective as of September 30, 2017)

Currency Unit	EUR
US$1.00	€0.846

Weights and Measures
Metric System

ABBREVIATION AND ACRONYMS

BRRD	Bank Resolution and Recovery Directive	IBRD	International Bank for Reconstruction and Development
CAD	Current account deficit	IFI	International Financial Institutions
CBM	Central Bank of Montenegro	IMF	International Monetary Fund
CFAA	Country Financial Accountability Assessment	LDP	Letter of Development Policy
CPF	Country Partnership Framework	MoF	Ministry of Finance
CRD	Capital Requirements Directive	MOH	Ministry of Health
DPF	Development Policy Financing	MTEF	Medium-Term Expenditure Framework
DPL	Development Policy Loan	NPL	Non-performing loans
EC	European Commission	PAR	Public administration reform
ECA	Europe and Central Asia	PBG	Policy Based Guarantee
ERP	Economic Reform Program	PEFA	Public Expenditure and Financial Accountability Assessment
EU	European Union	PFM	Public Financial Management
EUR	Euro	PFR	Public Finance Review
FDI	Foreign Direct Investment	PPP	Purchasing power parity
FMS/MOP	Family Material Support	PSD	Payment System Directive
FSAP	Financial Sector Assessment Program	SAI	State Audit Institution
FSDPL	Financial Sector Development Policy Loan	SEE	Southeast Europe
FSPBG	Financial Sector Policy Based Guarantee	SMEs	Small and medium enterprises
FX	Foreign Exchange	TA	Technical Assistance
GDP	Gross Domestic Product	UNDP	United Nations Development Program
GNP	Gross National Product	VAT	Value added tax
GoM	Government of Montenegro	WB	World Bank
		WHO	World Health Organization

Vice President:	Cyril Muller, ECAVP
Country Director:	Linda Van Gelder, ECCWB
Senior Practice Directors:	Carlos Felipe Jaramillo, GMFDR; Ceyla Pazarbasioglu-Dutz, GFMDR; Carolina Sanchez, GPVDR
Practice Directors:	John Panzer, GMFD2; Alfonso Garcia Mora, GFMD1;
Practice Managers:	Gallina Vincelette, GMF12; Mario Guadamillas, GFM03; Luis-Felipe Lopez-Calva, GPV03
Task Team Leaders:	Sanja Madzarevic-Sujster, GMF12; Cevdet Unal, GFM03; Trang Van Nguyen, GPV03

MONTENEGRO

FIRST FISCAL AND FINANCIAL SECTOR RESILIENCE POLICY-BASED GUARANTEE

TABLE OF CONTENTS

PROGRAM SUMMARY iv
1. INTRODUCTION AND COUNTRY CONTEXT 1
2. MACROECONOMIC POLICY FRAMEWORK 2
   2.1 Recent Economic Developments 2
   2.2 Macroeconomic Outlook and Debt Sustainability 6
   2.3 IMF Relations 9
3. THE GOVERNMENT'S PROGRAM 9
4. THE PROPOSED OPERATION 10
   4.1 Link to Government Program and Operation Description 10
   4.2 Prior Actions, Results and Analytical Underpinnings 10
   4.3 Link to CPF, Other Bank Operations and the WBG Strategy 19
   4.4 Consultations, Collaboration with Development Partners 19
5. OTHER DESIGN AND APPRAISAL ISSUES 20
   5.1 Poverty and Social Impact 20
   5.2 Environmental, Forests and other Natural Resource Aspects 22
   5.3 PFM, Disbursement and Auditing Aspects 23
   5.4 Monitoring, Evaluation and Accountability 24
6. SUMMARY OF RISKS AND MITIGATION 24
ANNEX 1. POLICY MATRIX 26
ANNEX 2. LETTER OF DEVELOPMENT POLICY 29
ANNEX 3. FUND RELATIONS ANNEX 35
ANNEX 4. ENVIRONMENT AND POVERTY/SOCIAL ANALYSIS TABLE 38
ANNEX 5. RATIONALE AND DETAILS OF THE PROPOSED POLICY-BASED GUARANTEE 39
ANNEX 6. SUPERVISORY MEASURES TAKEN AGAINST THREE BANKS WITH QUALIFIED AUDIT REPORTS 41
ANNEX 7. INDICATIVE TERM SHEET OF THE PROPOSED POLICY-BASED GUARANTEE 42

This operation is prepared by a Bank team consisting of Sanja Madzarevic-Sujster (co-TTL), Cevdet Unal (co-TTL), Trang Nguyen (co-TTL), Gianfranco Bertozzi, Manjola Malo, Biljana Kozlovic, Darjan Milutinovic, Zoran Anusic, Denis Mesihovic, Aleksandar Crnomarkovic, Svetlana Proskurovska, Jeff Chelsky, Boryana Gotcheva, Dorothee Chen, Josefina Posadas, Stefanie Brodmann, Maja Murisic, Esma Kreso, Dragana Varezic, Luz-Meza Bartrina, Neil Ashar, and Monica Restrepo. The team benefited from guidance from Linda Van Gelder (Country Director, ECCWB), John Panzer (Director, GMFD1), Gallina Vincelette (Practice Manager, GMF12), Mario Guadamillas (Practice Manager, GFM03), Luis-Felipe Lopez-Calva (Practice Manager, GPV03), Marco Hernandez and Timothy Johnston (Program Leaders), Tatiana Proskuryakova (former Country Manager) and Emanuel Salinas (Country Manager). The support by Boba Vukoslavovic, Mira Kovacevic and Nancy Davies-Cole is gratefully acknowledged.

PROGRAM SUMMARY

MONTENEGRO

FIRST FISCAL AND FINANCIAL SECTOR RESILIENCE POLICY-BASED GUARANTEE

Member Country	Montenegro
Implementing Agency	Ministry of Finance (MoF) of Montenegro will be responsible for the overall implementation of this operation.
Financing Data	IBRD Guarantee Amount: EUR 80 million
Operation Type	First in a Programmatic Series of two Policy-Based Guarantees (PBGs)
Pillars of the Operation and Program Development Objective(s)	The proposed First Fiscal and Financial Sector Resilience PBG supports government policy reform program for: (i) Strengthening Fiscal Sustainability; and (ii) Strengthening Financial Sector Resilience.
Result Indicators	1. Tax revenues as a share of GDP increased from 37.3 percent of GDP in 2016 to 38.5 percent of GDP in 2019 2. PEFA score on multi-year budget perspective improved from C+ in 2016 to B in 2019 and capital budget execution rate improved from 23 percent in 2016 to 75 percent in 2019. 3. General government wage bill as a share of GDP reduced from 13 percent in 2016 to 11 percent in 2019 4. Pharmaceutical spending reduced from 1.4 percent in 2016 to 1.3 percent of GDP in 2019 5. Pension and social benefit transfers as a share of GDP reduced from 12.9 percent of GDP in 2016 to 11.2 percent in 2019 and labor force participation increased from 54.5 percent in 2016 to 55.5 percent in 2019 6. Spending on items procured centrally reduced from 0.6 percent of GDP in 2016 to 0.5 percent of GDP in 2019. 7. Improved quality of loan portfolio by restructured loan amounts of at least EUR15 million and well capitalized banking sector with the solvency ratio staying above 10 percent by 2019 8. Three banks with qualified audit reports in 2015 maintain solvency ratios above 10 percent or intervened by 2019 9. The CBM receives quarterly financial reports from factoring companies by 2019 10. Improved banking supervision and resolution frameworks consistent with the Basel Core Principles and BRRD
Overall risk rating	Substantial
Climate and disaster risks	*Are there short and long term climate and disaster risks relevant to the operation?* *Yes* [ ] *No* [X]
Operation ID	PE-P161664

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
PROGRAM DOCUMENT FOR A FIRST FISCAL AND FINANCIAL SECTOR RESILIENCE POLICY-BASED GUARANTEE

1. INTRODUCTION AND COUNTRY CONTEXT

1. **This proposed first in a series of two Fiscal and Financial Sector Resilience Policy-Based Guarantees (PBG) to Montenegro of EUR 80 million supports reforms to strengthen public finance sustainability and financial sector resilience.** The proposed PBG series underpins the authorities' reform priorities for an orderly fiscal adjustment through increasing tax revenues, lowering public spending and strengthening medium-term and capital budget process to address external imbalances and rapidly rising public debt level. The program further supports the overhaul of the financial sector legislation to accelerate the resolution of non-performing assets, expand and strengthen the supervisory powers of the Central Bank, and enable proactive restructuring or resolution of ailing banks. These PBG-supported reforms contribute to preserving macroeconomic stability, improving investor confidence and crowding in private financing, thereby strengthening the resilience of the economy to shocks. This PBG program has been closely coordinated with international partners, including the International Monetary Fund (IMF) and the European Commission (EC), to ensure complementarities in policy support and technical assistance (TA). The objectives of the PBG are aligned with the key priorities of the World Bank Group Country Partnership Framework FY16–FY20.

2. **Close to a decade after the global financial crisis, Montenegro faces fiscal and financial sector vulnerabilities that hamper its economic growth prospects**. Since 2009, rapidly rising fiscal deficits on average at 5 percent of GDP, high current account deficit of 18 percent of GDP and high unemployment of 17 percent raise concerns over the sustainability and inclusiveness of the growth model. Borrowing to finance the deficit led to a steep increase in public and publicly guaranteed (PPG) debt to 71.4 percent of GDP in 2016 from 32.3 percent in 2008. The combined effects of the heavy debt burden partly due to large-scale public infrastructure investments, untargeted social programs, steady rises in public wages and pensions, and a narrow tax base threaten medium-term fiscal sustainability. While financial sector stability has improved since the global financial crisis, banks' profitability is low and uneven, and despite the sharp downward trend, the non-performing loans (NPL) ratio remains above the pre-crisis levels, with large variations across banks.

3. **The proposed operation supports a package of reforms that aims to stabilize public debt levels, boost investor confidence, mitigate the impacts of fiscal consolidation on the most vulnerable, and strengthen macro-financial supervision.** Reducing the deficit and stabilizing debt is of utmost urgency given the need to reassure financial markets with existing annual financial obligations amounting to 12 percent of GDP in 2019-2021. In the context of a euro-based economy, the Montenegro 2017-2020 Fiscal Strategy and the Government Economic Reform Program 2017-2019[1] are built on commitments to improve the fiscal outlook and strengthen the financial sector soundness to ensure that gains in poverty reduction are not achieved at the cost of prosperity of future generations. The proposed PBG supports fiscal sustainability and financial sector resilience, which as identified in the 2016 Systematic Country Diagnostic,[2] have fundamental impact on Montenegro's ability to accelerate and sustain growth and combat poverty.

4. **Without the reforms supported by this operation, the fiscal adjustment would be abrupt and likely harmful for the poor, judging from the poverty and inequality response after the global financial crisis**. The global financial crisis hurt the bottom 40 percent of the population slightly stronger than the average, with consumption of the former declining by 2.7 percent versus 2.2 percent of the latter

[1] As the European Union (EU) candidate member, Montenegro submitted the ERP to the European Commission (EC) as part of the economic governance surveillance.
[2] The 2016 Montenegro Systematic Country Diagnostic (www.worldbank.org/montenegro).

group during 2009–14. Although poverty in Montenegro has been on the decline since 2013[3] with the return of economic growth and increased transfers, the labor market has not seen robust improvements, in part due to potential work disincentives generated by the new mothers' benefit introduced in 2015.[4] Both the labor participation rate and employment rate remain low--at below 55 and 46 percent, respectively, with female rates well below those of men.

5. **A PBG would help Montenegro alleviate funding needs, while improving debt sustainability and financial sector stability.** With heightened roll-over risks in the external bond market in the coming years, and heavy domestic pressures (as reflected by short maturities and modest volumes), Montenegro would benefit from accessing alternative funding sources. The proposed PBG will be instrumental in diversifying Montenegro's funding sources, improving the ability to mobilize financing from the private sector on competitive terms (particularly to extend maturities beyond the usual four years) to better support the 2018 budget financing needs and the 2019-21 liability management. These objectives are defined in the Fiscal Strategy 2017-2020. The fiscal consolidation program under implementation and the strengthened regulatory framework in financial and public finance management areas have important direct impact on de-risking the country to attract investors and leverage World Bank resources. This sentiment has been broadly echoed by market partners that engaged with the government and the Bank in a market sounding analysis in September 2017. It is also being reflected in an improved outlook given by two credit rating agencies in September and early October 2017.

6. **The risk assessment for the proposed series of two policy-based guarantees is high.** Macroeconomic, political and governance risks are assessed as high; social and stakeholders' risks are substantial. These risks stem from political pressures associated with the implementation of the proposed reforms in a current minority coalition government that came in power in November 2016. Some affected stakeholders, like mothers of three and more children, have expressed discontent with the reforms. The authorities have adopted a set of compensatory measures to mitigate the impact of the withdrawn lifetime mothers' benefit, declared as unconstitutional. Several downside macroeconomic risks can affect the results of the operation, associated with (i) potential worsening of financing conditions and EUR depreciation due to further tightening of US monetary policy; (ii) growth shock related to the deterioration in the external (including EU) prospects and geopolitical tensions; and (iii) potential delays in the implementation of consolidation measures, and accumulation of new contingent liabilities. If these scenarios would materialize the public debt would grow close to 93 percent of GDP by 2020, threatening an orderly refinancing of the large debt liabilities coming due in 2019-2021. The financial sector is exposed to non-systemic risks through vulnerabilities in some domestically owned banks; yet, these risks are mitigated by supervisory measures and the high level of capital in the system. Support provided by all international partners should help ensure commitment for implementing an ambitious reform program. The proposed operation has modest positive environmental impact and climate change mitigation co-benefits in terms of reducing local air pollution or impacts thereof and contributing to the gradual shift towards less emission-intensive sources of energy.

2. MACROECONOMIC POLICY FRAMEWORK

2.1 RECENT ECONOMIC DEVELOPMENTS

7. **Montenegro is a small, service-based economy, with a GDP of approximately $4.4 billion in 2016.** Trade of goods and services makes up 103 percent of GDP, with services accounting for about 60 percent of economic activity and tourism (along the Adriatic coast) playing a key role within the service sector. Industry, including energy, mining and manufacturing comprise about one tenth of the total economy and 40 percent of exports, concentrated in metals exports. Agriculture makes 8 percent of the economy. It is a significant source of income, especially in the poorer northern region of the country.

[3] Poverty measured as consumption below the international middle-income-country poverty line of $5.5/day 2011PPP is estimated to have declined from 8.7 percent in 2012 to an estimated 4.3 percent in 2016.

[4] Through the amendments to the Law on Social and Child Protection in 2015 a new lifetime benefit for mothers with three or more children was introduced leading to major withdrawal to inactivity of all age female groups. The program amounted to 1.9 percent of GDP a year and was assessed as unconstitutional by the Constitutional Court of Montenegro in April 2017.

Montenegro is a highly import dependent economy, relying heavily on capital inflows to support growth, and as such is vulnerable to external shocks.

8. **Montenegro's macroeconomic policy track record over the last decade has been mixed.** From the early 2000s until independence in 2006, Montenegro unilaterally introduced the euro as its currency, gradually improved macroeconomic stability. Prior to the global financial crisis, Montenegro was one of the fastest growing non-oil exporting economies in the region, with rising employment and incomes. Yet, growth of over 6 percent on average per year in period 2004-2008 was fueled by external demand and capital inflows particularly to tourism, real estate and the banking sectors.

9. **The global financial crisis ended the period of economic boom with a real estate and credit bubble bust**. Sharp reversal in capital flows dried up credit to the private sector, investment collapsed and the economy contracted 5.8 percent in 2009. With the collapse of both external and domestic demand, the economy went through large rebalancing. The most affected sectors by the credit crunch were the metal industry, construction and financial activities. NPLs rose to above 25 percent by June 2011 and the profitability of banks declined as provisioning needed to be increased. Fiscal policy played a counter-cyclical role, but government revenues declined more than discretionary spending. Large fiscal deficits led to the doubling of the public debt as a share of GDP within four years. Collapse in domestic demand led to imports shrinking more than exports, with the current account deficit (CAD) narrowing from about half of GDP in 2008 to 23 percent in 2010. After a brief recovery in 2010-11, Montenegro faced a second recession, triggered by tightened global financial and adverse weather conditions in 2012 (Table 1). The steel mill went bankrupt, and the production by the loss-making Aluminum Company KAP was largely curtailed. In 2013, the government had to repay guarantees issued to KAP (3 percent of GDP), increasing the fiscal deficit and debt.

Table 1. Montenegro: Recent Economic Developments, 2010-2016 (percent of GDP)

	2010	2011	2012	2013	2014	2015	2016
Real GDP growth (%)	2.7	3.2	-2.7	3.5	1.8	3.4	2.9
Consumer prices (period average, %)	0.5	3.1	4.1	2.2	-0.7	1.5	-0.2
Gross national savings	-1.0	1.8	2.1	5.1	5.0	6.9	8.0
Gross investment	25.2	22.7	22.8	24.3	23.3	25.2	31.3
Unemployment rate	19.6	19.7	19.8	19.5	18.0	17.6	17.7
Fiscal sector							
Revenues and grants	42.2	39.5	40.9	42.3	44.6	41.5	42.5
Expenditures	46.7	44.6	46.8	46.9	47.7	48.8	45.6
Primary balance	-3.6	-3.7	-4.0	-2.4	-0.9	-4.9	-1.0
Overall balance	-4.6	-5.1	-5.8	-4.6	-3.1	-7.3	-3.1
Public Debt	50.7	57.2	65.4	66.0	67.1	73.7	71.4
o/w Public guarantees, % of GDP	10.0	11.7	12.0	8.5	7.2	7.5	7.0
External sector							
External Debt	141.7	145.0	155.9	155.9	163.4	161.9	160.9
o/w Private debt, % of GDP	102.4	100.7	103.2	104.8	108.3	98.6	101.1
Current account balance	-22.5	-17.6	-18.5	-14.5	-15.2	-13.2	-18.1
Foreign Direct Investment (net)	17.7	11.9	14.5	9.6	10.2	16.9	9.4

Note: Retroactive changes to the fiscal numbers are due in 2018 as the country aligns its fiscal statistics with the ESA2010. This will affect the general government coverage. Public debt does not include arrears of the local government amounting to 3.6 percent of GDP at end-2016.
Source: MONSTAT, Ministry of Finance and Central Bank of Montenegro; IMF; WB Staff estimates.

10. **The social impact of the global financial crisis was significant.** The share of population living below the international middle-income-country poverty line of $5.5/day 2011PPP increased from 3.3 percent in 2008 to 8.7 percent in 2012. The poverty gap similarly increased. Unemployment increased to close to 20 percent by 2012, with a low level of participation (at 50 percent) and a growing share of long-term unemployed. Although unemployment rates between men and women were similar, the female labor force participation was significantly lower (13 percentage points) than that of males.

