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Program Information Document (PID)

Concept Stage | Date Prepared/Updated: June 20, 2018| Report No: 130564

BASIC INFORMATION

A. Basic Project Data

Country	Project ID	Project Name	Parent Project ID (if any)
Montenegro	P167665	Montenegro Sector Fiscal and Financial Sector Resilience PBG	P166205
Region	Estimated Board Date	Practice Area (Lead)(s)	Financing Instrument
Europe and Central Asia	July 2019	Macroeconomics, Trade and Investments Finance, Competitiveness and Innovation	Policy-Based Guarantee
Borrower(s)	Implementing Agency		
Montenegro	Ministry of Finance		

Proposed Development Objective(s)

Pillar A. to strengthen public finance sustainability and Pillar B. to strengthen financial sector resilience.

Financing (in US$, Millions)

SUMMARY

Total Financing	180

DETAILS

Source:	
IBRD Guaranteed	90
Private non-guaranteed	90

Decision
Following corporate review, decision was taken to proceed with the preparation of the operation.

B. Introduction and Context

Country Context

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 its pre-crisis levels, with large variations across banks.

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 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 Montenegro Systematic Country Diagnostic, have fundamental impact on Montenegro's ability to accelerate and sustain growth and combat poverty.

Relationship to CPF

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, as envisaged in the Focus Area 1. 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.

C. Proposed Development Objective(s)

The objective of the program is to **strengthen 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 vulnerable. It also strengthens the quality of financial intermediation and assets.

Key Results

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. Increase of the Eco Fund revenue collected from 0 in 2017 to 5 million in 2019.
8. 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
9. Three banks with qualified audit reports in 2015 maintain solvency ratios above 10 percent or intervened by 2019
10. The CBM receives quarterly financial reports from factoring companies by 2019
11. Improved banking supervision and resolution frameworks consistent with the Basel Core Principles and BRRD

D. Concept Description

The Fiscal Sustainability pillar of the PBG aims to reduce fiscal vulnerabilities. Significant fiscal vulnerabilities have emerged since 2015. The new Government has taken initial steps to reduce the fiscal deficit by adopting the five-year plan for the rehabilitation of public finances in December 2016 and by adopting the Fiscal Strategy 2017-2020 with the first set of concrete measures to stem fiscal imbalances already undertaken. These measures, supported by the PBG1, include tax policy reform, as well as social benefit reforms. The markets have already recognized these actions and have enabled a partial refinancing of the Eurobonds coming due in 2019-21. PBG2 supports further measures to tighten spending, strengthen public finance management and mobilize additional revenues are needed to stem public debt growth.

The Financial Sector Resilience pillar supports enhancements of the bank resolution framework, and addressing vulnerabilities stemming from banks with qualified audit reports. While 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. While overall NPLs have declined, also supported by the measures taken under the PBG1, some domestically owned banks have very high NPLs and/or very low provisioning levels; three of them received repetitive qualified audited reports since 2015. PBG2 supports the introduction of the bank resolution framework, including for ailing banks, and further tightening of the classification on nonperforming assets.

E. Poverty and Social Impacts and Environment Aspects

Poverty and Social Impacts

Some of the PBG2 prior actions are expected to have adverse, but limited distributional and social impacts in the short run, including the workforce rightsizing in the public sector. However, the overall poverty impact is likely to be limited given the mitigating measures in place, including compensation packages for laid off workers, existing programs of employment support and labor regulations. Moreover, the affected workers tend to be in the middle and upper quintiles of the income distribution.

Environment Impacts

The reform supported by the PBG2 will have positive effects on the environment and will contribute to mitigation and adaptation measures to combat adverse climate impacts. The adoption of the new Law on Climate Change will deliver climate change co-benefits for (i) mitigation through the establishment of a system for monitoring and controlling of emissions of greenhouse gases as part of a national ETS and by using funds obtained through the sale of emissions allowances to finance environmental projects through Eco Fund, providing further co-benefits; and (ii) adaptation through strengthening of climate aspects in national policies and regulations and supporting further alignment with the EU 2030 climate and energy policy framework.

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APPROVAL

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