PROGRAM INFORMATION DOCUMENT (PID)
CONCEPT STAGE

June 6, 2017
Report No.: AB7911

Operation Name	Montenegro Fiscal and Financial Sector Resilience
Region	EUROPE AND CENTRAL ASIA
Country	Montenegro
Sector	Central Government (Central Agencies) (100%)
Operation ID	P161664
Lending Instrument	Policy-Based Guarantee
Borrower(s)	MONTENEGRO
Implementing Agency	Ministry of Finance
Date PID Prepared	June 7, 2017
Estimated Date of Appraisal	October 2017
Estimated Date of Board Approval	Q3 FY18
Corporate Review Decision	Following the corporate review, the decision was taken to proceed with the preparation of the operation.

I. Key development issues and rationale for Bank involvement

The proposed PBG supports Montenegro's efforts to strengthen public finance sustainability and financial sector resilience. It underpins the authorities' commitments expressed in the 2017-2020 Fiscal Strategy as well as builds on the Government Economic Reform Program 2017-2020 submitted to the European Commission (EC) as part of the economic governance surveillance for the EU candidate countries. The World Bank Western Balkans Regular Economic Report, the latest 2016 EC Progress Report on Montenegro the upcoming 2017 IMF Article IV all emphasize the importance to maintain macroeconomic stability, stating that the rapidly rising public debt and high fiscal deficits, together with high external imbalances and high unemployment are of marked concern for sustainable and inclusive growth. The combined effects of large-scale public infrastructure investments (the Bar-Boljare highway section in the order of 24 percent of GDP), public wage, pension and a new mothers' benefit programs launched in 2015 challenge medium-term fiscal sustainability.

II. Proposed Objective(s)

This operation supports reforms to safeguard fiscal sustainability and make financial sector more resilient to potential shocks. These reforms substantiate the government Fiscal Strategy 2017-2020 by helping the authorities design fiscal consolidation measures that will not only achieve the debt stabilizing levels, but ensure the social protection of the most needy. It also strengthens the quality of financial intermediation and assets. The reforms backed by this operation enjoy coordinated support from the EC, the IMF and the World Bank, including by targeted technical assistance.

III. Preliminary Description

Significant fiscal vulnerabilities have emerged since 2015. The new Government has already taken initial steps to reduce the fiscal deficit, by adopting the five-year plan for the rehabilitation of public finances in December 2016. However, additional measures are necessary to reach stabilization of public

debt ahead of the large refinancing needs in 2019-21. Reversing these trends, introducing measures to tighten the spending, strengthen public finance management and mobilize revenues are part of the Fiscal Sustainability pillar.

W**hile financial sector stability improved since the global financial crisis, pockets of vulnerabilities exists.** The banking sector remains liquid and well capitalized with a capital adequacy ratio of 16 percent well above the regulatory minimum threshold. Yet, profitability remains low and uneven among banks. Some domestically owned banks have very high NPLs and/or very low provisioning levels; three of them have received qualified audited reports in 2015 as identified by the 2016 Financial Sector Assessment Program (FSAP). Importantly, upcoming implementation of IFRS 9 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. The Financial Sector Resilience pillar aims to support enhancements of the NPL resolution framework, addressing vulnerabilities stemming from banks with qualified audit reports, expanding the financial sector supervisory framework, and enhancing institutional, financial and personal independence of the CBM.

The proposed operation is fully consistent with the FY16–FY20 Country Partnership Framework (CPF). It helps the authorities design the content of fiscal consolidation measures as well as strengthen its regulatory framework in financial and public finance management areas. By supporting macro and fiscal stability as well as financial sector resilience the operation addresses critical elements for sustained shared prosperity. Without such reforms, the adjustment could be much more abrupt and harmful for the bottom 40 percent of the population. The IMF provides a set of technical assistance and surveillance under the Article IV. The EC and the Bank coordinate technical assistance and budget support on PFM as part of an engagement that will be completed by the end of 2018.

IV. Poverty and Social Impacts and Environment Aspects

This operation is expected to have high social and gender, and low, but positive environmental impacts. While a rise in VAT and abolishment of mothers' benefits will have adverse social impact in the near term, there are few prior actions that will have positive indirect social impact. This include a rise in means-tested child benefits, compensatory actions and activation measures for affected mothers, as well as positive health affect from tobacco and sugary drinks excise rise. The positive impact on the environment is expected through the introduction of the excises on coal (which will affect only around 3 percent of households that use coal for heating).

V. Tentative financing: US$90 million in equivalent EUR, Policy Based Guarantee

VI. Contact point

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