11. **At the expense of further indebtedness, the economy began recovery in 2013 and has by now regained the output lost since 2008.** Average annual GDP growth in 2013-2016 was just under 3 percent, largely backed by buoyant growth in construction, retail and tourism. Aiming to connect the underdeveloped North of the country with the fast-developing South and to stimulate growth that lost traction, in 2015 the government embarked on a large public-sector investment of the Bar-Boljare highway (Box 1). Additionally, ahead of the general elections in 2016, it boosted personal consumption through the introduction of mothers' benefits,[5] a 10-percent rise in public sector wages and a 20-percent rise of the minimum pension. This led to further poverty reduction to below 5 percent,[6] yet without sustained improvements in the labor participation rate. These interventions increased public debt to above 71 percent of GDP and set it on a rising trajectory for the medium term.

Box 1. Bar-Boljare Highway

The largest investment in the Montenegrin history, the Bar-Boljare Highway is a project to connect port of Bar to the road network of Serbia in the north passing through the underdeveloped northern region. The 160-kilometer Bar-Boljare highway would provide a link to the Pan-European Corridor XI.

In October 2014, the Government and China EXIM Bank signed a financing contract for the construction of the highway section of 41 km amounting to equivalent EUR 687 million (the loan is in USD). The overall cost of the construction, per the contract with the China Roads and Bridges Corporation signed in February 2014, amounts to EUR 809.6 million, or 23 percent of GDP of that year. The Law on Highway enacted by the Parliament in November 2014 allows for a full tax exemption of civil works, labor, and highway-related import by the Chinese construction companies.

The works started in 2015 and are set to end in 2019. Domestic firms are expected to contract around 30 percent of the overall project cost. It is estimated that approximately 4,000 new workers will be employed over the course of the construction period. As per the IMF estimate, total GDP including the highway in 2023—the year with the largest difference—would be about 4¼ percentage points of 2014 GDP higher than without it. Growth thereafter would be slightly lower in the scenario with the highway because the higher capital stock would imply larger depreciation.

12. **The recent investment and consumption growth led to a renewed widening of the CAD.** After reaching historical lows of 13.2 percent of GDP in 2015, the CAD widened to 18 percent in 2016 on the back of rising construction-related imports and large dividend payouts. Growth in tourism and transport revenues were not enough to offset the double-digit surge in imports, largely on the back of machinery and equipment for the highway and windmill construction. The trade deficit continued to deteriorate, to 42 percent of GDP, while net FDI declined in 2016 to a pre-independence low of 9.4 percent. Supported by buoyant tourism and moderation of imports, by June 2017, both CAD as well as net FDIs slightly improved, to 16 and 10 percent on a four-quarter basis, respectively, with net FDIs covering two-thirds of the CAD financing. Yet, external debt remains high at above 160 percent of GDP, increasing the vulnerability to any changes in the external financing conditions.

13. **The Government, elected in November 2016, adopted an ambitious fiscal consolidation strategy to contain fiscal risks.** Although the general government deficit declined to 3.1 percent of GDP in 2016 from 7.3 percent in 2015, mostly on the back of under-execution of the highway capital budget, it was clear that a sharp rise in non-discretionary spending had to be reversed. In December 2016, the government adopted a package of measures amounting to 3 percentage points of GDP. The Fiscal Strategy for 2017-2020 adopted in June 2017 further deepens the consolidation efforts. It proposes an adjustment of additional 3.2 percentage points of GDP (or 2.2 percentage points of GDP once netted out for regular pension indexation, NATO spending requirements and other one-off costs). When compared to the small states of the EU[7], the total level of public spending in Montenegro remains seven percentage points of

[5] Amendments to the Law on Social and Child Protection in 2015 stipulated that mothers with (i) three children and 25 years of work and social insurance record or (ii) more than three children and 15 years of work and insurance, were entitled to a monthly benefit equivalent to 70 percent of the average net wage in the previous year (EUR 336 in 2016). In addition, mothers with three or more children who have been registered as unemployed with the Employment Agency for at least 15 years were entitled to 40 percent of the average net wage (EUR 192 in 2016).

[6] Measured as consumption below the international middle-income-country poverty line of $5.5/day 2011PPP.

[7] Estonia, Cyprus, Latvia, Lithuania, Malta, and Slovenia.

GDP higher than of the EU small states (40 percent of GDP) in 2016, while the wage bill at 13 percent of GDP is about two percentage points of GDP higher. Further, public sector employment in Montenegro at 30 percent is also above the share for the small EU states (at 25 percent). Current transfers as well as capital spending are also well above the EU small states averages.

14. **The implementation of the Fiscal Strategy aims to bring the fiscal deficit target down to 4 percent of GDP in 2017** from over 6 percent in the original budget (Table 2). The measures adopted so far, most of which are also part of this proposed PBG-1, are more weighted on the revenue side when judged by the savings gains, while as the program materializes permanent savings on the expenditure side gain prominence:

- *On the revenue side*: (i) a rise in excises on oil, tobacco, sugary drinks, and alcohol; (ii) an introduction of a new excise on coal; (iii) a reduction in VAT exemptions; (iv) an increase in the VAT rate (from 19 to 21 percent); and (v) collection of tax arrears and fiscalization;
- *On the spending side:* (i) initially a 25-percent reduction of the amount of the mothers' benefit, but then abolishment of the benefit with a rise of means-tested child benefits by 20 percent); (ii) an 8 and then additional 6-percent reduction in wages of public sector officials; (iii) a one percent reduction of civil servants' wages, except for lower grades; (vi) a reduction of public sector wage bonuses; and (vii) an introduction of the centralized procurement. The Strategy further proposes pharmaceutical, public administration, as well as the pension reform, to be supported by DPF/PBG-2, to improve efficiency and reduce long-term fiscal risks.

Table 2. Operations of the General Government (Percent of GDP)[1/]

	Actual		Projection		
General Government, % of GDP	**2016**	**2017e**	**2018f**	**2019f**	**2020f**
Total revenues	**42.5**	**42.0**	**43.1**	**42.4**	**42.0**
Tax revenue	37.3	37.8	38.7	38.4	38.0
Non-tax revenue	4.7	3.3	3.6	3.5	3.4
Grants	0.4	1.0	0.8	0.6	0.6
Total expenditures	**45.6**	**46.5**	**45.6**	**43.2**	**40.0**
Current expenditures	41.3	38.0	36.3	35.0	35.0
Wages and salaries	12.9	11.9	11.2	10.8	10.7
Goods and services	5.8	4.6	4.6	4.4	4.4
Interest	2.2	2.4	2.4	2.4	2.5
Subsidies and transfers	20.5	19.1	18.2	17.4	17.4
Capital expenditure[2/]	4.3	8.6	9.3	8.2	5.0
Net lending	0.0	0.0	0.0	0.0	0.0
Overall balance	**-3.1**	**-4.5**	**-2.5**	**-0.7**	**2.0**
Primary balance	-1.0	-2.1	-0.2	1.6	4.5
Public debt with guarantees	**71.4**	**76.7**	**78.2**	**77.2**	**72.3**
o/w Guarantees	7.0	7.7	7.3	7.0	6.7
GDP (EUR million)	3,954	4,219	4,466	4,666	4,853

1/ Fiscal and growth projections presented assume the consolidation package adopted by the Government in June 2017. Retroactive changes to the fiscal numbers are due in 2018 as the country aligns its fiscal statistics with the ESA2010. Data are presented on a modified accrual basis. Government arrears (at 5 percent of GDP in 2016) are not recorded under the public debt numbers.
2/ IMF adjusts capital spending for the USD:EUR exchange rate movements for the highway contract, which raises spending and deficit levels. It also assumes additional capital and social spending for 2020. The authorities have hedged the exchange rate for the construction contract, but have not hedged the exchange rate for the loan agreement.
Source: Ministry of Finance; WB Staff projections.

15. **While the financial sector has largely recovered from the impact of the global financial crisis, vulnerabilities remain.** The financial system is bank-centric, with 15 banks operating currently in a small market. While the banking sector remains liquid and well capitalized with a capital adequacy ratio of 16.6

percent, profitability is low and uneven among banks. Following the burst of the asset bubble in 2008, asset quality in the Montenegrin banks deteriorated, with the NPL ratio peaking at above 25 percent in June 2011. Credit contracted sharply, too. After four years of 4 percent on average contraction during 2009-12, credit recovery is slowly gaining pace. Deposits have seen a growth 8 percent a year since 2012, being the main funding strategy for the local banks, as parent banks deleveraged. The credit to deposit ratio declined from its peak of 167 percent in April 2009 down to 86 percent in August 2017. The level of NPLs is being continuously reduced thanks to the sale of non-performing assets to factoring companies and write-offs. Yet, despite the downward trend, the NPL ratio remains above the pre-crisis levels, and concentrated in small number of banks.

2.2 MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

16. **With unilateral euroization, Montenegro relies on fiscal policy and structural reforms to maintain flexibility, macroeconomic stability and ability to respond to shocks.** Montenegro's macroeconomic framework is based on: (i) the government's medium-term Fiscal Strategy for 2017-2020, (ii) the macro prudential policies by the Central Bank of Montenegro, and (iii) the government reform program outlined in 2017-2019 Economic Reform Program (ERP).

17. **The economic outlook is moderately positive with an annual average growth at around 2.5 percent between 2018-2020** (Table 3). Fiscal adjustment measures are estimated to have a modest negative impact on growth (assuming a multiplier of -0.5).[8] Investment (including the Bar-Boljare highway, and private investment in energy and tourism) will be the main driver of growth initially, which will then be replaced by services exports and personal consumption, once the highway and large tourist resorts are finalized in 2020. Job creation will support more sustainable growth of household consumption and partially compensate the consolidation drag on disposable incomes. Inflation is projected at 2.3 percent on average throughout 2017-2020, affected by the rise in excises and the VAT early in the projection period. Poverty (measured at US$5.5 in 2011 PPP) is projected to decline to 4.8 percent by 2019, subject to private sector employment rebound, including in construction and tourism.

18. **The medium-term fiscal framework, as adopted in the Fiscal Strategy, aims for balanced budget, setting the public debt of Montenegro on a downward trajectory.** With highway spending set to increase substantially in 2017-19, the overall deficit will remain high until the recently adopted reforms bring savings and the highway construction comes to an end in 2019. With the implementation of the envisaged public administration, social, health and pension reforms, the government is expected to enhance control over public finances and reach primary budget surplus by 2019. This would mostly be supported by the reduction of general government spending from its peak of 46.5 percent in 2017 to 43 percent of GDP by 2019. Further, as the highway section construction ends, and capital spending is halved, the primary surplus in 2020 rises further to above 4 percent of GDP, just at the time that a past bond, amounting to 12.4 percent of GDP, comes for redemption. Correspondingly, public debt (with guarantees) would decline from 77 percent in 2017 to 72 percent by 2020. Faster reduction of public debt would be hampered by the increasing share of the USD-denominated debt linked to the highway construction.

19. **External imbalances are set to narrow once the construction slows, but will remain high**. As imports for the highway construction taper off, the current account deficit should narrow to below 17 percent of GDP by 2020, from its peak of close to 19 percent in 2018. A growth in exports of steel, aluminum and pharmaceuticals as well as of transport and tourism services are projected to remain strong without any expected terms of trade turbulences. Yet, without further rise in factor productivity and competitiveness, external imbalances are set to stay high. FDIs are set to grow over the next two years to above 11 percent of GDP as recapitalization of banks complies with the new regulatory framework, and as the new tourism capacities attract new investors. Diversification of the sources of growth through strengthening backward linkages of the tourism sector would be required to increase the multiplier effect of the sector. With the continued strengthening of the financial sector and gradual firming of economic

[8] IMF (2017). Montenegro–-Staff Report for the 2017 Article IV Consultation.

activity and incomes, national savings are projected to gradually rise to an average of 9 percent of GDP in 2018-2020, reducing somewhat the reliance on foreign savings.

Table 3. Montenegro: Macroeconomic Outlook, 2016-2020 (percent of GDP)

	2016	2017e	2018f	2019f	2020f
Real GDP (% change)	2.9	4.2	2.8	2.5	2.1
Contributions					
Consumption	4.5	3.0	1.3	2.1	2.7
Gross Fixed investment	6.1	2.4	2.3	0.2	-0.9
Net exports	-7.6	-1.2	-0.8	0.2	0.3
Unemployment rate	17.7	17.0	16.6	16.1	16.1
CPI period average	-0.2	2.3	3.1	2.1	1.6
Fiscal accounts	*(Percent of GDP unless otherwise indicated)*				
Expenditures	45.6	46.5	45.6	43.2	40.0
Revenues	42.5	42.0	43.1	42.4	42.0
General government balance	-3.1	-4.5	-2.5	-0.7	2.0
Primary balance	-1.0	-2.1	-0.2	1.6	4.5
Public debt	64.4	69.0	70.9	70.2	65.6
Public debt and guarantees	71.4	76.7	78.2	77.2	72.3
Monetary indicators	*(Annual percentage change unless otherwise indicated)*				
Broad money growth	9.5	-	-	-	-
Credit to non-government	0.3	3.4	4.2	3.0	2.6
Balance of payments	*(Percent of GDP unless otherwise indicated)*				
Current account balance	-18.1	-18.6	-18.0	-17.0	-16.5
Imports of G&S	62.9	62.0	61.5	60.6	60.0
Exports of G&S	40.5	39.3	39.6	40.0	40.2
Foreign direct investment (net)	9.4	11.4	11.6	11.1	9.5
Gross reserves in months of G&S	4.7	-	-	-	-
External debt	160.9	163.4	166.7	166.3	161.9
Other memo items					
Nominal GDP (in millions of EUR)	3,954	4,219	4,466	4,666	4,853
Nominal GDP (in millions of US$)	4,377	4,688	4,962	5,185	5,392

Note: Fiscal and growth projections presented in the table are largely aligned with the Montenegro Fiscal Strategy 2017-2020, but show more gradual consolidation path. Retroactive changes to the fiscal numbers are due in 2018 as the country aligns with the ESA2010. Private external debt is not officially published and therefore present an estimate.

Source: MONSTAT, Ministry of Finance and Central Bank of Montenegro; IMF; WB Staff estimations and projections.

20. **External financing needs for 2018-2020 will amount to about 30 percent of GDP a year, gradually increasing as large repayments come due** (Table 4). The government financing needs (deficit and debt repayment) will increase in 2019, with the Eurobond due adding alone 9 percent of GDP. Without the recently adopted fiscal consolidation program, PPG debt would hit 81 percent of GDP by 2019, just at the time when the country will need to return to markets for the Eurobond refinancing. With the planned fiscal strategy, total financing needs in 2019 would amount to 13 percent of GDP. The proposed PBG-1 amounting to 1.8 percent of GDP aims to attract private sector interest for a lending up to 5 percent of GDP (Annex 6). This would support the 2018 budget financing needs and the 2019-21 liability management. The new Medium-Term Debt Management Strategy is being prepared with the IMF support focusing on the liability management.

Table 4. External Financing Requirements and Sources (percent of GDP)

	Outturn	Projections			
	2016	**2017e**	**2018f**	**2019f**	**2020f**
Requirements	34.8	28.0	26.5	31.3	33.1
Current Account Deficit	18.1	18.6	18.0	17.0	16.5
(of which scheduled interest payments)	5.2	5.1	4.8	4.6	4.5
Principal Repayments	12.6	5.9	5.6	11.8	14.4
Official creditors	1.7	1.8	1.7	1.6	1.6
Banks	5.3	1.2	0.6	7.9	10.9
Other private	5.7	2.9	3.3	2.2	2.0
Increase in net official reserves	4.1	3.4	2.9	2.5	2.2
Sources	34.8	28.0	26.5	31.3	33.1
Foreign Investment (net)	9.4	11.4	11.6	11.1	9.5
Portfolio Investment (net)	-0.5	-0.5	-0.5	-0.5	-0.6
MLT Disbursements	14.7	14.8	13.4	18.8	22.2
Official creditors	0.6	3.2	3.0	2.9	2.8
Banks	7.6	8.7	6.9	9.6	7.8
Other private	6.4	2.9	4.9	6.2	11.6
Short-term & other capital (net)	11.2	2.2	2.1	2.0	1.9

Source: MONSTAT, CBCG, MOF, staff calculations.

21. **Montenegro's public debt including guarantees is projected to decline to 72 percent of GDP by 2020; yet this scenario is associated with high downside risks.** The risks to the baseline scenario are associated with (i) further tightening of US monetary policy and euro depreciation; (ii) deterioration in the external environment including a weaker EU outlook and regional geopolitical tensions; and (iii) potential delays in implementation of consolidation measures, or accumulation of new arrears/activation of contingent liabilities. Given the large part of the debt is in US$, a 15-percent euro depreciation would push public debt close to 83.4 percent of GDP by 2020, while with higher interest rates, public debt would grow to close to 80.2 percent of GDP. Under a lower GDP growth scenario public debt would rise above 81 percent by 2020, while combined risks would push public debt to 92.9 percent of GDP by 2020 (Figure 1).

22. **Total external debt is projected to decline to 162 percent of GDP by 2020, from the peak of 167 percent of GDP in 2018** (Figure 2). However, projections remain highly sensitive to changes in macroeconomic assumptions; lower growth, as per the government lower-growth scenario in the ERP, and implicit interest rate shocks (of 30 percent rise) would push external debt to 171 percent and 165 percent of GDP, respectively. Yet, external debt is most sensitive to the CAD shock which if restored to historical values of average 22 percent of GDP, would push the debt close to 187 percent of GDP.

Table 5. Scenario Analysis–Montenegro's Public and Publicly Guaranteed Debt (percent of GDP)

	2016	**2017e**	**2018f**	**2019f**	**2020f**
Baseline	71.4	76.7	78.2	77.2	72.3
Higher interest rate	71.4	78.5	81.9	83.0	80.2
Lower growth	71.4	79.3	81.8	83.2	81.2
15% US$ Depreciation	71.4	88.3	89.5	88.4	83.4
Combined shock	71.4	82.2	87.8	92.2	92.9

Note: Baseline scenario reflects the government current fiscal and macro scenario. One-time real devaluation of 15 percent in 2017; Growth shock scenario implies low-growth scenario as per the Government Economic Reform Program (ERP) of average 1.7 percent in 2017-20. Interest rate scenario assumes a rise in interest rates by 300 basis points. Combined shock assumes no fiscal consolidation takes place, combined with lower growth and higher interest rate.
Source: WB Staff projection

Figure 1. Public Debt Sustainability

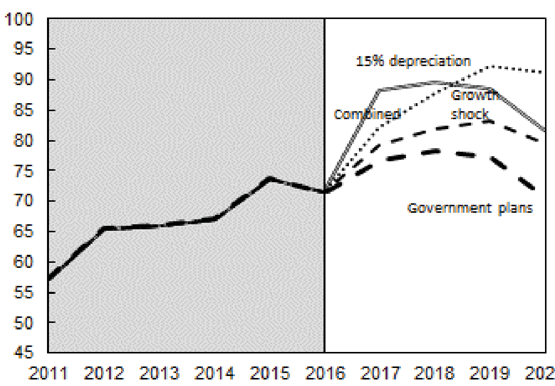
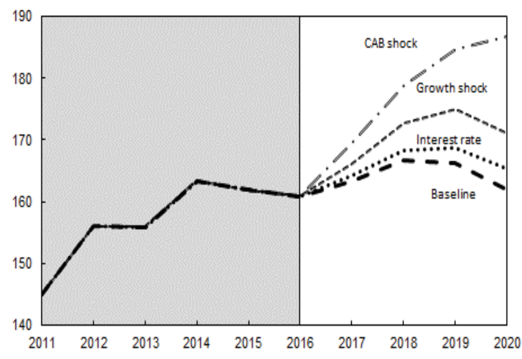


Figure 2. External Debt Sustainability



Source: Staff calculations.

