

MONET



MONTENEGRO ECONOMIC TRENDS



November 2004

ABOUT ISSP

The Institute for Strategic Studies and Prognoses (ISSP), established by Professor Vukotic in 1999, is the first independent economic institute in Montenegro. USAID assisted in this process and continues to support the work of the Institute. ISSP has a wide network of associates both in Montenegro (about 150) and abroad. ISSP is a member of the Balkan Network, the Global Development Network established by the World Bank and the European Integration Network. ISSP cooperates with ICER (Torino), WIIW (Vienna), CEPS (Brussels) and Chesapeake Associates (Washington).

The Institute's mission is "to provide research that will contribute to Montenegro's economic transformation and to change the current mindset, as well as to train today's young people how to function successfully in the new environment."

Major projects:

- o Macroeconomic reform in Montenegro
 - a) Privatization
 - b) Monetary Reform
 - c) Capital Markets Development
 - d) Fiscal Reform
 - e) Reform of the Pension System
 - f) Introduction of the SNA system
- o Macroeconomic indicators in Montenegro
- o Economic education

President:

Professor Veselin Vukotic, Ph.D.

Executive Director:

Petar Ivanovic, Ph.D.

Advisory Board Chairman:

Professor Mirosljub Labus, Ph.D.

CONTACTS

ISSP

Address: Naselje pod Ljubovic, Lamela C (1 i 2),
81000 Podgorica, Montenegro, Yugoslavia
Tel/Fax: (381) 81 634 338; 634 329
Website: www.isspm.org / Email: ISSP@cg.yu

CEPS

Address: Place du Congres 1, 1000 Brussels,
Belgium
Tel: (32) 2 229 39 11, Fax: (32) 2 229 39 71
Website: www.ceps.be / Email: info@ceps.be

ABOUT CEPS

CEPS was established in 1983. It performs independent analyses and critiques on European economic policy and politics, as well as on European institutions and security. It disseminates its findings through a regular flow of publications, public events and electronic commentaries.

CEPS is an independent membership-driven organization with more than 100 corporate members and a large number of central banks, diplomatic missions and international business organizations in its constituency.

ABOUT MONET

MONET (www.isspm.org) is the result of the joint work of ISSP in Podgorica and CEPS in Belgium. It is financed by the grant from the European Agency for Reconstruction.

MONET team

-ISSP-

ISSP team leaders:

Professor Veselin Vukotic
Petar Ivanovic

Researchers:

Jadranka Kaludjerovic,
Maja Bacovic,
Milorad Katnic,
Nina Labovic,
Ana Krsmanovic,
Tijana Stanković,
Milica Vukotic,
Jelena Janjusevic,
Ivana Vojinovic,
Milica Dakovic.

Lay out and web site:

Boris Buskovic

-CEPS-

Program Director:

Daniel Gros

Team Leader:

Vladimir Najman (monet@ceps.be)

Resident Economist:

Przemyslaw Wozniak (monet@ceps.be),
przemek@case.com.pl)

Project Associates

Zeljko Brkovic, Milan Dabovic, Miloica Dakic, Mirjana Djuranovic, Danijela Vukajlovic Grba, Jovanka Knezevic, Darinka Micanic, Draginja Milatovic, Dejan Miljkovic, Dragica Pekovic, Milan Perovic, Natasa Radunovic, Vesna Samardzic, Zdravka Savic, Ljubinka Sekulic, Marina Vukanovic, Bosa Vukicevic, Tamara Saveljic, Zoran Djikanovic, Dragana Radevic, Darko Konjevic, Jelena Jokanovic, Maja Drakic

Table of contents

Events	3
Executive Summary	5
Part 1	
Chapter 1. Output	8
Chapter 2. Employment	18
Chapter 3. Wages	22
Chapter 4. Prices	28
Chapter 5. Budget	40
Chapter 6. Money	52
Chapter 7. Capital Market	60
Chapter 8. External Sector	66
Chapter 9. Regional Comparison	74
Part 2	
Comment 1. European Union Fiscal Rules	78
Comment 2. The effects of the VAT rate increase	84
Comment 3. The Law on Mortgage	89
Comment 4. Determinants of unemployment in Montenegro	92
Comment 5. Price Regulation in the Telecommunications Sector	100

Events

April 2004

- 04. **Treasury bills issue.** Government in Montenegro issues 56-day-treasury bills in the amount of € 5.5 million.
- 15. **Treasury bills issue.** Government in Montenegro issues 28-day-treasury bills in the amount of € 17 million.
- 20. **Registered around 40,000 new employees.** In a year, since the time the Decree on Tax Relief for New Employees was adopted, around 40,000 new employees were registered, or 40% more than were planned.
- 21. **Adopted Law on Tax on Passenger Vehicles Use.** The Government of Montenegro adopted the Law on tax on Passenger Vehicles Use, which introduced the obligation to pay a tax for the use of passenger vehicles in the amount of €15 to €50, depending on the vehicle size. This tax will be collected once a year, when the vehicle is registered.

May 2004

- 05. **Established the State Union Court.** The deputies of the State Union Parliament established the last institution of the State Union – the State Union Court. The Parliament of the Union was also established. The Rules of Work are adopted and the members of the six delegations for European and world institutions and organizations were elected.
- 11. **Announced Tender for the sale of a part of the company Radoje Dakic.** Agency for Reconstruction and Foreign Investments announced Tender for sale of 52.2% of the capital of “Radoje Dakic” in factories of transmissions, construction and equipment and in the factory of machines.
- 18. **New petrol price increase.** One liter of the “super” petrol in Montenegro costs €0.97 instead of the previous price of €0.93. Unleaded petrol cost €0.98 per liter, diesel €0.76, eco-diesel €0.77 and oil €0.56.
- 26. **New Broker House entered on the Montenegrin Capital Market.** Montenegroberza and NEX Montenegro Stock exchanges accepted membership of the new broker House from Bijelo Polje – Market Broker.

June 2004

- 01. **Ironwork from Niksic was sold to “Midland”.** Control share package of the Niksic Ironwork, i.e. 59.27% of the share capital, was sold to the multinational holding company “Midland”. “Midland” accepted to engage 2,000 employees, of which 500 are on the waiting list. In the first year it is planned to engage 200, and in the next year, 300 employees.
- 03. **New Tender for “Planinka”.** Commercial Court in Bijelo Polje, in cooperation with the Ministry of Tourism, repeated international Tender for sale Hotel “Planinka”, which is in ownership of the SKY Center “Durmitor” in Zabljak. Tender for Planinka was announced at the end of February, together with tender for sale Hotels Zabljak and Jezera, but there were no interested buyers.
- 09. **Seven million dollars for health reform and five million dollars for pension system.** The Board of Directors of the World Bank approved credit in the amount of 12 million dollars for Serbia and Montenegro. The World Bank would, with seven million dollars, finance the start of reforms in the health system of Montenegro.
- 10. **Treasury bills issue.** Government in Montenegro issues 28-day-treasury bills in the amount of € 15 million.
- 16. **Adopted Law on Changes in Law of Privation of the Montenegrin Economy.**
- 17. **Old foreign exchange currency saving converted into bonds.** The Government of Montenegro adopted the Decree on Foreign Exchange Currency Savings Conversion into Bonds. This Decree prescribes ways and conditions for bond realization, as well as conditions for their use before the due date.

24. **Treasury bills issue.** Government in Montenegro issues 56-day treasury bills in the amount of € 4 million.

July 2004

01. **Adopted Law on Changes and Amendments of the Law on Pension and Invalid Insurance.** According to the Law, taxes and contributions on all wages in Montenegro would be lower by 5%. These tax reliefs relate to employers.
08. **Treasury bills issue.** Government in Montenegro issues 28-day-treasury bills in the amount of € 15.5 million.
15. **Adopted Law on Investment Funds.**
18. **Sold Confection Factory.** After two unsuccessful tenders, the Confection Factory was sold to the "Plus Komerc" from Niksic for €200,000. The new owner has the obligation to pay €60,000 after the contract is signed, while the rest would be paid in equal annuities over the next nine months.
22. **Treasury bills issue.** Government in Montenegro issues 56-day-treasury bills in the amount of € 4.5 million.
29. **Adopted Law on Mortgage..**

August 2004

05. **Treasury bills issue.** Government in Montenegro issues 28-day-treasury bills in the amount of € 16 million.
05. **Sign contract on Corporation "Jakic" sale.** Corporation "Jakic" from Pljevlja was sold to the American company, Prim Pacific. Total price amounted to € 9.5 million. In the next four years, the buyer of the corporation is obligated to invest € 7.8 million in the corporation development.
09. **Announced Tender for KAP.** Preliminary Tender for sale of the Aluminum Mill from Podgorica was announced. Requests were accepted through September 13th.
10. **Increased price of the eco diesel.** One liter of eco diesel costs €0.8, which is 4% higher than in the last two weeks.
19. **Treasury bills issue.** Government in Montenegro issues 56-day-treasury bills in the amount of € 5 million.

September 2004

01. **Expected annual revenue in the amount of \$208 million.** For eight months in 2004 the Aluminum Mill in Podgorica produced 80,393 tons of aluminum and realized revenues in the amount of approximately \$137.8 million. In this period, approximately \$117 million worth of aluminum was exported.
07. **Auction for four companies.** Shares and portions of property of the companies Crnagoraput, Zitoprodukt, Lovcen and Centrojadrans were offered on public auction. A minority package of 30.2% of the shares of Crnagoraput from Podgorica, which is in ownership of the government Funds, was offered for a starting price of € 5.5 million.
17. **\$18 million credit for Montenegro.** The Board of Directors of the World Bank approved credit for support of Montenegrin reforms in financial, energy and health sector, pension system and public administration, in the amount of €18 million. The credit should help the continuation and consolidation of the improvements that were realized in these areas, and which were supported by WB and other donators.
22. **The number of tourists increased by 22.9%.** In August 2004, more than 208,000 tourists visited Montenegro, of which 161,000 were domestic and 47,000 were foreign. In total, tourist visits were around 22.9% higher compared to the same period last year. The total number of nights stayed in this period was also higher, by 25.1%. In the period from January to August of 2004, 529,000 tourists visited Montenegro, or 6.9% more than in the same period of 2003, while the total number of overnight stays was higher by 9.5%.
22. **Economic Forum in Milocer.** Economic Forum was held in Milocer, in Budva. Over 400 economists from Serbia and Montenegro and the region, as well as representatives of international institutions participated in the forum.

Executive Summary

First section

According to data for the first three quarters of 2004, the Montenegrin economy is slowly recovering and situation in economy improves overall.

The signs of recovery could be observed in the industrial production sector. In the first three quarters of 2004 is, compared to the same period in 2003, higher by 11.9%. This increase is due to higher production in utilities sector and in the processing industry, while the average production of the sector of mining did not contribute to the total industrial production increase.

According to employment in Montenegro, the signs of recovery on the labor market are not obvious yet. The total employment in Montenegro increased over the period March – August and declined in September. On the other hand, the unemployment continually decreases, reaching 60,505 persons in September, which is the lowest level in the last four years.

In the annual terms, the wages in 2004 are significantly higher than in 2003. Period over period comparison (the average of the first nine months of 2004 over first nine months of 2003) shows that the wages in 2004 are 14.9% higher than in 2003.

The inflation continually decrease in the 2004. The annual change of CPI registered sharp decreases in both the second and third quarters of 2004. Dropping from the level of 5.8% at the end of the first quarter it reached 0.9% at the end of the second and finally 0.3% at the end of the third quarter.

The 2004 is characterized by a better fiscal discipline. Budget cumulatively collected € 270,6 million, or 92.5% of plan. Total expenditures amounted €283.6 million, and were lower by 18% than planned, while the total spent amount was higher by 5% as compared to 2003.

The increased loans activity as well as increase in household deposit also effected the improvement in the economy. Total household deposits reached €60.3 million at the end of August 2004, while the total amount of loans approved by Montenegrin banks in August was €239.6 million.

Total number of transactions realized in the first nine months on the Montenegrin Stock exchanges was 234% higher compared to the same period in 2003, while the total turnover realized in the first 9 months of 2004 total turnover has significantly decreased – around 36%, as compared to same period in 2003.

The current account deficit in Montenegro in first half of 2004 amounted to US\$ 135.2 million and nominally increased by 46.4% compared to the first half of 2003. However, total revenues rose by 50.1% compared to the first half of 2003, while total expenditures of the current account in first six months 2004 nominally increased by 49.2% compared to the same period of the previous year.

Second section

European Union Fiscal Rules

Fiscal rules are defined as a combination of fiscal goals and a set of regulations by which is determined what the government should do to achieve defined goals, i.e. as permanent restrictions to fiscal policy, expressed in the summary indicators of fiscal performances, such as budget deficit, lending, debt or its main components.

The effects of the VAT rate increase

Distrust of International Monetary Fund and World Bank in the capability of Montenegro to independently resolve the problem of possible deficit, caused by the reduction of employers' payroll taxes and contributions to pension and health care, was the reason why they requested the increase of VAT rate on 18 %.

The Law on Mortgage

The Government of Montenegro in July 26th 2004 adopted *Law on Mortgage*. This law regulates rights, obligations and relations between mortgage creditor and client; volume and types of the mortgages; the procedure of remuneration; as well as all other issues necessary for efficient functioning of the mortgage right, especially related to the extra judicial execution, which the Law on Mortgage introduced.

Determinants of unemployment in Montenegro

High degree of regulatory influences the increase of unemployment. Rigid labor legislation actually maintains existing jobs and discourages the creation of new jobs. Also, high taxation of income discourages economic activity, which is best seen through the influence of taxes on the unemployment – higher taxes and higher unemployment.

Price Regulation in the Telecommunications Sector

There is an ongoing process of reform of the telecommunication sector in Montenegro. Agency for Telecommunication is preparing Law on Regulation of Tariffs of Telecommunications Operators. One of the most important aspects of the regulation is the regulation of prices. There are two main approaches to the price regulation: the price cap regulation and the rate-of-return regulation (ROR).

PART 1

Chapter 1. Output

Table 1.1 Major Developments in the Real Sector

	GDP		Industrial production					Tourism			Retail trade turnover (nominally)		
	1989=100	Annual change in %	Total		Processing industry**		Aluminum production (ton)	Electricity generation (in MWh)	persons	Annual change in %	Share of foreign tourists in total in %	index 1999=100	Annual change in %
			2000=100*	Annual change in %	2000=100	Annual change in %							
1990	89.0	-11.0	194.8										
1991	70.0	-21.3	169.0			102,256	2,963,675						
1992	61.0	-12.9	136.0	-19.5		89,165	2,312,621						
1993	39.0	-36.1	77.3	-43.2		38,104	1,694,769						
1994	39.0	0.0	70.1	-9.2		10,574	1,997,483						
1995	46.0	17.9	69.2	-1.4		26,071	1,504,302						
1996	57.0	23.9	102.9	48.7		51,178	3,102,091						
1997	61.0	7.0	104.5	1.5		80,600	2,276,868						
1998	64.0	4.9	105.3	0.8		76,737	2,713,936						
1999	58.0	-9.4	96.8	-8.0		80,936	2,711,929				100		
2000	59.8	3.1	100.0	3.3	100.0	95,526	2,698,019	448,187		17.8	271	170.9	
2001	59.7	-0.2	98.0	-2.0	101.6	2.3	108,123	2,492,993	555,040	23.8	20.8	369	36.1
2002	60.2	0.8	98.7	0.7	103.9	1.3	116,482	2,194,516	541,699	-2.4	25.1	352	-4.5
2003			100.9	2.2	101.8	-2.1	120,212	2,586,485	598,539	10.5	23.6	413	17.3
2002-Q1			88.0	-15.1			26,619	507,743	33,292	-5.1	20.9	305.8	8.2
2002-Q2			89.0	-5.8			29,513	265,271	118,958	21.7	25.5	334.3	-0.3
2002-Q3			101.0	16.1			30,105	501,282	352,718	-8.9	26.9	398.6	-15.5
2002-Q4			116.7	9.4			30,245	920,220	36,731	4.3	25.6	370.0	-4.0
2003-Q1			108.5	23.3	104.4	-100.0	29,744	1,010,097	26,913	-19.2	21.7	366.8	19.9
2003-Q2			87.9	-1.2	105.9	-100.0	29,988	377,521	123,180	3.5	27.5	392.4	17.4
2003-Q3			98.1	-2.9	99.2	-100.0	30,176	458,240	420,910	19.3	25.0	454.4	14.0
2003-Q4			106.8	-8.5	108.7	-100.0	30,304	740,627	27,536	-25.0	30.3	438.3	18.5
2004-Q1			106.6	-1.7	108.9	-46.7	30,168	840,947				399.8	9.0
2004-Q2			117.5	33.6	120.3	14.3	29,783	980,915				439.6	12.0
Jan-03			99.74	17.2	81.3	-100.0	10,217	337,645	9,519	-8.9	22.3	351.9	14.7
Feb-03			113.00	27.9	117.6	-100.0	9,238	371,125	9,520	-18.3	18.7	368.1	28.9
Mar-03			112.66	14.3	114.4	-100.0	10,289	301,327	7,874	-29.7	24.1	380.3	17.1
Apr-03			82.47	-11.3	92.5	-100.0	9,903	125,751	13,792	-11.5	24.8	380.3	18.4
May-03			79.91	0.4	107.1	-100.0	10,258	86,870	37,457	9.6	33.8	396.4	18.2
Jun-03			101.41	7.5	118.0	-100.0	9,827	164,900	71,931	4.0	23.9	400.5	15.7
Jul-03			100.09	-3.9	96.3	-100.0	10,190	183,360	182,814	20.8	18.8	432.8	3.6
Aug-03			98.79	6.9	96.3	-100.0	10,213	143,300	169,966	23.9	20.7	477.3	10.5
Sep-03			95.53	-10.1	105.0	-100.0	9,773	131,580	68,130	6.1	35.6	453.1	30.9
Oct-03			103.55	-11.1	119.1	-100.0	10,135	170,262	13,723	-37.4	34.8	428.8	11.2
Nov-03			102.52	-10.8	95.9	-100.0	9,881	222,064	7,436	8.9	31.4	436.9	21.2
Dec-03			120.67	1.6	111.1	-100.0	10,287	348,301	6,377	-20.1	22.3	449.3	23.4
Jan-04			99.67	-0.1	80.2	-100.0	10,274	275,727	6,578	-30.9	23.7	395.7	12.4
Feb-04			109.04	-3.5	115.5	-1.8	9,588	340,680	14,318	50.4	47.6	399.8	8.6
Mar-04			111.55	-1.1	131.0	14.9	10,305	224,540	5,369	-31.8	55.0	403.9	6.2
Apr-04			119.35	44.6	113.3	22.4	9,846	327,487	14,198	2.9	33.5	432.8	13.8
May-04			116.73	46.0	123.4	15.2	10,091	393,076	43,697	16.7	36.1	449.3	13.3
Jun-04			116.38	16.5	124.3	5.30	9,846	260,352	63,895	-11.2	32.5	436.9	9.1
Jul-04			105.56	6.1	108.8	13.00	10,291	175,014	168,401	-7.9	22.9		
Aug-04			99.01	0.2	112.2	16.50	10,174	212,450	208,816	22.9	22.6		
Sep-04			109.51	14.6	128.6	14.6	9,869	139,978					

