

MONTENEGRO

PREPARING FOR PROSPERITY

Country Economic Memorandum
**Ensuring Sustainability,
Connectivity, and Flexibility
for Dynamic Growth**

Country Economic Memorandum

Towards a New Growth Model

May 24, 2013
The World Bank

Roadmap

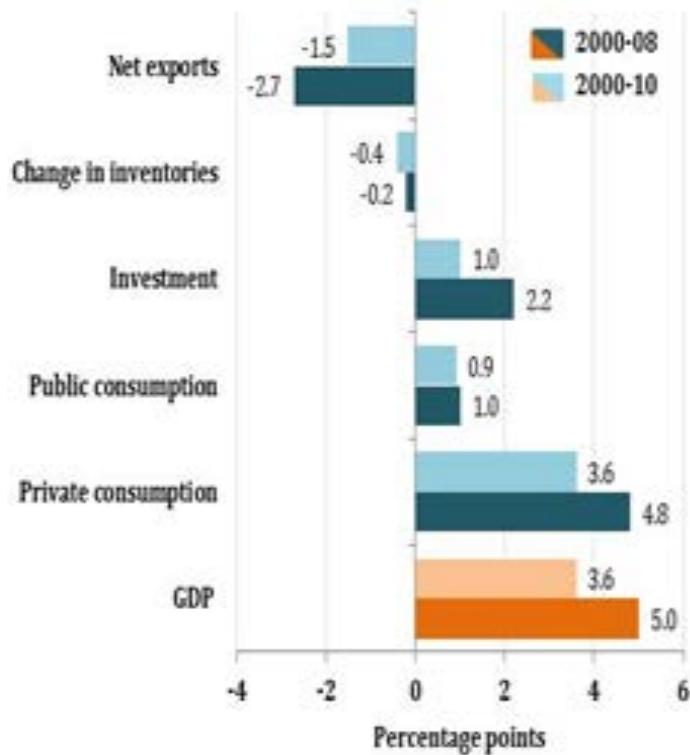
- **Sustainability**
 - Sources of growth
 - Ensuring fiscal and financial sustainability
 - Towards a new growth model
- **Flexibility**
 - Investment climate survey
 - Doing business in Montenegro
 - Product market regulations
 - Labor market regulations
- **Policy recommendations**

Sources of Growth

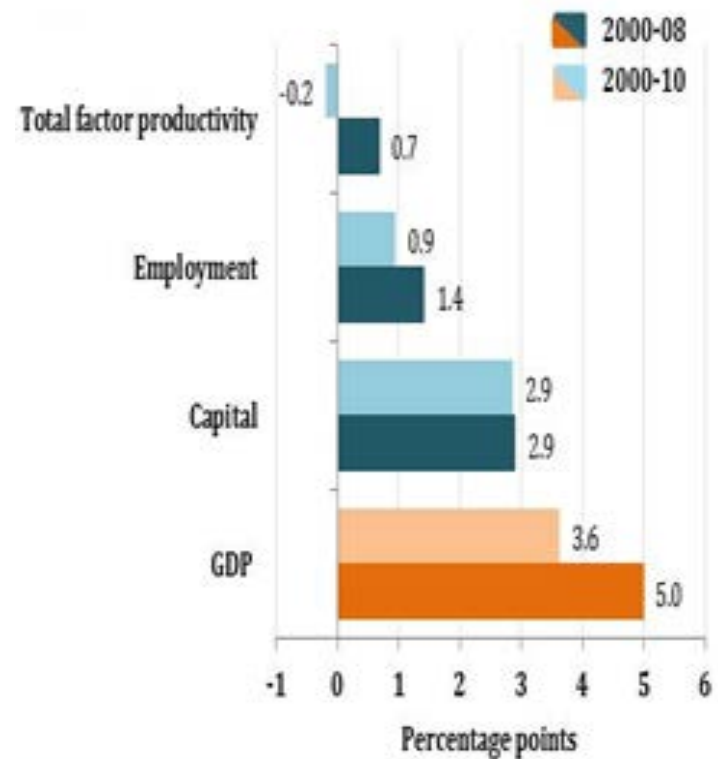
Domestic-demand driven, robust pre-crisis growth...

...led by factor accumulation rather than increases in TFP.

Demand-Side Sources of Growth in Montenegro, 2000-10



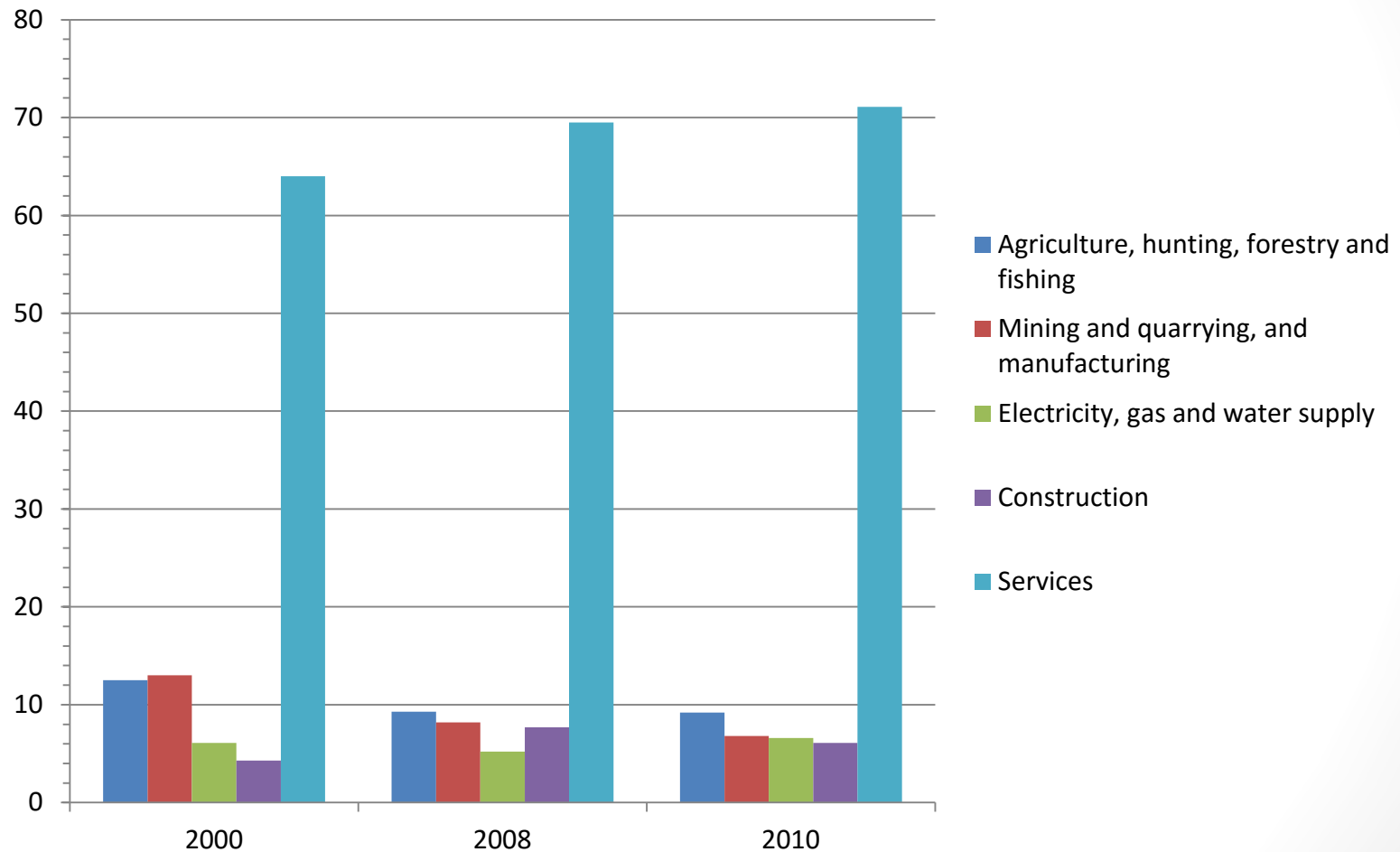
Factor-Input Sources of Growth in Montenegro, 2000-10



Sources: MONSTAT and World Bank staff calculations.

Production shifted from agriculture, mining, and manufacturing towards construction and services...