23. **The macroeconomic policy framework, although subject to high risks as described above, is considered adequate for policy lending.** The authorities have already adopted the most difficult policies from the fiscal consolidation package. Staff considers the fiscal trajectory proposed by the government and incorporated in the draft 2018 budget appropriate to ensure a steady improvement in Montenegro's fiscal and public debt positions.

2.3 IMF Relations

24. **The IMF and the Bank collaborate closely to support the Government in expenditure-led fiscal consolidation, improving tax administration and financial sector reforms.** The IMF provides policy advice and analysis through its surveillance and technical assistance on monetary and exchange rate policies, tax policy, financial sector stability, and the debt management. The Article IV consultations with Montenegro were concluded on September 8, 2017.

3. THE GOVERNMENT'S PROGRAM

25. **Strengthening public finances and supporting recovery are the core priorities of the Government's reform agenda**. Following Parliamentary elections in 2016, the Government adopted the Economic Reform Program (ERP) for 2017-2019 in January 2017 recognizing that economic growth and convergence with the EU countries is unlikely to happen if not accompanied by structural reforms to strengthen competitiveness and ensure macroeconomic stability. The Government also publicly emphasized that renewed growth will not be achieved without the restoration of private sector confidence and private investment, both of which have been hampered due to growing fiscal vulnerabilities. Further, in June 2017, the Parliament has enacted the Fiscal Strategy for 2017-2020 that sets a medium-term consolidation program. The government program receives broad support from political and social partners, as well as the international community.

26. **Over the medium term, the ERP priorities are set at strengthening macroeconomic stability and improving competitiveness.** The first set of priorities is aimed to be addressed through consolidation of public finances and strengthening the stability of the financial sector. Complementing past efforts to improve compliance, the authorities are committed to further step up efforts in tax collection; introducing fiscalization and enforcing better compliance of businesses with regard to issuance of VAT receipts and tax payments. The authorities are committed to further strengthening public finances by switching to accrual accounting, introducing three-year rolling budgets, strengthening program and capital budgeting. Addressing structural weaknesses and deficits in public administration, health and social sectors tops the reform agenda. Beyond fiscal consolidation, the ERP outlines the need to continue strengthening its financial sector and business environment. Strengthening the independence and the supervisory powers of the Central Bank, incentivizing banks to resolve the non-performing assets and addressing weaknesses of the ailing banks would benefit growth and convergence.

27. **The EU accession negotiations have given a new impetus to reform.** The 2017-19 Economic Reform Program, submitted to the EU as part of the economic governance surveillance process for the

candidate countries reinvigorated the earlier outlined priorities of: (i) strengthening of fiscal stability; (ii) preserving the predictable and competitive tax system; (iii) strengthening of the physical infrastructure; (iv) systemic reduction of informality; (v) strengthening support for small and medium-sized enterprises with diversification of the production and export bases; (vi) development of human resources and increasing flexibility in the labor market; (vii) strengthening social inclusion; and (viii) further strengthening the rule of law.

4. THE PROPOSED OPERATION

4.1 LINK TO GOVERNMENT PROGRAM AND OPERATION DESCRIPTION

28. **This proposed DFP/PBG program supports reforms to safeguard fiscal sustainability and make the financial sector more resilient to potential shocks.** These reforms are consistent with the government's Fiscal Strategy 2017-2020 and the Economic Reform Program for 2017-2019 as outlined above. The proposed operation is the first one in a series of two programmatic loans organized under two pillars (i) strengthening fiscal sustainability; and (ii) strengthening financial sector resilience, that underpin and inform the government reform agenda. The reforms supported by this operation enjoy coordinated support from the EC, the IMF and the World Bank, including with targeted TA.

4.2 PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS

Pillar 1: Strengthening Fiscal Sustainability

29. **Significant fiscal vulnerabilities have emerged since 2015.** The Government is taking steps to reduce the fiscal deficit by adopting in December 2016 a five-year plan for rehabilitation of public finances, and the Fiscal Strategy for 2017-2020 with additional measures to reach stabilization of public debt ahead of the large refinancing needs in 2019-21. Addressing the near-term fiscal risks is the core of the support through the PBG-1. Implementing policies to increase the quality of the fiscal adjustment is also part of this pillar. The overall fiscal adjustment supported by the first operation (PBG-1) amounts to 3 percent of GDP and is evenly split between raising new tax revenues and reducing excessive spending given the urgency to tame deficit and debt rise (Table 6). For the second loan in the series, the focus will be on removing the longer-term risks in pension, labor, health and public administration sectors, supporting permanent reduction in expenditures in these categories

Table 6. Fiscal Impact of the Supported Policy Measures by PBG-1, Percent of GDP

Policy Measure	Fiscal savings 2017-2018
Increase in excises on tobacco, sugary drinks, coal, alcohol	1.13
VAT rate increase to 21% from 19%	0.98
Abolishment of mother's benefit and increase in child benefits	0.52
Further reductions in wages, including 6-percent for officials, 1-percent for civil servants, and the rationalization of supplements	0.24
Pharmaceutical reform	0.11
Total	**2.98**

Prior Action 1: *To improve revenue collection, the Member Country has: (i) increased the statutory rate of the value-added tax from 19 percent to 21 percent, through the amendment of the Law on Value Added Tax; (ii) increased the excise tax rates on tobacco products, alcohol, and sugary drinks and introduced a new excise tax on coal through the amendments to the Law on Excises.*

30. **To meet its medium-term consolidation goals on the revenue side, several taxes have been raised.** At 37.3 percent of GDP, tax revenues are above the comparable level of the EU small states comparators; yet, below the average for the EU28 (at 40 percent of GDP in 2016). To strengthen revenue collection and meet medium-term fiscal targets to stabilize public debt, in July 2017 the Parliament: (i) increased the statutory rate of the value-added tax (VAT) from 19 percent to 21 percent, through the amendment of the Law on Value Added Tax (Official Gazette 50/2017 as of July 31, 2017); (ii) increased

the excise tax rates on tobacco products, [9] alcohol, [10] and sugary drinks[11] (OG 50/2017 as of July 31, 2017); and (iii) introduced a new excise tax on coal[12] (OG 50/2017 as of July 31, 2017). The rise in the VAT rate from 19 to 21 percent still leaves Montenegro as a country with moderate tax rate when compared to its EU peers.[13] The rise in excise taxes affects products with adverse health effect (tobacco, sugary drinks and alcohol). Additionally, since burning of coal in Montenegro contributes to local pollution and imposes health costs on the population, the excise on coal will have positive environmental impact in terms of reducing local air pollution and related adverse health impacts, with very limited social impact given a very low use of coal among households. Moreover, given that the energy sector is the major source of GHG emissions in Montenegro, the excise on coal will help incentivize the transition toward sustainable and cleaner energy mix, thereby contributing toward achieving the country's climate change mitigation targets and commitments. Even though the excise on coal will gradually increase from EUR 0.15 per Gigajoule to EUR 0.30, given that the implicit coal subsidies are estimated at as much as 14 percent of GDP[14], the excise at this level will still leave the price of coal well below its true costs (including those related to local pollution and climate change impacts), thereby limiting its positive effects. These tax reforms are adopted in line with the increased revenue collection objective of the government, while improving efficiency and maintaining equity in the system. These efforts are consistent with the trends and requirements by the EU related to excises.

31. Going forward, as part of the DPF/PBG-2, the authorities aim to introduce electronic fiscalization of all cash and non-cash transactions to reduce undeclared turnover and thus income. These measures would lead to increased revenue collection from tourism and catering services, as well as reduce the compliance costs with the VAT returns.

Expected result: Tax revenues as a share of GDP increased from 37.3 percent of GDP in 2016 to 38.5 percent of GDP in 2019.

Prior Action 2: *To strengthen its public finance management, the Member Country has: (i) introduced a three-year rolling budget through the amendments to the Law on Budget and Fiscal Responsibility; and (ii) adopted a Decision on Program Budgeting.*

32. **Prior Action 2 aims to support the introduction of a three-year rolling budget and strengthening of program budgeting.** Currently, the Guidelines of Macroeconomic and Fiscal Policy developed each year for a three-year period include medium-term budgetary framework and expenditure limits. But further improvements are needed along the lines of making the medium-term budgetary framework more credible, incorporating more analysis into the budget process, consideration of medium-term plans to incur multi-annual commitments and introduce a three-year rolling budget. The Parliament has enacted the amendments to the Budget and Fiscal Responsibility Act in October 2017 to introduce three-year rolling budget. Program budgeting lacks a number of elements necessary to achieve its objectives, including monitorable performance indicators. The adoption of a Decision on Program Budgeting in November 2017 aims to strengthen development of sub-programs, and determine and measure appropriately objectives and performance indicators across budget programs.

33. Under the DPF/PBG-2, given weaknesses in fiscal reporting and transparency, advancing the implementation of accrual accounting and financial reporting through enactment of the Law on Public Sector Accounting will be key to enhancing the robustness of the annual budget. In collaboration with SlovakAid, the MoF has been working on the preparation of financial reporting action plan, which aims to set the roadmap and sequence of reform steps, that should be adopted by the end of 2017. In addition,

[9] An increase in specific excise in 2017 from 22€/kg to 30€/kg and proportional to 32 percent, an increase in the specific excise to 40€/kg in 2018, an increase to 50€/kg in 2019.

[10] Excise tax on ethyl alcohol increased from July 1, 2017 from €650 per hectoliter of pure alcohol to €850, in 2018 from €850 to €1050, in 2019 from €1050 to €1250, and in 2020 from €1250 to €1500.

[11] Excise on carbonated water with added sugar will increase in January 2018 from € 0.1/l to 0.3€/l, in 2019 to 0.4€/l, and 0.5€/l in 2020.

[12] Excise tax on coal will be introduced from 2019, and will amount to 0.15€/GJ. In 2020 it will be increased to 0.30€/GJ

[13] Further, the lower statutory VAT rate at 7 percent for basic food package remained unchanged.

[14] IMF Country Report No. 17/277

strengthening prioritization, selection, appraisal and evaluation of capital investments will enhance the credibility of capital budgeting and increase the transparency of the sector.

Expected result: PEFA score on multi-year budget perspective improved from C+ in 2016 to B in 2019 and capital budget execution rate improved from 23 percent in 2016 to 75 percent in 2019.

Prior Action 3: *To reduce the public-sector wage bill, the Member Country has: (i) enacted the amendments to the Law Salaries for Public Sector Employees to reduce wage coefficients by 1 percent and officials' wages by 6 percent; and (ii) amended the Decision on Variable Part of Pay to reduce performance bonuses.*

34. **Prior Action 3 supports the public-sector wage bill reduction.** Despite the Government's attempts to control public employment and the size of the wage bill since 2013, the problem of high personnel spending persists, making fiscal consolidation a challenge. Presently the Government's wage bill constitutes 13 percent of GDP, which is among the highest in Europe. At the same time, the quality of public services falls below citizens' expectations. To contain the share of the wage bill in government expenditure, the Government chose a two-prong strategy: reduce the level of public servant salaries and reduce public employment, while taking measures to uphold and improve government performance. In December 2016, the government reduced coefficients for senior officials classified in top income brackets of Groups A, B and C by 8 percent. Further, the Parliament enacted amendments to the Law on Salaries of Employees in the Public Sector (LSEPS) in 2017[15] that include: a further 6 percent reduction in the coefficients used to calculate base salaries for senior positions in the public administrations. In March 2017, additional reduction of 1 percent for all salary coefficients equal to or exceeding 4.1 was legislated for a period ending on December 31, 2018. The coefficients for public employees in Group D with lower grades remained unchanged, as part of the social policy to protect employees with low earnings. Taken together, the salary coefficients for higher earners saw a cumulative reduction by approximately 14 percent from the level set in March 2016. The reduction of senior officials' wages lowered the decompression ratio to 1:10.65 (President to state employee) after the recent corrections of coefficients. The law also clarifies the limits of base pay for officials of municipalities, setting the maximum salaries for mayors, but it also requires automatic reduction of wages in local self-governments with revenue shortfalls of 10 percent or more to meet financial obligations. The amended law establishes high fines for violation of the law. The Government has approved a Decision on Variable Pay[16] that establishes that variable pay can be paid for exceptional results and high-quality performance, but that it cannot exceed 50 percent per month of average earnings in Montenegro during the previous year, and are subject to availability of budget resources.

35. Going forward, as part of the DPF/PBG-2, the authorities plan to reduce employment in the public administration, informed by functional reviews, with the adoption of time-bound restructuring plan and establish controls and transparency of the payroll by introducing an automated employee payroll calculation module for the central public administration linked to employee records. By operating such payroll module, the Government will be able to improve payroll accuracy, eliminate payments to absent workers, strictly enforce LSEPS, and take corrective policy measures to ensure better efficiency of personnel expenditure.

Expected result: General government wage bill as a share of GDP reduced from 13 percent in 2016 to 11 percent in 2019.

Prior Action 4: *To rationalize costs of pharmaceuticals the Member Country has: (i) adopted the Decision on a Definition of a List of Medicines – a list of essential drugs to be fully covered by the Health Insurance Fund, and a List of co-paid drugs; and (ii) introduced Managed Entry Agreements for high-cost medicines in order to decrease spending on high-cost medicine and keep pharmaceutical budget under control.*

36. **Prior Action 4 aims to contain pharmaceutical expenses.** Pharmaceuticals are a major driver of health spending and arrears. Due to lack of managed-entry agreements (MEAs) and other cost-

---

[15] Official Gazette of Montenegro (OG), 021/17 from March 31, 2017 and June 30, 2017 (OG, 042/17)
[16] OG 028/17

containment tools, the value of the Montenegrin pharmaceutical market reached 1.8 percent of GDP in 2016 (up 6 percent from 2015). Arrears stood at 1 percent of GDP before government cleared part of it from general taxes. In 2016 only, public spending on medicines increased by 10 percent.[17] In addition, the use of reimbursed medicines for indications that are not yet approved for reimbursement in many other countries, as well as reimbursement of drugs that are not on the list are major cost drivers of spending on pharmaceuticals. The existing list of reimbursed drugs based on International Non-Proprietary Names (INNs) with unrestricted reimbursement in terms of indications has been revised by the Ministry of Health (MoH) working group and the Decision on the Definition of a List of Medicines —of essential drugs to be fully covered by the Health Insurance Fund and a list of co-paid drugs subject to co-payment up to 48 percent—was adopted on October 26, 2017. In addition, the revised list includes a provision on MEAs for high-cost medicines as a cost-containment policy tool which should keep pharmaceutical budget under control[18]. The expected savings from the MEAs and the dual list of drugs amounts to EUR 5 million or 10 percent of the pharmaceutical public spending in 2016.

37. Under the DPF/PBG-2, the Government aims to develop clinical protocols and pharmacotherapeutic guidelines to rationalize prescriptions and the use of expensive drugs, and adopt the Rulebook on Health Technology Assessment as a tool to support decision-making about reimbursements. The DPF/PBG-2 will also support the adoption of the Law on Pharmacies that will regulate the retail sector in terms of geographic and demographic criteria for opening new pharmacies, prohibition of vertical integration, and define more stringent conditions regarding space and staffing.

Expected result: Pharmaceutical spending reduced from 1.4 percent of GDP in 2016 to 1.3 percent of GDP in 2019.

Prior Action 5: *To improve social and fiscal sustainability of social benefit system, the Member Country has: (i) amended the Law on Social and Child Protection to abolish the lifetime benefits for mothers of three or more children and increase the amount of the means-tested child allowance; and (ii) adopted the Law on Implementation of the Constitutional Court Decision to compensate former recipients of the lifetime benefit.*

38. **Prior Action 5 supports strengthening of the social protection and child benefit system.** Current transfers, especially social spending, represent a significant part of public expenditure. Montenegro's social protection spending is not only among the highest in Europe but also likely to adversely affect labor participation.[19] A lifetime benefit, introduced in January 2016, entitled mothers of three and more children to a monthly benefit equivalent to 70 percent (40 percent in case of unemployed mothers) of the average net wage in Montenegro in the previous year.[20] This benefit failed to achieve its fertility objective (with median age of beneficiaries at 55), discouraged formal work, and proved fiscally unsustainable. Its cost, at 1.9 percent of GDP in 2016 (or 1.6 percent on a net basis[21]), was more than five times the spending on poverty-targeted social assistance (FS/MOP) and almost double the total social assistance budget. Generous transfer amounts and eligibility based on unemployment registration created disincentives for formal employment where female employment rates are already low. Out of around 22,000 beneficiaries, nearly 64 percent were previously unemployed, 22 percent were pensioners, and 14 percent were previously employed. A Constitutional Court ruling in April 2017 proclaimed the mother benefit unconstitutional on the grounds of discrimination against other groups. The ruling gave the government three months to restore beneficiaries to a status that is not worse than the one they had at the time when they became eligible for the benefit.

---

[17] The largest increase was recorded in ATC code L—antineoplastic and immunomodulation agents (up 16 percent to EUR 13.5 million) which are usually subject to different cost-containment measures in other countries, including risk-sharing and MEAs with the objective to share financial risks and uncertainty between the payer and pharmaceutical companies.

[18] In accordance with Article 7 of the Decree on Criteria for Drug Listing adopted in July 2016

[19] Montenegro Systematic Country Diagnostic.

[20] Amendment to the Law on Social and Child Protection (Art. 54a and 54b), OG 42/15 of July 29, 2015. While receiving the mother benefit, women could not be employed or receiving pensions. As part of the 2017 budget, the authorities reduced the benefit to €264 and €144 per month, starting January 2017, to rein in its cost.