1. REAL SECTOR

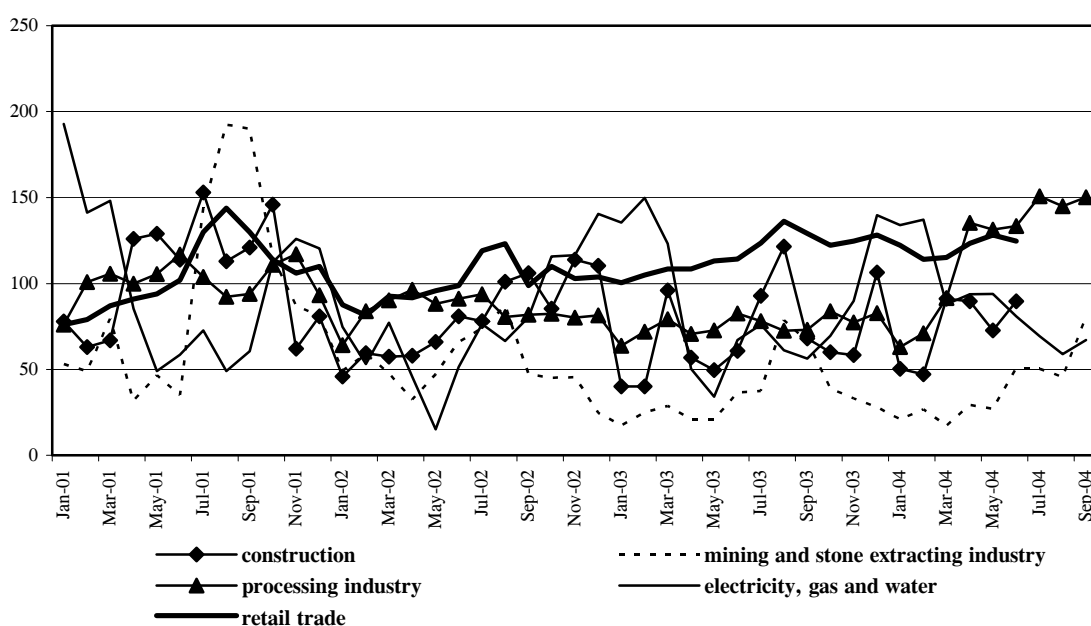
- Average industrial production in the first three quarters of 2004 was 11.9% higher than the average industrial production in the same period of 2003.
- Average electricity production in the first three quarters of 2004 was 28.7% higher than in the same period of 2003.
- Average aluminum production in the first three quarters of 2004 was 0.4% higher compared to the same period of 2003.

The following analysis comprises the most recent developments in the sectors of industrial production, tourism, transport, trade, forestry and construction in 2004. Due to the lack of data, several sectors (health care, education, financial services and services to firms) of the economy are not included in the analysis, and hence, it is difficult to determine the prevailing aggregate trends in the real sector. However, the most important sectors were analyzed, which, when combined, account for approximately 55% of the GDP.

In the first nine months of 2004, the average industrial production was 11.9% higher compared to the same period of 2003. This increase was due to the registered positive annual dynamics in processing industries (19.6% in September, 16.5% in August, 13.5% in July), as well as for electricity, gas and water supply (12.2% in September, 63.7% in June and 274.2% in May). However, the average production of the sector of mining and quarrying was 16.6% lower in the first nine months of 2004 compared to the corresponding period in 2003 and has not contributed to the total industrial production increase. In September 2004, total industrial production increased by 10.6% compared to the same month in 2003.

Summing up the first six months of 2004 in the non-industrial sectors, positive annual dynamics prevailed in road transport of persons, railway transport of goods, as well as retail trade, catering, forestry, and construction, compared to the same period of the previous year.

Graph 1.1: Situation in the certain sectors of the real economy (2000=100)



Source: Monstat

Chapter 1. Output

Table 1.2. Industrial production: disaggregated indices of major industries

	share in the index	2001	2002	1-12.2003		1-9 2004.	01.2004	04.2004	05.2004	06.2004	07.2004	08.2003	09.2003
	2003	2000		1-12.2002		1-9, 2003.	01.2003	04.2003	05.2003	06.2003	07.2003	08.2002	09.2002
INDUSTRY TOTAL	100	99.3	99.9	99.7	102.4	111.6		144.69	146	116.5	106.1	100.2	114.6
MINING AND STONE EXTRACTING	7.2	88.5	95.1	71.6	101.4	81.1		103.42	95.9	103.3	99.3	42.9	92.7
PROCESSING UNDUSTRY	67.9	101.6	103.9	101.8	97.9	110.7		122.46	115.2	105.3	113.0	116.5	119.6
ELECTRICITY, GAS AND WATER PRODUCTION	24.9	93.9	87.7	106.5	117.5	121.9		255.69	374.2	163.7	85.8	90.7	112.3
MINING AND STONE EXTRACTING	7.2	88.5	95.1	71.6	101.4	81.1		103.42	95.9	103.3	99.3	42.9	92.7
RAW MATERIALS EXTRACTION	2.8	78.0	119.1	89.2	85.4	90.5		99.58	634.5	96.8	102.6	72.8	115.0
OTHER RAW MATERIALS EXTRACTION	4.4	94.6	81.1	61.3	115.0	74.8		105.18	75.4	108.6	96.9	31.70	86.3
Metal ores mining	2.9	96.3	96.6	70.4	88.3	101.2		134.32	82.7	113.5	96.7	74.6	67.0
Other ores and stone extraction	1.5	90.3	41.9	38.5	217.8	23.40		124.50	40.3	81.8	98.1	5.90	100.0
PROCESSING UNDUSTRY	67.9	101.6	103.9	99.5	97.9	110.7		122.46	115.2	105.3	113.0	116.5	119.6
MAN. OF FOOD PROD., BAVERAGES AND TOBACCO	8.2	104.6	91.8	90.7	101.40	123.9		165.90	112.7	113.8	123.7	129.1	111.8
Manufacture of food products and baverages	6.9	100.1	90.0	98.1	109.50	105.3		154.87	97.4	90.2	102.8	94.5	86.0
Manufacture of tobacco products	1.3	121.9	99.1	62.8	73.00	232.3		216.49	242.5	577.2	283.4	305.4	205.0
MANUFACTURE OF TEXTILE AND TEXTILE PRODUCTS	1.4	72.1	81.5	61.2	75.20	112.2		63.61	100.3	171.9	161.4	116.4	184.1
Manufacture of yarn and fabrics	0.3	94.1	70.5	42.9	80.70	51.5		19.71	30.40	221.1	154.5	111.4	54.8
Manufacture of wearing apparel and fur	1.1	64.9	85.0	67.1	73.80	125.2		78.63	118.2	167.7	162.2	118.2	239.8
MAN. OF LEATHER AND LEATHER PRODUCTS	0.1	73.6	57.3	40.5	60.4	-	-	-	15.40	21.80	9.0	-	-
WOOD PROCESSING AND WOOD PRODUCTS	1.5	78.2	54.8	26.3	80.4	152.4		382.61	98.2	103.0	184.8	155.0	167.2
MANUFACTURE OF PAPER; ISSUING AND PRINTING	1	107.2	98.4	62.1	59.2	85.2		93.88	81.5	82.1	92.9	89.2	95.4
Maufacture of cellose, paper and paper processing	0.2	89.8	99.1	27.5	26.5	82.1		125.35	94.3	79.4	94.2	101.4	122.0
Issuing, printing and reproduction	0.8	129.7	97.7	106.7	101.8	86.0		87.24	78	83.1	92.4	85.3	87.1
MANUFACTURE OF COKE AND OIL DERIVATES	0.1	111.1	63.8	8.5	12.5	-	-	-	-	-	-	-	-
MANUFACTURE OF CHEMICAL PRODUCTS AND FIBERS	1.5	99.9	105.5	71.8	78.5	110.5		109.5	140.4	134.1	128.2	83.7	65.2
MANUFACTURE OF RUBBER AND PLASTIC PRODUCTS	0.2	72.9	91.9	55.0	51.0	36.5		31.1	61.9	30.10	27.5	26.60	39.1
MANUFACTURE OF PRODUCTS OF OTHER NONMETAL MINERALS	7.3	107.2	112.9	110.6	100.3	95.8		95.1	91.8	102.3	98.2	91.5	98.7
MAN.OF BASE METALS AND METAL PRODUCTS	45.1	109.7	115.2	117.0	102.2	110.8		120.2	121.5	102.5	111.4	119.6	128.5
Manufacture of basic metals	43.7	111.2	116.8	118.5	102.1	110.3		119.15	120.8	104.0	111.1	118.3	126.5
Manufacture of metal products, except machines	1.4	75.4	97.9	102.0	104.7	121.1		160.43	147.5	76.0	119.8	168.1	191.3
MANUFACTURE OF MACHINERY AND DEVICES, OTHER	0.7	12.5	52.3	30.1	77.1	134.2		193.70	135.1	163.7	39.2	3113.3	15.5
MANUFACTURE OF TRANSPORT EQUIPMENT	0.7	144.0	174.0	167.9	95.8	114.2		219.1	127.3	95.3	105.7	44.1	133.4
PROCESSING INDUSTRY, OTHER	0.1	39.6	63.3	11.6	33.1	85.9	-	521.0	60.3	49.2	56.3	68.5	54.3
ELECTRICITY, GAS AND WATER PRODUCTION	24.9	93.9	87.7	106.5	117.5	121.9		255.7	374.2	163.7	85.8	90.7	112.3

1.1. PRODUCTION

The total production index in Montenegro consists of the indices of industrial production, forestry, and construction. Total production (without agriculture) was 12% higher in the first six months of 2004 as compared to the same period in 2003.

1.1.1. Industrial production

The average industrial production in the first eight months of 2004 was 11.9% higher than in the corresponding period of 2003. In the first three quarters of 2004, the average industrial production was 11.9% higher than in the same period of 2003. Annual growth rates of industrial production were 6.1%, 0.2% and 10.6% in July, August and September 2004 respectively.

Three major industrial sectors

The processing industry, which represents 67.9%¹ of total industrial production, was 11.7% higher in the first nine months of 2004 than in the same period of the previous year. Annual growth rate of the processing industry in September 2004 was 19.6%, while it was 16.5% in August, and 13% and 5.3% in July and June 2004, respectively.

Positive trends were registered in several sub-sectors of the processing industry in 2004. The industry *food products, beverages and tobacco* (8.2% of total industrial production) increased its production by 22.5% in the first nine months of 2004 compared to the same period of the previous year.

In addition, one of the major sub-sectors of the processing industry, “*basic metals and metal products manufacturing*” (45.1% of total industrial production), increased its production by 12.5% in the first three quarters of 2004 compared to the same period in 2003. The sub-sector “*Wood processing and wood products*,” which accounts for 1.5% of total industrial production, increased its average production by 54.9% in the first nine months of 2004 compared to the same period in 2003. The sub-sector “*Manufacturing of textiles and textiles products*” (which accounts for 2.0% of total industrial production) increased its average production by 22.8% in the first nine months of 2004 compared to the same period in 2003. However, several other sub-sectors within the processing industries sector experienced a decrease in production. The average production of the sub-sector “*Manufacturing of products of other non-metal minerals*” (7.4% of total industrial production) declined in the first nine months of 2004 by 3.9% compared to the same period in 2003, while production within the sector of “*Manufacturing of paper; issuing and printing*” (1.8% of total industrial production) declined by 13.8%.

The second major industrial sector, *electricity, gas and water*, which accounts for 24.9% of total industrial production, saw its average production increase by 21.2% in the first nine months of 2004 compared to the same period of the previous year. The annual growth rate of its production was positive in April, May and June 2004, amounting to -155.7%, 274.2% and 63.4% respectively, thus contributing to the average production increase in the first eight months of 2004. In September 2004, annual growth rate of this production was 12.3%.

¹ Data based on the share of sales in 2003, used in official statistics in 2003.

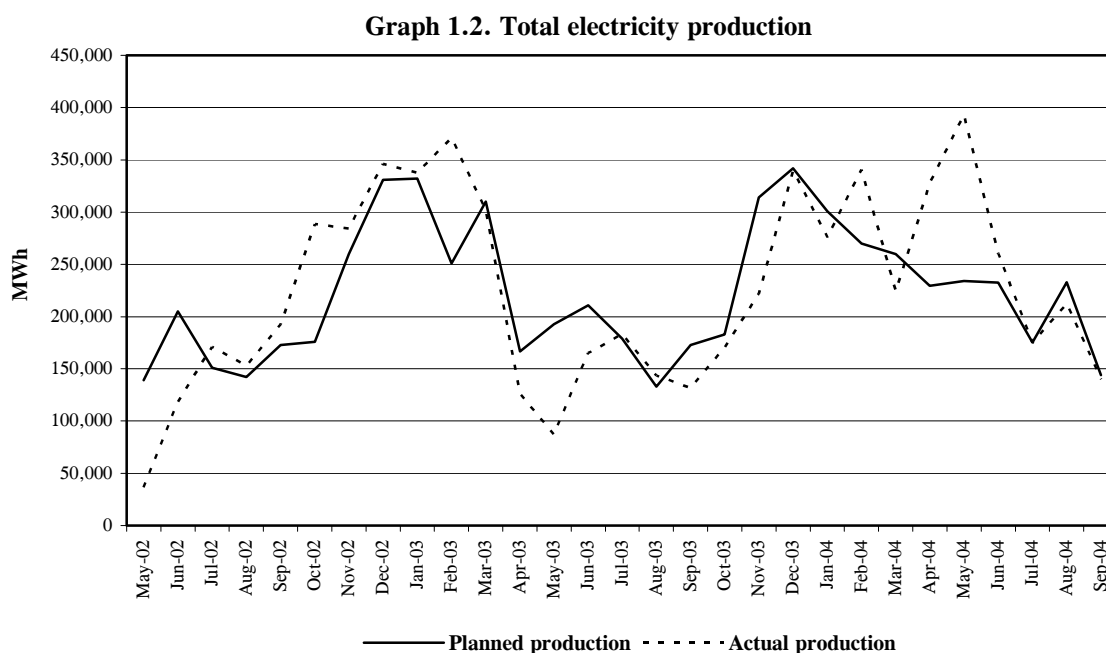
The mining and quarrying industry, which accounts for about 7.2% of total industrial production, declined an average of 16.6% in the first nine months of 2004 compared to the same period in 2003. The average annual growth of its production in July and August 2004 was negative as well, amounting to -0.7% and -57.1% respectively. In September 2004, annual growth rate of this production was -7.3%.

Leading industrial producers

The Power Company of Montenegro (Elektroprivreda Crne Gore), one of the most important industrial producers in Montenegro, increased its electricity generation by 48.2% in August 2004 compared to the same month in 2003. This was much better than in July, when electricity generation was 4.4% lower, than in July of 2003.

Electricity generation in September 2004 increased by 19.7% compared to the corresponding month in 2003. Total electricity generation in the first three quarters of 2004 was 28.7% higher than in the first three quarters of 2003.

The following graph (1.2) presents the aggregate actual and planned electricity production of the three power plants existing in Montenegro: *Perucica Hydro Plant*, *Piva Hydro Plant*, and *Pljevlja Thermal Plant*.



