30. MONTENEGRO

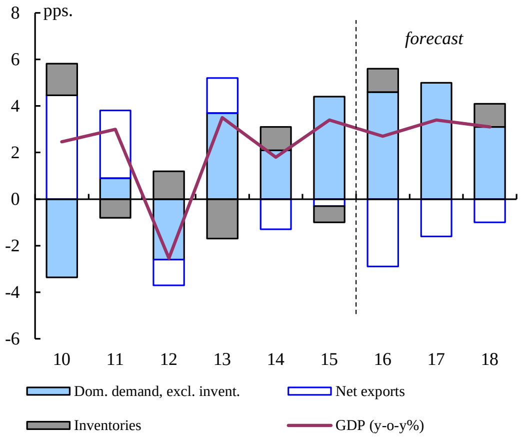
Large public spending results in fiscal strain

Domestic demand has been recovering driven by private consumption and investments. However, the impact of economic growth on job creation is lower than expected. External imbalances have become more pronounced, but imports are projected to ease as some import-intensive investments come to a conclusion. The fiscal position remains weak, accentuated by recent increases in public spending, and is set to deteriorate further when a large highway project resumes.

Lower growth than expected

After recording annual growth of 3.4% in 2015, the pace moderated to 2% in the first half of 2016, when growth was still largely driven by a surge in investments, and to a lesser extent by private consumption and exports. The high import-dependence of investments fuelled imports which grew faster than exports, resulting in a negative contribution of net exports to growth.

Graph II.30.1: **Montenegro - GDP growth and contributions**



Domestic demand is projected to further accelerate in 2016 driven by private and government consumption as well as investments, the latter mostly private. The contribution of domestic demand to growth is forecast to remain broadly similar in 2017 after public investments accelerate, offsetting the deceleration in private and public consumption. Domestic demand is projected to record some deceleration in 2018 as the intensity of investments is assumed to decline in real terms over the year.

Imports on the rise

Net exports are set to remain on negative territory over the forecast horizon due to the weak and volatile performance of manufacturing (especially, the metal industry which is being restructured), and the expected robust growth of investments with strong import needs, in particular for construction machinery and appliances to equip the new infrastructures (namely hotels, roads and power plants), sustaining the high trade deficit. Moreover, the transport of these goods is also likely to narrow the surplus of the services account, in spite of a benign outlook for the Montenegrin tourism industry. A declining trend of imports is expected in 2017 and 2018, as some construction projects are being completed. Overall, the current account deficit is set to further increase while continuing to be largely financed by net FDI inflows.

Weak labour market performance

Despite robust investment activity, job creation is set to remain modest over the forecast period. Moreover, employment growth during 2016 is being offset by the number of women leaving the labour market to become eligible for generous pension rights, thanks to a new law for mothers of three or more children. Once the statistical impact of this law fades in 2017, we project employment to resume annual growth rates (between 2% and 3%) similar to previous years.

A consumption boost before the elections

As financial stability indicators keep improving and lending to households growing, private consumption is expected to accelerate supported also by low inflation. However, in the context of the parliamentary elections that took place in October 2016, a series of expenditure measures were introduced at the beginning of the year, such as a generous new benefit for mothers, or the realignment of salaries in the public sector that resulted in an overall increase of wages across the board. Notwithstanding any future government policy on wages and pensions, credit activity is projected to recover and moderate inflation is expected to continue supporting private consumption in 2017 and 2018.

Inflation to gradually stabilise

Despite the increase in households' disposable income, imported inflation (namely fuels and food) has been keeping overall prices practically flat during 2016. A marginal regain of inflation could be expected by end-2016 to gradually increase in 2017 and 2018 as global oil prices recover some lost ground.

A revival of fiscal imbalances anticipated

In 2016, Montenegro has planned to spend 8.8% of GDP into public investments, most of it on a highway. However, due to delays with construction permits and readjustment of technical standards, the government only spent 0.5% of GDP until August, substantially narrowing the budget deficit to 0.9% of GDP, well below the 6.5% figure planned for the period. Government borrowing for the highway and other works, together with the cyclical end-of-the-year spending surge, would increase public debt and deficit, albeit by less than originally planned for 2016.