Sectoral Decomposition of Gross Value Added Growth in Montenegro, 2000-10



...while education had a significant impact on growth

Contribution of Education and Knowledge to Growth in Montenegro, 2000-10

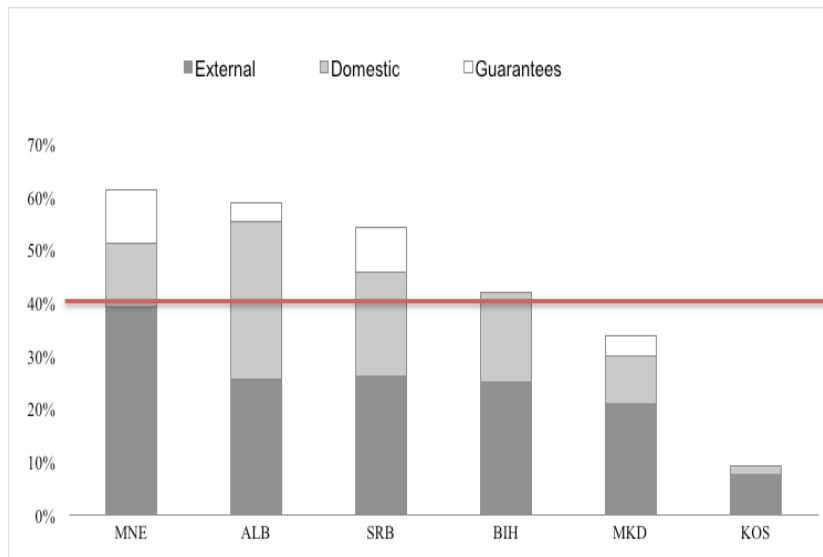
		2000–2008		2000–2010	
GDP		5.0%	100	3.6%	100
	Capital	2.9%	58.2	2.9%	79.2
	Uneducated labor force	0.8%	16.2	0.5%	14.9
	Retaining existing educational level of labor force	0.6%	12.0	0.4%	11.0
	Improvement of educational structure	0.9%	17.7	0.9%	25.3
	Advance of applied (technical/vocational) knowledge	-0.2%	-4.1	-1.1%	-30.3

Ensuring Fiscal Sustainability

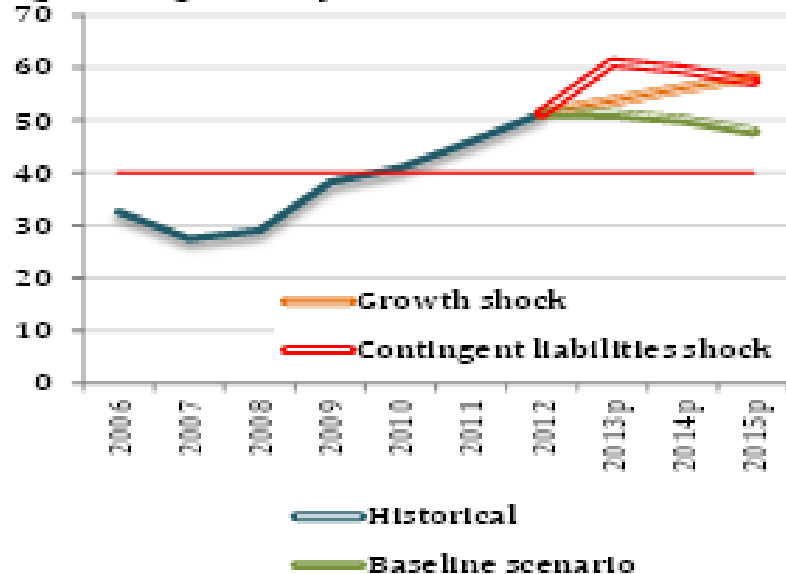
Fiscal policy has been mostly procyclical which built up high public debt...

...highly sensitive to any shock.

Public Debt and Guarantees (Percentage of GDP)



Public debt (percentage of GDP)



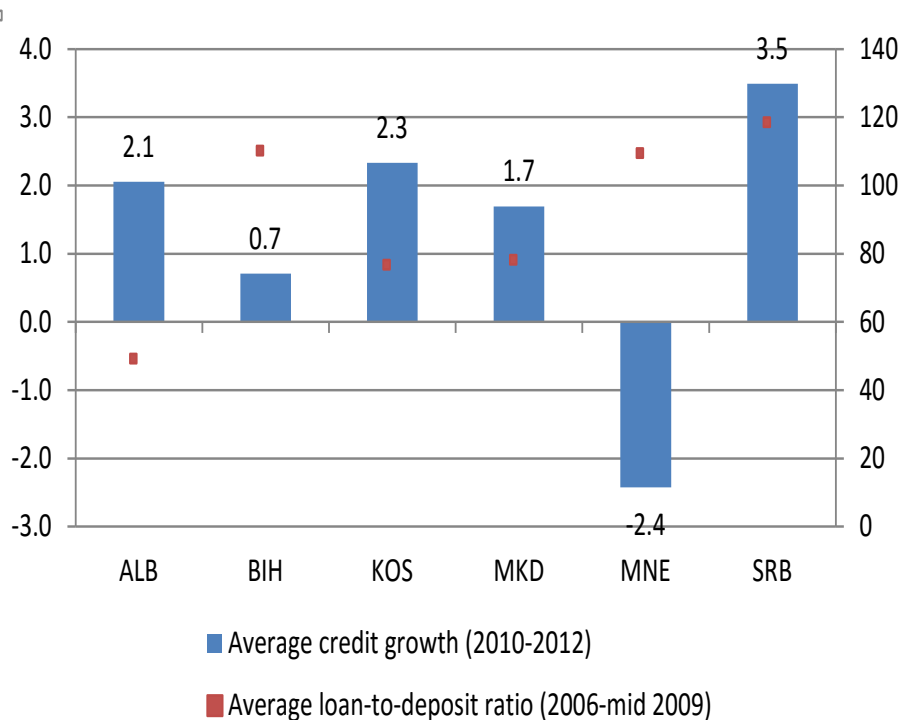
Notes: Contingent liabilities' shock assumes a one-off assumption of total guarantees in 2013. Growth shock assumes 0.2 percent average growth for 2013-2015. The baseline scenario follows the Government's budget scenario, which assumes 2.5 percent growth in 2013 and the pick-up thereafter.

Sources: CBCG and MoF, and World Bank staff calculations.

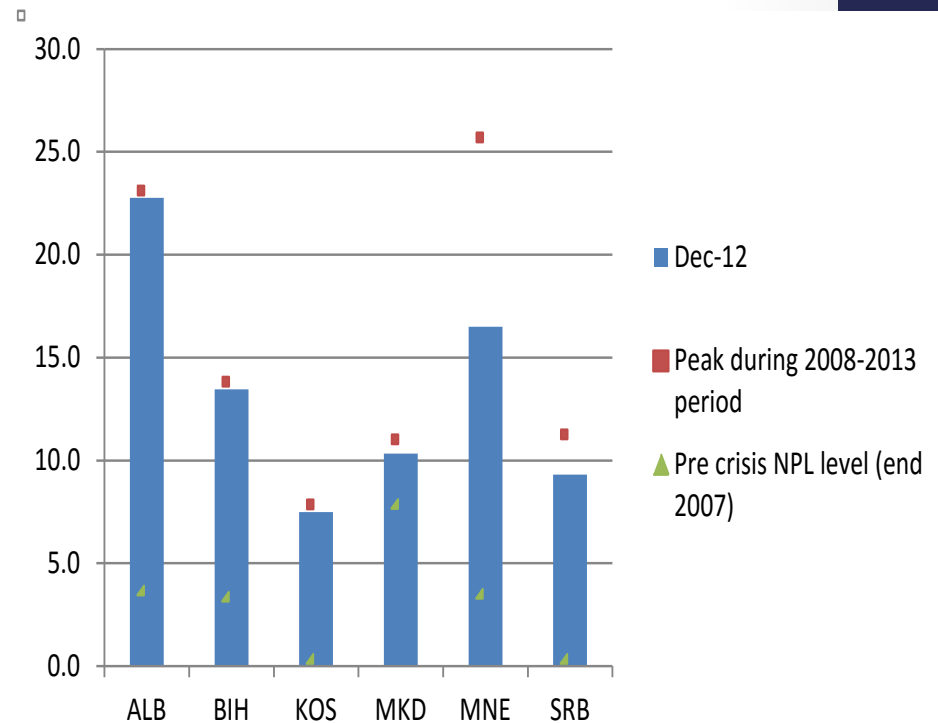
Ensuring Financial Sustainability

Credit boom and bust increased nonperforming loans, making banking system vulnerable