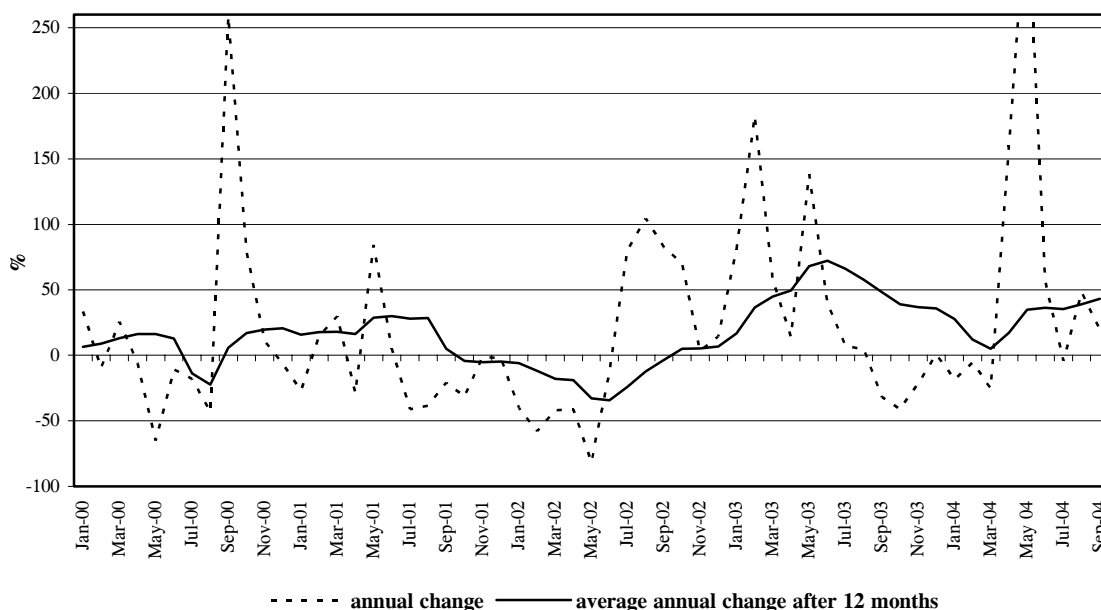
Source: The Power Plant of Montenegro (EPCG)

Total actual production of the three plants in the third quarter of 2004 was 4.5% under the planned level. The actual production in August 2004 was 9% under the planned level; while in July, it was almost at the planned level. Actual production of the three plants in September 2004 was 3% under the planned level.

Individually, actual production of the *Thermal Plant Pjevlja* in the second quarter of 2004 was almost the same as was planned, and in the third quarter of 2004, actual production of the *Thermal Plant Pljevlja* was 1% above the planned level. Total actual production of the *Piva Hydro Plant* was 93.6% above the planned level during the second quarter of 2004 and 35.6% under the planned level in the third quarter of 2004. The actual production of the

Perucica Hydro Plant exceeded the planned level by 54.7% in the second quarter of 2004 and was just 1% above the planned level in the third quarter of 2004.

Graph 1.3. Dynamics of electricity production

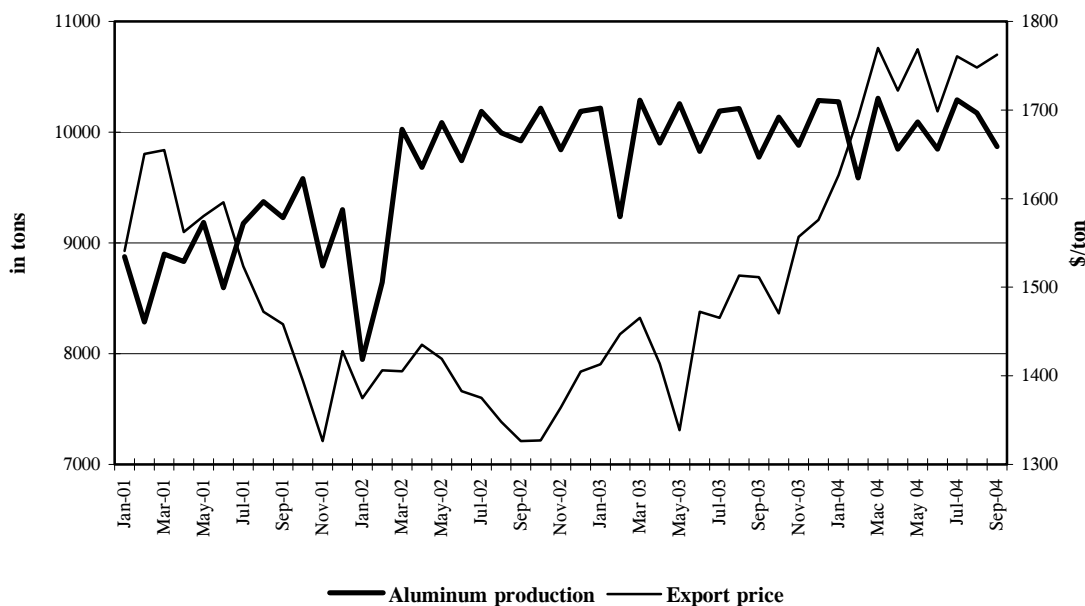


Source: EPCG

Note: 12-month averages of annual changes are moving averages of annual changes during the past 12 months

During the third quarter of 2004, production of the Aluminum Combine Podgorica (**KAP**) increased by 0.5% compared to the same period in 2003. Total aluminum production during the first three quarters of 2004 was 0.4% higher compared to the corresponding period in 2003.

Graph 1.4: Aluminum production and exports prices



Source: KAP

Graph 1.4 presents the monthly dynamics of aluminum production since January 2001, as well as prices at which KAP exported its aluminum. Aluminum production, as the graph presents, increased in March and May 2004 after falling in February and April. Since May,

Chapter 1. Output

the increase continued into July and August of 2004. Furthermore, and in line with the global trend of the rapid growth in metal prices, the average monthly aluminum price has been going up particularly quickly in recent months and has reached the level of 1,762 \$/ton in September 2004.

Table 1.3 Indices of development in the various sectors of the economy

	index value	2002	1_06.2004		01/2004	02/2004	03/2004	04/2004	05/2004	06/2004
	base period	1999	1_06.2003		01/2003 =100	02/2003 =100	03/2003 =100	03/2003 =100	03/2003 =100	06/2003 =100
Production	Total	101.5	101.0	111.6	98.9	96.2	99.1	138.6	135.7	100.1
	Industrial production	101.9	104.2	114.4	99.9	96.5	98.9	144.6	146.0	116.5
	Forestry	94.0	93.7	117.0	114.0	138.9	239.8	155.5	82.3	76.2
	Construction	198.9	168.2	112.0	109.0	118.0	95.0	157.7	146.8	128.7
Transport	road (goods)	97.0	92.1	95.0	84.0	157.6	110.0	68.8	79.5	95.1
	road(persons)	65.6	80.9	123.4	102.3	172.0	115.4	132.1	120.6	111.3
	sea (goods)	2.1	1.0	50.0	122.0	83.5	36.3	60.1	59.4	70.8
	railway (goods)	106.4	156.5	147.0	154.8	132.4	96.3	141.9	294.9	151.0
	railway (persons)	98.1	62.8	64.0	71.0	53.8	63.1	62.3	60.3	75.8
Retail trade	current prices	136.9	152.0	111.0	113.0	108.6	106.2	113.8	113.3	110.4
	deflated by CPI	79.3	126.2	106.9	107.4	103.0	100.4	110.9	110.2	109.4
Catering	current prices	221.3	255.9	104.0	101.0	78.9	123.5	231.0	195.6	108.6
	deflated by CPI	128.2	212.6	100.2	96.0	74.9	116.7	225.1	190.3	107.6
CPI		172.7	120.4	103.8	105.2	105.4	105.8	102.6	102.8	100.9

Source: Monstat Monthly Statistical review, no. 8/2001, 4/2002, 9/2003, 10/2003 and 8/2004.

1.1.2. Forestry and Construction

Monstat's data on forestry and construction are the only available data that present activities in these sectors, and they are based on a rather limited sample of firms that are active in forestry and construction.

Forestry

In June 2004, the annual growth rate of forestry production was negative (-23.8%), while the average production in the first six months overall was 17% higher than in the corresponding period of 2003.

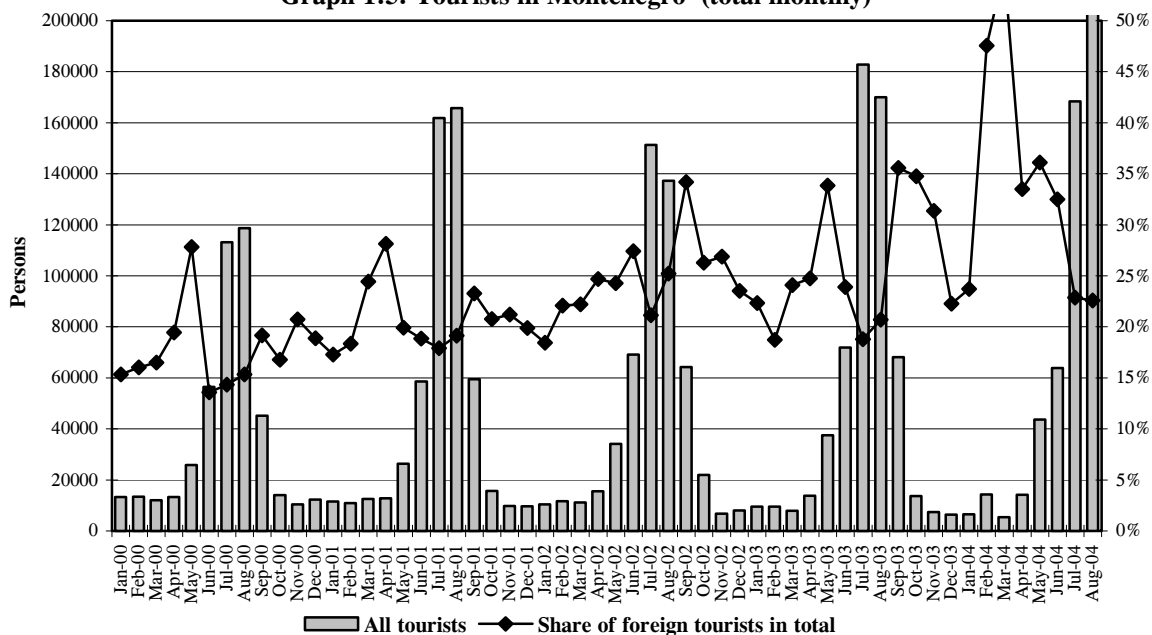
Construction

In June 2004, the annual growth rate of construction activities was positive, amounting to 28.7%. Average production in the first half of 2004 overall was 12% higher compared to the same period of the previous year.

1.2. TOURISM

In the period from January-August 2004, the total number of tourists increased by 4.5% compared to the same period in 2003. The number of domestic tourists declined by 1.9%, while that of foreign guests increased by 27.3% compared to the first eight months of 2003. The share of foreign tourists was 22.6% in August 2004, 1.9 percentage points more than in August 2003 (see graph 1.5).

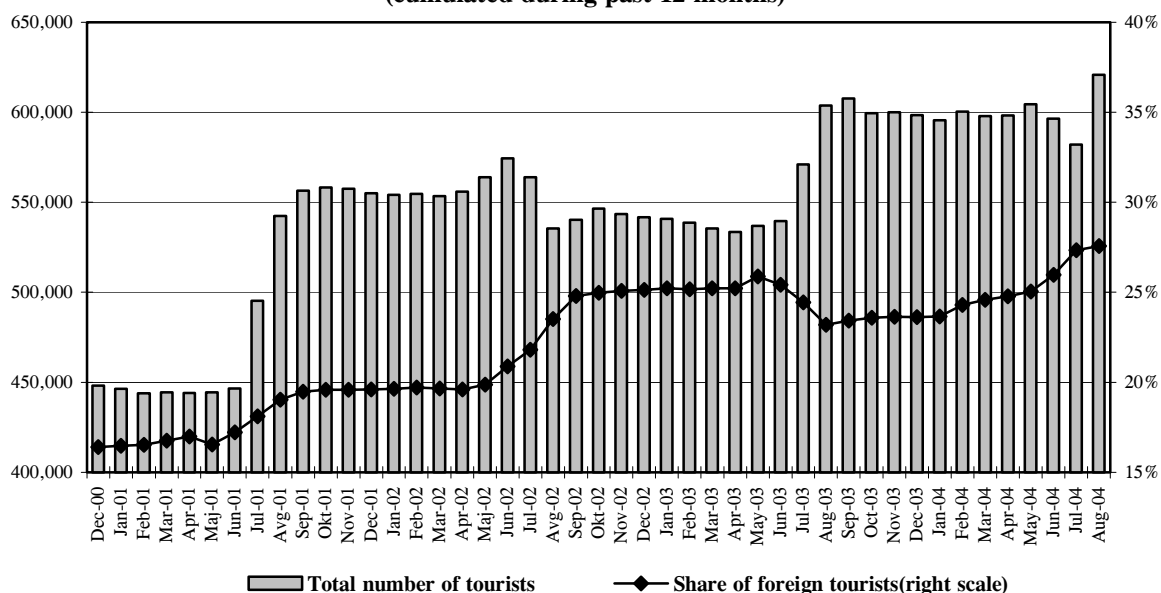
Graph 1.5. Tourists in Montenegro (total monthly)



Source: Monstat

The number of tourists cumulated over the previous 12-month period is presented in graph 1.6. The graph points to the relative stabilization of the annual number of tourists in the fourth quarter of 2003 and the first two quarters of 2004. In August 2004, the number of tourists increased by 23% compared to the corresponding period of the preceding year. The share of foreign tourists was 4.7 percentage points higher in the first eight months of 2004 as compared to the same period of the previous year.

Graph 1.6: Annual visits of tourists in Montenegro (cumulated during past 12 months)

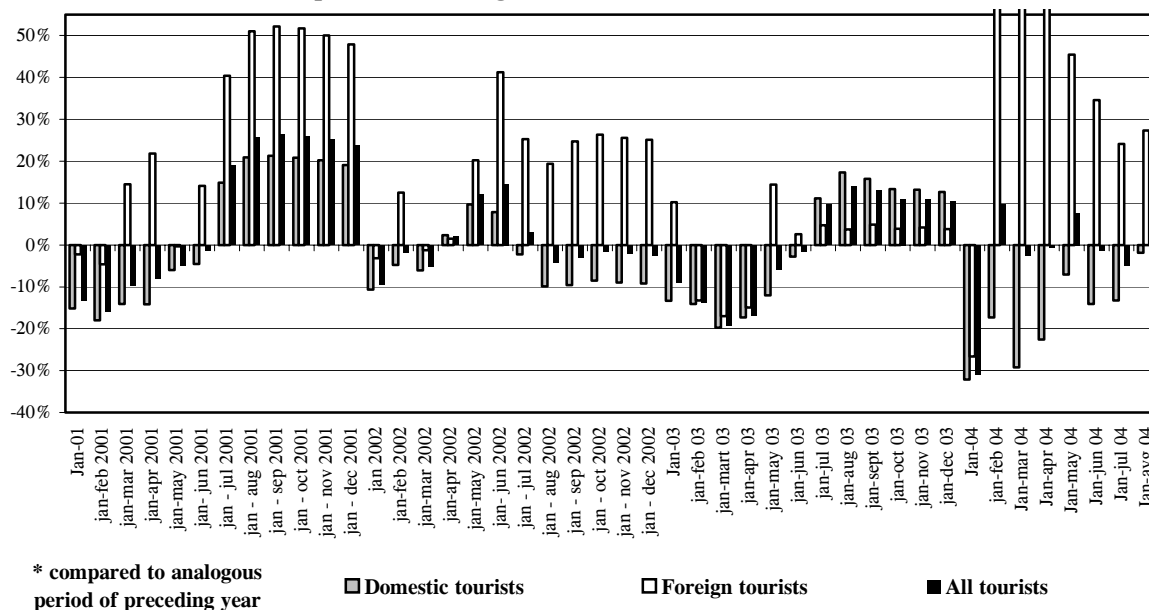


Source: Monstat

The growth rates of tourism, cumulated since the beginning of the respective year, are presented in graph 1.7. Data for the period January-August 2004 indicate that the total number of domestic tourists decreased by 1.9% compared to the same period in 2003, while the number of foreign tourists in this period increased by 27.3%.

Tourism revenue earned from domestic tourists increased by 3% while revenue from foreign tourists increased by 38% in the first six months of 2004, compared to the same period of the previous year.

Graph 1.7. Annual growth rates of number of tourists*



Source: Monstat

1.3. OTHER SECTORS OF SERVICES

Transport

In June 2004, transportation activities were at slightly lower levels than in June 2003, and that was also the case with road transportation of goods (4.9% lower), railway transportation of persons (24.2% lower) and sea transportation of goods (29.2% lower). On the other hand, road transportation of passengers was 11.3% higher than in June 2003, while the analogous figure for railway transportation of goods was 51% higher as compared to June 2003. (see table 1.3).

Revenue from the export of transportation services, as evidenced in the Balance of Payments statistics, increased by 57% in the first six months of 2004 compared to the same period in 2003.