[21] Subtracting the cost of pensions that otherwise would have been paid to part of the beneficiaries

39. The Government responded by adopting two laws in June 2017.[22] Amendments to the Law on Social and Child Protection abolished the mother benefit and strengthened the existing family and child protection system with: (i) a 20-percent increase in the child allowance for children in FS/MOP recipient families, children with disability, and children without parental care; (ii) a 20-percent increase in the birth grant, the compensation for giving birth when one of the parents is either registered unemployed or full-time student, the care and support allowance and the personal disability allowance; and (iii) more inclusive and incentive-compatible design of the last-resort social assistance benefit. Changes were introduced in the institutional arrangements for activation of the able-to-work FS/MOP beneficiaries to specify the roles of stakeholders, increase the involvement of the Employment Agency and strengthen mutual obligations.

40. The Law on the Execution of the Constitutional Court Decision outlined three types of compensatory measures to replace the mother benefit. First, the women who had voluntarily left formal open-ended employment to switch to the mother benefit (3,161 women) are entitled to pension insurance contributions and temporary financial compensations, depending on their prior wage, and for a duration of 36-60 months, depending on their age.[23] Second, the women who were former recipients of old-age and disability pensions (4,761 women) can re-enter the pension system. Third, the women who qualified on years of registration as unemployed (close to 14,000 women) can revert to their status of registered unemployed with the Employment Agency of Montenegro and use its jobs counseling and employment support services. The poorest among them, those who had switched from the FS/MOP to the mother benefit can return to poverty-targeted social assistance if they continue to qualify.

41. As part of the DPF/PBG-2, the authorities plan to reform pension and labor systems to improve their fiscal and social sustainability. Montenegro's pension system is fiscally unsustainable and it faces erosion of pension adequacy in the long run. In 2016, pension expenditures engaged 10.4 percent of GDP of which only 7.3 percent of GDP was financed through contributions. Contributor coverage below 65 percent, numerous early retirement options (70 percent of new beneficiaries are early retirees), and an unfavorable system dependency ratio (1.7 insured to pensioners) have produced a large pension deficit despite a relatively modest replacement rate (56 percent net in 2016) and contribution rate of 20.5 percent. Nevertheless, the current valorization and indexation pattern (75 percent CPI and 25 percent wages for both) would, under baseline fiscal assumptions, reverse the fiscal strain but erode pension adequacy in the long run. Further, the authorities aim to increase hiring flexibility and decrease informality, reduce unfair competition to regular businesses from informal ones, and increase the security of workers.

Expected results: Pension and social benefit transfers as a share of GDP reduced from 12.9 percent of GDP in 2016 to 11.2 percent in 2019 and labor force participation increased from 54.5 percent in 2016 to 55.5 percent in 2019.

Box 2. Implementation of the Law on the Execution of the Constitutional Court Decision

The government has taken steps to support timely execution of these legislative changes. By end of August 2017, most women who used to receive unemployment benefit had regained this right, and more than 4,000 former recipients have re-registered with the Employment Agency and are offered its regular services, including assessment of individual capacities and limitations for participation in the labor market, awareness raising and employment counselling. Most of the women who were former recipients of old-age and disability pensions have re-entered the pension insurance system. The Centers for Social Work have approved half of the applications for temporary financial compensations, with the other half under review. Supported by the social welfare information system, the payment of compensation, including retroactive payments for July and August, started in September 2017. Centers for Social Work have received roughly 7000 appeals related to the mother benefit, many complaining that their entitlements have been taken away. The appeal does not stop the execution of the decision of the Centers for Social Work. While the grievance and redress mechanisms are in place, the ongoing efforts are important to monitor implementation.

[22] Official Gazette of Montenegro OG 42/17 of June 30, 2017 and OG 50/2017 of July 31, 2017

[23] Unless they become employed, these women are eligible for monthly financial compensations of 193, 264, and 336 euro a month respectively, corresponding to monthly wages before terminating employment. Women older than 55 will receive the compensation until they become pension eligible (currently at age 62). Those between 45 and 54 will receive the benefit for five years, while those between 33 and 44 will receive it for three years.

Prior Action 6: *To reduce the cost of procurement, the Member Country has introduced centralized procurement through the adoption of the Decree on Centralized Procurement of Goods and Services.*

42. **Prior Action 6 aims to improve the efficiency of public procurement**. While the Public Procurement System in Montenegro is well organized, there is room for improvement of the Review Mechanism of the procurement cycle. Even though it rests on a sound legal framework, largely aligned with the EU *acquis*, it is excessively fragmented. Spending analysis of procured goods and services at the central government level exposed the following concerns: (i) inefficiency in public procurement that leads to acquisition of low-quality goods and services; (ii) significant differences in the purchase price for the same items by different ministries; and (iii) lack of standardized technical specifications for the acquisition of a given good or service. Considering the fragmentation of the procurement framework and the capacities of the country, the establishment and use of central purchasing body is recommended. The recommendation is based on Article 33 of the Public Procurement Law of Montenegro, which allows for joint procurement of goods and services for frequent consumption. The main 'attractiveness driver' behind a central purchasing system is savings through lower prices due to the scale effect, faster procedures, promotion of normalization and standardization, and lower transaction costs. It further brings indirect benefits of increased certainty and predictability, as well as professionalization of public procurement practices. On October 26, 2017, the authorities adopted the Decree on Centralized Procurement of Goods and Services and authorized the Department of Public Property to implement centralized procurement for ten commonly used procurement items, including ICT, gas, fuel, stationery, sanitation, cars, furniture, postal, telecommunication and insurance services, for all line ministries and subordinated public agencies, representing some 11 percent of the total spending on other purchases of goods and services for the general government.

43. Going forward, the DPL/PBG-2 will support the implementation of the centralized procurement starting from 2018 with gradual implementation of the centralized procurement on selected goods and services. The Directorate for Property (DOP) identified to pilot CPB has more than eight years of experience with centralized procurement, with no records of reported corruption cases. The Bank will support DOP with TA in standardizing procedures and increasing transparency. The DOP has experience in using Framework Agreement which will be further enhanced, and CPB/DOP will be brought into Anti-Corruption Agency focus. The associated risks of corruption or mismanagement would be further mitigated by the roll out of e-procurement platform, financed by EU and expected to be finalized by 2019.

Expected results: Spending on items procured centrally reduced from 0.6 percent of GDP in 2016 to 0.5 percent of GDP in 2019.

Pillar 2: Strengthening Financial Sector Resilience

44. **While financial sector stability improved since the global financial crisis, vulnerabilities remain.** Some domestically owned banks are more vulnerable than the rest of the banking sector. They have very high NPLs and/or very low provisioning levels; three of them have received qualified audited reports in 2015 and 2016 and have been suffering from poor asset quality, credit risk management and low profitability since the crisis. The 2016 Financial Sector Assessment Program (FSAP) stress tests indicated that, these banks are vulnerable to shocks, such as protracted economic slowdown, even under the moderate stress scenario. Although none of these banks are systemic, as they hold less than 18 percent of banking sector assets, their continued or worsened weak performance could pose risks to financial sector stability in Montenegro through contagion or moral hazard channels. Importantly, upcoming implementation of IFRS9 regulations could pose additional risks to the sector, in particular for banks with lower capital cushions (none of them are systemic), through tighter provision requirements. Therefore, the CBM is proactively addressing the vulnerabilities in these banks through supervisory measures.

Table 7. Financial Soundness Indicators

	2013	2014	2015	2016	2017 Sept
Regulatory capital as percent of risk-weighted assets	14.44	16.18	15.49	16.08	16.78
Non-performing loans (NPL), in percent of gross loans	18.38	16.78	13.43	11.14	7.40
Provisions, in percent of NPL	44.69	45.56	48.30	55.54	56.65
Gross profits, in percent of average assets (ROAA)	0.12	0.83	-0.08	0.26	1.03
Gross profits, in percent of average equity capital (ROAE)	0.85	5.67	-0.55	1.95	8.05
Liquid assets, in percent of total assets	19.99	22.23	24.77	24.52	25.80

Source: CBM

***Prior Action 7**: To enhance the NPL resolution framework, the Member Country has enacted amendments to the Law of the Voluntary Financial Restructuring of Debts towards Financial Institutions to expand the coverage, lower the associated administrative costs and revise the disclosure requirements of non-performing loans.*

45. **Prior Action 7 supports the enhancement of the non-performing loans resolution framework** through the enactment of the amendments to the Law of the Voluntary Financial Restructuring (OG 37/2017) to support the operationalization of the voluntary debt restructuring framework. To expedite the NPL resolution process, in particular for the corporate segment, the government adopted the Law of the Voluntary Financial Restructuring of Debts towards Financial Institutions in April 2015 and established a framework to facilitate out-of-court negotiations and debt restructuring between a debtor and a plurality of creditors, providing tax and loan-provisioning incentives. Nevertheless, until June 2017, creditors did not opt to use this framework and the improvement in NPLs was mostly limited to write-offs and sale to factoring companies. Among others, the June 2017 amendments extended the timeline for the use of the framework, expanded the coverage, described alternative restructuring solutions, lowered the associated administrative costs, modified tax incentives, and revised the disclosure in line with the FSAP 2016 recommendations. Along with the CBM's encouragement, these measures are expected to result in improvement in asset quality with the amount of restructured loan under this framework reaching EUR11 million by end-2017.

46. Under the DPF/PBG-2, the authorities will continue to work on strengthening the minimum standards for management of credit risk in line with the European Banking Agency guidelines to (i) prohibit banks to classify assets as performing or nonperforming on the basis of adequate collateral held by them, rather than the borrowers' ability to repay; and (ii) strengthen requirements for reclassification of nonperforming assets to higher categories ensuring uniform prudential treatment of restructured loans, which would further incentivize proactive resolution of the NPLs and thus unlock the credit recovery. These measures are expected to result in continuous stability in the financial sector with the capital adequacy ratio remaining above 10 percent to which the implementation of IFRS 9 and transposition of Capital Requirements Directive (CRD) IV will exert downward pressures.

Expected result: Improved quality of loan portfolio by restructured loan amounts of at least EUR15 million and well capitalized banking sector with the solvency ratio staying above 10 percent by 2019.

Prior Action 8: *The CBM has (i) approved time-bound Supervisory Action Plans (SAP) for three banks with qualified audit reports in 2015, requiring full compliance with minimum regulatory requirements and provisions and (ii) made progress in implementation of SAPs including balance sheet adjustments, additional provisioning requirements, and recapitalization processes for these banks, where necessary.*

47. **Prior Action 8 aims to address vulnerabilities stemming from the three ailing banks** which received qualified audit reports in 2015 and 2016. In line with the 2016 FSAP recommendations, the CBM has prepared time bound supervisory action plans (latest update was in October 2017) for these three banks and is closely monitoring their cautionary measures including capital increases. One of these banks has been under daily oversight of the CBM since November 2015 while for other two, on-site inspection processes have been completed. In particular, all three banks were asked to hold regulatory reserves where necessary in line with the SAPs and NPL ratios, provisions and capital adequacy levels were adjusted based on the findings of the on-site inspectors and audit reports. Annex 6 summarizes the

measures and progress made so far. Going forward, as a follow up to the measures taken to address existing vulnerabilities in the three banks, the CBM will need to focus on contingency measures for adverse case scenarios. Hence, under the DPF/PBG-2 the CBM will update SAPs to include contingency measures for three banks and take action to resolve, restructure or liquidate banks that are materially non-compliant with the regulatory requirements and SAP provisions.

Expected result: Three banks with qualified audit reports in 2015 maintain solvency ratios above 10 percent or intervened by 2019.

Prior Action 9: *To expand the financial sector supervisory framework the Member Country has adopted the Law on Financial Leasing, Factoring, Purchase of Receivables, Micro-Lending and Credit-Guarantee Operations bringing factoring, leasing and micro-finance companies under CBM oversight.*

48. **Prior Action 9 aims to support expansion of the supervisory authority of the CBM to non-banking financial sector.** With this law, the CBM will have the authority to regulate and supervise the factoring sector, along with leasing and MFI sectors. This is essential as factoring grew rapidly in recent years as significant decline in NPLs was mostly due to the transfer of non-performing assets from the banks' balance sheet to factoring companies. Yet, the CBM lacks an oversight over factoring companies reducing the transparency of the financial system. This also leads to inadequate monitoring of the contagion risk as most of the asset transfers were between banks and their own subsidiaries. A new Law on Financial Leasing, Factoring, Purchase of Receivables, Micro-Lending and Credit-Guarantee Operations was enacted in October 2017. The Law, which would also regulate provisioning of factoring services and purchase of receivables for the first time in Montenegro, improves legal clarity and legal certainty of non-bank financial services in Montenegro, increase efficiency of provision of services on the supply side and protection of consumers' rights on the demand side, as well as enhance the supervisory and regulatory role of the Central Bank.

Expected result: The CBM receives quarterly financial reports from factoring companies by 2019.

Prior Action 10*: To strengthen financial sector supervisory framework, the Member Country has amended the Central Bank Law to (i) enhance institutional, financial and personal independence of the CBM, and (ii) enable the CBM to regulate and supervise payments institutions, including e-money institutions, in line with the EU Payment Systems Directive.*

49. **Prior Action 10 aims to strengthen financial sector supervisory framework by enabling the operational and supervisory independence of the CBM.** The EU accession process requires Montenegro to improve institutional, financial and personal independence of the CBM which is essential to further enhance its supervisory role. Existing incompatibles include among others, lack of additional safeguards to ensure independent decision-making process, requirement of consultation with government for establishment of special reserves to be used for specific operating expenses, the possibility of presence of government members at the Council meetings, exhaustive list of legal grounds for dismissal of the governor, and the absence of remedy to contest decision on the governor's dismissal. The amendments to the Law on CBM, enacted in October 2017, removed among else, the ex-ante consultation with government on specific operating expenses, regulate reporting requirements to the parliament, and limit the legal grounds for dismissal of the CBM's Council. The PBG-1 also supports amendments to the Central Bank Law regarding the Payment System Directive which reinforces the powers of the CBM to regulate payment and settlement systems in Montenegro and extend the ambit to cover payment institutions and e-money institutions.

50. Going forward, the authorities are facing an ambitious schedule to transpose the EU directives on capital requirements, banking recovery and resolution and deposit insurance. The proposed DPF/PBG-2 aims to support further strengthening of the financial safety net through amendments to the Banking Law, enactment of the Bank Resolution Law and the Deposit Protection Law, and of the financial sector supervisory framework through the adoption of the new Banking Law.

Expected result: Improved banking supervision and resolution frameworks consistent with the Basel Core Principles and BRRD.

51. **The design of the operation reflects lessons learned, results and recommendations of a range of recent and ongoing lending, as well as analytical and advisory services.** This operation builds on the 2011 Financial Sector DPL and the 2012 Policy Based Guarantee which focused on financial sector issues. The lesson learnt from this operation was that PBGs can potentially be a useful instrument for supporting countries facing large financing needs, but such instruments in a context of challenging macro-fiscal situation need to incorporate a consistent macro-economic framework with necessary macro and fiscal actions for risk mitigation. This proposed operation also complements the recently approved Tax Administration project with a focus on strengthening tax collection and reducing tax compliance costs. The design of this operation was informed by the 2016 Financial Sector Assessment Program, the 2016 Systematic Country Diagnostic, the 2017 Montenegro Policy Notes prepared for the new Government, the World Bank Western Balkans Regular Economic Reports, the 2016 EC Progress Report on Montenegro, the 2017 IMF Article IV and the forthcoming Public Finance Review that all underlined the urgent need to address key vulnerabilities of the economy. While the scope of the program is wide, the analytical and advisory work underpins not only the policy areas, but also the specific prior actions. Table 8 lists recent analytical activities and their relation to the prior actions supported by the PBG.

Table 8. PBG Prior Actions and Analytical Underpinnings

Prior actions	**Analytical Underpinnings**
Pillar 1: Strengthening Fiscal Sustainability	
Prior Action 1: To improve revenue collection, the Member Country has: (i) increased the statutory rate of the value-added tax from 19 percent to 21 percent, through the amendment of the Law on Value Added Tax; (ii) increased the excise tax rates on tobacco products, alcohol, and sugary drinks and introduced a new excise tax on coal through the amendments to the Law on Excises.	WB (2017). Montenegro Policy Notes WB (2017, forthcoming). Montenegro Public Finance Review IMF (2017). Fiscal Adjustment and Spending Reforms, selected issues WB (2017). Montenegro Tobacco Excise Tax Impact, PBG background note
Prior Action 2: To strengthen its public finance management the Member Country has: (i) introduced a three-year rolling budget through the amendments to the Law on Budget and Fiscal Responsibility; and (ii) adopted a Decision on Program Budgeting.	WB (2013). Montenegro Public Expenditure and Financial Accountability Assessment EC Country Report (2016 and 2017) Government, Public Financial Management Strategy 2016-20
Prior Action 3: To reduce public sector wage bill the Member Country has: (i) enacted the amendments to the Law on Salaries for Public Sector Employees to reduce wage coefficients by 1 percent and senior officials' wages by 6 percent; and (ii) amended the Decision on Variable Part of Pay to reduce performance bonuses.	WB (2017, forthcoming). Montenegro Public Finance Review IMF (2017). Fiscal Adjustment and Spending Reforms, selected issues Government, Public Administration Reform Strategy 2016-19
Prior Action 4: To rationalize costs of pharmaceuticals the Member Country has: (i) adopted the Decision on a Definition of a List of Medicines – a list of essential drugs to be fully covered by the Health Insurance Fund, and a List of co-paid drugs; and (ii) introduced Managed Entry Agreements for high-cost medicines in order to decrease spending on high-cost medicines and keep pharmaceutical budget under control.	WB (2017). Montenegro Policy Notes WB (2017, forthcoming). Montenegro Public Finance Review Agency for Medicines and Medical Devices (CALIMS), 2016 WB (2017). PBG background note on pharmaceuticals
Prior Action 5: To improve social and fiscal sustainability of social benefit system, the Member Country has: (i) amended the Law on Social and Child Protection to abolish the lifetime benefits for mothers of three or more children and increase the amount of the means-tested child allowance; and (ii) adopted the Law on Implementation of the Constitutional Court Decision to compensate former recipients of the lifetime benefit.	WB (2017). PBG background note on mother benefits WB (2017, forthcoming). Montenegro Public Finance Review WB (2013). "Activation and Smart Safety Nets in Montenegro: Constraints in Beneficiary Profile, Benefit Design, and Institutional Capacity
Prior Action 6: To reduce the cost of procurement, the Member Country has introduced centralized procurement through the adoption of the Decree on Centralized Procurement of Goods and Services.	WB (2017, forthcoming). Montenegro Public Finance Review EC Country Report (2016 and 2017) WB (2017). PBG background note on centralized procurement
Pillar 2: Strengthening Financial Sector Resilience	

Prior Action 7: To enhance the NPL resolution framework the Member Country has enacted amendments to the Law of the Voluntary Financial Restructuring of Debts towards Financial Institutions to expand the coverage, lower the associated administrative costs and revise the disclosure requirements of	WB (2017). Montenegro Policy Notes WB/IMF 2016 Financial Sector Assessment Program
Prior Action 8: The CBM has (i) approved time-bound Supervisory Action Plans (SAP) for three banks with qualified audit reports in 2015, requiring full compliance with minimum regulatory requirements and provisions and (ii) made progress in implementation of SAPs including balance sheet adjustments, additional provisioning requirements, and recapitalization processes for these banks, where necessary.	WB (2017). Montenegro Policy Notes WB/IMF 2016 Financial Sector Assessment Program
Prior Action 9: To expand the financial sector supervisory framework the Member Country has adopted the Law on Financial Leasing, Factoring, Purchase of Receivables, Micro-Lending and Credit-Guarantee Operations bringing factoring, leasing and micro-finance companies under CBM oversight.	WB (2017). Montenegro Policy Notes WB/IMF 2016 Financial Sector Assessment Program WB (2017). Comments on the draft law
Prior Action 10: To strengthen financial sector supervisory framework the Member Country has amended the Central Bank Law to enhance institutional, financial and personal independence of the CBM and (ii) enable the CBM to regulate and supervise payments institutions, including e-money institutions, in line with the EU Payment Systems Directive.	WB (2017). Montenegro Policy Notes WB (2017). Comments on the draft law

4.3 LINK TO CPF, OTHER BANK OPERATIONS AND THE WBG STRATEGY

52. **The proposed programmatic series is fully consistent with the FY16–FY20 Country Partnership Framework (CPF)**. The proposed policy program helps the authorities design the content of and implement fiscal consolidation measures as well as strengthen its regulatory framework in financial and public finance management areas. By supporting macroeconomic and fiscal stability as well as financial sector resilience—top priorities identified in the 2016 Systematic Country Diagnostic—the operation enforces critical elements for sustained shared prosperity. Such reforms are necessary to avoid abrupt adjustments that could reverse welfare gains for the population.

