30. MONTENEGRO

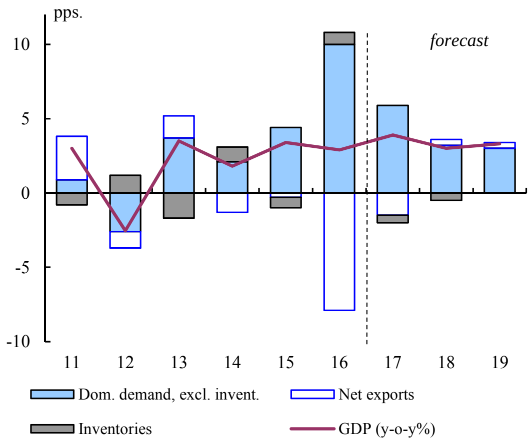
Rebalancing growth drivers

Strong growth driven by large infrastructure investments is gradually being taken over by private consumption. The introduction in mid-2017 of a comprehensive fiscal consolidation strategy is expected to improve the fiscal position over time, but would also weight on growth, particularly in 2018. Moreover, until the expected completion of the highway works in mid-2019, the public debt and budget are set to remain under significant pressure.

Higher than expected growth in 2017

In the first half of 2017, real GDP growth accelerated to 4.2% (y-o-y) and was largely driven by private consumption fuelled by rising employment and strong lending to households. Despite the adoption of some consolidation measures, public consumption growth further increased. The pace of gross fixed capital formation slowed down considerably early this year after completion of the construction of a wind power plant and several hotels. The revival of exports, fuelled by the good performance of tourism and sales of mineral ores, helped reduce the drag from net exports.

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



The role of investment as the major driver of growth is being gradually overtaken by private consumption. This trend is expected to continue over the forecast period, even if a temporary setback of private consumption could be expected in 2018 due to the planned increase of the VAT rate.

Reduction of external imbalances likely

The current account deficit narrowed to 17.5% of GDP in the four quarters to June, compared to 19.6% in the four quarters to March. A sharp deceleration of merchandise imports, largely due lower imports of construction equipment, helped reducing the trade gap. This has been accompanied by improvements in the balance of services owing to the good performance of tourism and the growing surpluses in the primary and secondary income balances. Start of production of a wind power plant and a new tobacco factory planned in November 2017, followed – later on – by the completion of the interconnection electricity cable with Italy, and the opening of some new hotels, are expected to turn the contribution to growth from net exports into positive territory in the next two years and to further reduce external imbalances.

Slight improvement in labour market conditions

Strong economic activity led to further improvements in the labour market. According to the Labour Force Survey (LFS), the unemployment rate declined in the second quarter of 2017 to 15.3%, down from 17.7% a year before. However, given the strong seasonal pattern of the Montenegrin labour market, unemployment is expected to increase again by the end of the year. In 2018 and 2019 a further reduction of the unemployment rate is expected, albeit at a lower rate, as investments are being gradually completed.

Fluctuating prices

Inflation further accelerated in the first eight months of 2017, averaging 2.7% y-o-y, mainly due to rising fuel prices. Moreover, the introduction in June of higher excises on alcohol and tobacco, together with strong demand from tourism, are contributing to rising prices in restaurants and cafes as well as accommodation services. The planned introduction of a higher VAT rate and excises in 2018 would add to inflationary pressures, but this one-off year-on-year price effect will peter out after one year. Yet, overall inflation might remain around 2% in 2019, supported by some further acceleration in private consumption.

Credit to corporates remains subdued

Credit growth remains strong thanks to household and general government borrowing, amidst weak lending to the corporate sector. It is expected that the increase in lending activity, supported by the Central Bank's ongoing programme for reducing commercial banks' non-performing loans, would help ease lending conditions to corporates as the sector keeps deleveraging gradually.

Meanwhile, the financial crisis legacy of high level of indebtedness and liquidity constraints continues constraining the corporate sector, and represents a major risk for the economy, resulting in a large number of firms with their bank accounts frozen due to contract enforcement claims. A decline or a slowdown in the number of tourists represents another important risk for the main export industry of the country.