Retail trade

In the first six months of 2004, the average level of real² retail sales services was 6.9% higher than in the corresponding period of 2003 (or 11% higher in the case of nominal retail sales). The annual real growth rate of retail sales was 9.4% in June 2004, while in nominal terms it was 10.4%.

Catering

The average real level of catering in the first six months of 2004 was 0.2% higher than in the same period of 2003, while the analogous figure in current prices rose by 4% compared to the same period of the previous year. On an annual basis, the real growth of catering in June 2004 amounted to 7.6%, while the nominal growth was 8.6%.

² Deflated by CPI

Chapter 2. Employment

Table 2.1. Labor force and unemployment

	Population (mid-year) without migrations ¹	Total employed persons (all sectors)	Number of unemployed (2)	Unemployment rate %	Unemployment rate % (estimate)	Unemployment rate ISSP survey* %
	Official data			ISSP estimate based on official data	ISSP	
1991	591,269	144,045	58,144	28.8	21.6	
1992	593,618	134,205	64,632	32.5	23.6	
1993	595,976	130,901	62,818	32.4	22.4	
1994	598,344	128,835	58,210	31.1	21.8	
1995	600,721	125,090	59,045	32.1	22.2	
1996	603,108	124,264	60,225	32.6	21.9	
1997	605,504	120,604	63,995	34.7	23.5	
1998	607,909	117,745	68,373	36.7	25.7	
1999	610,324	115,349	75,303	39.5	27.3	
2000	612,749	113,818	83,583	42.4	27.8	
2001	615,183	114,076	81,561	41.7	24.8	
2002	617,627	113,743	80,865	41.5	23.7	
2003	620,145	111,852	71,679	39.0	21.4	
2002-Q1		113,715	81,085	41.6	23.7	
2002-Q2		113,785	81,541	41.7	23.4	
2002-Q3		113,877	80,935	41.5	25.1	
2002-Q4		113,593	79,898	41.3	23.4	
2003-Q1		112,587	76,275	40.4	23.4	
2003-Q2		112,173	72,744	39.3	21.7	
2003-Q3		112,338	66,964	37.3	20.3	
2003-Q4		110,312	70,732	39.1	21.1	
2004-Q1		108,185	71,123	39.7	22.6	
2004-Q2		109,709	68,589	38.4	21.6	
2004-Q3		110,713	61,602	35.7	19.8	
Jan-03		112,673	76,584	40.3	22.6	
Feb-03		112,771	76,077	40.5	22.5	
Mar-03		112,317	76,165	40.4	22.6	
Apr-03		112,132	74,896	40.0	22.3	
May-03		111,738	73,250	39.6	22.0	
June-03		112,648	69,735	38.2	21.0	
July-03		112,905	66,951	37.2	20.3	
Aug-03		112,647	66,277	37.0	20.2	17.0
Sep-03		111,461	67,664	37.8	20.4	
Oct-03		110,911	71,023	39.0	21.2	
Nov-03		110,387	72,547	39.7	21.6	
Dec-03		109,639	68,625	38.5	20.6	
Jan-04		108,562	69,573	39.1	22.2	
Feb-04		107,359	71,419	39.9	22.7	
Mar-04		108,634	72,378	40.2	22.8	
Apr-04		109,623	72,202	39.7	22.5	
May-04		109,642	68,993	38.6	21.7	
June-04		109,863	64,572	37.0	20.6	
July-04		110,886	62,143	35.9	19.9	
Aug-04		111,158	62,159	35.9	19.9	
Sep-04		110,054	60,503	35.5	19.5	

Source: Monstat, Employment Office of Montenegro and ISSP

Methodological note:

- **Population (mid-year) without migrations** is an ISSP estimate based on vital statistics. The starting point is a census data for 1991 and population for each subsequent period is obtained by adding the difference between births and deaths in respective periods as reported by the Monstat.
- **Official unemployment rate** was calculated from official data on number of employed and unemployed with the use of the formula:
$$UR = \frac{n}{n+z} \cdot 100$$

where UR-unemployment rate, n-number of unemployed and z-number of employed persons.
- **An ISSP estimate of the unemployment rate** is obtained by combining data from Monstat, Federal Labor Force Survey and ISSP Household Survey. These data are used to estimate the number of employed persons per household, number of households, average number of households, as well as the official number of employed and unemployed. In this way we obtain the number of employed and unemployed in the economy and the rate is calculated using the standard abovementioned formula.
- **ISSP Survey unemployment rate** has been obtained from the ISSP Household Income Expenditures Surveys and is, based on the answers to the following questions: During the previous week, did you work, or were you involved in any gainful activity, for money or in-kind compensation (at least one hour)? Although you did not work in the previous week, do you have a job? Did you look for a job in the past 4 weeks? Then, using the standard formula the rate is calculated.

¹ Data for 1991 and 2003 are census data: national and etnical structure – date per municipalities and settlements, census of the population, households and apartments in 2003, MONSTAT and preliminary census results for 2003, MONSTAT. Total population in period 1992-2002 is ISSP estimation based on the average annual population growth rate between two successive periods.

CHAPTER 2. EMPLOYMENT

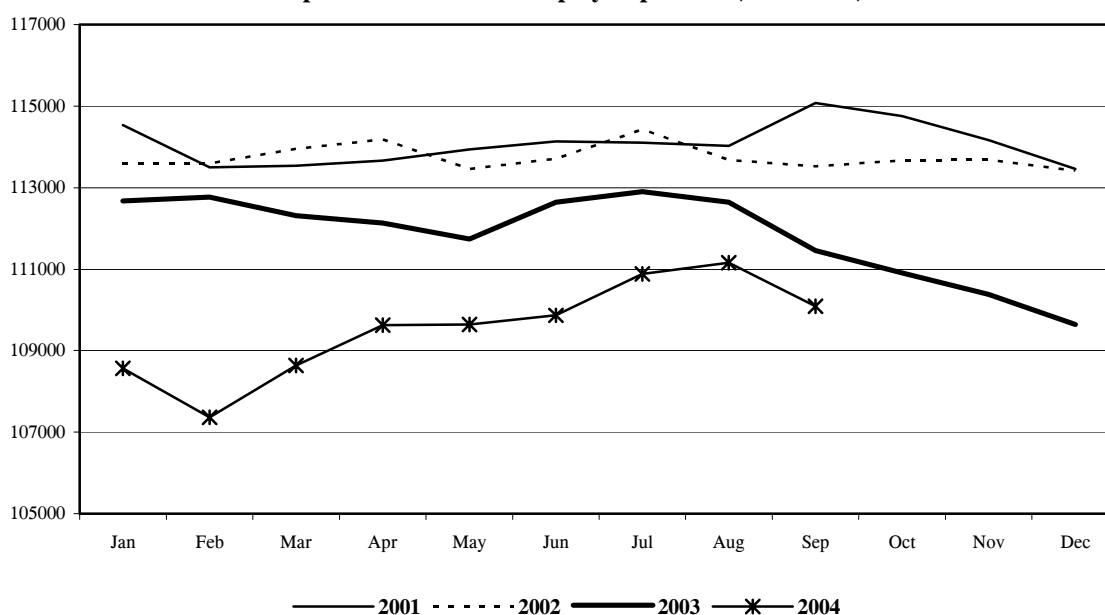
- According to official data, after a constant decline since the second half of 2003, employment in Montenegro started to increase in March 2004 and again decreased in September.
- The number of registered unemployed persons, in the first nine months of 2004, is 6.8% lower as compared to the corresponding period of last year.
- The share of employment in the services sector, in total employment, is increasing, while the share of agriculture and industry is declining.

2.1 EMPLOYMENT AND UNEMPLOYMENT

According to the official data, after declining in the first two months of 2004, employment in Montenegro began to increase in March and continued to do so until August when the number of employed persons reached 111,158 people, but in September, employment decreased by over 1000 persons (110,094). The average number of employed persons during the nine months of 2004 is 2.5% lower than in the same period of 2003. Employment in the second quarter increased by 1.4% from the first and the third was 0.9% higher than the second quarter; however, employment in the first quarter was 1.9% lower than it was in the fourth quarter of 2003.

Month to month dynamics show that employment shows the highest increases in March by 1.2%, and April and July by 0.9%, while in other months, the average rate of increase was 0.2% (with the exception of February, January and September). In annual terms, employment in all nine months of 2004 is lower than in 2003.

Graph 2.1: Number of employed persons (2001-2004)

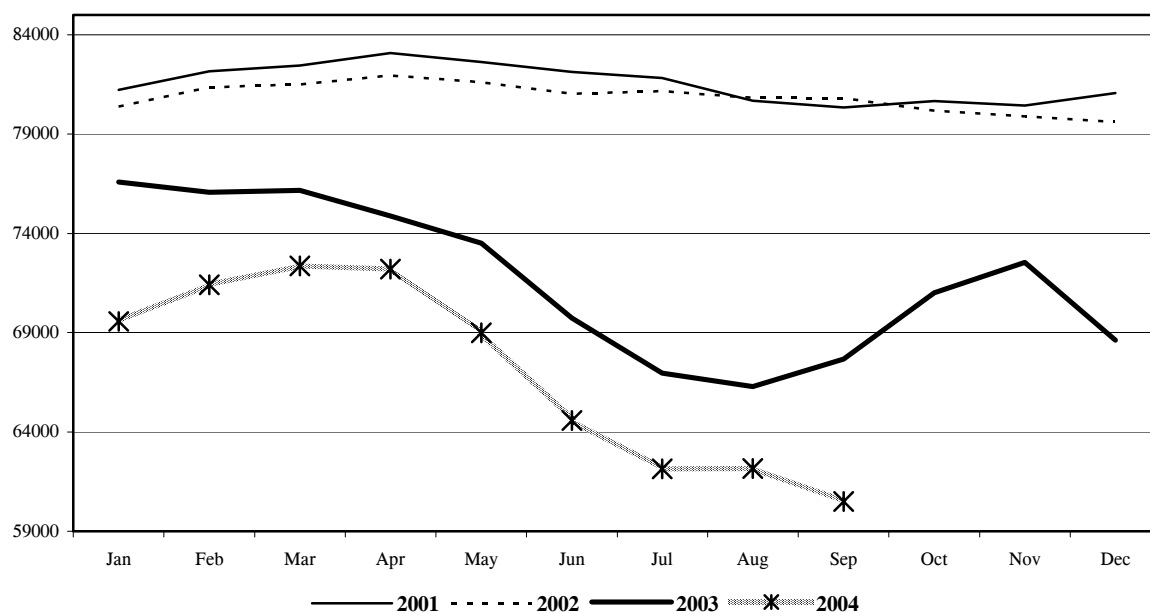


Source: Monstat

As shown in the graph above, the dynamics of the official number of employed persons in 2004 is similar to that of 2001, but with sharper fluctuations and on a lower level. Namely, in the beginning of the year we notice a decline until February, which is then followed by an increase.

Changes in the number of unemployed persons were similar to those in 2003. In annual terms, unemployment in 2004 was lower than in 2003, with unemployment in the first nine months of 2004 being 6.8% lower than in 2003. The reason for this decrease is, unfortunately, mostly due to administrative measures. If we compare quarters, unemployment in the first quarter was 3.6% lower than in the fourth quarter of 2003, and 9.4% lower in the second quarter of 2004 as compared to the first. The decline continues, with unemployment in the third quarter being 10.2% lower than in the second quarter of 2004.

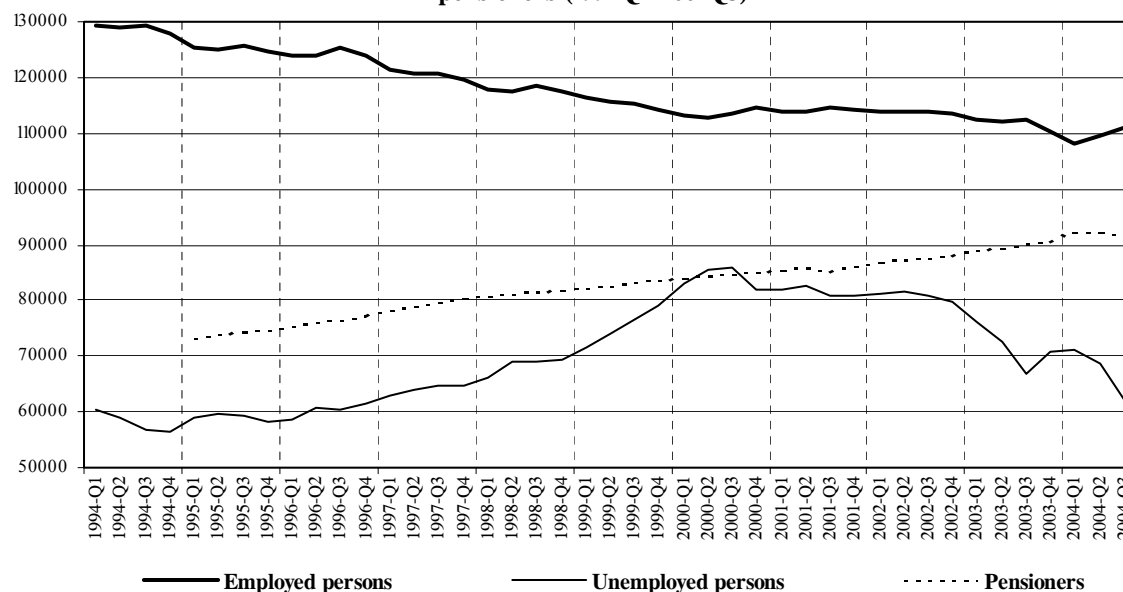
Graph 2.2: Number of unemployed persons (2000-2003)



Source: Employment Office of Montenegro

As shown in graph 2.2, the number of unemployed persons typically increases until April (seasonal effect), with 2003 being the exception. Beyond April, the further dynamics of the number of unemployed in 2004 is similar to 2003, but on a lower level.

Graph 2.3: The official number of employed, unemployed persons and pensioners (1994Q1-2004Q3)



Source: Monstat, Employment Office of Montenegro and ISSP

Note: data are quarterly averages

The number of pensioners in the first four months of 2004 increased, and then declined in June and July by 0.4% and 0.1%, respectively. Overall, the average number of pensioners in the first seven months of 2004 is 3.1% higher than in 2003.

2.2. EMPLOYMENT BY SECTORS

In order to estimate in which sectors the share of employment is changing, we have divided activities into five sectors – agriculture (includes agriculture, forestry, water supply and fisheries); industry (includes mining, manufacturing, utilities and construction); public services sector (includes state administration, education and health), services sector (includes trade, transport, mortgages, hotels and restaurants, financial intermediation) and other services (includes communal, social and other services).

Table 2.2: Employment by sectors (%of total)

	Agriculture	Industry	Services	Public services	Other services
2001	3.3	36.6	28.4	27.8	4.0
2002	3.1	35.9	28.2	28.5	4.2
2003	2.8	34.6	28.5	29.0	5.0
1/6/2004	2.6	32.7	30.0	29.0	5.6

Sources: Monstat and ISSP calculations

Note: Agriculture includes agriculture, forestry, water supply and fisheries; Public services sector includes state administration, education and health; Industry sector includes mining, manufacturing, utilities and construction; Services sector includes trade, transport, mortgages, hotels and restaurants, financial intermediation; Other services sector includes communal, social and other services

As shown in the table, over 60% of total employment in Montenegro is in the services sectors (60.1% in 2001, 60.9% in 2002, 62.6% in 2003, and 64.3% in the first half of 2004). The largest individual share is had by the Industry sector (32.7% in the first half of 2004), closely followed by the Services sector (30%) and Public services sector (29%).

Table 2.3: Annual change in the number of employed persons (in %)

	Agriculture	Industry	Services	Public services	Other services
2002	-5.2	-2.1	-1.0	2.3	5.9
2003	-11.6	-5.3	-0.4	0.0	16.9
1/6/2004	-9.1	-9.2	2.9	-3.2	8.9

Sources: Monstat and ISSP calculations

However, if we observe annual changes in employment by sector, a decline is noticed. Industrial employment and agricultural employment have declined over all of the observed periods. Regardless of the increased share of services in total employment, employment in the public services sector is lower in the first half of 2004 compared to the first half of 2003. Services sector employment declined, in annual terms, in 2002 and 2003, while in the first half of 2004 it is higher by 2.9%. The only sector that recorded positive changes in employment, over all observed periods is the “other” services sector.

These changes could be partly explained by a decrease in overall official employment. The decrease in the public services sector is most likely a consequence of program reduction of public servants and a reduction in the number employed in education.