53. **The DPF/PBG builds on earlier and ongoing operations in Montenegro**. The Financial Sector DPL (2011) and the 2012 PBG focused on financial sector reforms, while the recently approved Tax Administration project focuses on strengthening tax collection and reducing compliance costs.

4.4 CONSULTATIONS, COLLABORATION WITH DEVELOPMENT PARTNERS

54. **Montenegro has strengthened its public consultative process**. Since 2012, all new laws and strategies are subject to a mandatory public consultation period. The Decree on the Manner and Procedure for Carrying out Public Consultations in Preparation of Laws regulates the public consultation process. In 2012, the Government introduced Regulatory Impact Assessments (RIAs) as a mandatory requirement for all laws and bylaws to assess the fiscal, social, environmental and economic impact of the proposed legislation. During public consultations, the government collects citizens' comments on the draft laws/strategies, while in the second stage, the accepted comments from the public are incorporated in the final documents. National consultations typically gather wide range of relevant stakeholders' views, including from the private sector and civil society. All reforms supported by this PBG have been, or are in the process of, public consultation as required by the law, except for the Law on the Execution of the Constitutional Court Decision, which went through the special procedure given the time sensitivities.

55. **On the social benefit reform, the Government undertook public consultations for preparing the amendments to the Law on Social and Child Protection.** The Decision of the Constitutional Court of Montenegro prescribed the time limit of three months from the date of the Decision (April 19, 2017) for the government to implement this decision. Therefore, the adoption of the laws followed an accelerated procedure which does not require public consultations. Still, in February 2017, the Minister of Labor and Social Policy established a working group comprised of representatives of state government

ministries and agencies, local governments, trade unions and civil society organizations (CSO), to work on the amendments to the Law on Social and Child Protection. Citizens, professional and scientific institutions, state and municipal bodies, Centers for Social Work, trade unions, professional associations, non-governmental organizations, media, communities and other interested parties were invited to public consultations in a roundtable discussion on June 7, 2017. Representatives of the mother association of beneficiaries, CSO, and the media were present. The government solicited, responded to, and documented comments and suggestions; some were reflected into legal changes (for example, the working group accepted the arguments against the establishment of social-medical institutions, as well as the suggestion on restructuring of the disability benefits). The Law on the Execution of the Constitutional Court Decision was presented by the Prime Minister to Parliament, informed by analysis conducted by the Ministry of Labor and Social Welfare, as a high-priority legislation under shorted procedures and did not go through public consultation prior to enactment. After the government session and a week before it was enacted on June 30, 2017, the Deputy Prime Minister, Minister of Finance, and Minister of Labor and Social Welfare issued a joint press statement and organized a press conference on both laws.

56. **The Bank has maintained close collaboration with other development and social partners.** This operation has been prepared in close consultation with the IMF, particularly in the areas of macroeconomic and financial sector policies. Fund and Bank staffs have sought each other's input in internal review processes. Further, the program has been closely coordinated with the EU Delegation to Montenegro (on public administration, financial sector and PFM reforms) and the Directorate General ECFIN of the EC (on fiscal and macro aspects). The Bank has coordinated closely with the United Nations Development Program (health, and social benefits), and the WHO (health). Consultations with social partners (association of employers and trade unions) were carried out on public administration, financial sector and labor market reforms.

5. OTHER DESIGN AND APPRAISAL ISSUES

5.1 POVERTY AND SOCIAL IMPACT

57. **While the overall program is expected to yield positive poverty and social impact in the medium term, several prior actions may lead to adverse distributional and social impacts in the short run, with mitigating measures put in place.** The indirect effects of restoring fiscal and financial stability—through economic growth, investment, and job creation—could lead to welfare improvements in the future. In addition, reforming social benefits that discourage employment is expected to have positive impacts on labor market engagement and labor income, the most important channel for sustainable poverty reduction. In the meantime, a few reforms supported by the PBG-1 would have immediate negative poverty and social impacts, including: (i) indirect tax increases (Prior Action 1), (ii) withdrawal of the mother benefit (Prior Action 5), and (iii) changes in the copayment policy (Prior Action 4). The net impact of the removal of the mother benefit, increases in child allowances, and indirect tax increases, is simulated to increase the poverty headcount[24] by 2.1 percentage points (mostly driven by the mother benefit removal), with a small impact on the Gini coefficient of inequality (by 0.4 percentage points). The overall poverty and social impact is expected to be attenuated by mitigating measures part of Prior Action 5, namely measures to return mother beneficiaries to their earlier status, including financial compensatory packages for formerly working mothers. The increase in child allowances in Prior Action 5 is estimated to offset the impact of indirect tax increases in Prior Action 1 on the overall poverty headcount. Reducing public officials' wages by 6 percent (Prior Action 3) is not expected to have an impact on poverty since the reduction applies to only senior public officials in high-and medium-wage brackets, and public sector workers tend to be in the top three income quintiles. Table 9 shows that the simulated decline in consumable income from increased VAT and excise rates is smallest for the bottom consumption decile and does not differ much across the other deciles.

[24] Poverty in this analysis is measured as consumable (after tax) income under the value of the 2013 national poverty line in current year prices (188 euro/day).

Table 9: Change in Consumable Income from Increased VAT Rate and Excises, by Decile

Consumption Decile	Average consumable income per adult equivalent (Euros per year)			
	Before (19% VAT + old excises)	After (21% VAT + new excises)	Difference	% Change
1	1570.4	1555.5	-14.9	-0.9%
2	2351.1	2315.1	-35.9	-1.5%
3	2739.8	2695.8	-43.9	-1.6%
4	3118.2	3068.4	-49.7	-1.6%
5	3415.2	3368.9	-46.3	-1.4%
6	3747.2	3688.9	-58.2	-1.6%
7	4160.9	4097.0	-63.8	-1.5%
8	4687.1	4622.3	-64.8	-1.4%
9	5499.2	5421.1	-78.1	-1.4%
10	7998.6	7885.1	-113.5	-1.4%

Source: World Bank staff calculations from 2015 Household Budget Survey.
Note: In the fiscal incidence analysis, disposable income is set as equal to consumption, and consumable income here reflects after-tax consumption.

58. *PSIA of increases in indirect taxes.* The VAT and excise tax increases envisioned are expected to have a small poverty and distributional impact. Fiscal incidence analysis--using administrative and household budget survey (HBS) data, following the Commitment to Equity (CEQ) approach—simulates the direct effect of all of these higher taxes to increase poverty (measured in consumable income) by 0.4 percentage points, with near-zero impact on the Gini. Over time, however, the rise in excise tax rates on tobacco, alcohol and sugary drinks could yield positive health and productivity effects and lower rates of illnesses related to smoking, drinking, and dietary behaviors.[25] This poverty impact of increases in indirect taxes mainly comes from the increase in VAT and tobacco tax. Prior to the reform, the standard VAT rate was 19 percent, with a reduced rate of 7 percent for some items (basic food stuff, medicines, educational materials, and other select goods and services) and exemption (zero rate) for some goods and services related to exports and international transactions, as well as medicines and medical devices on the Health Insurance Fund list. Analyzed as part of the whole fiscal system, the VAT structure is estimated to have a marginal effect on poverty of 3.4 percentage points. Its marginal effect on inequality is small since the lower rate for necessities makes it somewhat progressive, which is partially offset by the higher consumption propensities of the poor. Under the reform supported by the DPL/PBG, the expected poverty impact of increasing the standard rate from 19 to 21 percent is limited (0.3 percentage point increase in the poverty headcount, with zero impact on inequality), because of no changes in the reduced rate and exemption. The increases in the other excises are simulated to have negligible impacts on poverty and inequality due to their small shares in consumption. For example, according to the HBS, only around 1 percent of households report expenditures on coal and will be affected by the coal excise. There may be indirect impact of the coal excise on electricity prices, which cannot be quantified with available data. However, the indirect impact is not expected to be substantial due to the small size of the coal excise, and an existing electricity subsidy for recipients of last-resort social assistance protects the poorest households.

59. *PSIA of social benefits reform.* Removing the mother benefit addresses a work disincentive. This benefit has created a perverse incentive for people, particularly women, to register as unemployed, in expectation of being rewarded with lifetime benefits provided by the state. The number of registered unemployed women had increased from 16,981 in January 2015 to 26,799 in 2017. More than 3,000 women had left formal jobs to receive the benefit. Over time, the indirect positive effect of removing this work disincentive on labor market attachment across the population, particularly female workers, is expected to support poverty reduction through increased labor income. However, it would have negative poverty and social impacts in the short run. Proximate estimates based on age and number of children in the household suggest that the introduction of the mother benefit in 2016 could have reduced the poverty

[25] Evidence from Chile shows, for example, that depending on the price elasticities, the net effects of raising tobacco tax—reduced purchasing power but lower medical expenses and rise in income due to longer work life—could be positive for low-income groups (Fuchs, A. and F. Meneses, 2017, "Are Tobacco Taxes Really Regressive?" World Bank Policy Research Working Paper 7988).

headcount (measured in consumable income) by close to 2 percentage points. The withdrawal of this benefit, before taking into account compensation, would have the reversed effect on poverty and social impacts on beneficiaries. Compensations and mitigation measures (supported under the DPL/PBG as part of Prior Action 5), are expected to cushion the adverse impact of removing the mother benefit. First, with the objective of supporting child welfare instead of rewarding giving birth, the government simultaneously introduced a 20-percent rise in child allowance which will reduce poverty by 0.4 percentage points. Second, a law executing the Constitution Court decision restores the status of beneficiaries to the one they had at the time when they became eligible for the benefit. The most affected group—women who had left employment for the benefit—are entitled to temporary compensations equivalent to approximately their previous monthly wage. The older ones among them, who might have more difficulty returning to employment, are eligible to receive financial compensations for longer (5 years for those aged 45-55 and until they can start receiving pension for those aged 55-61).

60. *PSIA of health reform.* The pharmaceutical reform aims to reduce cost of drugs. The introduction of the dual list of reimbursed medicines (one list of essential drugs and one list of co-paid drugs) is expected to have negligible poverty and distributional impacts. For every drug, there will be the option of purchasing the brands on the basic list that would be fully reimbursable by the Health Insurance Fund, or brands on the co-payment list that will involve co-payments from the patients.

61. **Gender dimensions**: The main gender impacts relate to the immediate adverse impact of withdrawing the mother benefit on former beneficiaries and potentially a positive impact on female labor market attachment. In Montenegro, female-headed households have similar consumable income as male-headed households in the bottom deciles of the distribution, and slightly higher consumable income than male-headed households in the higher deciles. Removing the mother benefit is expected to improve female labor force participation in the medium term, which, at 47.4 percent in June 2017, already trails that of men by at least 13 percentage points. However, the immediate poverty impact is simulated to be a bit stronger among female-headed households, increasing the poverty headcount by 2.2 percentage points, compared to the impact on male-headed households of 1.9 percentage points. The compensatory packages, mentioned above, would help mitigate the poverty and social impact. The World Bank intends to continue engaging with the government to monitor the implementation of the laws related to the mother benefit. The VAT reform is simulated to have a small poverty impact, with slightly higher impact among female-headed households in the bottom two deciles. Increasing excise tax on tobacco and alcohol could have gender-differentiated impacts due to smoking and drinking behaviors among men and women (smoking prevalence is 35 percent among males and 27 percent among females, according to WHO data). Reducing public officials' wages affects only those in the top and medium wage brackets and is not expected to disproportionately hurt women, given the gender pay gap in Montenegro.

5.2 ENVIRONMENTAL, FORESTS AND OTHER NATURAL RESOURCE ASPECTS

62. **The impact of this operation on the environment is expected to be modestly positive**. Prior Action 1 is expected to have positive direct and indirect impacts on the environment. It foresees a gradual increase in the excise on coal to EUR 0.30 per Gigajoule (GJ) by January 1, 2019. The increase in prices of coal used for heating could be a deterrent in using this environmentally least favorable heating resource, and would lead to use of more sustainable and cleaner heating options, thereby improving the local air quality and reducing adverse health impacts thereof. A possible shift from coal to wood/lumber for heating, and potential pressures on the forestry sector might occur, although it is estimated that only 2 percent of households use coal for heating,[26] with the majority of coal used by the Pljevlja Thermal Power Plant. The pressure on lumber as one of the heating options is rather low. In addition to that, the forestry sector in Montenegro is assigned to the Ministry of Agriculture and Rural Development, that is also rapidly moving towards the EU established legal and institutional requirements including those for sustainable wood and lumber use and improved control of logging.

[26] According to the Montenegro Statistical Office some 68 percent of households use solid fuels for heating. Out of those 79 percent use firewood, 6.4 percent combination of firewood and electricity, 6.1 percent firewood and coal, and 0.5 percent coal or coal and electricity in combination.

63. **Environmental and climate action represents important development priorities for Montenegro, recognized as such in the Constitution of Montenegro.** The main driver behind the strengthening of environmental policy and legislation has been the process of accession to the EU. The environment sector is defined as a priority in the Accession Program of Montenegro 2016-2018 and in the Economic Reform Program 2017-2020. Major steps have been taken in Montenegro during the last few years towards alignment with the EU environmental legislation. Strategic master plans on water supply, waste and wastewater have been adopted in 2004 and 2005, along with the National Strategy on Sustainable Development (2016), National Waste Management (2015), National Strategy on Biodiversity (2010) and National Strategy on Climate Change (2015).

64. **Institutional and governance framework for environment and climate change policies has strengthened.** Environmental governance and policy making is assigned to the Ministry of Sustainable Development and Tourism. The Environmental Protection Agency was established in 2008, as a separate body to ensure implementation of the legislation, strategies, programs and international treaties. The Law on EIA and Law on IPPC have become effective in 2008, while certain issues remain, such as the water permit being separate from the IPPC permit, and the potential lack of capacity and assistance offered to local communities. In 2012, a separate Administration for Inspection Affairs was established merging the environmental, forestry, water, housing and sanitary-epidemiological inspections into one central agency. The reform of the National Council for Sustainable Development in 2012–2013 expanded its mandate to include Climate Change. Based on the 2015 Environmental Performance Report prepared for UNECE, some of the issues in the country include lagging of both development and implementation of strategic documents at the local level (mostly due to poor staffing at the local level), or lack of funding for example for the Biodiversity Strategy.

5.3 PFM, Disbursement and Auditing Aspects

65. **The PFM system is reliable, and the government is committed to continued strengthening of the system.** The Bank's diagnostic work, although identified areas for improvement, concluded that key dimensions of the PFM system are in place. The government is committed to further enhance the system. It adopted the Strategy for Public Administration Reform and the PFM Reform Program, which provide clear strategic guidance and reform objectives for the period 2016-2020. Additional strategies and action plans targeting specific areas complement the framework for the future reform, such as strategies for further development of the PIFC; gradual transition to accrual financial reporting; external audit; alignment with ESA 2010 reporting requirements.

66. **Timeliness and process of the budget preparation and credibility of the budget are satisfactory, albeit with some room for improvement.** Budget is in general adopted timely and in line with the budget calendar. Annual budget of the central government is made publicly available as per the Law on Budget and Fiscal Responsibility. Supplementary budgets were passed in two out of five previous years, which albeit accepting external factors and turbulent environment, also points to room for further improvements in the budgeting process. Credibility of the budget is moderate since deviations of actual versus budgeted expenditures are in general between five and ten percent. Budget includes information for the budget year. Consideration of medium-term projections is meager in the process of entering into multi-annual contracts, costing and selecting capital projects or preparing the next year's budget. There is a need for substantial improvements in medium-term budgetary framework and in general strategic outlook in budgeting and management of public funds, areas supported also by this operation.

67. **Budget execution and cash management have been strengthened over the past several years.** A Single Treasury Account (STA) captures vast majority of all receipts and payments of government entities. Controls over payments within budget appropriations have been established and respected in practice. However, further improvements are needed in commitments control, i.e. control over assuming commitments and liabilities by budget users in order to prevent accumulation of arrears. Current financial reporting standards provide reliable financial information, but comprehensiveness needs to be enhanced. Current cash basis of accounting does not provide sufficient information on assets. The government adopted a strategy for financial reporting reform and transition towards accrual accounting and financial reporting. These actions are supported directly by this operation.

68. **Institutional and regulatory framework for financial controls have been established and gradually strengthened.** The Law on Public Internal Financial Control (PIFC) establishes the legal basis in this area. The functions of internal audit and, at a slower rate, financial management and control have been instituted and developed in majority of public entities. The State Audit Institution (SAI) has made substantial progress over the past several years and is still strengthening its capacity further. The SAI continuously improves its audit methodology, its coverage of audited public expenditures, and the types of audits performed.