The fiscal position is expected to strengthen once the highway works are completed

The strong acceleration of economic activity in the first half of 2017 was reflected in growing general government revenue, with stronger demand fuelling VAT and excise receipts as well as corporate income tax and social security contributions. On the expenditure side, the intensified highway works boosted capital spending, although actual expenditure still remained below the budget target. Overall, the consolidated general government deficit reached 2.6% of full-year GDP in June (compared to the deficit target of 4.1% forecast in the plan) due to capital and social security underspending, and a marginal surplus in the local government budget. Also in June, the stock of public debt declined to 61.8% of GDP, down from 64.4% at the end of 2016. However, both the budget deficit and public debt are expected to increase substantially by the end of 2017, once the total costs of the highway works will have fully materialised. The fiscal strategy adopted in June projects a 2 pps. increase of the normal VAT rate to 21% in January 2018, as well as further increase of excises, and the freezing of public sector wages. These measures are expected to contribute reinforcing the budget by additional 2 pps. of GDP annually until 2019.

The construction of the highway has been, so far, the key driver of fiscal deficits. The works are expected to be completed in mid-2019, easing the pressure on public finances.

Table II.30.1:

Main features of country forecast - MONTENEGRO

		2016			Annual percentage change					
		mio EUR Curr. prices	**% GDP**	**98-13**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**
GDP		3787.5	100.0	-	1.8	3.4	2.9	**3.9**	**3.0**	**3.3**
Private Consumption		3067.0	81.0	-	2.9	2.2	5.4	**4.5**	**2.5**	**2.8**
Public Consumption		711.4	18.8	-	1.4	1.9	0.8	**1.8**	**0.9**	**1.4**
Gross fixed capital formation		944.3	24.9	-	-2.5	11.9	27.5	**7.5**	**3.5**	**1.5**
of which: equipment		-	-	-	-	-	-	**-**	**-**	**-**
Exports (goods and services)		1634.2	43.1	-	-0.7	5.7	6.2	**6.8**	**4.5**	**2.4**
Imports (goods and services)		2596.9	68.6	-	1.6	4.4	17.3	**6.5**	**2.3**	**1.0**
GNI (GDP deflator)		-	-	-	-	-	-	**-**	**-**	**-**
Contribution to GDP growth:	Domestic demand			-	2.1	4.4	10.0	**5.9**	**3.2**	**3.0**
	Inventories			-	1.0	-0.7	0.8	**-0.5**	**-0.5**	**0.0**
	Net exports			-	-1.3	-0.3	-7.9	**-1.5**	**0.4**	**0.4**
Employment				-	7.1	2.4	1.8	**2.6**	**2.3**	**2.0**
Unemployment rate (a)				-	17.9	17.8	18.0	**17.2**	**16.7**	**16.0**
Compensation of employees / head				-	6.1	0.9	4.4	**1.7**	**2.0**	**2.4**
Unit labour costs whole economy				-	-	-	-	**-**	**-**	**-**
Real unit labour cost				-	-	-	-	**-**	**-**	**-**
Saving rate of households (b)				-	-	-	-	**-**	**-**	**-**
GDP deflator				-	-	-	-	**-**	**-**	**-**
Consumer-price index				-	-0.5	1.4	0.9	**2.5**	**2.2**	**2.0**
Terms of trade of goods				-	-	-	-	**-**	**-**	**-**
Trade balance (goods) (c)				-	-39.8	-40.0	-45.7	**-45.6**	**-44.0**	**-42.4**
Current-account balance (c)				-	-15.2	-13.2	-17.9	**-18.0**	**-16.7**	**-16.0**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				-	-	-	-	**-**	**-**	**-**
General government balance (c)				-	-2.9	-8.3	-3.7	**-6.2**	**-5.6**	**-2.7**
Cyclically-adjusted budget balance (d)				-	-	-	-	**-**	**-**	**-**
Structural budget balance (d)				-	-	-	-	**-**	**-**	**-**
General government gross debt (c)				-	58.6	62.3	67.2	**69.5**	**73.2**	**74.9**

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