Chapter 3. Wages

Table 3.1: Wages and salaries

Minimum wage	Average gross wage (official)	Total contributions on gross wage	Average disposable wage	Average pension (paid)	Ratio min. wage/ average disposable wage (%)	Average disposable wage*	Total labor cost**	Average tax rate (% gross wage)
Official data IN DINARS						ISSP estimates IN DINARS		
1994	65.0	292.7	154.1	139.0	47.0		406.0	33.0
1995	128.0	637.8	330.8	307.0	280.0		873.0	32.0
1996	243.0	1349.0	689.7	659.0	600.0		1826.0	31.0
1997	332.0	1801.4	922.5	879.0	738.0		2445.0	31.0
1998	453.0	2503.8	1276.1	1228.0	1073.0		3391.0	31.0
1999	663.0	3159.3	1227.3	1932.0	1581.0		4356.0	19.0
IN EURO						IN EURO		
2000	37.0	150.9	55.5	96.4	83.5		218.0	19.0
2001	42.0	176.2	68.5	108.0	97.0	174.0	249.0	19.0
1-6/2002	42.0	185.8	72.9	112.9	106.0		262.5	19.0
2002-Q1	46.0	178.5	69.7	108.9	103.0		254.2	19.0
2002-Q2	46.0	193.1	76.2	116.9	108.0		270.9	19.0
Jan-02	46.0	166.5	65.0	101.7	101.0		239.7	19.0
Feb-02	46.0	181.3	70.7	110.6	104.0		257.5	19.0
Mar-02	46.0	187.8	73.3	114.5	104.0	186.0	266.2	19.0
Apr-02	46.0	194.0	78.3	115.7	104.0		270.1	19.0
May-02	46.0	191.0	74.5	116.4	110.0		274.4	19.0
Jun-02	46.0	194.5	75.8	118.7	110.0		273.4	19.0
New personal income tax system								
Minimum wage	Average earnings of employee	Total contributions and taxes	Average earning without taxes and contributions	Average pension (paid)	Ratio min. wage/ average earning without taxes and contributions (%)	Average disposable wage *	Total labor cost**	Average tax rate (% earning)
7-12/2002	50.0	272.6	101.2	171.4	112.0		365.6	15.4
2003	50.0	271.2	97.2	174.0	113.0		364.2	14.1
2003-Q1	50.0	233.5	83.9	149.6	112.0		316.8	13.0
2003-Q2	50.0	274.3	99.4	174.8	112.0		366.9	14.3
2003-Q3	50.0	281.9	100.7	181.3	112.0		378.1	14.5
2003-Q4	50.0	295.0	104.7	190.3	112.0		395.1	14.8
2004-Q1	50.0	283.9	101.7	182.1	120.0		378.6	14.0
2004-Q2	50.0	301.1	108.9	192.2	122.0		399.2	14.4
2004-Q3	50.0	310.1	108.6	201.5	24.8		414.0	14.6
Jul-02	50.0	251.3	94.0	157.2	112.0	208.2	338.4	14.9
Aug-02	50.0	267.6	98.7	168.9	112.0		360.1	15.3
Sep-02	50.0	270.8	100.8	170.0	112.0		363.1	15.4
Oct-02	50.0	277.5	103.0	174.5	112.0	204.2	371.7	15.5
Nov-02	50.0	278.9	103.6	175.3	112.0		373.3	15.5
Dec-02	50.0	289.6	107.0	182.6	112.0		387.2	15.7
Jan-03	50.0	242.5	88.0	154.5	112.0		327.1	13.4
Feb-03	50.0	198.9	72.2	126.7	113.0		272.7	11.8
Mar-03	50.0	259.2	91.6	167.6	113.0		350.5	13.9
Apr-03	50.0	276.4	100.4	176.0	113.0		369.4	14.4
May-03	50.0	273.3	99.3	174.0	113.0		365.5	14.3
Jun-03	50.0	273.1	98.6	174.6	113.0		365.9	14.3
Jul-03	50.0	275.5	97.8	177.7	113.0		370.5	14.3
Aug-03	50.0	280.6	100.1	180.5	112.0		376.5	14.5
Sep-03	50.0	289.8	104.2	185.6	112.0		387.2	14.7
Oct-03	50.0	288.1	102.3	185.8	112.0		386.4	14.6
Nov-03	50.0	275.8	97.3	178.5	112.0		371.5	14.3
Dec-03	50.0	321.2	114.6	206.5	112.0		427.2	15.3
Jan-04	50.0	267.0	97.4	169.6	120.0		355.9	13.6
Feb-04	50.0	292.1	104.6	187.5	120.0		389.0	14.2
Mar-04	50.0	292.4	103.2	189.3	120.0		391.1	14.2
Apr-04	50.0	301.4	108.9	192.5	122.0		399.7	14.4
May-04	50.0	297.1	107.6	189.6	122.0		394.2	14.3
Jun-04	50.0	304.7	110.4	194.4	122.0		403.6	14.5
Jul-04	50.0	307.1	106.5	200.6	122.0		411.3	14.5
Aug-04	50.0	312.8	109.6	203.1	24.6		417.3	14.7
Sep-04	50.0	310.3	109.7	200.6	24.9		413.3	14.6

Minimum wage is the lowest wage that an employer is obligated to pay. Average gross wage includes the portion that employee receives as well as employee's portion of social contribution and taxes. Average disposable wage is the amount that employee receives. Average earning of employee includes basic wage of employee (earlier disposable wage), its share of contributions and taxes and all other benefits that employee receives (meal allowance, summer allowance, per diems, honoraria, etc). *Average wage is calculated from ISSP Household survey. First survey was conducted in June 2001, till now there have been 8 surveys. **Total labor cost includes average gross wage/average earnings, employer part of contribution and taxes and other benefits.

CHAPTER 3. WAGES AND SALARIES

- *The average wage and salary in September of 2004 amounted to 200.6 €, which is 8.1% higher than in the same period last year.*
- *Highest average wages and salaries after taxes and contributions in Montenegro in the first half of 2004 were in Podgorica, amounting to 236.9 €.*
- *The Government of Montenegro adopted a reduction in the personal income tax rates and a reduction of the contributions for pension and health insurance that are paid by employers.*

3.1. WAGES AND SALARIES

Average wages and salaries (W&S) after taxes and contributions in the first eight months of 2004, except for May and September, were increasing on a monthly level. Also, if we observe annual changes, the wages in 2004 are significantly higher than in 2003. The highest individual annual increase happened in February 2004 due to an extremely low level of average W&S in February last year. Period over period comparison (average first nine months of 2004 over first nine months of 2003) shows that the wages in 2004 are 14.9% higher than in 2003.

Wages and salaries in the third quarter are 4.8% higher as compared to the second quarter and 5.5% higher than the first quarter.

Table 3.2: Changes in average wages and salaries after taxes and contributions

	Annual changes	Monthly changes	Changes compared to December 2003
Jan-04	9.8%	-17.9%	-17.9%
Feb-04	48.0%	10.6%	-9.2%
Mar-04	12.9%	0.9%	-8.3%
Apr-04	9.4%	1.7%	-6.8%
May-04	9.0%	-1.5%	-8.2%
Jun-04	11.4%	2.5%	-5.9%
Jul-04	12.9%	3.2%	-2.9%
Aug-04	12.5%	1.3%	-1.6%
Sep-04	8.1%	-1.2%	-2.9%

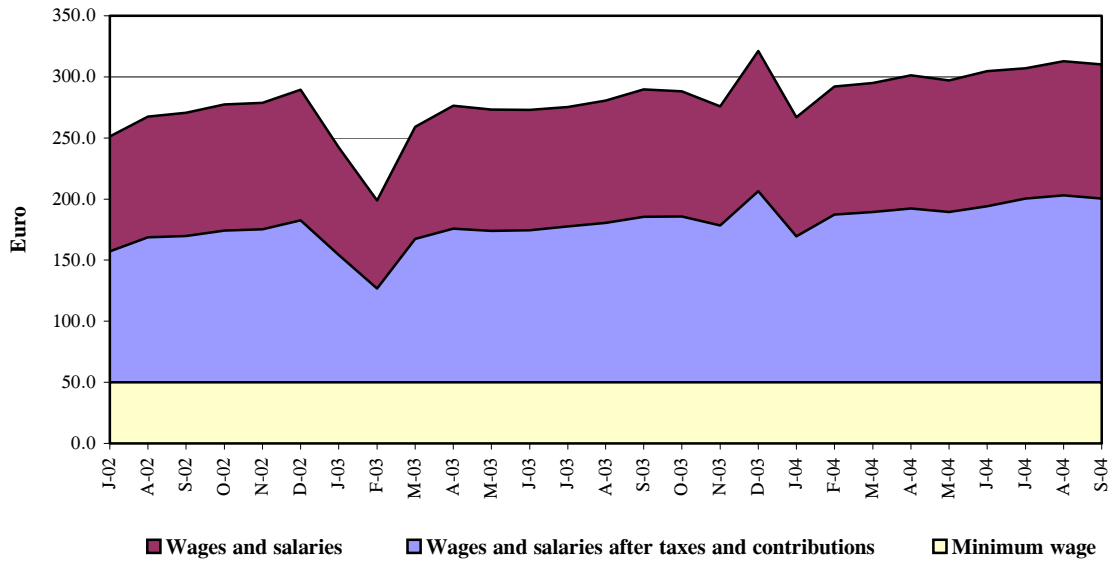
Source: Monstat and ISSP calculations

However, if we compare the 2004 W&S after taxes and contribution levels to December 2003, we see that they still have not reached the December level. A possible reason for this is the very high level of wages in December (206.2€) and the strong decrease in January 2004 (-17.9%).

The minimum wage remained the same throughout 2004, so it did not influence the level of wages. On average, employees have paid more tax in 2004 than in 2003, namely, the average tax paid for the first eight months of 2004 amounted to 42.8€, while in the same period in 2003, it was 36.9€ - an increase of 17.4%. This may be explained by tax rates, namely the average tax rate (paid tax) in 2004 was 14.3%, while in 2003, it amounted to 13.9%. The reason for increased taxes paid is the actual increase in the wage level;

however the amount of taxes paid increased by a higher rate than wages in the same period (15.9% as compared to 14.9%).

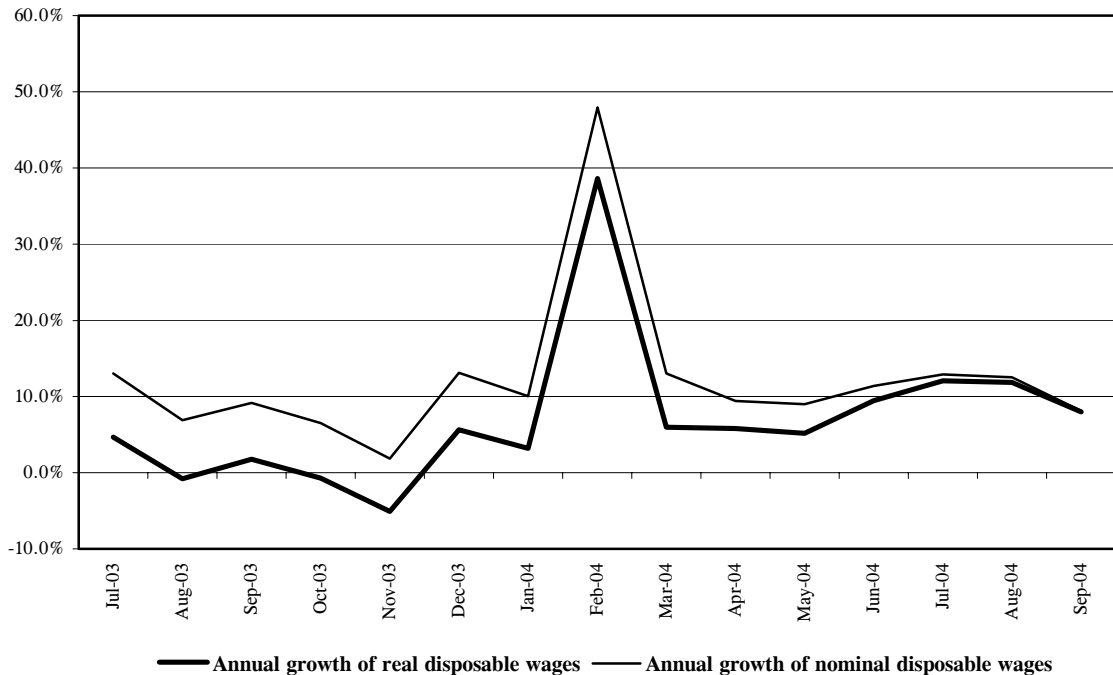
Graph 3.1: Wages and salaries, wages and salaries after taxes and contributions and minimum wage (July 2002-September 2004)



Source: Monstat and ISSP calculations

In real terms, due to low levels of inflation in 2004, real wages were positive throughout the whole period and are approaching the nominal wage level. Moreover, in August and September of 2004, real wages were equal to nominal wages due to 0 inflation.

Graph 3.2. Annual growth of nominal and real disposable wages



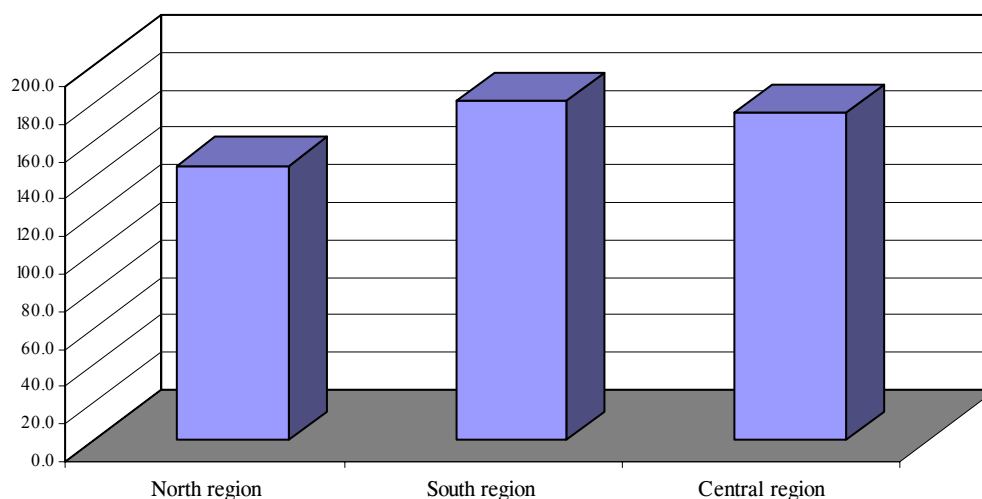
Sources: Monstat and ISSP calculations

Average pension amounted to 122 € in the first seven months of 2004. However, the Government announced that the pensions would be increased by 1.49%, according to the new Pension law that anticipates semi-annual adjustments in the pension level by combining a 50% increase in average wage and a 50% increase in CPI.

3.2. AVERAGE W&S AFTER TAXES AND CONTRIBUTIONS BY REGION

According to Monstat data, the highest average W&S after taxes and contributions are in the southern region, amounting to 180.9 €, while they are lowest in the northern region (146.4€). The average wages in the central region amounted to 174.8€.

Graph 3.3: Average wages and salaries after taxes and contributions
(January-June 2004)



Sources: Monstat and ISSP calculations

The difference between the central and southern regions is not so significant, while the average wage in the northern region is 19% lower than the southern and 16.3% lower than the central region. The reason for this is the lower level of development in the northern region as compared to the other two regions.

If we observe the individual municipalities, the average wage in the first half of the year is highest in Podgorica (232.9 €), followed by Kotor (224.4 €) and Bar (192.7 €). On the other side of the scale are Bijelo Polje with the lowest average wages (104.7€), Rožaje (105.2€), and Cetinje(108.1€).

Table 3.3: Average W&S after taxes and contributions by municipality (average January-June 2004)

Municipality	In € monthly
Podgorica	232.9
Kotor	224.4
Bar	192.7
Pljevlja	191.1
Herceg Novi	189.4
Tivat	182.2
Danilovgrad	179.7
Nikšić	178.4
Budva	166.9
Plužine	165.2
Šavnik	159.5
Kolašin	153.7
Berane	144.6
Andrijevica	139.8
Žabljak	130.0
Mojkovac	123.9
Plav	119.6
Ulcinj	112.9
Cetinje	108.1
Rožaje	105.2
Bijelo Polje	104.7

Sources: Monstat and ISSP calculations

The average S&W in Bijelo Polje is nearly 54% lower than in Podgorica.

3.3. AVERAGE W&S AFTER TAXES AND CONTRIBUTIONS BY ACTIVITY

For the purpose of comparison by sector, we have grouped all activities into five sectors: Industry, Agriculture, Public services, Services and Other services. Industry includes mining, manufacturing, utilities and construction; Agriculture includes agriculture, forestry fisheries and water supply; Public services sector includes state administration, education and health; Services sector includes trade, transport, mortgages, hotels and restaurants, financial intermediation; Other services sector includes communal, social and other services.

Table 3.4: Average wages and salaries after taxes and contributions by sectors (in € per month)

	Industry	Agriculture	Public services sector	Services sector	Other services sector
7-12/2002	177.4	86.2	200.6	182.9	174.5
1-6/2003	161.9	83.4	204.4	190.2	153.5
7-12/2003	178.4	90.0	217.9	206.7	183.1
1-6/2004	176.5	97.7	218.3	208.2	142.5

Sources: Monstat and ISSP calculations

Note: Industry sector includes mining, manufacturing, utilities and construction; Agriculture includes agriculture, forestry fisheries and water supply; Public services sector includes state administration, education and health; Services sector includes trade, transport, mortgages, hotels and restaurants, financial intermediation; Other services sector includes communal, social and other services

As shown in table 3.4, the highest average W&S after taxes and contributions, over all observed periods, are found in the Public services sector (or wages financed from the budget). The lowest average W&S are in the Agriculture sector. Relatively high salaries, compared to other sectors, are also found in the Service sector. The fact that the highest average wages and salaries are in the Public service sector could indicate that the Government is very generous in redistribution, bearing in mind that the money collected from other sectors finances these wages.