69. **The legal framework for procurement is generally in line with EU requirements with the Public Procurement Law that came into effect in 2012**. Open competitive procurement is the default method which is followed in the large majority of cases, while the use of other methods should be justified. The institutional framework is well organized, although the roles and responsibilities of some central institutions could be streamlined in view of avoiding overlapping. The Strategy for Development of Public Procurement System in Montenegro for 2016-2020 and its Action Plan are in place and serve as a roadmap for accelerating the reform agenda. Procurement has been made more transparent through a web-based portal that shows the procurement plans of spending units, bidding opportunities, and contracts awarded. The introduction of e-procurement from 2018 will strengthen public procurement enforcement' capacity at all levels.

70. **The Single Treasury Account is held in the Central Bank and operated in a reliable environment**. No additional fiduciary arrangements including audit are required for the operation, given the progress in public financial management reforms, the unmodified (clean) audit opinion provided in the CBCG's audited financial statements of 2016 and the positive assessment of the capacity of the Central Bank and functioning of the Treasury.

5.4 MONITORING, EVALUATION AND ACCOUNTABILITY

71. **The MoF is responsible for the overall coordination of the proposed operation.** While the MoF is the main policy counterpart for the Bank team for the fiscal consolidation pillar, the Central Bank of Montenegro is the main counterpart for the financial sector pillar. The line ministries play an important role in the implementation of policy actions set forth in the policy matrix (Annex 1) and have been coordinating the technical support requirements with development partners.

72. **The specific expected results indicators, set out in Annex 1, will be used to monitor the implementation of the operation.** The Bank, in collaboration with the Montenegrin authorities, will monitor and evaluate the program's achievement of these results.

73. **Grievance Redress.** Communities and individuals who believe that they are adversely affected by specific country policies supported as prior actions or tranche release conditions under a World Bank Development Policy Operation may submit complaints to the responsible country authorities, appropriate local/national grievance redress mechanisms, or the WB's Grievance Redress Service (GRS). The GRS ensures that complaints received are promptly reviewed in order to address pertinent concerns. Affected communities and individuals may submit their complaint to the WB's independent Inspection Panel which determines whether harm occurred, or could occur, as a result of WB non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the World Bank's attention, and Bank Management has been given an opportunity to respond. For information on how to submit complaints to the World Bank's corporate Grievance Redress Service (GRS), please visit http://www.worldbank.org/GRS. For information on how to submit complaints to the World Bank Inspection Panel, please visit www.inspectionpanel.org.

6. SUMMARY OF RISKS AND MITIGATION

74. **The proposed operation faces high overall risk, with macroeconomic, political and governance risks assessed as high, while the social and stakeholders' risks are assessed as substantial.** These risks stem from political pressures associated with the implementation of proposed reforms to reduce fiscal risks in a minority coalition government.

75. ***Macroeconomic risk:*** The achievement of the operation's expected results would be more difficult in the case of a lower growth scenario. With the EU as its main trading partner, a slower-than-expected growth in the EU could dampen Montenegro's economic recovery, further straining its public finances and negatively affecting the fiscal and debt consolidation agenda. Montenegro is vulnerable to a slowdown in capital inflows, weak export demand, lower remittances, and thus growth, that may increase debt service requirements over the medium in a volatile financing environment. Financial sector risk is low but material as the vulnerabilities in domestic banks could affect the entire system through contagion and moral hazard channels. However, the macro-fiscal impacts of financial sector risks are contained by sufficient level of funds in the Deposit Protection Fund. There are also downside risks associated with potential worsening of financing conditions reflected in interest rate shock and EUR depreciation due to further tightening of US monetary policy. Given the increasing share of the USD-denominated public debt, USD appreciation would further worsen the debt metrics and strain public finances. Potential delays in the implementation of consolidation measures, and accumulation of new arrears/contingent liabilities that happened in the past, would again worsen the credit rating outlook and thus hamper the refinancing options at the time of the redemption of over 40 percent of public debt in 2019-21. However, the substantial fiscal consolidation and deeper structural reforms supported under this operation could support sustainable growth and recovery and help mitigate the risks over the medium term. Furthermore, in light of the government's significant financing needs, the proposed DPL/PBG will help (partially) mitigate the financing pressures in the short term. Yet given the scale of uncertainty in the external environment, this operation will face high risks under any scenario.

76. ***Political and governance risk***: Beyond the negative effects on fiscal and debt consolidation, weaker growth and high unemployment could increase social discontent and weaken the public support for economic reforms, including those supported under this operation. Political discontent against reforms could potentially undermine support for the minority Government's agenda. This could reduce the Government's political ability to implement and sustain the needed fiscal and structural reforms. The loss of support to the government's agenda to strengthen public finances could induce the loss of consumer and investor confidence and further financial market volatility. The EU accession negotiations, as well as enhanced economic governance should help ensure staying on the course. The accession negotiation will also be instrumental in helping Montenegro establish a good track record on fighting corruption and organized crime.

77. ***Social and Stakeholder risk.*** Affected stakeholders (some mothers) have expressed discontent against the proposed reforms, while trade unions may oppose the labor market and pension reforms. Supporting the government in a clear communication strategy, engaging with all affected stakeholders, strengthening employment service delivery as well as adoption of the compensation measures like in the case of mothers' benefits, could go a long way to mitigate such risks.

Table 10. Summary Risk Ratings

Risk Categories	**Rating (H, S, M or L)**
1. Political and governance	H
2. Macroeconomic	H
3. Sector strategies and policies	M
4. Technical design of project or program	M
5. Institutional capacity for implementation and sustainability	M
6. Fiduciary	M
7. Environment and social	S
8. Stakeholders	S
9. Other	L
Overall	High

ANNEX 1. POLICY MATRIX

Prior Actions under the DPL1/PBG1 (2017)	Indicative triggers for DPL2/PBG2 (tentative 2019)	Results Indicators
	Pillar 1: Strengthening Fiscal Sustainability	
Prior Action 1: To improve revenue collection, the Member Country has: (i) increased the statutory rate of the value-added tax from 19 percent to 21 percent, through the amendment of the Law on Value Added Tax; (ii) increased the excise tax rates on tobacco products, alcohol, and sugary drinks and introduced a new excise tax on coal through the amendments to the Law on Excises.	**Trigger 1**: To improve revenue collection and reduce informality the Member Country enacted a Law on Electronic Fiscalization.	Tax revenues as a share of GDP increased. Baseline: 2016=37.3% Target: 2019=38.5%
Prior Action 2: To strengthen its public finance management the Member Country has: (i) introduced a three-year rolling budget through the amendments to the Law on Budget and Fiscal Responsibility; and (ii) adopted a Decision on Program Budgeting.	**Trigger 2:** To strengthen its public finance management the Member Country (i) enacted the Law on Public Sector Accounting to enhance completeness of the annual budget and advance the implementation of accrual accounting and financial reporting in the public sector; and (ii) amended the Decree on Capital Budgeting to strengthen prioritization, selection, appraisal and evaluation of capital investments.	PEFA score on multi-year budget perspective improved. Baseline: 2013=C+ Target: 2019=B Capital budget execution rate improved. Baseline 2016: 23% Target 2019: 75%
Prior Action 3: To reduce public sector wage bill the Member Country has: (i) enacted the amendments to the Law on Salaries for Public Sector Employees to reduce wage coefficients by 1 percent and senior officials' wages by 6 percent; and (ii) amended the Decision on Variable Part of Pay to reduce performance bonuses.	**Trigger 3:** The Member Country has (i) begun implementation of a central government payroll module that shall be integrated with the central personnel records; and (ii) adopted the time-bound public-sector staff optimization plan and launched its implementation to reduce the employees at the general government level.	General government wage bill as a share of GDP reduced. Baseline: 2016=13% Target: 2019=11%
Prior Action 4: To rationalize costs of pharmaceuticals the Member Country has: (i) adopted the Decision on a Definition of a List of Medicines – a list of essential drugs to be fully covered by the Health Insurance Fund, and a List of co-paid drugs; and (ii) introduced Managed Entry Agreements for high-cost medicines in order to decrease spending on high-cost medicine and keep pharmaceutical budget under control.	**Trigger 4:** The Member Country has developed clinical protocols and pharmacotherapeutic guidelines in order to rationalize prescriptions and the use of expensive drugs, as well as has adopted the Rulebook on health technology assessments as a tool to support decision-making about reimbursements.	Pharmaceutical spending reduced. Baseline: 2016=1.4% of GDP Target: 2019=1.3% of GDP or less
Prior Action 5: To improve social and fiscal sustainability of social benefit system, the Member Country has: (i) amended the Law on Social and Child Protection to abolish the lifetime benefits for mothers of three or more children and increase the amount of the means-tested Child Allowance; and (ii) adopted	**Trigger 5:** The Member Country has improved social and fiscal sustainability of the pension system through amendments to the Law on Pension and Disability Insurance to eliminate special retirement conditions and penalty-free retirement with 40 years of service regardless of age; eliminate special conditions for retirement; and revise valorization and indexation.	Pension and social benefit transfers as a share of GDP reduced. Baseline: 2016=12.9% of GDP Target: 2019=11.2% of GDP

Prior Actions under the DPL1/PBG1 (2017)	Indicative triggers for DPL2/PBG2 (tentative 2019)	Results Indicators
the Law on Implementation of the Constitutional Court Decision to compensate former recipients of the lifetime benefit.	**Trigger 6:** To increase hiring flexibility and decrease informality the Member Country has amended the Labor Law to (i) extend the maximum length of fixed-term contracts from 24 to 36 months, and (ii) an employment contract shall be concluded prior to commencement of work, in a written form.	Labor force participation rate increased. Baseline: 2016=54.5% Target: 2019=55.5%
Prior Action 6: To reduce the cost of procurement, the Member Country has introduced centralized procurement through the adoption of the Decree on Centralized Procurement of Goods and Services.	**Trigger 7:** The Member Country has introduced centralized procurement for standard goods and services including telecommunications, fuel, coal, stationery, sanitation, cars, furniture, insurance among others.	Spending on items procured centrally reduced. Baseline: 2016=0.6% of GDP Target: 2019=0.5% of GDP
Pillar 2: Strengthening Financial Sector Resilience		
Prior Action 7: To enhance the NPL resolution framework the Member Country has enacted amendments to the Law of the Voluntary Financial Restructuring of Debts towards Financial Institutions to expand the coverage, lower the associated administrative costs and revise the disclosure requirements of non-performing loans.	**Trigger 8:** The Member Country has adopted amendments to the Decision on the minimum standards for management of credit risk in line with the EBA guidelines to (a) prohibit banks to classify assets as performing or nonperforming on the basis of adequate collateral, rather than the borrowers' ability to repay; and (b) strengthen requirements for reclassification of nonperforming assets to higher categories ensuring uniform prudential treatment of restructured loans.	Improved quality of loan portfolio Baseline: 0 Target: restructured loan amounts of at least EUR 15 mill by 2019 Well-capitalized banking sector Baseline: Capital adequacy ratio Baseline 2016=16.1 percent Target: 2019=above 10 percent
Prior Action 8: The CBM has (i) approved time-bound Supervisory Action Plans (SAP) for three banks with qualified audit reports in 2015, requiring full compliance with minimum regulatory requirements and provisions and (ii) made progress in implementation of SAPs including balance sheet adjustments, additional provisioning requirements, and recapitalization processes for these banks, where necessary.	**Trigger 9**: The CBM updates SAPs to include contingency measures for three banks, and takes action to resolve, restructure or liquidate banks that are materially non-compliant with the regulatory requirements and SAP provisions.	Three banks with qualified audit reports in 2015 maintain solvency ratios above 10 percent or intervened.
Prior Action 9: To expand the financial sector supervisory framework the Member Country has adopted the Law on Financial Leasing, Factoring, Purchase of Receivables, Micro-Lending and Credit-Guarantee Operations bringing factoring, leasing and micro-finance companies under CBM oversight.		Factoring companies supervised by the CBM Baseline: 2016=No supervision Target: 2019=The CBM receives quarterly financial reports from factoring companies
Prior Action 10: To strengthen financial sector supervisory framework the Member Country has amended the Central Bank Law to enhance institutional, financial and personal independence of the CBM and (ii) enable the CBM to regulate	**Trigger 10:** To strengthen financial sector supervisory framework and the financial safety net the Member Country enacted: (i) amendments to the Banking Law, the Bank Resolution Law, and the Deposit Protection Law to enhance the bank resolution framework; and (ii) the Banking Law to enhance	Improved banking supervision and resolution frameworks consistent with the Basel Core Principles and BRRD

Prior Actions under the DPL1/PBG1 (2017)	**Indicative triggers for DPL2/PBG2 (tentative 2019)**	**Results Indicators**
and supervise payments institutions, including e-money institutions, in line with the EU Payment Systems Directive.	requirements for quality of capital, liquidity and leverage buffers by transposing the European CRD IV.	Baseline: 2016=No Target: 2019=Yes

ANNEX 2. LETTER OF DEVELOPMENT POLICY

Ministry of Finance
Montenegro
Class:
Reg. No.: 01-19399/1

Podgorica, November 9th, 2017

Dr. Jim Yong Kim
President
The World Bank
Washington D.C.

Subject: Letter of Development Policy
Montenegro: First Fiscal and Financial Sector Resilience Policy-Based Guarantee

Dear Dr. Kim,

On behalf of the Government of Montenegro, we kindly request the endorsement of the first EUR80 million operation in a series of two Programmatic Fiscal and Financial Sector Resilience Policy-Based Guarantees (PBG) to support our economic reform program. We are committed to safeguard fiscal sustainability and make our financial sector more resilient to shocks. The reform agenda is incorporated into our 2017-2020 Fiscal Strategy and builds on the Government Economic Reform Program 2017-2019 submitted to the European Commission (EC) as part of the economic governance surveillance for the European Union (EU) candidate countries.

After a double-dip recession in the period of 2008-2012, when the poverty rate, unemployment and public debt doubled, economic growth resumed with an average growth rate of close to 3 percent since 2013. Growth has picked up to over 4 percent in the first half of 2017 due to intensified personal consumption, an acceleration of the Bar-Boljare highway construction (connecting the port in the south with the least developed north and the border with Serbia) and a record high tourism performance. The labor market started recovering with average unemployment rate declining to 16.7 percent by June 2017 (down from 17.7 percent for 2016). Credit to the economy recovered and the non-performing loan ratio declined to below 8 percent from over 25 percent at its peak in 2011. The convergence with the EU countries has been restored and the country is now where it was back in 2008, at 42 percent of GDP per capita in PPS of the EU28. Yet, the vulnerabilities accumulated during the past needed to be addressed urgently to restore the investors' confidence.

Since 2010, primary deficits of over 3 percent of GDP a year led to a steep rise in public and publicly guaranteed debt to above 71 percent of GDP by 2016. At the same time, current account deficit, netted out for foreign direct investments, has been at over 4 percent of GDP, leading to a rise in external debt to above 164 percent of GDP. The twin deficits need to be tamed urgently and the Fiscal Strategy adopted by the Parliament in June 2017, supported by the International Monetary Fund and Your team, aims to address these immediate vulnerabilities. Together with the 2017 budget, in December 2016, the new government adopted a set of fiscal consolidation measures amounting to overall 3.2 percent of GDP to be implemented over the medium term as a combination of revenue and spending measures. From June, additional 3 percentage points of GDP in cumulative savings was approved, including increasing VAT rate from 19 to 21 percent, increasing excises on tobacco, sugary drinks, alcohol and coal, further reduction of public sector officials' wage, as well as abolishing lifetime benefits for mothers of three and more children that withdrew the most productive part of society from the labor market. The measures adopted so far aim to reduce the 2017 deficit to 4 percent of GDP from 6 percent of GDP in the absence of the reform program. Furthermore, the Strategy proposes to reach the budget surplus and decline in public debt from 2019, for the first time since the country's independence since 2007.

As a small euroized economy, we need to build resilience to external shocks to avoid disorderly and painful adjustments. Thus, we are also working on the overhaul of the financial sector legislation to strengthen its resilience. We appreciate the World Bank technical support in that regard. Among the priorities for the medium term are strengthening the non-performing assets resolution and the supervision of ailing banks, enhancing the independence of the Central Bank of Montenegro and the extension of its supervisory role to the nonbanking financial sector, as well as addressing the full harmonization of the financial sector legislation with the EU Directives on the Capital Requirements Directive IV, Payment System, and the Bank Recovery and Resolution.

These measures should not be looked at in isolation of structural reform agenda the government committed to in the 2017-2019 Government Economic Reform Program. The level of government expenditures at 46 percent of GDP is high compared to EU peers, and this level will be further adjusted upwards as we align the fiscal statistics with the ESA2010 with the support of Eurostat. Such a level of spending crowds out private sector and we are adamant to address it through social and public administration reforms. Despite efforts to improve business environment, private sector development is still hampered by the lack of green-field investments into productive sectors, low backward linkages of the tourism sector with the rest of the economy, and lack of available labor force. The inactivity of the labor force remains high, at 45 percent, and we are working with the World Bank to reduce disincentives to work.

This letter summarizes crucial aspects of our program focused on enhancing fiscal sustainability and strengthening financial sector resilience. We believe that this Policy-Based Guarantee provides the appropriate tool for the Bank's support in addressing our medium-term policy agenda, whereby we count on the World Bank as a partner.

Strengthening Fiscal Sustainability

To strengthen revenue collection, the Parliament increased the statutory rate of the value-added tax (VAT) from 19 percent to 21 percent in July 2017, along with the excises on tobacco products, alcohol, and sugary drinks. This tax rates adjustment would account for half of the planned fiscal adjustment envisaged. While the rise in the VAT and excise tax rates will make the tax system slightly more regressive, the lower VAT rate (at zero for drugs on the Health Insurance list and 7 percent for basic food package) remains unchanged, and the increase in excise taxes will affect products with an adverse health effect. We have also introduced the excise tax on coal, in line with the country's energy and climate policy objectives, that aims to contribute towards achieving the GHG emissions reduction target, as committed in the context of the Paris Climate Agreement. While the excise on coal will not be revenue exhaustive (it will gradually increase to EUR 0.30 per GJ in 2020), it would aim to change the consumers' behavior in favor of transition toward sustainable and cleaner energy mix. At the same time, the excise on coal is expected to have somewhat limited overall social impact since the use of coal, as a source for heating, is estimated to be used by 1 percent of households.

Going forward, we will continue to strengthen the tax compliance in the service sector, and appreciate the help of your team in support of this agenda. We aim to introduce fiscal registers which will help reduce undeclared turnover, leading to increased revenue collection, particularly from tourism and catering services.

To strengthen public financial management system, the Parliament enacted the amendments to the Law on Budget and Fiscal Responsibility on October 16, 2017. The amendments require preparation of a three-year rolling budget, for which the first year is mandatory and the subsequent two years are for medium-term planning purposes. We aim to strengthen our medium-term budget planning by introducing medium-term commitments into the line ministries' budgets. In addition, we have adopted a Decree on Program Budgeting in November 2017 to further strengthen accountability of the budget process by more systematically monitoring progress toward budget and policy objectives using performance indicators.