Credit Growth, percent



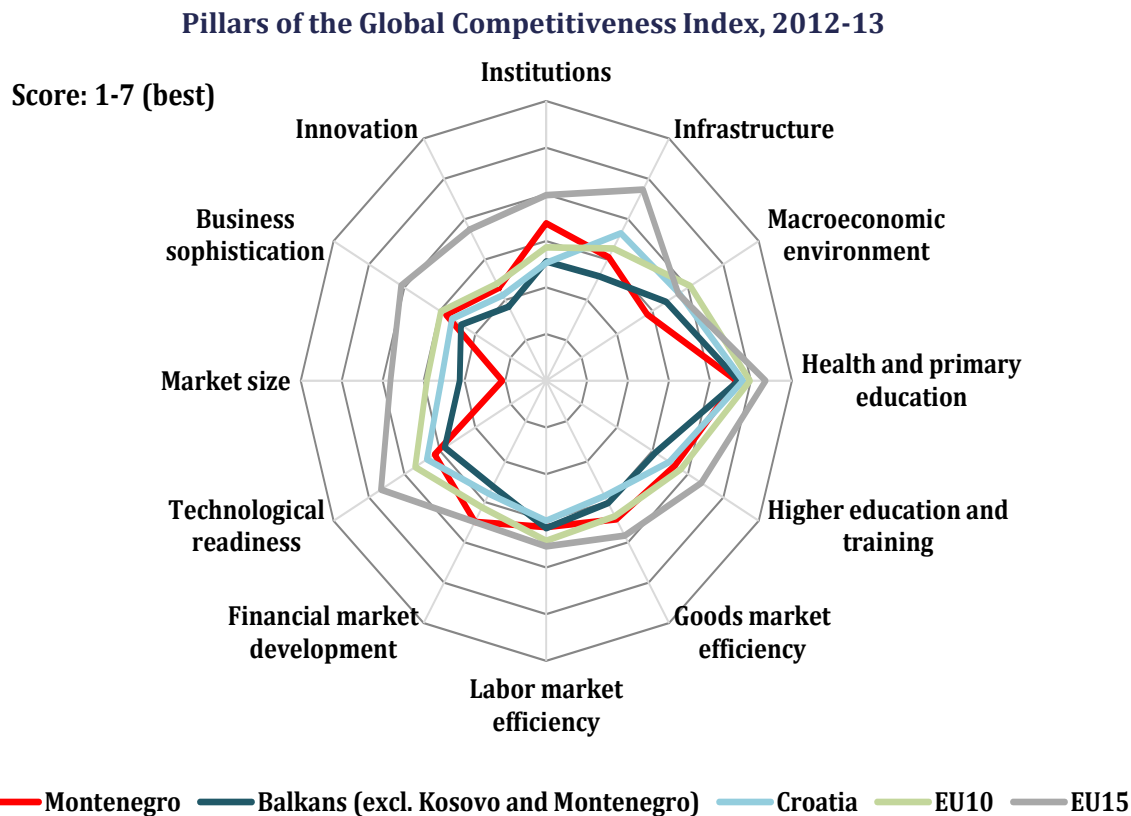
Nonperforming Loans, percent of total loans



Sources: CBCG and SEE Regular Economic Report

Montenegro's New Growth Model

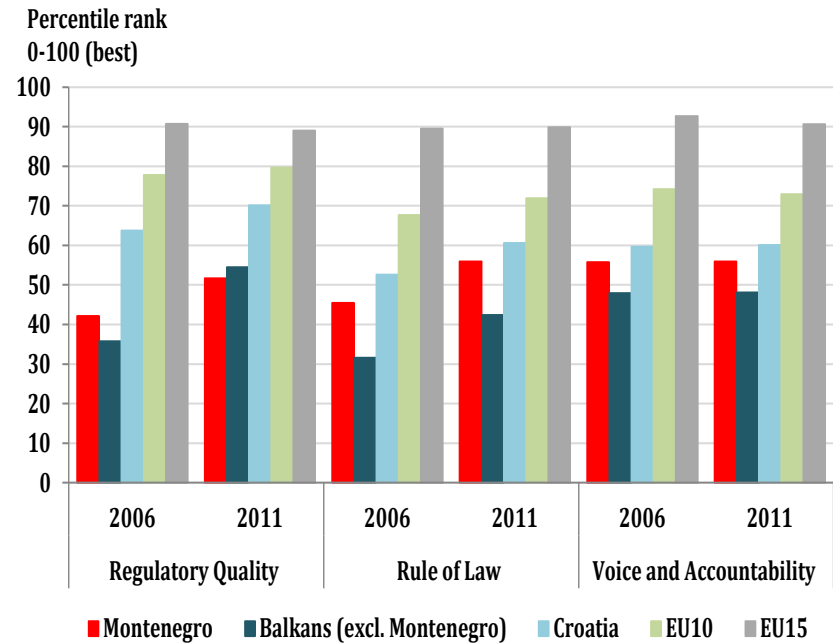
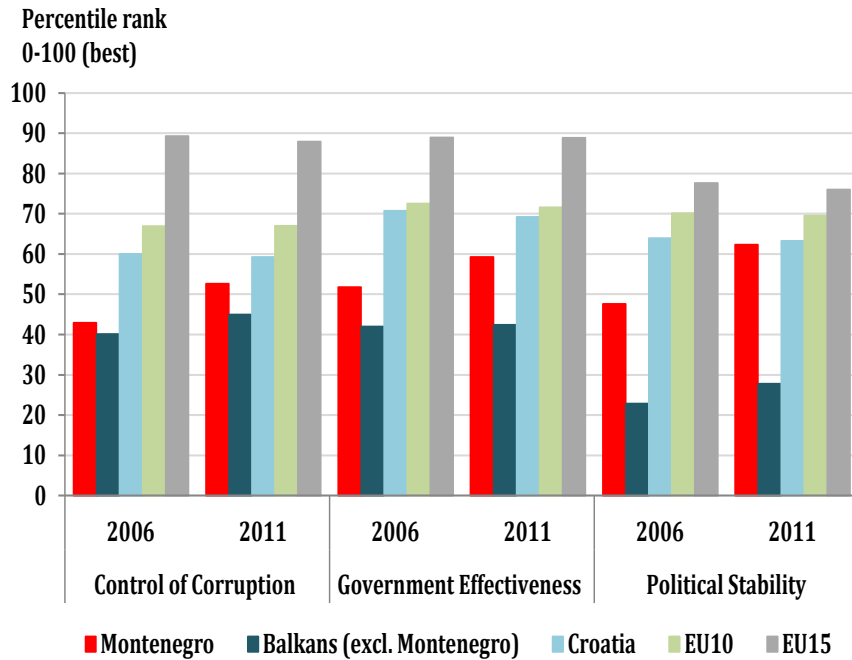
Largest gaps in competitiveness are in technological readiness, labor market efficiency, higher education and innovation



Source: World Economic Forum.

New growth model needs to involve public sector institutions and the rule of law.