The Ministry of Transport foresees borrowing some 6.4% of GDP in 2017 to finance the highway, and additional 6.8% of GDP in 2018. These loans are assumed to increase the general government debt and deficit proportionally. According to Montenegro's fiscal rules, once the public debt exceeds 60% of GDP (as happened at the end of 2015), the government must present a debt restructuring plan to reduce the debt below this threshold within 5 years. However, such a plan and its related fiscal consolidation measures have not been adopted so far. Therefore, a technical assumption of no policy change is maintained for the purposes of this forecast. A reassessment of the fiscal situation will have to be done on the basis of the fiscal strategy after the elections.

Downside risks

Recent increases in public expenditure without an adequate financing plan represent a non-negligible risk for public finances should the new government fail to produce a consolidation plan. Another important risk remains the exposure of the Montenegrin economy to external shocks, in particular tourism, which together with related services accounts for 20% of the economy, and raw materials exports, namely aluminium and steel, which account for 23% of total merchandise exports and rely on global market prices.

Table II.30.1:

Main features of country forecast - MONTENEGRO

	2015			Annual percentage change						
	mio EUR	Curr. prices	% GDP	97-12	2013	2014	2015	2016	2017	2018
GDP		3624.7	100.0	-	3.5	1.8	3.4	**2.7**	**3.4**	**3.1**
Private Consumption		2871.9	79.2	-	1.6	2.9	2.2	**3.3**	**1.8**	**2.0**
Public Consumption		701.5	19.4	-	1.3	1.4	1.9	**4.0**	**1.1**	**1.6**
Gross fixed capital formation		736.3	20.3	-	10.7	-2.5	11.9	**5.9**	**16.0**	**5.0**
of which: equipment		-	-	-	-	-	-	**-**	**-**	**-**
Exports (goods and services)		1539.2	42.5	-	-1.3	-0.7	5.7	**1.8**	**2.1**	**1.6**
Imports (goods and services)		2213.6	61.1	-	-3.1	1.6	4.4	**6.0**	**4.1**	**2.6**
GNI (GDP deflator)		-	-	-	-	-	-	**-**	**-**	**-**
Contribution to GDP growth:	Domestic demand			-	3.7	2.1	4.4	**4.6**	**5.0**	**3.1**
	Inventories			-	-1.7	1.0	-0.7	**1.0**	**0.0**	**1.0**
	Net exports			-	1.5	-1.3	-0.3	**-2.9**	**-1.6**	**-1.0**
Employment				-	1.1	7.1	2.4	**1.6**	**2.7**	**3.0**
Unemployment rate (a)				-	19.5	18.0	17.5	**17.8**	**17.6**	**17.3**
Compensation of employees / head				-	-2.0	6.1	0.9	**4.7**	**0.4**	**1.2**
Unit labour costs whole economy				-	-	-	-	**-**	**-**	**-**
Real unit labour cost				-	-6.2	10.5	-1.4	**2.6**	**-1.4**	**-1.0**
Saving rate of households (b)				-	-	-	-	**-**	**-**	**-**
GDP deflator				-	-	-	-	**-**	**-**	**-**
Consumer-price index				-	1.8	-0.5	1.4	**0.5**	**1.2**	**2.0**
Terms of trade of goods				-	-	-	-	**-**	**-**	**-**
Trade balance (goods) (c)				-	-39.5	-39.8	-40.4	**-41.1**	**-41.5**	**-40.9**
Current-account balance (c)				-	-14.5	-15.2	-13.3	**-15.3**	**-17.4**	**-17.6**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				-	-	-	-	**-**	**-**	**-**
General government balance (c)				-	-4.6	-2.9	-8.4	**-4.7**	**-7.6**	**-7.1**
Cyclically-adjusted budget balance (d)				-	-	-	-	**-**	**-**	**-**
Structural budget balance (d)				-	-	-	-	**-**	**-**	**-**
General government gross debt (c)				-	57.6	54.8	61.2	**66.1**	**71.8**	**75.8**

(a) as % of total labour force. (b) gross saving divided by gross disposable income. (c) as a % of GDP. (d) as a % of potential GDP.