If we observe individual activities, the highest average W&S after taxes and contributions were in August in the Financial intermediation activity (372 €) and Utilities (304.62 €), while the lowest are in Constructing (103.5 €).

3.4. REDUCTION IN THE TAX BURDEN

In the last issue of MONET, we presented the planned changes that would reduce the tax burden in Montenegro¹. However, since World Bank and IMF were opposed to those changes, the Ministry of finance spent a lot of time and effort to convince them that the budget will be sustainable. As a result of negotiations, some reductions have been agreed to; the tax rate reduction is in the same amount but with different dynamics.

¹ See MONET 17, Chapter Wages

Table 3.5: Accepted changes in tax and contributions rates

	Monthly level of income in €	Change in the tax system effective since July 2004-December 2004	Contribution to PIO Fund	Contribution to Health Fund
Effective since July 2004- December 2004	0-65€	0%		
	65-218€	0+ 16% on amount over 65€	Employee 12%	Employee 7.5%
	218-381€	24.4€ +20% on amount over 218€	Employer 10.8%	Employer 6.5%
	Over 381€	57.0€ + 24% on amount over 381€	Total 22.8%	Total 14%
Effective since January 2005	0-65€	0%		
	65-218€	0+ 15% on amount over 65€	Employee 12%	Employee 7.5%
	218-381€	23€ +19% on amount over 218€	Employer 9,6%	Employer 6%
	Over 381€	54€ + 23% on amount over 381€	Total 21.6%	Total 13.5%

Source: *Changes and Amendments of the Personal Income Tax Law, Changes in the Pension Law*
(www.skupstina.cg.yu)

Additionally, changes that were included in the law previously and are abolished now were related to tax relief for new employees. According to that provision, companies that, within a business year, will hire new employees for a contract of at least two years will be allowed to reduce their tax base by the amount of gross salaries paid to these employees, augmented by the employer's portion of social contributions². This tax relief can be used in a one-year period (one yearly gross wage of newly hired employees plus the employer's portion of contributions can be deducted from the tax base) and cannot exceed the tax base.

However, the relief exists and it is regulated in the Decree on Tax Relief for Newly Employed Persons, which is actually the same decree that was adopted last year (for details on that see previous issues of MONET) whose application is extended. The decree became effective on May 19 2004 and it is in force until December 1, 2004.

² Gross wage includes only contributions that employee pays.

Chapter 4. Prices

Table 4.1. Prices

	Consumer price index (Cost of living) ¹						RPI Total, official			Producer prices changes	
	CPI Total, official			Food, tobacco and beverages annual changes	Goods less food, tobacco and beverages annual changes	Services annual changes					
	2000=100	monthly change in %	annual change in %				2000=100	monthly change in %	annual change in %	2000=100	annual change in %
PRICES IN DINARS											
1995	9.8	6.2	83.7				206	6.5	100.1		
1996	18.2	3.4	89.7				379	3.3	89.1		
1997	22.9	1.4	26.5				456	1.1	20.8		
1998	29.8	3.1	29.8				582	2.9	27.5		
1999	47.1	6.2	56.6				931	7.1	58.0	85.9	
DM (until December 2001) and EURO (from January 2002)											
2000	100.0	3.4	36.1	10.9	23.2	12.2	100.0		25.0	100.0	16.5
2001	120.2	1.8	21.8	18.9	22.8	42.0	123.0	8.6	23.1	114.5	14.5
2002	142.0	0.7	16.8	15.7	18.7	19.5	147.6	3.1	17.4	119.7	4.5
2003	151.6	0.50	6.8	3.9	9.3	7.3	159.4	0.5	7.7	127.8	2.9
2002-Q2	142.7	1.5	19.4	19.7	18.5	19.7	148.9	1.3	20.4	122.56	5.8
2002-Q3	143.5	0.1	16.3	15.3	20.0	13.9	151.1	0.4	15.2	120.50	4.0
2002-Q4	145.2	0.3	11.8	9.5	17.7	13.1	152.8	0.3	8.7	121.16	2.9
2003-Q1	146.7	0.1	7.3	4.5	7.5	4.8	158.2	0.4	8.9	121.61	-0.7
2003-Q2	152.4	0.5	6.7	3.1	10.4	5.1	161.1	0.2	8.2	128.15	4.5
2003-Q3	153.0	0.2	6.6	3.9	11.7	10.5	161.9	0.1	7.1	129.33	0.2
2003-Q4	154.3	0.3	6.3	4.2	7.3	9.0	162.0	0.0	6.7	132.09	7.5
2004-Q1	155.0	0.1	5.5	3.9	8.1	7.7	161.9	0.1	7.1	130.9	7.6
2004-Q2	154	0.2	6.3	4.2	7.3	9.0	161.7	0.2	7.5	129.9	7.2
2004Q3	155	0.1	5.5	3.9	8.1	7.7	161.9	0.1	7.1	130.9	7.6
Sep-03	153.6	0.5	6.3	3.7	11.2	9.7	161.8	0.3	7.4	129.7	0.4
Oct-03	154.0	0.3	6.3	4.1	10.2	9.5	162.0	0.1	7.1	130.9	7.0
Nov-03	154.2	0.1	6.4	4.3	6.0	9.0	162.0	0.0	6.8	132.1	7.3
Dec-03	154.7	0.3	6.2	4.2	5.8	8.4	162.0	0.0	6.7	133.3	8.2
Jan-04	154.9	0.1	5.2	3.5	8.6	7.3	162.2	0.1	5.2	133.0	6.3
Feb-04	155.2	0.2	5.4	3.8	8.1	8.1	163.0	0.5	5.7	133.8	6.9
Mar-04	155.3	0.1	5.8	4.3	7.6	7.6	163.1	0.1	5.5	0.0	8.7
Apr-04	155.4	0.0	2.6	2.0	2.6	7.0	163.3	0.1	2.3	139.0	6.3
May-04	156.0	0.4	2.8	-0.3	0.5	3.6	164.3	0.6	2.7	139.6	6.7
Jun-04	155.1	-0.6	0.9	-1.0	3.3	8.1	164.3	0.0	2.4	139.0	5.5
Jul-04	153.9	-0.7	0.9	-0.1	2.7	3.6	164.3	0.0	2.1	139.3	5.7
Aug-04	153.9	0.0	0.8	-0.3	2.8	3.6	164.4	0.1	2.1	139.7	6.0
Sep-04	153.8	0.0	0.3	-0.8	2.2	2.7	164.8	0.2	2.0	138.8	4.9

Sources: Price indices published by Statistical Office of Montenegro

Table presents end-of-period values for monthly data and average period values for quarterly and annual data.

Currencies: DIN till 1999, DM from 2000 till 2002 and € from 2002.

Since MONET 15 we have used year 2000 as a base for CPI and RPI (2000=100)

- One-base index is calculated as chain index according to Monstat indices based on respective previous years

** Monthly and annual changes are based on data taken from Monstat publications.

¹ Cost of Living is the official name of Consumer price index (CPI) in Montenegro

4. PRICES

- Inflation sharply declined to 0.3% in the third quarter of 2004
- Retail prices were falling slower than consumer prices
- The deflation of Food prices had a downward effect on total inflation in Q2 and Q3 2004.
- The cost of the Food consumer basket increased at the end of the second quarter to €265, and decreased at the end of the third to €254.
- Producer prices increased much more than consumer and retail prices at the annual level during Q2 and Q3 2004.
- Inflation forecast interval for the next 12 months: 3.7%-5.3%

4.1. CONSUMER PRICE INDEX (CPI)

The annual change of CPI registered sharp decreases in both the second and third quarters of 2004. Dropping from the level of 5.8% at the end of the first quarter it reached 0.9% at the end of the second and finally 0.3% at the end of the third quarter. The average annual inflation in the second quarter was 2.1%, resulting from a 2 percentage point drop in inflation in April (as compared to March) and a 1 percentage point drop in June (as compared to May). July and August brought similar levels from June (0.9% and 0.8% respectively), but September brought a decline of 0.3%. Various measures of CPI inflation in the three quarters of 2004 are presented below:

		Inflation in 2004				
		Annual change ²	"Average on average" ³		Average annual ⁴	Average monthly ⁵
			Compared to the same quarter last year	Compared to the previous quarter		
	Q1	5,8%	5,8%	0,5%	5,5%	0,1%
CPI	Q2	0,9%	2,0%	0,2%	2,1%	-0,1%
	Q3	0,3%	0,6%	-1%	0,7%	-0,3%

Source: Monstat

Monthly CPI changes in the second quarter of 2004 were: 0% in April, 0.4% in May, and -0.6% in June. The third quarter registered lower monthly changes of CPI: -0.7% in July and 0% in August and September.

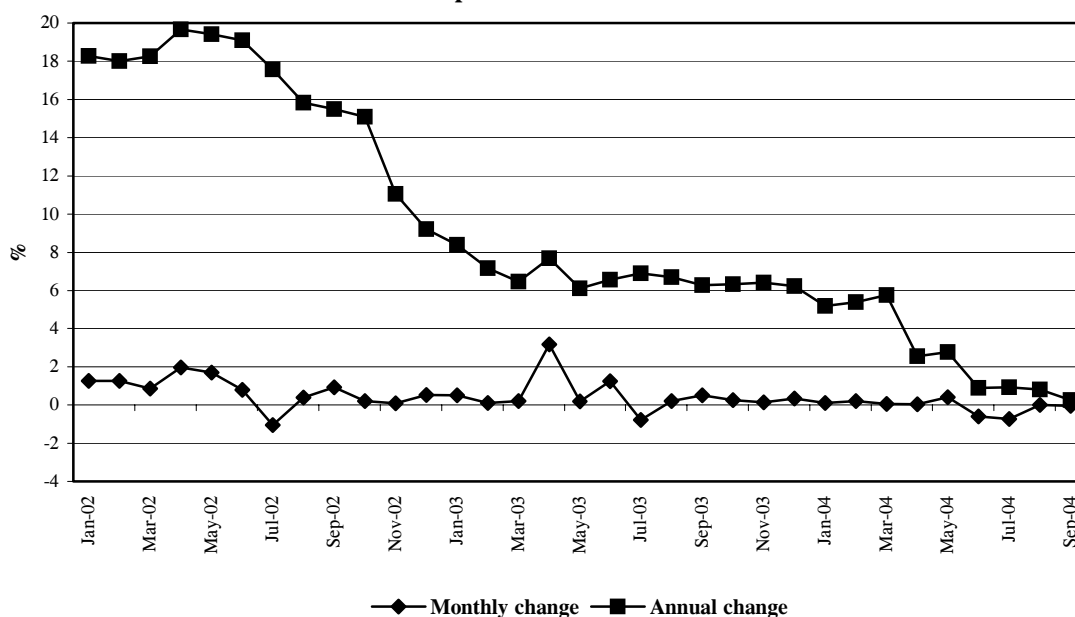
² "Annual change" represents a ratio of index in observed month and the same month in the previous year. In this case it is the change of index in March 2004 compared to the index in March 2003. This way of measuring inflation is also called "end-of-period-inflation". ISSP uses annual change of CPI as main indicator of inflation. Inflation in the certain year is presented by CPI "dec-on-dec".

³ "Average on average" represents ratios of an average of indices in the observed period to an average of indices in the previous period (previous quarter or the same quarter of the last year)

⁴ "Average annual inflation" represents arithmetic average of indices of annual change in the observed period.

⁵ "Average monthly inflation" is calculated by applying geometric averages for 3 months of observed period.

Graph 4.1 CPI Inflation



Source: Monstat

The Retail Prices Index (RPI) exhibited similar trend to that of the CPI, continuing a slower declining dynamics. The annual rate of change of retail prices was higher than consumer prices, reaching 2.4% at the end of the second and 2% at the end of the third quarter of 2004.

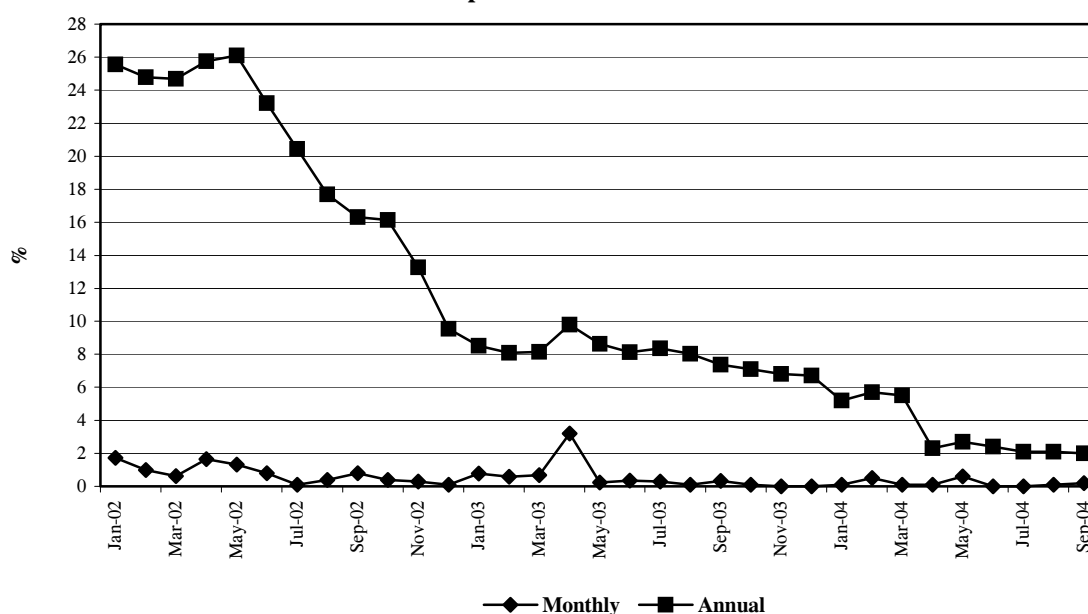
RPI in 2004					
	Annual change	"Average on average"		Average annual	Average monthly
		Compared to the same quarter last year	Compared to the previous quarter		
CPI	Q1	5,5%	5,8%	5,5%	0,2%
	Q2	2,0%	1,8%	2,5%	0,2%
	Q3	2,4%	1,6%	2,1%	0,1%

Source: Monstat

Monthly inflation of retail prices was:

- In the second quarter: 0.1% in April, 0.6% in May and 0% in June.
- In the third quarter: 0% in July, 0.1% in August and 0.2% in September.

Graph 4.2 RPI Inflation



Source: Monstat

4.1.2. Disaggregated price changes

Table 4.2 Annual inflation of disaggregated CPI components

Product or service group	Total index	Food	Tobacco and beverages	Clothing and footwear	Accommodation	Hygiene and personal care	Education and culture	Traffic vehicles and transport and communication services
Consumption Weights in 2003	100	58,10	6,80	8,23	11,20	5,25	4,80	5,62
Consumption Weights in 2004	100	57,56	7,34	8,23	11,16	5,25	4,8	5,66
2003.								
Jan	8,4	7,8	4,88	13,8	4,09	9,99	31,6	2,2
Feb	7,17	6,4	4,62	13,83	3,5	9,08	30,07	2,86
Mar	6,46	4,71	4,54	14,39	3,38	8,59	26,9	6,08
Apr	7,69	5,02	3,23	10,59	15,66	9,07	27,62	7,18
May	6,12	3,16	1,41	9,58	15,74	8,6	25,18	5,14
Jun	6,56	4,39	0,32	10,41	15,18	5,68	24,54	4,52
Jul	6,90	4,38	0,25	9,89	17,19	5,42	23,72	7,43
Aug	6,70	4,38	-0,04	9,52	16,20	5,34	22,55	7,55
Sep	6,28	4,11	-0,08	7,91	16,24	5,69	18,29	7,64
Oct	6,33	4,60	-0,11	6,70	16,13	5,23	18,25	6,75
Nov	6,42	4,79	-0,18	6,28	16,20	5,11	18,42	6,14
Dec	6,23	4,67	-0,13	7,30	16,14	4,20	15,51	5,54
2004.								
Jan	5,20	3,90	-0,06	6,75	15,27	4,21	9,48	4,52
Feb	5,40	4,26	-0,03	6,70	15,06	3,06	11,57	3,93
Mar	5,76	4,83	-0,02	6,85	15,44	3,04	11,92	1,22
Apr	2,55	2,14	1,57	6,09	3,11	1,86	5,90	0,09
May	2,77	-0,43	0,75	5,79	0,47	2,25	4,56	2,41
Jun	0,89	-1,15	0,75	5,54	2,66	2,25	5,95	6,67
Jul	0,93	-0,22	0,88	5,47	0,49	2,22	5,48	1,97
Aug	0,81	-0,43	0,75	5,79	0,47	2,25	4,56	2,41
Sep	0,26	-1,00	0,56	5,74	0,41	1,46	1,51	2,13

Source: Monstat

Food tobacco and beverages only exhibited inflation in the month of April, when annual inflation was 2%; while in the rest of the second and third quarters of 2004 it deflated. Goods less food, tobacco and beverages registered higher annual rates (3.3% at the end of the second and 2.2% at the end of the third quarter). Services prices still had the highest annual inflation.