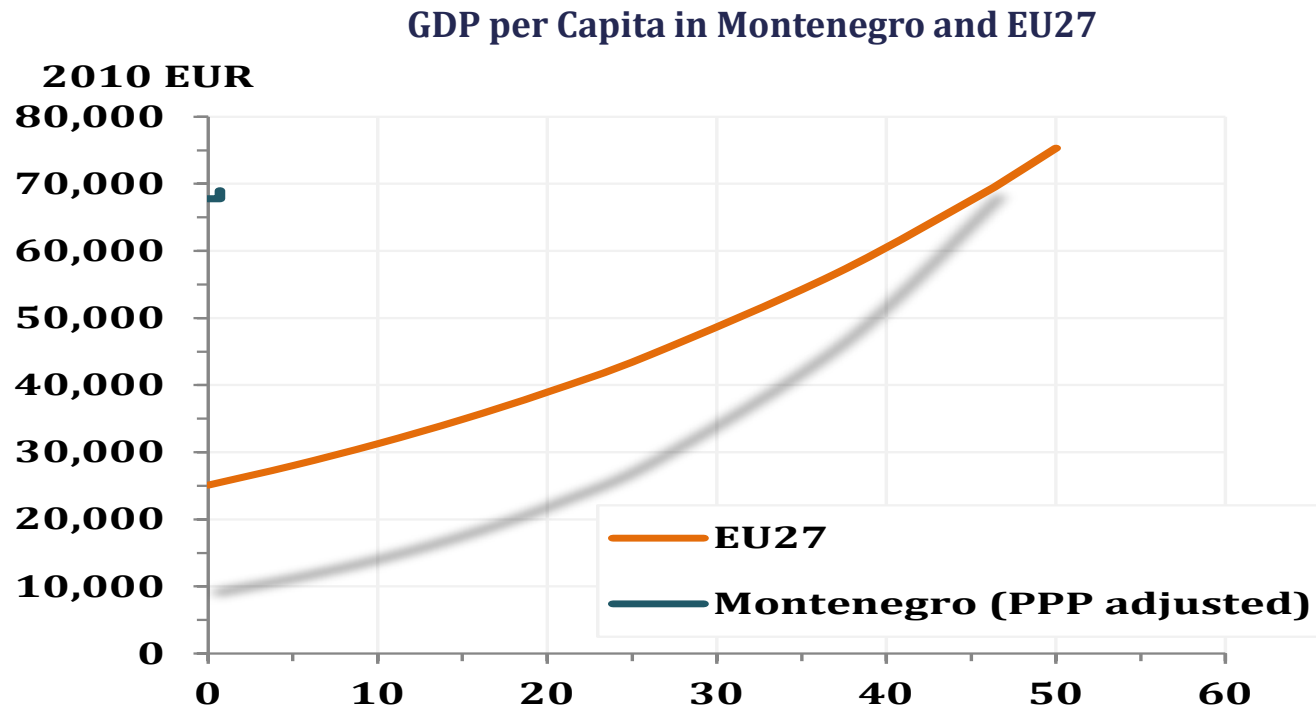
World Governance Indicators



Source: World Bank

Does Higher Growth Matter?

With an annual 2.4% growth in total factor productivity, PPP adjusted GDP per capita reaches the level of EU27 in less than 50 years



Sources: EUROSTAT and World Bank staff estimates.

Investment Climate Survey Insights

- **Enterprise survey designed by the WB, comparable with other Business Environment and Enterprise Performance Surveys (BEEPS)**
- **Tries to identify barriers to business growth and investment**
- MICS and BEEPS measure how constraints are perceived and ranked by businesses

	MICS (2012)	BEEPS (2008)
	Average Severity: 0-4 (most severe)	Rank: 1 (top constraint)-14
Access to finance	1.9	3
Electricity	1.3	1
Tax rates	1.3	2
Informality	1.2	-
Quality of labor force	1.2	5
Tax administration	0.9	4

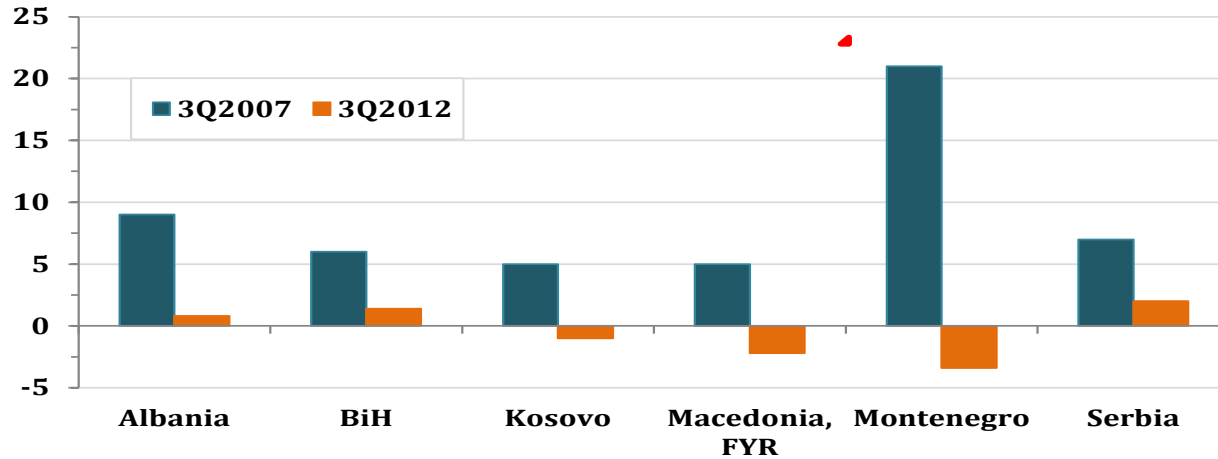
Note: The area of informality is introduced in the MICS (2012).

Source: Šonje and Galac (2012).

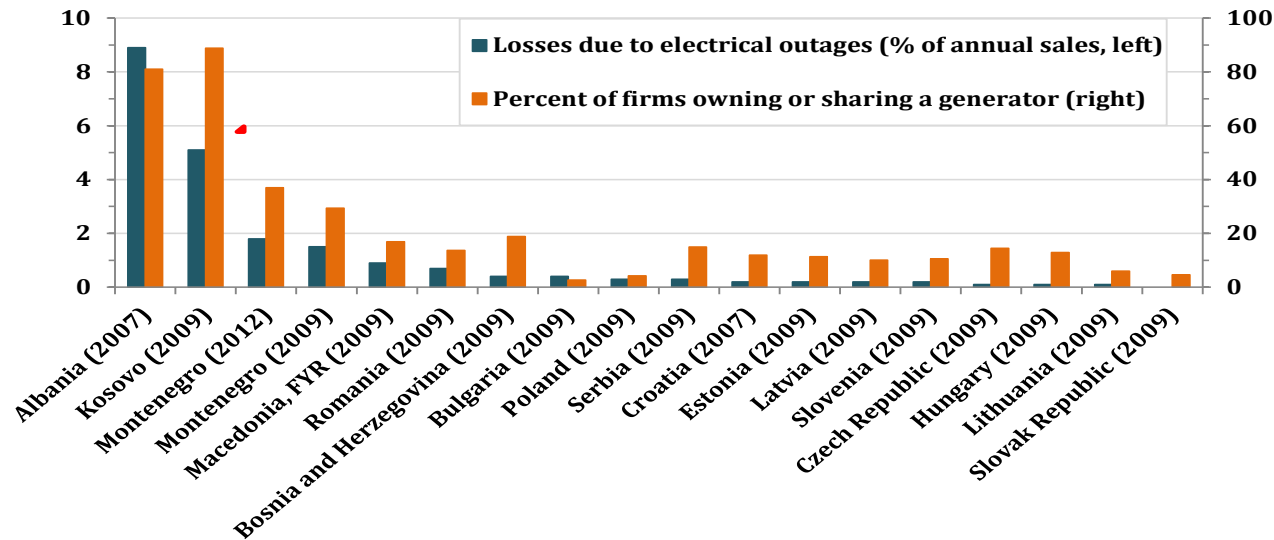
Top constraint is access to finance despite improvements in the legal and regulatory environment for getting credit.

Pre- and Post-Crisis Credit Growth in the Western Balkans

Quarter on quarter percentage change



Supply of electricity is another major constraint.