In 2018, consistent with the 2016-2020 Public Finance Management Reform Program, we aim to adopt the Law on Public Sector Accounting which would strengthen fiscal reporting in the context of a transition to accrual accounting. Passage of this law will enhance the completeness and quality of financial information and budget reporting, which should enable improved planning and management of budget funds. Further, to establish more credible capital budgeting, and with the technical support from the World Bank, we will be amending the Decree on Capital Budgeting to strengthen the Government's ability to prioritize, select, appraise and evaluate capital projects. We will use this opportunity to provide more clarity on the procedures and controls for project management, enhance the quality of project reporting, and strengthen the framework for project monitoring and evaluation (during both implementation and post-implementation).

We need to consolidate public administration cost. At 13 percent of GDP, the public-sector wage bill remains comparatively high and is creating pressures on public finances. This became even more obvious after the Law on Salaries for Employees in the Public Sector decompressed the salary scale and included various bonuses into the basic coefficients in early 2016, which led to an expansion in wage bill expenditure. We subsequently implemented a series of amendments to the Law on Salaries for Employees in the Public Sector: first, reducing the wages of senior officials (top Grades A to C as well as wages of local government mayors) by 8 percent in December 2016; then taking an additional 6 percent in June 2017; and reducing the base salary for all employees, except the low-income groups, by 1 percent from March 2017. Additionally, through the Government Decision from April 2017, we have limited the size of variable pay (i.e. performance bonuses) from 80 to 50 percent of the average salary in Montenegro.

Over the coming year, we will launch the implementation of the time-bound plans to optimize the size of the public service, which is large by OECD standards, amounting to 30 percent of total employment in 2015 (compared to an OECD average of 21 percent). Previous efforts to reduce the size of the civil service fell short of their objectives, partly due to excessive hiring at the local government level. Going forward, our approach will be grounded in our 2016-2020 Public Administration Reform (PAR) Strategy, which seeks an optimization based on an analysis of functions, organization, staffing, and competencies, with the implementation overseen by a PAR Council. We have requested the support of the World Bank for conducting functional reviews in the Ministry of Public Administration and Human Resources Directorate. Our aim is to advance the introduction of the Central Government Payroll Module in our Treasury system. Currently, payroll and public employment information are maintained separately by the Ministry of Finance and the Human Resource Management Agency, respectively. Through the planned integration of central government personnel records with automated salary calculation, the Government will ensure that salaries are paid to employees in line with employment records and the law. Also, it will be adopted the time-bound public-sector staff optimization plan and launched its implementation to reduce the employees at the central government level.

To ensure sustainability of health financing, we have approved the Health Reform Strategy in December 2016 that outlines measures which should prevent future incurrence of health sector arrears that we cleared in late 2016 in the amount of one percent of GDP. The Parliament has subsequently enacted the amendments to the Health Insurance Act in January 2017 to reduce sick leave benefit for employees to 70 percent from 100 percent of the last reported remuneration. The sick leave rate remains high and we have strengthened the control of the approval system to further eliminate abuses and contain the cost. Further, we had to stop the rising cost of pharmaceuticals. The size of the Montenegrin pharmaceutical market had reached 1.8 percent of GDP in 2016, of which 70 percent is publicly funded. In 2016, public spending on medicines increased by 10 percent and the largest increase was recorded in antineoplastic and immunomodulating agents, with spending on one such drug increasing by over 50 percent. In many countries, such medicines are subject to cost-containment measures, including risk-sharing and Managed Entry Agreements (MEAs) to share financial risks and uncertainty between the payer and pharmaceutical companies. In October 2017, we have concluded three MEAs for high-cost

medicines and negotiated additional 8, in accordance with the Article 7 of the Decree on Criteria for Drug Listing adopted in July 2016, to help keep the pharmaceutical budget under control. We aim to conclude at least additional 60 MEAs by the end of the year. Further, to help contain costs and ensure that public health needs are met in a more equitable way, the Government has in October 2017 adopted a Decision on a List of Reimbursed Medicines—that is a list of essential drugs to be fully covered by the Health Insurance Fund, and a List Subject to Co-payment up to 48 percent. We aim to save EUR 5 million, or 10 percent of the pharmaceutical budget in 2017, from the dual list of drugs which includes medicines subject to MEAs, while we have ensured a broad coverage of our citizens through the basic insurance that covers the positive list of reimbursed medicine.

Looking ahead, we will be developing clinical protocols and pharmacotherapeutic guidelines to rationalize prescriptions and the use of expensive drugs, as well as adopting a rulebook on health technology assessments as a tool to support decisions on reimbursement. This work will be completed before the end of 2018. The World Bank support in this area would be much appreciated.

To improve social and fiscal sustainability of Montenegro's social protection system and incentivize higher labor force participation, we have amended the Law on Social and Child Protection in June 2017 to abolish the so-called "mothers' benefit". They were introduced in 2016 by the parliament without the regular impact assessment procedure as a lifetime benefit for mothers of three or more children, Namely, women who had given birth to three or more children, with at least 25 years of work (or 15 years in case of four or more children) and a social insurance record of 15 years of unemployment registration, became eligible for a lifetime monthly benefit equivalent to 40 to 70 percent of the average net wage. Originally envisioned as a small benefit to promote fertility, it turned out to have significant implications for the government budget and labor market participation, but did not address fertility given the average age of beneficiary was 56. The high cost of the "mothers' benefit" alone triggered additional spending of 1.9 percent of GDP in 2016, close to the spending on all family and child protection programs combined. We were also concerned as we witnessed thousands of women leave formal jobs to receive the benefit, and thousands more registered with the Employment Agency as unemployed, in expectation of becoming eligible for the benefit. The need to reform the "mothers' benefit" intensified with the Constitutional Court of Montenegro's ruling of April 19, 2017. The Court concluded, among else, that legal provisions related to the "mothers' benefit" discriminated against other women and single-parent men and thus were not in line with the Constitution.

Fully aware of the potential social impact of abolishing the benefit, we introduced measures to cushion the negative effects and simultaneously strengthen the family and child protection system. Thus, the same amendments to the Law on Social and Child Protection also increased by 20 percent benefits to children in families receiving poverty-targeted social assistance, children with disabilities, children without parental care, the child birth benefit, compensation for giving birth when one of the parents is either registered unemployed or full-time student, the care and support allowance, and the personal disability allowance. We also adopted the Law on the Execution of the Constitutional Court Decision in June 2017 to specify mitigating measures and comply with the Constitutional Court ruling that the former recipients of the "mothers' benefit" should be restored to a status not worse than the one they had at the time they became eligible for the benefit. With this law, we introduced three sets of compensatory measures for 21,825 women who were receiving the benefit, based on the grounds for their eligibility. First, women who qualified based on years of registration as unemployed could return to the services and rights as registered unemployed. Second, women who were former pensioners could return to the pension system. Third, women who had left open-ended formal-sector jobs to switch to the "mothers' benefit" became entitled to temporary financial compensation depending on prior wage with duration between 36 and 60 months depending on age. The period within which the compensation is paid will count as work record, and the state budget will pay contributions to pension insurance. By now, most former pensioners have re-entered the pension insurance system and most former recipients of the unemployment benefit have regained access to their unemployment benefits. Payments of temporary financial compensation and

insurance contributions started in September 2017, with retroactive payments for July and August. There are also procedures for grievance and redress as specified in the laws, while our Social Card information system minimized administrative barriers for beneficiaries to access social assistance and enhanced targeting of social assistance.

Going forward, we aim to address the sustainability of our pension system. The current pension system has several critical shortcomings pertaining to its adequacy and sustainability. It is costly: it exhausts 11 percent of GDP and generates a deficit of almost 3 percent of GDP. At the same time, the adequacy of pension benefit is expected to decline to a socially unsustainable level over the long term. The work done jointly with Your team will inform the design of the amendments to the Law on Pension and Disability Insurance with an objective to eliminate special retirement conditions and penalty-free retirement with 40 years of service regardless of age. We will also revise valorization and indexation of pensions to decelerate the erosion of future replacement rates.

We have also initiated the reform of the labor legislation with the objective to improve employment outcomes as Montenegro is faced with high levels of informality and unemployment, and low level of labor participation (at 54 percent). A tripartite Commission composed of representatives of the Government, unions and employer federations, has drafted a new labor law. The reformed law includes two features that are expected to increase hiring flexibility and decrease informality: (i) extend the length of fixed-term contracts from 24 to 36 months, and (ii) conclude the employment contract prior to commencement of work, in a written form. We want to draw on the World Bank's support to strengthen the law further.

To reduce the costs of procurement, we have introduced Centralized Procurement for standard goods and services in line ministries through a Decree on Centralized Procurement for Goods and Services adopted in October 2017. In 2018, centralized procurement will begin for purchases of gas, stationary, furniture, personnel and building insurance, mobile and internet telecommunication services, sanitation services, and cars. In the next six months, we plan to save at least 5 percent of the initially planned budget due to strengthened negotiating power and a larger volume of standardized goods and services.

Strengthening Financial Sector Resilience

Montenegro's financial sector remains liquid and well capitalized with a capital adequacy ratio well above the regulatory minimum of 10 percent. However, as recommended by the 2016 IMF/WB Financial Sector Assessment Program (FSAP), there are several areas where additional efforts need to be invested to make the financial sector more resilient to shocks. Aware that any new regulatory change may temporarily put pressure on the banking sector, the high level of capital in the system should ensure that the transition will be smooth. The Central Bank of Montenegro (CBM) is actively working on impact assessments to identify and mitigate risks associated with ongoing regulatory changes.

To further resolve non-performing assets and improve credit risk management, we have adopted amendments to the Law on Voluntary Financial Restructuring of Debts towards Financial Institutions in June 2017 and extended the voluntary debt restructuring framework until May 2, 2018. The amendments include some of the FSAP 2016 recommendations such as expanding the coverage, lowering the associated administrative costs and revising the disclosure requirements. We are glad to report that over this short period of time, we have seen a significant increase in the amount of restructured loans under this Law, above EUR10 million, proving the effectiveness of the amendments.

Going forward, we aim to amend the Decision on the minimum standards for management of credit risk in line with the European Banking Authority guidelines to (a) prohibit banks to classify assets as performing or nonperforming on the basis of adequate collateral held by them, rather than the borrowers' ability to repay; and (b) strengthen requirements for reclassification of nonperforming assets to higher categories ensuring uniform prudential treatment of restructured loans.

To address weaknesses in three banks with qualified audit reports, the CBM has intensified supervision and performed on-site inspections. There was a significant progress made in the planned supervisory actions. Following the on-site examinations, NPL ratios, provisions and capital adequacy levels were adjusted based on the findings of the on-site inspectors and audit reports. The CBM had asked banks to hold regulatory reserves and increase capital where necessary in line with the supervisory action plans (SAPs). Further, banks were examined for closely related institutions and required to limit related party transactions in line with regulatory requirements. Banks were also asked to improve their financial reporting and correct factors that could cause qualified audit opinion.

Although not systemic, we plan to remain vigilant on updating and implementing SAPs for three banks and taking action to resolve, restructure or liquidate the banks that are materially non-compliant with the regulatory requirements and SAP provisions.

To expand the financial sector supervisory framework, we have adopted the Law on Financial Leasing, Factoring, Purchase of Receivables, Micro-Lending and Credit-Guarantee Operations in October 2017. The new law improves legal clarity and certainty of non-bank financial services in Montenegro, increases efficiency of service provision on the supply side and protection of consumers' rights on the demand side, as well as enhances the supervisory and regulatory role of the CBM over the non-banking financial sector by bringing factoring, leasing and MFI companies under CBM oversight.

Going forward, to further strengthen financial sector supervisory framework, we will prepare the new Banking Law to enhance requirements for quality of capital, liquidity and leverage buffers by transposing the EU Capital Requirements Directive IV.

To strengthen financial sector supervisory framework, we have enacted amendments to the Central Bank Law on October 16, 2017. With these amendments, we have enhanced central bank institutional, financial and personal independence, also required as part of our accession negotiations process with the European Union. We have also enabled the CBM to regulate and supervise payment institutions, including e-money institutions, in line with the EU Payment Systems Directive I.

Over the next year, we aim to further enhance the financial safety net through enactment of the amendments to the Banking Law, the Bank Resolution Law and the Deposit Protection Law, by transposing the EU Bank Recovery and Resolution Directive.

In closing, I would like to reiterate the strong commitment of the Government of Montenegro and the Central Bank of Montenegro to these reforms which will help safeguard fiscal sustainability and make our financial sector more resilient to shocks. We are confident that this letter outlines a coherent program of critical policy priorities over the medium term. We would like to reiterate that the continued support of the World Bank will be essential for achieving these goals and trust that this request for the World Bank support through a Policy-Based Guarantee will receive your endorsement.

Sincerely,

Darko Radunovic
Minister of Finance
Montenegro

ANNEX 3. FUND RELATIONS ANNEX

Press Release No. 17/XX
FOR IMMEDIATE RELEASE
September 13, 2017

International Monetary Fund
700 19th Street, NW
Washington, D.C. 20431 USA

IMF Executive Board Concludes 2017 Article IV Consultation with Montenegro

On September 8, 2017 the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Montenegro.[27]

Montenegro's economy continues to grow at a moderate pace, and growth should continue over the medium term, boosted by the implementation of large investment projects, including the construction of the Bar-Boljare highway. Staff projects the economy to expand by 3 percent in 2017 and 2¾ percent in 2018, with planned fiscal consolidation acting as a moderate drag on growth.

While the implementation of large publicly financed infrastructure projects will add to economic growth, the accompanying use of fiscal resources has contributed to a large increase in government debt, which reached 78 percent of GDP in 2016. Large refinancing needs in coming years are also a source of fiscal vulnerability.

Recognizing the need to reduce public debt, the government has embarked on a path of fiscal consolidation, beginning in the 2017 budget. Subsequently, the government announced in June 2017 a medium-term fiscal consolidation strategy that, if implemented, would considerably strengthen the fiscal position. Staff estimates that the government's fiscal measures would raise the primary fiscal surplus to 4½ percent of GDP by 2020, allowing government debt to fall to 66 percent of GDP by 2020.

Conditions in the banking sector continue to strengthen, with improving asset quality and recovering credit growth. Non-performing loans, however, remain elevated, and the sector appears to be over-banked, presenting a challenge for bank profitability.

The lack of an independent currency and declining fiscal space constrain Montenegro's ability to absorb shocks, which underscores the need for an improvement in economic flexibility to sustain growth over the long run. Low labor productivity and employment levels and a large informal sector limit potential growth. The government's plans to reform labor laws provide an opportunity to improve the flexibility of labor market outcomes, boost participation rates, and reduce informality.

---

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

Executive Board Assessment[28]

Executive Directors welcomed Montenegro's growth performance, bolstered by large investment projects and improving banking sector conditions. While the economic outlook is positive, risks stemming from the large increase in public debt and external financing needs raise concerns about fiscal sustainability and external stability. Against this background, Directors stressed the importance of continued fiscal adjustment to reduce debt and meet refinancing needs, sustained efforts to strengthen the financial sector, and fiscal and structural reforms to support higher and more inclusive growth.

Directors welcomed the authorities' well-specified, medium-term fiscal adjustment plan, which includes social protection measures for the most vulnerable. They concurred that, if fully implemented, the plan would place government debt on a strong downward path. Given the size of the intended adjustment, Directors saw merit in communicating the need and reasons for adjustment clearly to the public. They also saw scope for a further reduction in government expenditures over the medium term, including through civil service and pension reforms. Directors agreed that fiscal space does not exist to finance subsequent phases of the highway project with debt, and encouraged the authorities to explore other financing options.

Directors noted that, while the health of the banking system has improved, non-performing loans (NPLs)–while declining–continue to be high, and profitability remains weak. They concurred that the authorities should seek further reductions in the stock of NPLs while strengthening the supervisory and regulatory frameworks. Directors welcomed the authorities' intentions to undertake asset quality reviews. Noting that the system may be overbanked, they saw merit in possible efforts to promote consolidation. Directors encouraged the authorities to explore options to improve emergency liquidity assistance and welcomed their intention to expand supervision to cover the non-bank financial system. They welcomed the progress in implementing some of the FSAP recommendations and recommended that the authorities press ahead with measures to bolster financial sector resilience and further strengthen the AML/CFT framework.

Directors underscored the importance of structural reforms to boost competitiveness, productivity, and private sector investment to sustain economic growth over the longer term. They encouraged the authorities to use the new labor law under discussion to improve labor market flexibility, facilitate job creation, and reduce the informal economy. Directors supported shifting taxation from social contributions to increased coal excises to promote greater levels of formal employment, reduce energy subsidies, and decrease local pollution. Accelerating privatization of the remaining state-owned enterprises was also encouraged.

---

[28] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

Montenegro: Selected Economic Indicators

	2013	2014	2015	2016	2017 Proj.	2018 Proj.
Output, prices and labor market (percent change, unless otherwise noted)						
Real GDP (percent change)	3.5	1.8	3.4	2.5	3.0	2.8
Nominal GDP (in millions of euro)	3,362	3,458	3,625	3,773	3,970	4,187
Industrial production	10.6	-11.4	7.9	-4.4	...	...
Tourism (Overnight stays)	7.1	-9.2	5.3	8.4	...	...
Unemployment rate (in percent)	19.5	18.0	17.6	17.7	...	...
Consumer prices (average)	2.2	-0.7	1.5	-0.3	2.1	2.6
Consumer prices (end of period)	0.3	-0.3	1.4	1.0	1.6	2.6
Average net wage (12-month)	-1.7	-0.5	0.7	4.0	...	...
General government finances (percent of GDP) [1]						
Revenue and grants	41.3	43.5	40.7	43.3	43.5	45.1
Expenditure	45.8	44.2	46.6	49.4	50.0	50.7
Overall fiscal balance	-4.5	-0.7	-5.9	-6.0	-6.4	-5.6
Primary fiscal balance	-2.4	1.6	-3.5	-3.8	-3.9	-2.9
General government gross debt	58.7	63.4	69.3	70.0	71.6	73.6
General gov't gross debt (authorities' definition) [2]	55.2	59.9	66.7	67.5	69.1	71.3
General gov't debt, including loan guarantees	66.7	71.5	76.8	78.0	79.3	81.0
Monetary sector (end-period, percent change)						
Bank credit to private sector	1.9	-0.4	2.2	6.4	7.5	6.4
Enterprises	0.3	-2.5	1.7	1.6	...	...
Households	3.7	1.7	2.7	11.1	...	...
Private sector deposits	1.8	6.1	9.0	6.0	...	...
Balance of payments (percent of GDP, unless otherwise noted)						
Current account balance	-14.5	-15.2	-13.3	-19.0	-20.2	-21.2
Foreign direct investment	9.6	10.2	17.1	9.8	10.3	10.4
External debt (end of period, stock) [3]	153.5	163.1	163.1	166.8	169.8	173.5
REER (CPI-based; average change, in percent; - indicates depreciation)	-1.1	-0.2	1.5	0.3	...	...