Food product prices (57.6%⁶) caused the inflation rate to decrease during the second and third quarters of 2004. With a high share in total weight, the decreases in food prices pulled the total index down. In April and May the annual change of food prices was around 2.1%. However, since June these prices have registered deflation from 0.5% to 1.2%, which is obvious in the total index. Corn products (8.9%) registered high annual change compared to the total Food index: in the second quarter around 5.5% and in the third around 3.3% in each month. It is mainly due to the 13% annual rate of change of flour during the second and third quarters of 2004 and the annual inflation of bread that was around 5% in the second and around 2% in the third quarter. On a monthly level, the price of bread was constantly increasing by 0.3% on average. Vegetable prices (6.2%) had a significant annual rate of change in April and May (13%), mostly due to potatoes, which were 60% higher than in the same months last year. In the rest of the period, there was deflation, varying from 4% in July to 13% in September. Monthly prices were significantly under seasonal influence. Fruit prices (5%) deflated during the second and third quarters of 2004 with the lowest annual deflation rate of 1.5% in August and the highest in June, 12%. Apples, with a high weight (1.4%), were at the lowest level when compared to corresponding months from the previous year (20%). Meat prices (17.5%) registered lower annual rates in the second quarter (around 1%) as compared to the third quarter (2%). Fish prices (1.1%) were higher by 5.5% in all months of the second quarter, by 6.8% in July and August and by a high of 14.6% in September compared to the same months in the previous year. Monthly inflation of fish prices was unchanged except in July when it increased by 1.1%. The next food product group, Milk and milk products prices (8.9%), registered annual inflation of 6% in both April and May, 1.9% in June and July and around 2.3% in August and September, with mostly insignificant monthly changes (the highest was in August 0.3%). The rest of food products (5% - sugar, candies, honey, coffee, tea and spices) registered annual deflation during the second and third quarters, with the lowest in September at 5.5% and the highest in June at 22.5%. Coffee prices, with weight of 2.3% in total index, were approximately 10% lower as compared to the same 6 months of last year.

Tobacco and beverages (7.3%) prices registered low annual changes, 0.8% in the second and 0.6% in the third quarter of 2004. These price dynamics created a deflatory impact on total CPI during most of the period, except in September. Annual changes of Beverages (2.8%) were mostly unchanged on a monthly level, but on an annual level, inflation increased for “Vinjak” from 3.9% in April to 7.4% in August. The prices of Tobacco (4.5%) were unchanged on both monthly and annual levels, during the observed period.

The group **Clothes and Footwear prices (8.2%)** had an inflatory impact on the total index in the second and third quarters of 2004 with an annual change of about 6% in all observed months. This is a continuity of the same trend from the previous periods. The sub-group of Clothes prices (4.4%) was lower at the annual level (about 3% in all of the observed months), and varied at the monthly levels, from unchanged in April to the highest monthly change in June (0.3%). Footwear prices (3.8%) were surprisingly at a high annual level

⁶ There is the weight of the group in the total consumer basket placed in the brackets besides the name of the CPI products/services group or subgroup.

during the second and third quarters and constantly increased monthly. Thus, annual inflation varied around 8% in all months pushing total inflation up. On a monthly level, the increases were: 0.7% in April, 0.6% in May, 1.2% in June, 0% in July, 0.7% in August, and 0.1% in September.

Apartment prices (11.2%) had a significant drop in annual inflation compared to the first quarter of 2004 (15%), but still had an inflatory effect on the total index in the second quarter with an annual rate of 3.1% in April and 2.7% in both May and June. Higher apartment annual inflation was due to the high annual change of Communal services (1.74%), from 1.7% in the first quarter of 2004 to 18% in April and 15% in both May and June. The third quarter brought a decreasing impact of this group to the total index; thus, annual inflation was 0.5% in all three months with insignificant monthly changes. Another regulated price – Electricity price (6.1%) – was unchanged compared to the same period in the last year.

During the second and third quarters of 2004, **Hygiene and personal care (5.3%)** added mostly inflationary pressure to the total index. It was not significant in April and May with these products and services, with an annual change of 1.9% and 2% respectively. However, from June to August, when the total index dropped under 1%, annual inflation of this category of goods and services increased above 2% (around 2.2%) and in September was a bit lower (1.5%), pushing the total index up. Monthly inflation varied: 0.1% in April, 0.8% in May, 0.4% in June, 0.1% in July, and 0% in both August and September. Hygienic means (3.6%) prices registered the highest annual change in April (2.7%) and May (2%), then it dropped to 1.6% in June, July and August and hit its lowest point of 0.6% in September. In this product group, the price of detergents for manual washing registered high annual changes of 4-5% in each month from April to August but were unchanged in September. Also, hair shampoo annual inflation was 2.5%-3.5% during both observed quarters. Medicine (0.6%) prices registered annual changes of 0.7% in April and May and around 1.2% in the rest of the observed months. Prices of health care services (0.8%) deflated by 1.2% on an annual basis in April, but inflated above 5% in the rest of the observed period due to an increase in the price of curling hair service.

While **education and culture (4,8%)** prices were lower in the first quarter, the second and third quarters did have an inflatory effect on the total index with annual changes from 5-6% (from April to August) and 1.5% in September. Education product (3.4%) prices registered 1.8% annual inflation from April to July, mostly due to the high inflation of schoolbooks - 12%. However, newspapers and magazines were cheaper by 2% in the second and third quarters compared to the same period last year. Annual rate of change of Education services (1.5%) was more than 15.5% in the second quarter, 14.2% in both July and August and 7.1% in September. Education services inflation was so high due to the inflation of radio and TV subscription prices, which were at 70.7% in the second and 52.2% in the third quarter of 2004. Also, annual inflation of ticket prices was 2.6% in the second quarter and from 1-1.6% in the third quarter.

Traffic vehicles and transport and communication services registered variable annual inflation during the second and third quarters of 2004 (mostly due to changes in fuel prices): 0.9% in April, 6.2% in May, 6.7% in June, 2% in July, 2.4% in August, and 2.1% in September, pushing total inflation up. Traffic vehicles (0.2%) prices were approximately 3.5% more expensive in all months of the second and third quarters of 2004 compared to the same months last year. Fuel and lubricants (1.8%) annually deflated 1.7% in April with a monthly increase of 2.2%, followed by a significant increase of 13.2% on an annual basis and 8.1% on a monthly basis in May of 2004. After that, no monthly changes occurred, but

annual inflation was more than 14% both in June and July and 9% in August and September. The prices of Outlay for keeping cars (0.5%) had similar dynamic during the second and third quarters. Inflation of 7.5% in May was the result of an increase in the prices of car repair by 16.8% on an annual and monthly basis. The price of the same service increased by 33.6% in June compared to the same month of the previous year, which was a 14.4% increase compared to May of this year, and it has remained at this level until September. Mandatory car insurance premiums increased by 16.9% on an annual basis and 12.6% on a monthly basis, and maintained that level until September. Communication services (2.3%) prices registered annual inflation around 2.2% in the second and annual deflation of around 1.5% in the third quarter of 2004.

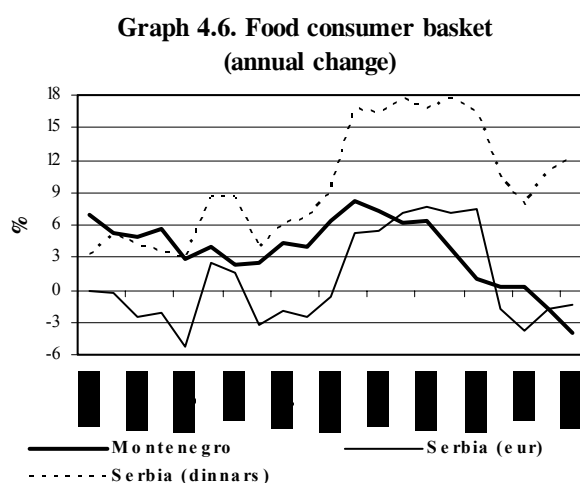
Summarizing, Food prices were lower in the second and third quarters of 2004 compared to the same time period of 2003. With a significant weight of 58% in the total consumer basket, they have created a downward effect on the total index. Prices of Food, Tobacco and Beverages, Accommodation (in May, July and August), Hygiene and personal care (in April and May), Traffic vehicles and transport and communication services (in April and May) have all created a deflatory effect on the total index, pulling inflation down. The pro-inflatory effect came from the price dynamics of several sectors: Clothing and Footwear, Education, and Culture during the whole period, Tobacco and beverages in the month of September, Accommodation in April, June, and September, and Hygiene and personal care, Traffic vehicles and transport, and communication services in June and during the third quarter.

4.1.3. COST OF THE FOOD CONSUMER BASKET (FCB)⁷

Table 4.2 Cost of the food basket in Montenegro (in €)

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
2003	240.06	242.10	241.72	246.01	257.92	263.57	252.86	260.00	264.15	262.06	258.73	258.74
2004	257.73	257.08	257.11	255.51	260.36	264.52	253.43	255.45	253.82			

Source: Monstat



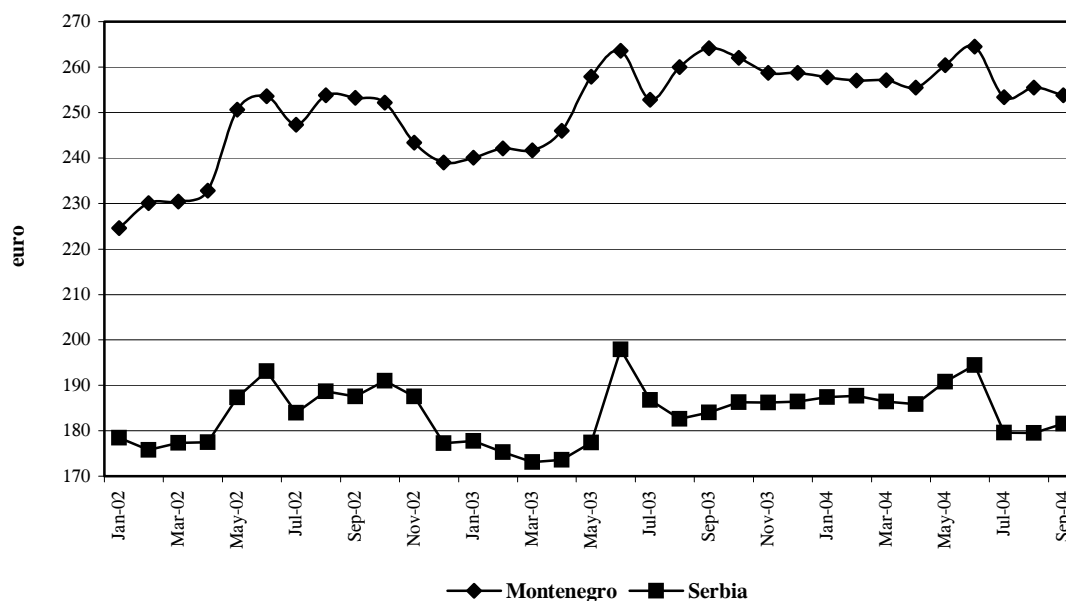
The total cost of a food consumer basket for a four-member family amounted to €253.8 in September 2004 that is 3.9% lower compared to the same month last year. Such a trend proved the annual dynamic of the Food group in CPI consumer basket (-1%), with the main message being that food prices are lower this year as compared to 2003. Since December 2003, the FCB annual change has been constantly decreasing, reaching deflation in August and September 2004. Compared to Serbia's FCB the annual change (in euros) was lower from

⁷ The food consumer basket consists of a group of basic food products in the quantities appropriate for a four-member family. The concept of the basket was developed following the guidelines of the EU to approximate the cost of basic food needs for a four-member family. Thus, it allows for easy comparisons between countries.

¹ All budget revenue categories are quarterly analyzed.

February to May 2004, higher in June, July and August, and lower again in September. Most fresh vegetable and fruit products experienced price decreases in the second and third quarters of 2004. The most significant average annual changes were seen for: potato 38% in Q2 and -23% in Q4, spinach -27% in Q3, green salad -57% in Q3, cucumber 35% in Q2 and 27% in Q3, pea 70% in Q2 and 30% in Q3, been around 23% in Q2 and Q3, tomato 24% in Q3, pears -25% and peaches -31% in Q2, nuts -34 in Q2 and -22% in Q3. Considering the average annual inflation of processed food products, the most significant changes were: sugar -16% in Q2 and -20% in Q3 and coffee -10% in Q2 and -8% in Q3.

Graph 4.5. Cost of the FCB in Montenegro and Serbia (in euros)



Source: Monstat and Federal Statistical Office (www.szs.sv.gov.yu)

The comparable food consumer basket cost amounted to €182 in Serbia, which is almost 40% less than in Montenegro. The average difference between the FCB in Montenegro and Serbia was 70€ in the second quarter and 74€ in the third quarter of 2004. The Serbian FCB registered an annual change of -1.8% in Q2 in euros (10.3% in dinars) and 1.3% in Q3 in euros (12.2% in dinars).

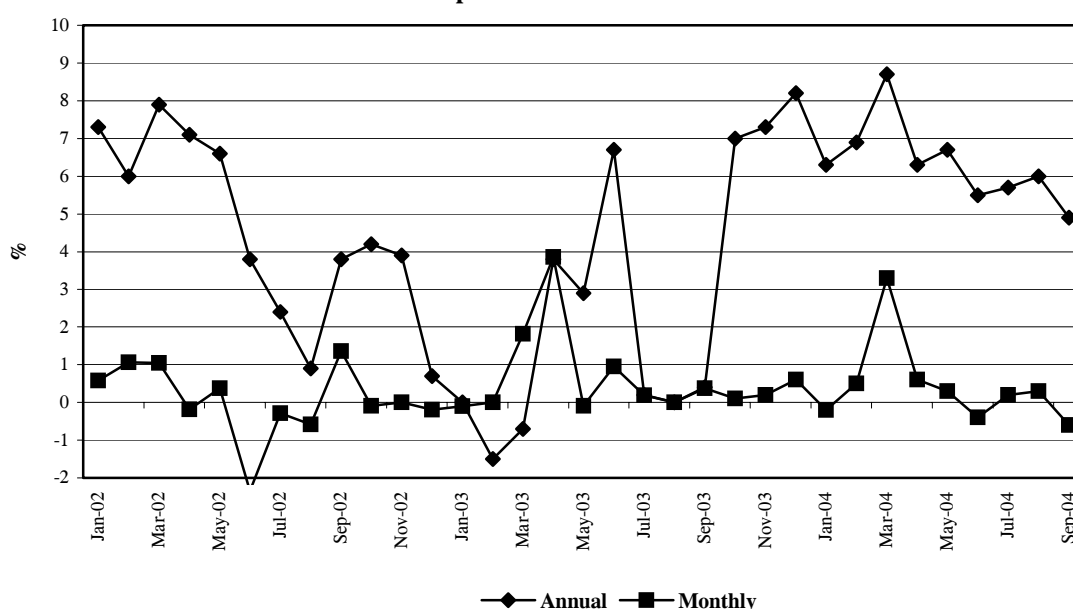
4.2. PRODUCER PRICES

4.2.1. PPI Inflation

Inflation in the producer and wholesaler sector, measured by the annual rate of change of the Produced Price Index (PPI), declined to 6.3% in April, increased to 6.7% in May, declined again to 5.5% in June, increased again to 5.7% in July and to 6% in August, and finally dropped to 4.9% in September. Comparing the average annual inflation for the last twelve months (October 03-September 04) to the previous 12 months, PPI increased 9.1%. The main factor behind the rising PPI prices was the increase of oil prices, as a significant cost of production. On a monthly basis, producer prices were mostly increasing in the second quarter: 0.6% in April and 0.3% in May, followed by a decrease of 0.4% in June. The

third quarter registered a similar trend: increases in July and August (0.2% and 0.3% respectively) and a decrease of 0.6% in September.

Graph 4.7 PPI inflation



Source: Monstat

4.2.2 PPI disaggregated changes

The most significant inflationary pressure in the disaggregated PPI during Q2 and Q3 2004 came from the processing industries, while inflation of the rest of the product groups were unchanged or with small increases.

Mining and stone extraction prices remained unchanged annually and monthly from April to July. In August their price increased 1.3% on an annual and monthly basis and remained the same in September 2004.

After an increase of 8.3% in April, **processing industries prices** reached a maximum annual change of 8.8% in May, the highest increase experienced in the last 2 years. Since then, it has been mostly decreasing to the level of 6.3% in September due to the high annual inflation of wood production, metal and basic metal products.

- Annual inflation of food, tobacco and beverage production significantly decreased to 15.3% in April, while in March it was 21%. During the second and third quarters of 2004 it has been decreasing, and has reached 2.2% in September. Monthly changes were 0% until September when it deflated by 3.5%.
- Chemical products prices were lower by 0.3% on an annual basis in the second quarter of 2004 and were unchanged in the third.
- Textile production was 0.1% more expensive in April compared to same month last year, and unchanged during the rest of the observed months.

Construction materials deflated by 1.2% during the period April-July 2004 on an annual basis, but afterwards experienced a price increase of 3.2% in August, as compared to July -- annual inflation was 2% in August and September in 2004.