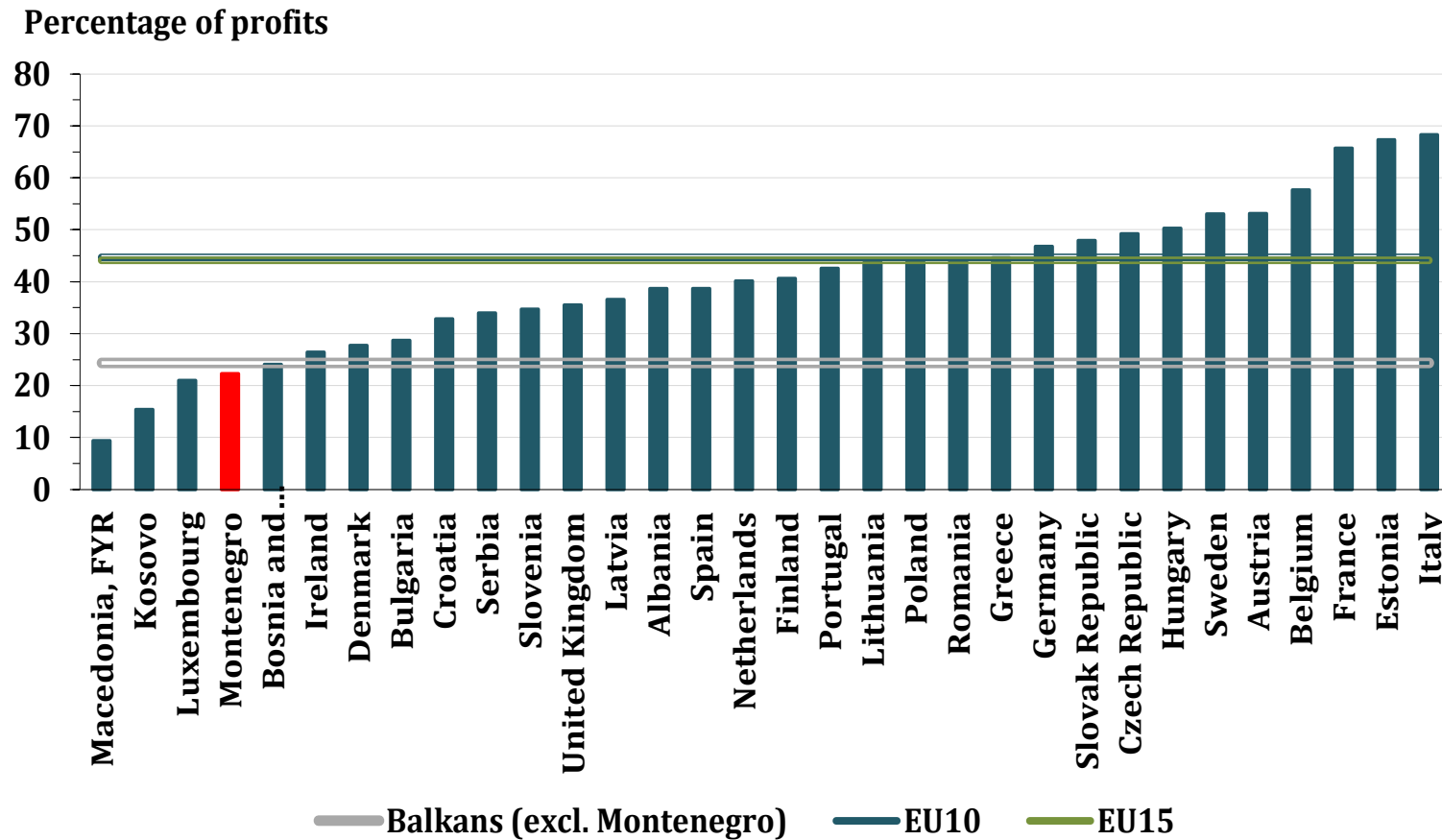


Note: Montenegro (2012) is from the MICS (2012). Montenegro (2009) is from the previous BEEPS.

Sources: CEM (2013) and Enterprise Surveys (2009).

Firm perceptions of tax rates may reflect the tax burden relative to the unfair competition from the informal sector

Total Tax Cost Borne by the Average Firm in Montenegro, 2012

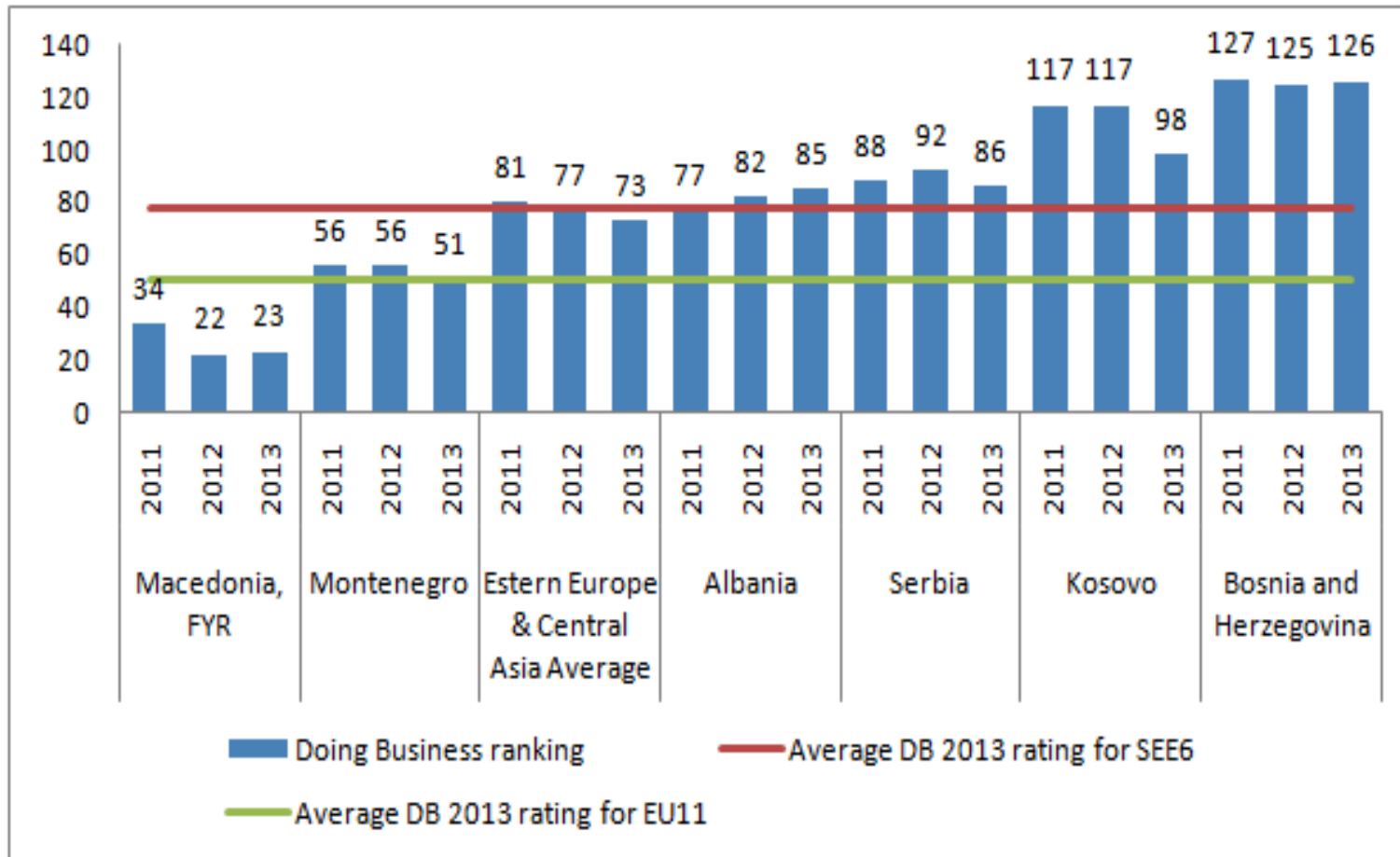


Source: Doing Business (2013).