Sources: Montenegro authorities; and IMF staff estimates and projections

1/ Includes extra-budgetary funds and local governments, but not public enterprises.

2/ The authorities do not include the arrears of local government in their definition of general government gross debt.

3/ Staff estimates, as private debt statistics are not officially published.

ANNEX 4. ENVIRONMENT AND POVERTY/SOCIAL ANALYSIS TABLE

Prior actions	Significant positive or negative environment effects (yes/no/to be determined)	Significant poverty, social or distributional effects positive or negative (yes/no/to be determined)
Pillar 1: Strengthening Fiscal sustainability		
Prior action #1	Yes, positive	Yes, negative. The proposed rise in excises and VAT would increase poverty of the tax system, but would also have positive health and environmental impact. The reduced VAT rate on basic products would remain unchanged at 7 percent, reducing the impacts on the bottom parts of the distribution.
Prior action #2	No.	No.
Prior action #3	No.	No. Wage reductions refer to those of Senior officials, high-wage brackets, as well as medium-wage brackets.
Prior action #4	No.	No. Negligible impact of the introduction of co-payment list since for every drug, there will be the option of obtaining the drugs from the basic list that is fully reimbursed.
Prior action #5	**No**	Yes, negative. The proposed 20-percent rise in means-tested benefits will be pro-poor, while abolishing the lifetime benefits will be mitigated by the employment policies, unemployment benefits, temporary financial compensation for formerly employed mothers who were recipients of the lifetime benefit and allowing re-entry to pension for elderly women.
Prior action #6	No	No
Pillar 2: Strengthening Financial Sector Resilience		
Prior action #7	No.	No.
Prior action #8	No.	No.
Prior action #9	No.	No.
Prior action #10	No.	No.

ANNEX 5. RATIONALE AND DETAILS OF THE PROPOSED POLICY-BASED GUARANTEE

1. **The Government of Montenegro has requested IBRD support in the form of a policy-based guarantee (PBG) to enhance a large market borrowing.** A PBG of EUR 80 million can be used to raise up between EUR 200-240 million, which will help Montenegro to meet its financing needs in 2018 and support refinancing liabilities coming due in 2019-2021. This outcome would represent a well leveraged transaction, in which approximately 2-3 times the guarantee amount may be mobilized, and would align with IBRD's broader objective to leverage its balance sheet and increase risk-sharing with private partners.

2. **The proposed PBG would help Montenegro to obtain financing at a sustainable cost and an attractive maturity, by catalyzing lower cost financing and a longer maturity than is currently available on a standalone basis.** Lenders today have limited appetite to provide scaled budget financing to Montenegro. Market sounding of local and foreign banks reveals that few institutions today are willing to lend to the government at reasonable maturities and manageable costs without some form of guarantee. Surveys have, nonetheless, also shown that the presence of IBRD, through its AAA coverage of a share of the transaction and its partnership role in the transaction, can improve terms for Montenegro in meaningful ways. Maturities of 10 years or longer appear achievable with the PBG-supported transaction, however few market participants consider this likely under efficient terms without a credit enhancement, at this point in time, in either the bank or the bond market. Notional cost savings may be estimated in the 200bp per annum, although a competitive process may lead to even greater cost reduction.

3. **The Government of Montenegro prefers to use the PBG to support a private transaction in the lending market, rather than a public transaction in the Eurobond market.** The projected size of the transaction is considered manageable in the former market but would represent a fairly small issuance volume in the latter, undermining the liquidity and efficiency of a theoretical bond. Numerous dealers consulted have also noted that price savings achievable in the bond market may be low, due to the aforementioned consideration, as well as to the limited credit rating improvement possible, weak demand in the liquid Emerging market bond investor base for non-standard or hybrid instruments such as partially covered Eurobonds, and difficulty with pricing and trading of the asset. Bank markets present their own challenges, including funding cost considerations for lending institutions, internal balance sheet charges, return requirements, reduced scalability, etc., all of which also may undermine efficiency. Yet, the expected benefits are considered higher in the loan market for this borrower, at this juncture in time than in the bond market.

4. **The PBG aims to mobilize a market loan that amortizes principal repayments and/or partially clears the debt hurdle faced by the Government between 2019-2021.** Rollover risks are high and need to be proactively managed. The external debt of Montenegro has an average time to maturity of roughly four years, which is higher than for domestic debt; however, very large Eurobond redemptions will come due between 2019-2021, representing over 45 percent of Montenegro's total debt. Near half of Montenegro's local debt has maturities of less than a year, suggesting risks during these years exist both externally and domestically. To ensure a manageable repayment profile and to address roll-over risks stemming from external debt in the next four years, the Government seeks to mobilize the PBG-supported funding with a grace period of at least four years.

Figure 1. Repayment Profile of Public Debt (EUR millions)

Source: MOF, IMF TA

5. **Following the PBG, the government will have more options open in debt management, including reentering the bond market, as economic and fiscal conditions continue to improve.** Despite the generalized optimism supporting Emerging bond markets, combined with extremely liquid financial conditions, which have led to historically low borrowing spreads for many countries, conditions for access to the external capital market for Montenegro is still not favorable. Montenegro's current outstanding bonds are comparatively small and illiquid, exchanging hands infrequently, and they are heavily concentrated with a narrow base of investors. Investment banks largely agree that Montenegro's greatest chance in the future for issuing a new Eurobond efficiently in the capital market hinges on demonstrating further economic growth and fiscal consolidation, and on developing and articulating a well-defined debt management strategy[29] that addresses medium-term liabilities and which stabilizes debt over the medium term. While recent improvements on some of these fronts is already visible, reflected by the recent upgrade in sovereign outlook by two of the main rating agencies, more progress would enhance Montenegro's credibility in the market and greatly strengthen its position with local and foreign banks, as well as bond investors.

6. **Approval is sought from the Bank's Board for the proposed PBG operation as per the PBG Indicative Term Sheet** (see Annex 7). The Executive Directors will be informed of the final terms and conditions of the PBG supported commercial financing operation after execution. If there is any substantial change in the terms and conditions of the PBG, the approval of the Executive Directors will be sought prior to execution.

[29] The IMF is providing the technical assistance to the Ministry of Finance on developing a medium-term debt management strategy and market relations strategy.

ANNEX 6. SUPERVISORY MEASURES TAKEN AGAINST THREE BANKS WITH QUALIFIED AUDIT REPORTS

Bank A		
Measures	Status	Deadline
EUR 10 million capital increase	EUR 5 million first tranche implemented	November 2017 for second tranche
Restrictions on lending and additional exposures.	Compliant	Ongoing
Prohibition of additional related party exposure	Compliant	Ongoing
Restrictions on donations and sponsorships	Compliant	Ongoing
Restrictions on dividend payments and bonuses	Compliant	Ongoing
Daily reporting to CBM	Compliant	Ongoing
Bank B		
Measures	Status	Deadline
Classification of receivables on the basis of the findings of the on-site Examination Report and external audit reports	Compliant with significant adjustments in NPL and solvency ratios	July 31, 2017
Increase provisioning to reflect adjustments in the NPLs	Compliant	July 31, 2017
Restrictions on lending and additional exposures	Complaint, last report submitted on September 30, 2017	Ongoing
Prohibition of accepting securities from related parties as collateral to receivables	Complaint, last report submitted on September 30, 2017	Ongoing
Collection of cash collateral of receivables. Report CBM on progress.	Compliant	Ongoing
Bank C		
Measures	Status	Deadline
Classification of receivables on the basis of the findings of the on-site Examination Report and external audit reports	Compliant with significant adjustments in NPL and solvency ratios	March 30, 2017
Increase provisioning to reflect adjustments in the NPLs	Compliant	March 30, 2017
Retain Minimum Solvency Ratio of 12%	Compliant. Increase in solvency ratio by means of subordinated debt and exchange of non-performing loans for immovable property	June 30, 2017
Reduce risk to related party exposures to comply with Banking Law limit	Compliant	December 31, 2016

ANNEX 7. INDICATIVE TERM SHEET OF THE PROPOSED POLICY-BASED GUARANTEE

This term sheet contains a summary of indicative terms and conditions of a proposed guarantee ("Guarantee") by the International Bank for Reconstruction and Development ("IBRD") for discussion purposes only and does not constitute an offer to provide a Guarantee. The provision of a Guarantee is subject, inter alia, to satisfactory appraisal by IBRD of the Policy Based Guarantee in support of the Fiscal and Financial Resilience Project ("Project") for Montenegro, compliance with all applicable policies of the World Bank, including those related to environmental and social safeguards, review and acceptance of the ownership, management, financing structure, and project/transaction documentation by IBRD, and the approval of the management and Executive Directors of IBRD in their sole discretion.	
IBRD-Guaranteed Loan (the Financing)	
IBRD-Guaranteed Loan Agreement:	Agreement among the Borrower, the Agent [on behalf of][and the] Lenders and IBRD as Guarantor setting out terms and conditions of the Financing, mechanism for payment on the Financing, and containing the Guarantee[30].
Borrower:	Montenegro
Guaranteed Lender/Beneficiaries of the IBRD Guarantee:	[Commercial bank lenders, or the Agent on their behalf, each to be identified]
Currency:	EUR
Principal Amount:	[200-240 million]
Term:	Up to [10-12] years
Repayment of the Financing:	[Annual][Semi-annual]
Loan Interest Rate:	[Spread above EURIBOR acceptable to IBRD] or [fixed interest rate acceptable to IBRD]
Use of Proceeds:	[Budget financing]
Drawdown:	[Single drawdown]
IBRD Guarantee Agreement	
Guarantor:	International Bank for Reconstruction and Development (IBRD)
Parties:	IBRD and the Guaranteed Lender (if several Guaranteed Lenders, a Facility Agent or Trustee acting on behalf of the Guaranteed Lenders).
Guarantee Face Value:	EUR 80 million
Guarantee Support:	IBRD would guarantee the payment, following occurrence of a Guaranteed Event, of [selected, pre-agreed debt service payments of principal and interest amounts]

[30] Alternatively, the guarantee agreement can be a stand-alone agreement between the Agent [on behalf of][and the] Lenders and IBRD. In those cases, IBRD will not be a party to the IBRD-Guaranteed Loan Agreement.

	due on scheduled payment dates up to the Maximum Guaranteed Amount.
Guaranteed Events:	Failure by the Borrower to [make certain payments of [principal] [and interest] on][repay at scheduled maturity the principal amount of] the IBRD-guaranteed Loan.
Guarantee Period:	[TBD]
Maximum Guaranteed Amount:	A partial amount of financing, not to exceed the Guarantee Face Value.
Amendments and waivers:	IBRD will be entitled to be kept fully informed about any proposed waiver or amendment to the terms of the transaction. Certain amendments or waivers to the provisions of the finance documentation and IBRD Guarantee, insofar as they relate to the IBRD Guarantee, requires the prior written consent of IBRD, including, but not limited to, any material amendment or modification to a finance document or any amendment or waiver that materially and adversely affects the rights and obligations of IBRD.
Suspension:	IBRD may, during the availability period for drawdown of the guaranteed financing, inform the Agent that no further drawdown of the guaranteed financing, from the date of notification by IBRD up until such notice is revoked by IBRD, will be covered by the IBRD Guarantee upon the occurrence of the following types of scenarios, inter alia: (i) an event of default occurs under the guaranteed financing; or (ii) the Agent or a beneficiary of the IBRD Guarantee engaged in certain sanctionable practices (fraud, corruption, coercion, collusion, obstruction) relating to the guaranteed financing. If the event giving rise to a suspension has been waived by IBRD, or remedied to IBRD's satisfaction, then IBRD may revoke its suspension notice and let the Agent know which amounts are reinstated for coverage under the IBRD Guarantee.

Exclusion:	IBRD is not liable for losses directly resulting from noncompliance with, or the invalidity, illegality or unenforceability of any transaction document under laws in effect on, or events occurring before, the date of the [Fiscal Agency Agreement] [IBRD-Guaranteed Loan Agreement]. IBRD may deny payment to a beneficiary of the IBRD Guarantee in the following types of scenarios, inter alia: (i) a sanctionable practice (fraud, corruption, coercion, collusion, obstruction) has been found to have been committed by the Agent or a beneficiary of the IBRD Guarantee; (ii) the Agent or a beneficiary of the IBRD Guarantee, inter alia, amends the guaranteed financing documents, or transfers, or assigns the financing to a non-commercial lender without IBRD's prior written consent; (iii) the Agent or a beneficiary under the IBRD Guarantee engages in Repackaging Arrangements in respect of the IBRD Guarantee.
Termination:	The Guarantee may be terminated, inter alia, if (i) an installment of the Guarantee Fee or Standby Fee is not paid when due; (ii) an amendment, waiver, modification or other change is made or given relating to certain provisions of the finance documentation, IBRD’s rights or obligations, or the Guarantee without IBRD’s prior written consent, including but not limited to any material amendment or modification to a finance document or any amendment or waiver that materially and adversely affects the rights and obligations of IBRD; (iii) following full payment of all guaranteed amounts or (iv) after the final date for payment under the Guarantee.

No Discharge:	Neither the obligations of IBRD under the IBRD Guarantee nor the rights, powers and remedies conferred upon the Agent with respect to IBRD by the IBRD Guarantee or by applicable law or regulation shall be discharged, impaired or otherwise affected by: (i) any insolvency, moratorium or reorganization of debts of or relating to the borrower; (ii) any of the obligations of the borrower under the financing agreements being or becoming illegal, invalid, unenforceable, void, voidable or ineffective in any respect; (iii) any time or other indulgence being granted to the borrower in respect of its obligations under the financing agreements; or (iv) any other act, event or omission (other than the failure of the Agent to make a timely and duly completed demand under the IBRD Guarantee) which might otherwise operate to discharge, impair or otherwise affect any of the obligations of IBRD under the IBRD Guarantee or any of the rights, powers or remedies conferred on the Agent by the IBRD Guarantee or by applicable law or regulation.
Reduction of Demand:	If, after the Agent has made a demand on IBRD for payment under the IBRD Guarantee, but before IBRD has made payment of the amount so demanded, the Agent receives payment in respect of such amount from the Borrower (or the Agent recovers otherwise than from IBRD) any sum which is applied to the satisfaction of the whole or any part of such amount, the Agent shall promptly notify IBRD of such fact and IBRD's liability under the IBRD Guarantee in respect of such demand shall be reduced by an amount equal to the portion so paid by the Borrower (or so recovered by the Agent) and so applied.
Non-Accelerability of Guarantee:	The Guarantee cannot be accelerated and become payable prior to the scheduled debt service payment dates under any circumstances, including if the underlying IBRD-Guaranteed Loan is accelerated as a result of a Guaranteed Event. In such instances, the IBRD Guarantee will cover payment of debt service up to the Maximum Guaranteed Amount in accordance with the original payment schedule.

Conditions Precedent to Effectiveness of the IBRD Guarantee:	Usual and customary conditions for financing of this type including but not limited to the following: a) Provision of relevant legal opinions satisfactory to IBRD (including a legal opinion from the appropriate official of Montenegro relating to the Indemnity Agreement); b) Payment in full of the Guarantee Fee, the Front-End Fee and the relevant installment(s) of the Standby Fee and reimbursement of IBRD's external legal expenses; c) Conclusion of an Indemnity Agreement between IBRD and Montenegro, and any other applicable documentation, acceptable to IBRD; and d) Satisfaction of any other conditions precedent under the financing documents.
Subrogation:	If and to the extent IBRD makes any payment under the Guarantee, IBRD will be subrogated immediately to the extent of such unreimbursed payment to the lenders' rights.
Right to Purchase:	[If IBRD guarantees payment of interest, then upon payment default by the Borrower, IBRD will have the right to purchase all rights, title and interests of the Beneficiaries in the Financing.]
Repackaging Arrangements:	The Guaranteed [Lenders] [Beneficiaries] will severally undertake for the benefit of IBRD that, provided the IBRD Guarantee remains in effect, they will not enter into or permit any of their affiliates to enter into any arrangement pursuant to which any security or other similar obligation is created or issued, the economic effect of which is the separation of rights of payment from IBRD under the IBRD Guarantee and of rights of payments from the Borrower under the financing, which is referred to as "Repackaging Arrangements".
Front-end Fee:	25 bps of the Guarantee Face Value payable by the Borrower.
Standby Fee:	25 bps per annum, charged periodically and applied to that portion of the guaranteed amount that IBRD has contractually committed and for which IBRD does not yet have financial exposure under the guarantee. The IBRD standby fee is normally charged semi-annually and accrues sixty (60) days after the date of signing of the agreement

	providing for IBRD's guarantee. Standby Fee also applies if IBRD limits coverage of the Guarantee pursuant to any limitation event. Payment of the Standby Fee is the obligation of Montenegro and must be paid in advance on regular payment dates.
Guarantee Fee (recurring):	[X] basis points per annum. The IBRD guarantee fee is charged on that portion of the guaranteed amount that IBRD has contractually committed and for which IBRD has financial exposure under the guarantee. (i.e. the present value of the Maximum Guaranteed Amount). Payment of this fee is the obligation of Montenegro and must be paid in a one-time lump sum. The Guarantee will terminate in the event of nonpayment of any installment of the relevant Guarantee Fee. {The guarantee fee level is determined by the average life of the guarantee: 50bps up to 8 years, 60bps from 8 to 10 years, 70bps from 10 to 12 years, 80bps from 12 to 15 years, 90bps from 15 to 18 years and 100bps from 18 to 20 years.}
External Legal Costs:	Reimbursement of IBRD external legal counsel expenses by Montenegro.
Governing law:	English law or New York Law.
Indemnity Agreement	
Parties:	IBRD and Montenegro (the "Member Country")
Indemnity:	The Member Country will reimburse and indemnify IBRD on demand, or as IBRD may otherwise direct, for all payments under the Guarantee and all losses, damages, costs, and expenses incurred by IBRD relating to or arising from the Guarantee.
Covenants:	Usual and customary covenants included in agreements between member countries and IBRD, as well as undertakings to pay the fees and expenses of IBRD's external counsels and other advisors in connection with the Loan negotiation.
Remedies:	If the Member Country breaches any of its obligations under the Indemnity Agreement, IBRD may suspend or cancel, in whole or in part, the rights of the Member Country to make withdrawals under any other loan or credit agreement with IBRD, or any IBRD loan to a third party guaranteed by the

	Member Country, and may declare the outstanding principal and interest of any such loan or credit to be due and payable immediately. A breach by the Member Country under the Indemnity Agreement will not, however, discharge any guarantee obligations of IBRD under the Guarantee.
Governing Law:	The Indemnity Agreement will follow the usual legal regime and include dispute settlement provisions customary for agreements between member countries and IBRD.