Legal Environment for Doing Business

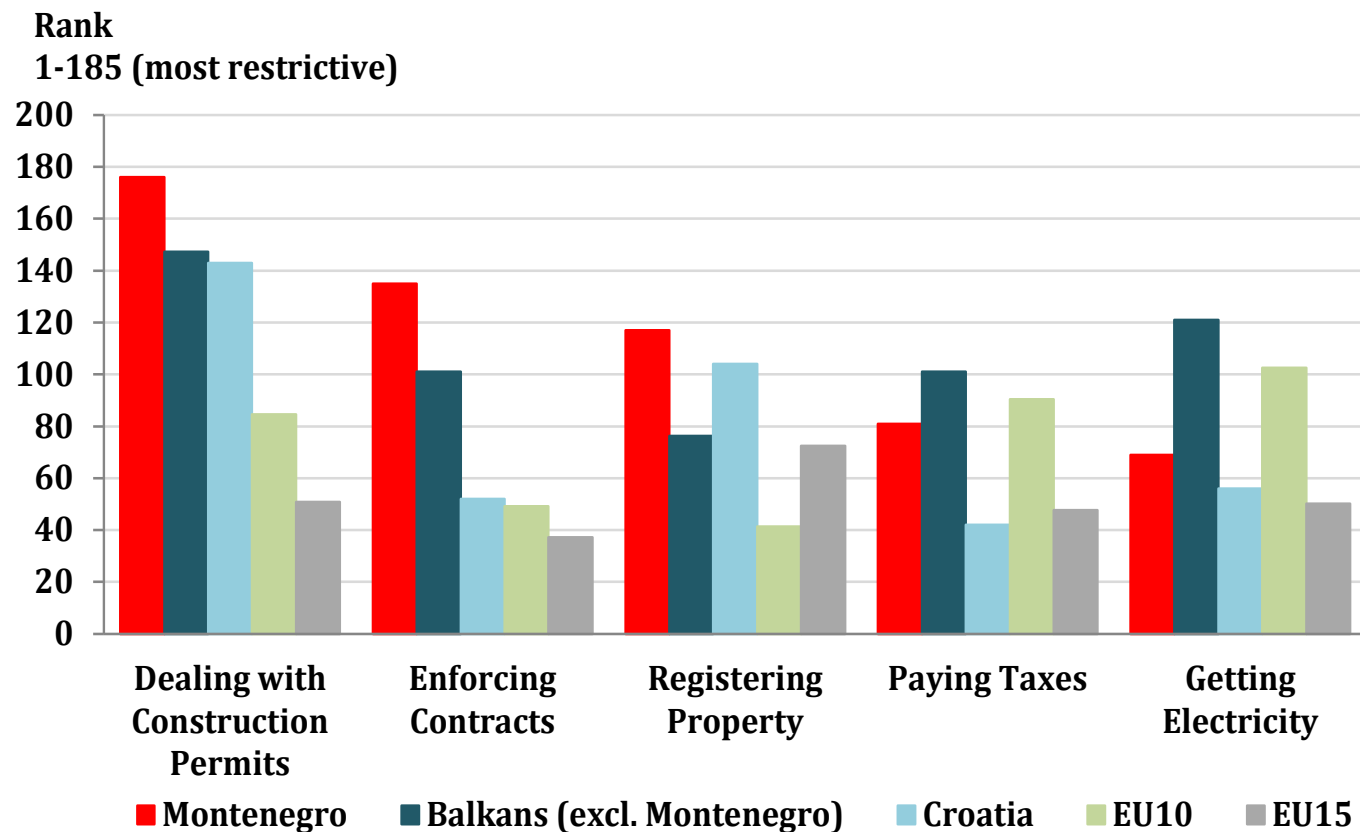
Steady and significant improvements

Ease of Doing Business, 2011-13



Several areas still need attention...construction permits, enforcing contracts, and registering property

Mean Rankings in the Ten Areas Measured by Doing Business, 2012



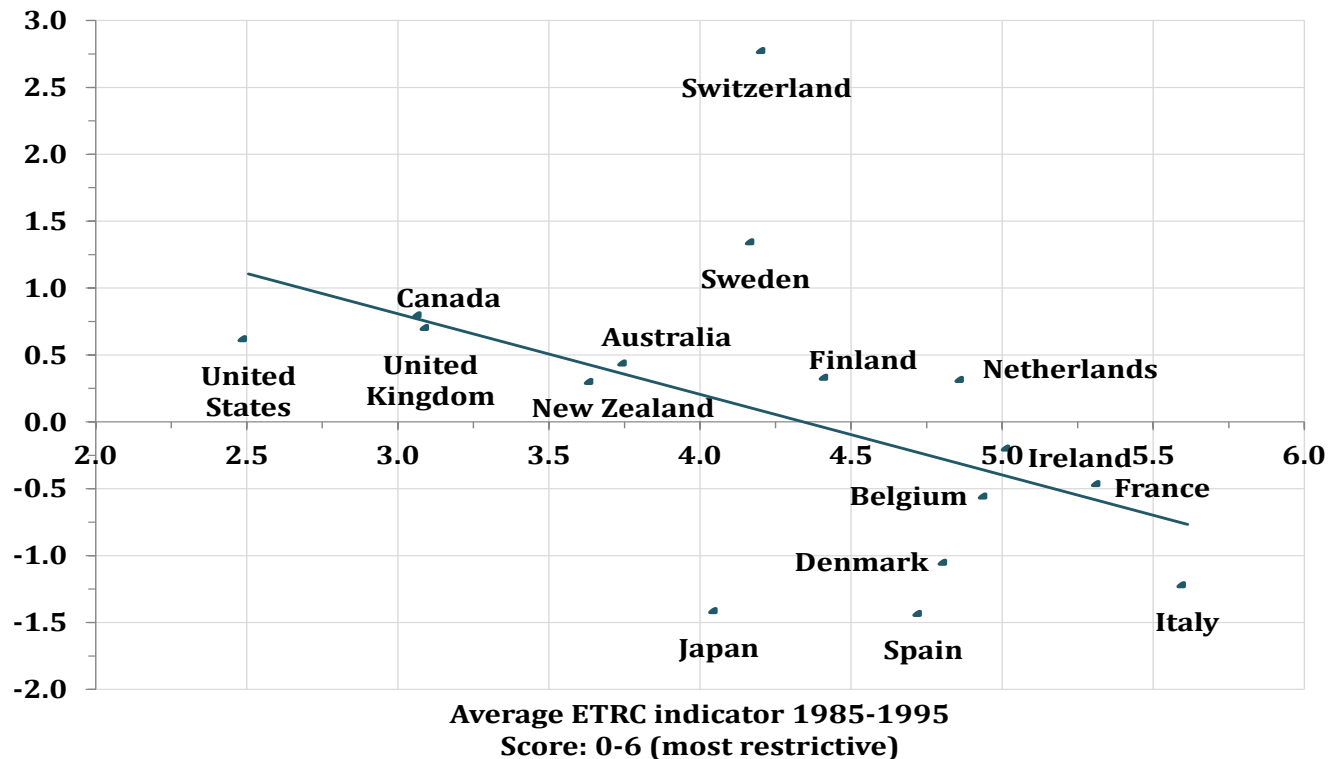
Source: Doing Business.

Product Market Regulation

Flexibility is associated with accelerated productivity growth

Productivity Acceleration and Product Market Regulation

Percentage point change in the average MFP growth
from 1985-95 to 1996-2007

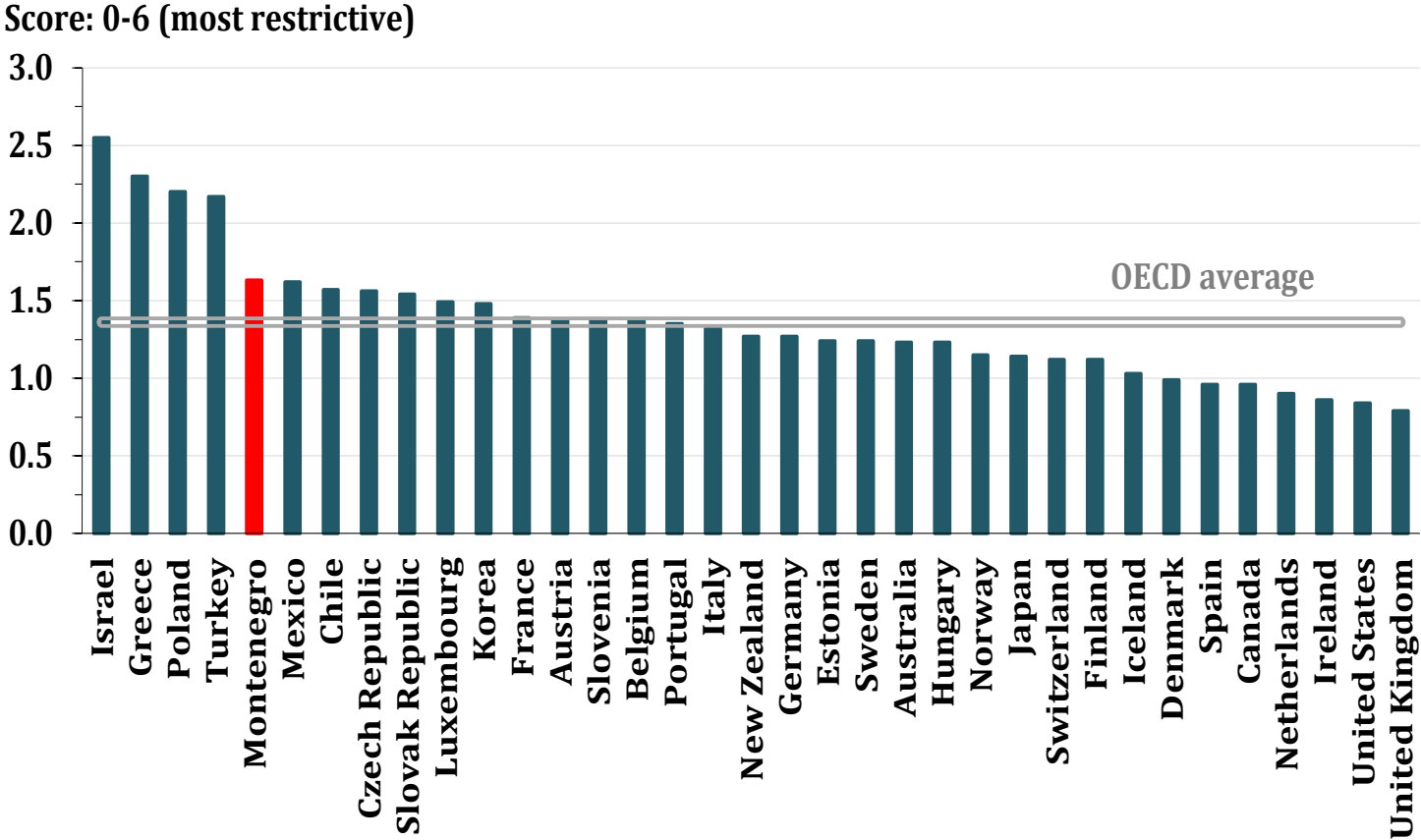


Note: The ETRC indicator summarizes regulatory provisions in seven sectors: telecoms, electricity, gas, post, rail, air passenger transport, and road freight.
Source: OECD (2012).

Montenegro lags behind OECD or most small EU states

PMR indicator includes indicators of: (i) State control; (ii) Barriers to entrepreneurship; and (iii) Barriers to trade and investment.

Aggregate PMR Score

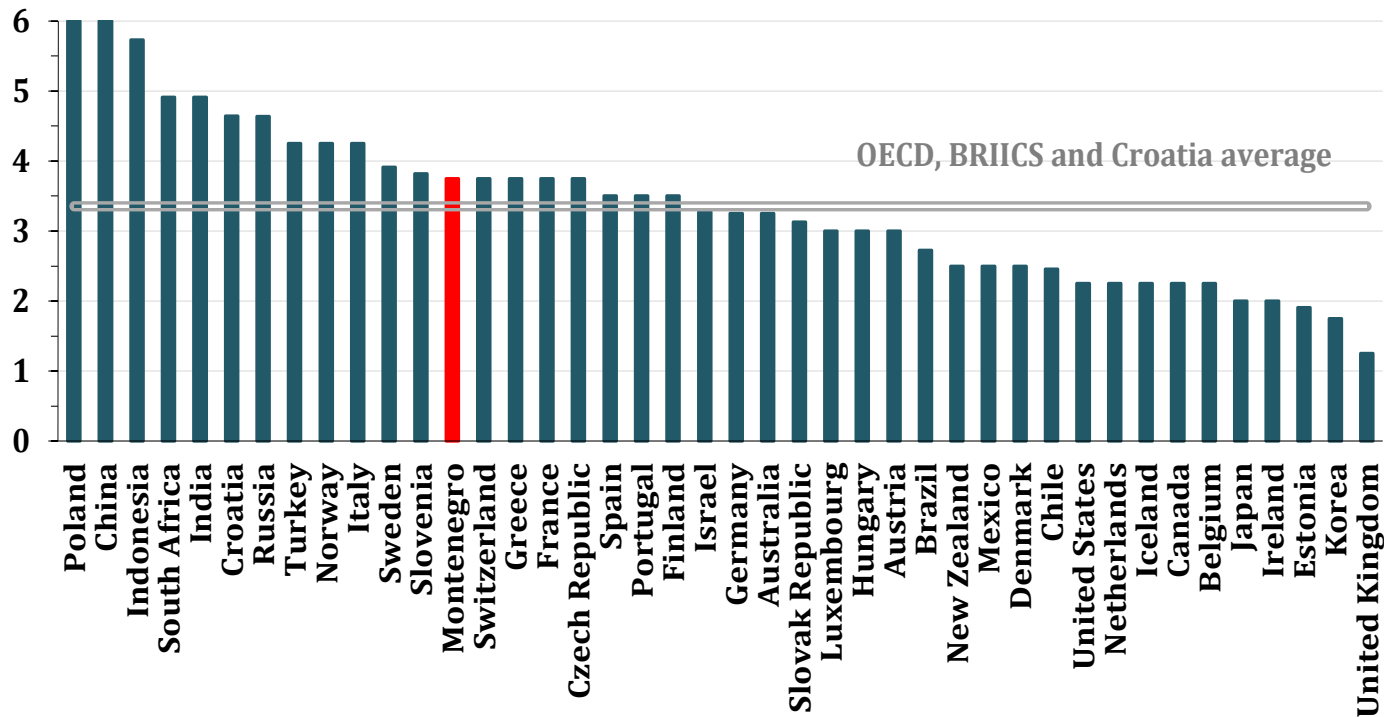


Areas for PMR improvement

- State control and barriers to trade and investment remain high
- High and widespread public ownership
- Information should be made more accessible to foreign parties
- Domestic regulations do not conform completely to the international standards

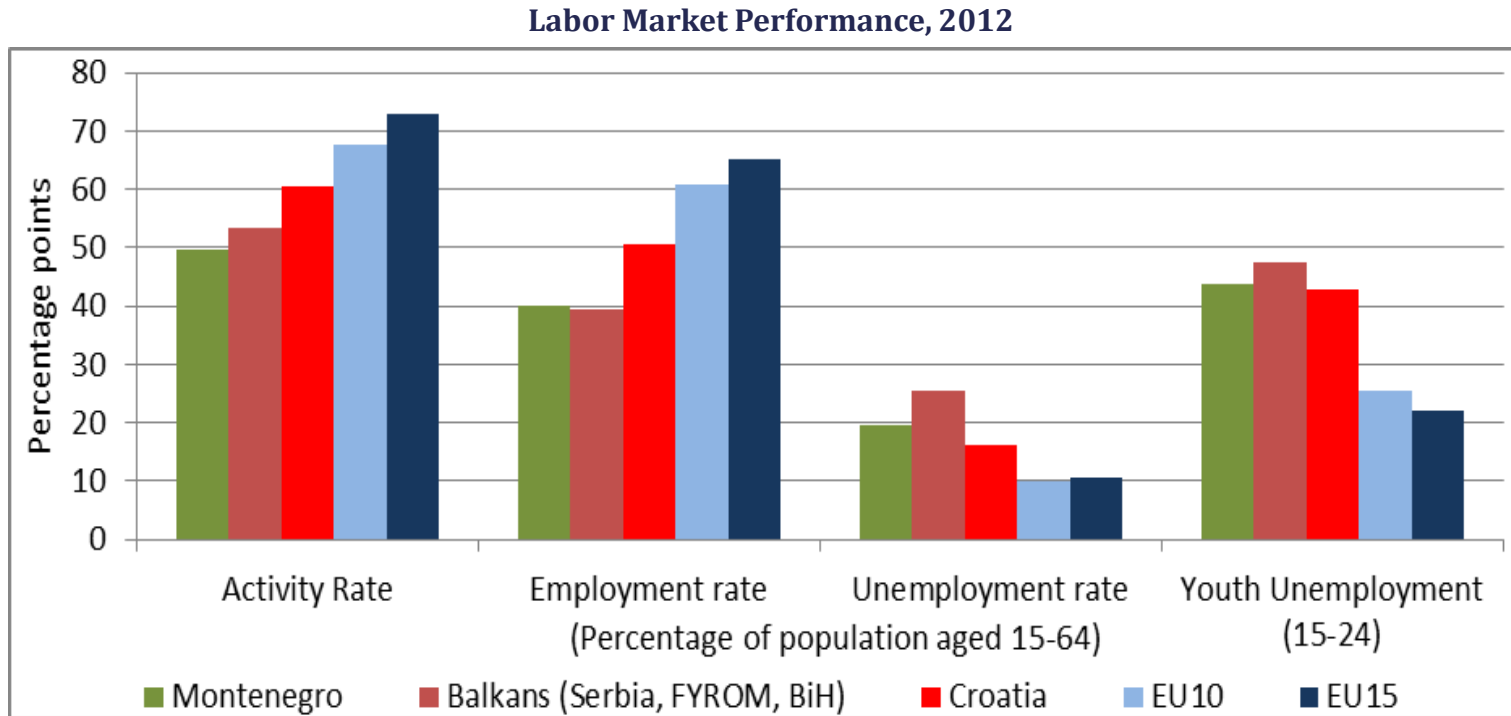
Public Ownership

Score: 0-6 (most restrictive)



Labor Market Regulation

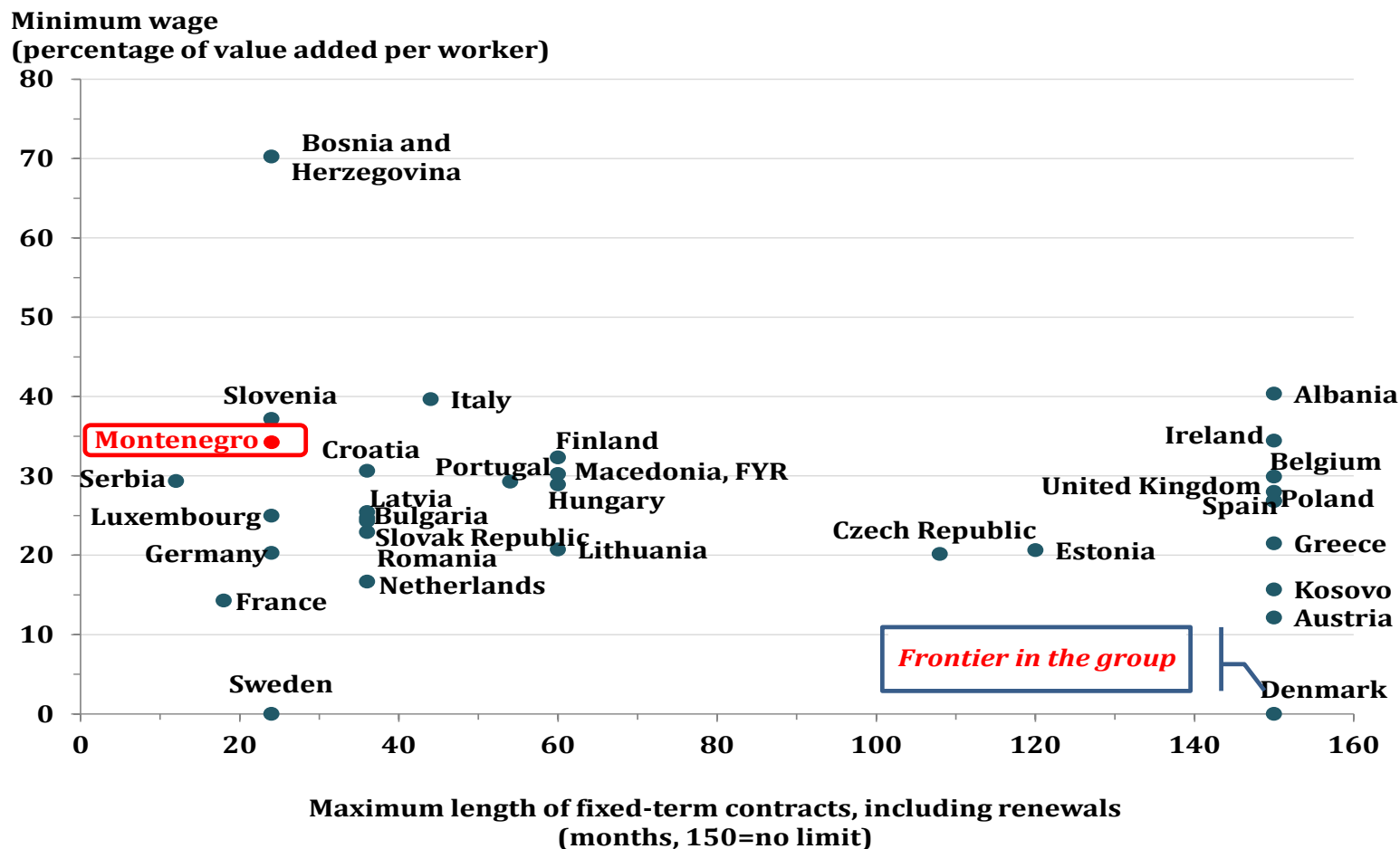
- Growth has been the primary driver of labor market performance...
- But, low labor force participation and employment, and persistent unemployment



Source: Eurostat and national statistical offices.

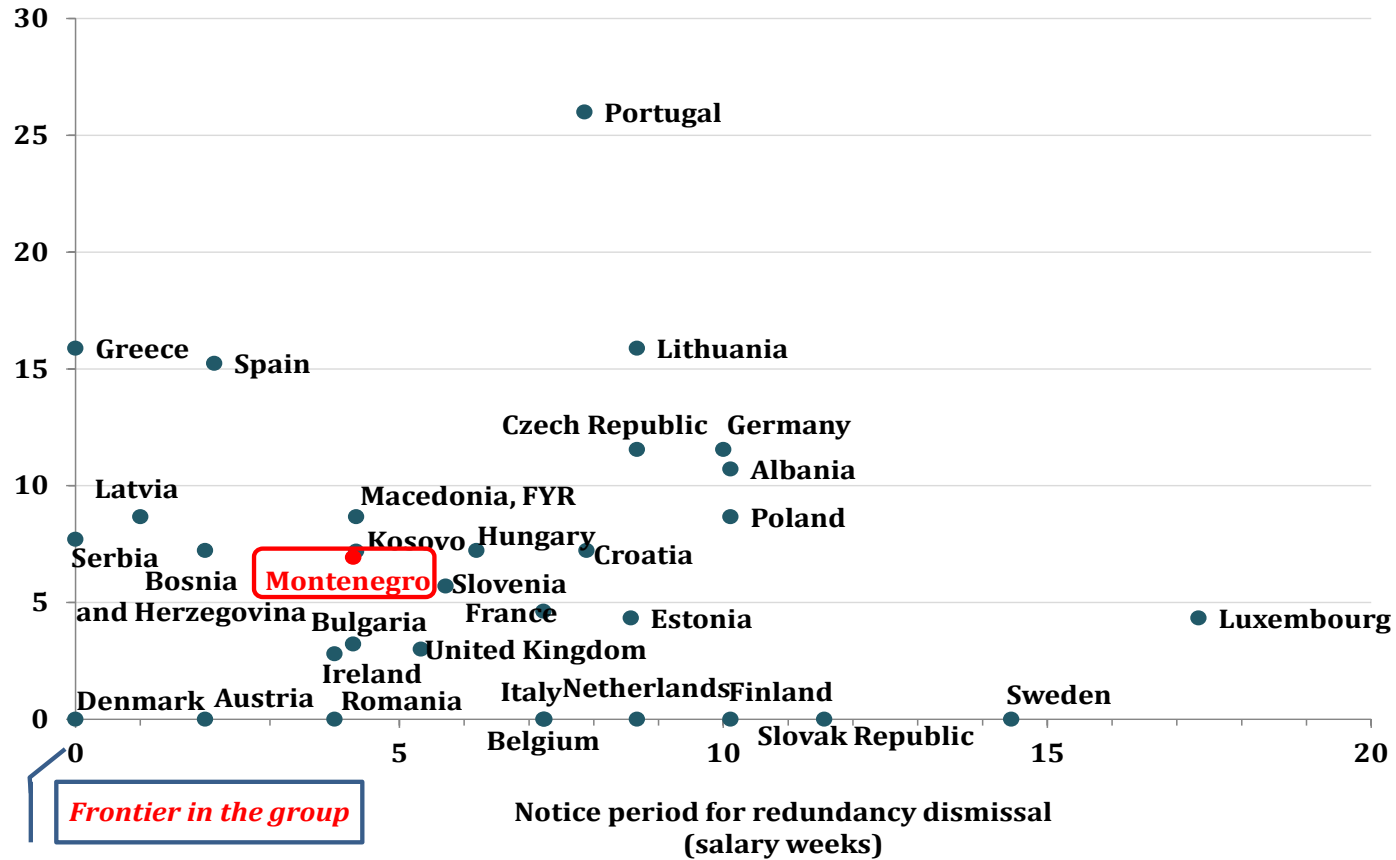
Less flexibility in hiring due to shorter maximum term of fixed contracts and high minimum wage

Areas Contributing to Rigidity of Hiring Sub-Index



Redundancy costs are not particularly high

Severance pay for redundancy dismissal
(salary weeks)



Policy Recommendations

Sustain the **fiscal consolidation** plans to reduce unsustainably high debt, clear the arrears and create fiscal reserves.

Ensure **financial sector sustainability** through strengthened supervision and **improve financial discipline**.

Continue **improving investment climate** to reach the global top 20.

Improve the **product market regulation** and **downsize government portfolio** in commercial sectors.

Ease the **labor market regulation** and **reduce disincentives to work**.