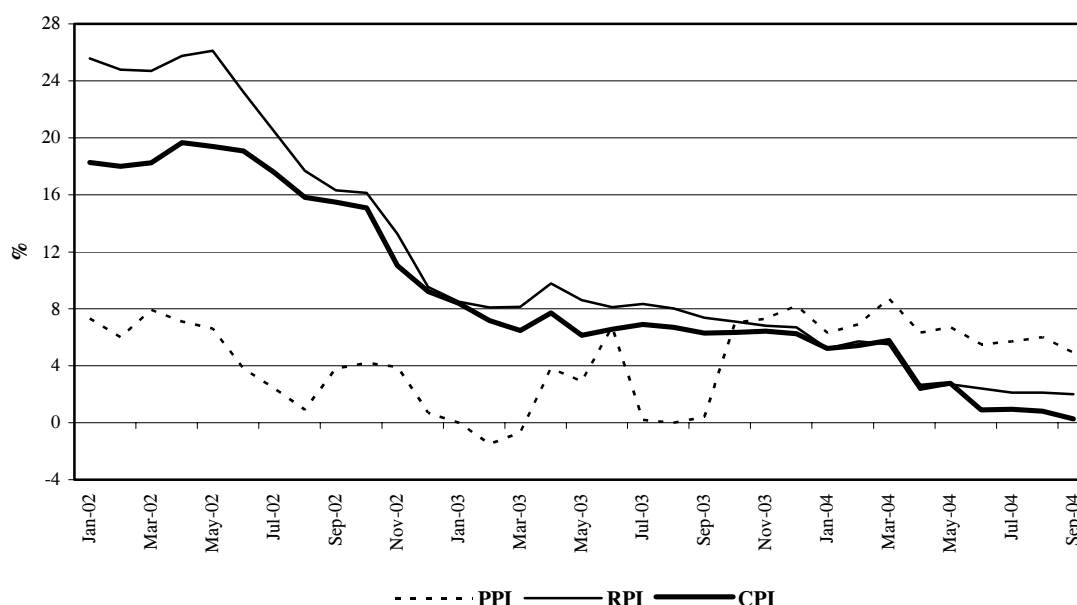
Electricity, gas and water prices did not change on an annual or monthly basis during the second and third quarters.

4.3 INFLATION MEASURED BY DIFFERENT INDICATORS: PPI, RPI AND CPI

Graph 4.10 shows annual rates of change of consumer, retailer and producer price indices. The last 12 months were characterized by higher annual rate of change of PPI compared to CPI and RPI. Food prices in the production phase were at a high level, while in the retail sector they mostly deflated. Production of leather and textile did not change significantly on an annual basis, but in the CPI consumer basket, footwear and clothing maintain high annual and monthly changes. There are two explanations:

- One explanation is based on market structure. Basically, such trends could refer to a more competitive trade sector, meaning that retailers were keeping high profit margins, and therefore final prices, until new competition increased the supplied products and lowered the prices. Therefore, the dynamic of retail and produce prices could refer to the decrease of previously high profit margins in order to keep their market share.
- Economic logic says that an increase of producer prices should increase retail prices higher, therefore increasing the cost of living as well. In the opposite case, it means that the final price is lower than the purchasing price and the costs of production are covered by other resources rather than price.

Graph 4.10. PPI, RPI and CPI - annual changes



Source: Monstat

4.4. FORECAST

Actual developments of CPI inflation in Q1 2004 suggest that inflation in the second and third quarters was much lower than in the optimistic scenario described in the previous issue of MONET. Actual annual inflation in September 2004 amounted to 0.3%, while our optimistic forecast predicted a rate of 2.4%.

As usual, we provide inflation forecasts for both an optimistic and a pessimistic scenario. The different assumptions made for each of these two scenarios follow:

The optimistic scenario of inflation developments in the next 12 months (October 2004 – September 2005) assumes continuity of the CPI dynamic, with following price changes:

- Actual October 2004 fuel price increase of 6% (considering weight in the basket, it would be 5.8%)
- PTT services increases 206% in January due to public announcement that phone impulse price will increase by 300%
- Projected monthly increase of fuel price by 0.10%.

The pessimistic scenario of inflation developments in the next 12 months (April 2004 – March 2005) assumes:

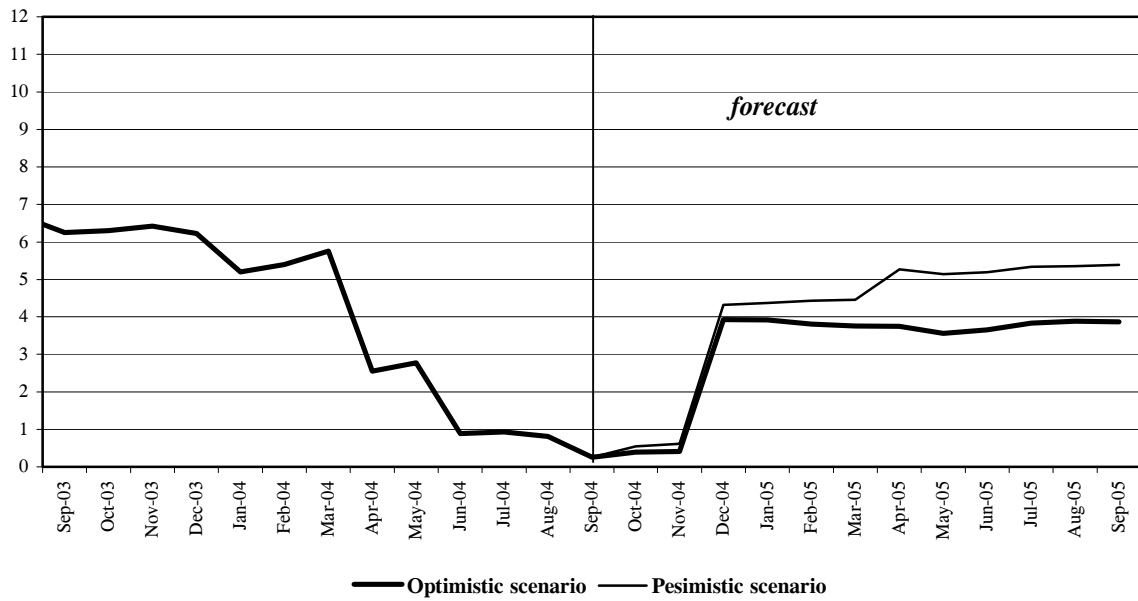
- Actual October 2004 fuel price increase of 6% (considering weight in the basket, it would be 5.8%)
- The consumer prices increase a bit faster in 2004 compared to 2003
- PTT services increases 206% in January due to public announcement that phone impulse price will increase by 300%
- Electricity price increase of 10% in April
- Projected monthly increase of fuel price by 0.15%

The resulting **projected inflation in the next 12 months ranging from 3.7% to 5.3%** is shown in Graph 4.11.

According to the optimistic scenario, the inflation rate in the remaining 1 quarter of 2004 (Q4) and the first three quarters of 2005 is projected to amount to: 3.80% in Q4 2004, 3.63% in Q1 2005, 3.53% in Q2 2005 and 3.74% in Q3 2005.

According to the pessimistic scenario, the inflation rate in the remaining 1 quarter of 2004 (Q4) and the first three quarters of 2005 is projected to amount to: 4.19% in Q4 2004, 4.34% in Q1 2005, 5.07% in Q2 2005 and 5.26% in Q3 2005. Considering pessimistic scenario without electricity price increase in April 2005, annual inflation would be lower and reach: 4.3% in Q2 2005 and 4.5% in Q3 2005.

Graph 4.11 Twelve months inflation forecast



Source: ISSP

5. BUDGET

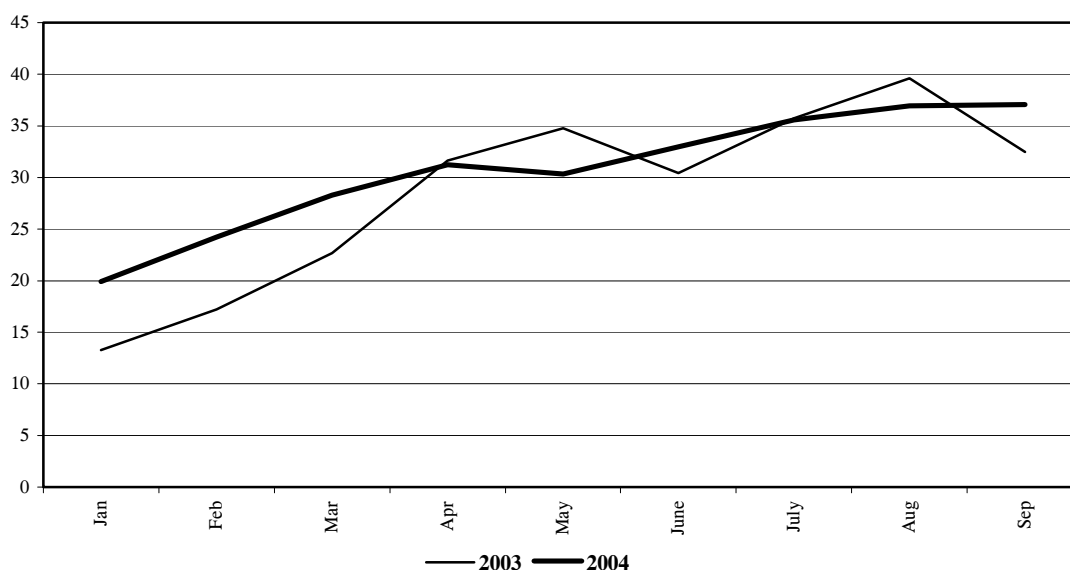
- Cumulative budget revenues for the first three quarters of 2004 were € 270.6 million, that is 67.5% of the total amount planned in 2004.
- Budget revenues increased 7.3% in the first nine months of 2004 compared to the same period in 2003.
- Total expenditures for the first three quarters of 2004 were € 283.6 million, which is 5% higher than the same period last year.

5.1. BUDGET EXECUTION IN 2004

5.1.1. Budget revenues and grants¹

Budget revenues are characterized by seasonal fluctuations in the first nine months of 2004. Considering the situation overall, budget revenues increased during the period January-September. An increase of revenue is probably required under the influence of the summer tourist season.

Graph 1. Monthly fluctuations of budget revenues in 2003 and 2004 in the period January – September



Source: Ministry of finance of Montenegro, calculations ISSP

Budget revenues in the first quarter were € 66.9 million, or 25.8% higher than in the same period last year. Similar situations were found in the next two quarters of 2004. The second quarter is characterized by revenue increasing approximately 3%, and in the third by 8.7%, as compared to the same periods last year (graph 2). Total revenues for the first three quarters of 2004 are € 270,644 million cumulative, which represents 92.49% of executions compared to the plan for the observed period

Table 5.1: Central Budget Revenues and Expenditures, 2001-2004 (in million €)

	2001 Jan-Dec Exec	2002 Jan-Dec Exec	2003 Jan-Dec Exec	2004 Jan-Dec Plan	Jan-Sep Exec	Jan-Sep Plan	Jan-Sep Exec/plan	2004.									
								Jan	Feb	Mar	Apr	May Exec	Jun	Jul	Aug	Sep	
A							%										
	Deposits from previous year																
	Total revenue and grants (1+2)	233.140	256.804	350.103	406.987	276.591	292.625	94.52	19.937	24.220	28.296	31.228	30.339	32.976	35.583	36.952	37.060
1	Total revenue (1.1+1.2)	221.220	229.847	337.519	400.987	270.644	292.625	92.49	17.206	24.220	25.494	30.815	30.339	32.976	35.583	36.952	37.060
1.1	Current revenue (1.1.1+1.1.2)	221.220	229.847	337.519	400.987	270.644	292.625	92.49	17.206	24.220	25.494	30.815	30.339	32.976	35.583	36.952	37.060
1.1.1	Tax revenue (1.1.1.1+1.1.1.2+1.1.1.3+1.1.1.4+1.1.1.5)	187.999	208.931	312.918	358.518	245.856	263.379	93.35	16.182	22.623	22.281	28.580	28.338	28.081	31.869	34.394	33.509
1.1.1.1	Personal income	56.654	57.889	63.961	71.231	44.179	50.807	86.96	2.710	5.258	3.553	6.680	4.842	5.165	5.483	4.997	5.492
1.1.1.2	Turnover (retail sales) tax	58.488	56.528	137.222	146.600	115.224	104.741	110.01	6.879	10.296	10.571	12.531	13.038	12.389	16.799	17.301	15.418
1.1.1.3	Excises	35.664	50.786	58.197	70.700	45.104	53.665	84.05	3.736	3.942	3.837	5.196	5.420	5.254	3.486	6.581	7.651
1.1.1.4	Taxes on international trade and transactions	27.274	26.376	36.845	47.000	27.468	38.144	72.01	1.522	2.532	2.911	2.912	3.365	3.334	3.973	3.763	3.157
1.1.1.4.1	Custom tariffs	13.894	12.605	35.078	44.000	25.336	35.353	71.66	1.376	2.342	2.658	2.671	3.106	3.073	3.707	3.480	2.923
1.1.1.4.2	Custom transit fees	13.380	13.771	1.766	3.000	2.132	2.791	76.40	0.146	0.190	0.253	0.242	0.258	0.261	0.265	0.283	0.234
1.1.1.5	Other taxes	9.920	17.342	16.694	22.987	13.881	16.021	86.64	1.335	0.595	1.409	1.259	1.674	1.939	2.128	1.752	1.791
1.1.2	Nontax revenues	33.221	20.916	24.601	42.469	24.788	29.245	84.76	1.024	1.597	3.213	2.235	2.001	4.895	3.714	2.558	3.551
1.2	Capital revenue				0.000	0.000	0.000		0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000
2	Grants	11.920	26.958	12.584	6.000	5.947	#	2.731	0.000	2.802	0.414	0.000	0.000	0.000	0.000	0.000	0.000
B	Total expenditure and net lending (1+2)	259.309	266.771	381.090	449.159	283.594	344.997	82.20	20.211	22.906	30.320	35.362	30.501	32.262	38.839	38.143	35.049
1	Total expenditure (1.1+1.2)	252.585	247.517	358.924	440.659	270.833	338.117	80.10	18.381	22.535	28.920	33.564	29.414	31.325	37.382	36.140	33.172
1.1	Current expenditure (1.1.1+1.1.2)	233.287	236.697	345.235	418.505	261.283	320.119	81.62	18.145	21.831	28.268	32.549	28.377	29.532	35.960	34.395	32.226
1.1.1	Interest	0.622	12.880	14.136	17.670	13.125	134.63	134.63	0.346	2.821	0.302	0.249	5.239	0.140	0.466	3.104	
1.1.2	Noninterest (1.1.2.1+1.1.2.2+1.1.2.3+1.1.2.4+1.1.2.5+1.1.2.6)	232.665	223.818	331.099	401.005	243.613	306.994	79.35	13.141	21.485	25.447	32.247	28.129	24.293	35.820	33.929	29.122
1.1.2.1	Wages and salaries	108.464	110.178	134.262	173.142	112.123	130.759	85.75	2.065	11.628	9.834	16.756	8.553	14.228	19.771	16.246	13.041
1.1.2.2	Goods and services	55.351	41.817	37.858	60.856	31.063	47.991	64.84	1.726	2.509	3.573	4.321	3.545	3.728	3.676	4.327	3.659
1.1.2.3	Social Insurance and Social Security Transfers	45.327	35.825	132.795	132.969	77.139	97.345	79.24	8.464	6.207	9.881	9.244	12.910	3.212	10.012	8.207	9.003
1.1.2.4	Subsidies to enterprises	12.249	18.169	14.631	9.200	6.101	7.415	82.28	0.251	0.460	0.803	0.470	1.164	0.643	0.746	0.800	0.765
1.1.2.5	Reserve	6.461	14.819	8.388	13.482	11.133	13.028	85.46	0.390	0.517	0.408	0.587	1.616	1.750	0.864	3.570	1.432
1.1.2.6	Other non - interest expenditure	4.813	3.010	3.165	11.356	6.054	10.536	57.45	0.246	0.164	0.949	0.869	0.341	0.732	0.750	0.780	1.222
1.2	Capital expenditure	19.298	10.820	13.688	22.154	9.550	17.998	53.06	0.236	0.704	0.652	1.016	1.036	1.793	1.422	1.745	0.946
2	Net lending	6.723	19.254	22.167	8.500	12.761	6.880	185.49	1.830	0.371	1.400	1.798	1.088	0.937	1.457	2.002	1.878
	Lending	13.974	19.490	22.590	8.500	12.761	6.880	185.49	1.830	0.371	1.400	1.798	1.088	0.937	1.457	2.002	1.878
	Repayment	7.250	0.236	0.423	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000
	Overall budget balance excluding grants (cash) (A-B-2)	-38.089	-36.925	-43.571	-48.172	-12.950		-3.005	1.314	-4.826	-4.548	-0.162	0.714	-3.256	-1.191	2.011	
	Overall budget balance (cash) (A-B)	-26.169	-9.967	-30.987	-42.172	-7.003		-0.274	1.314	-2.024	-4.134	-0.162	0.714	-3.256	-1.191	2.011	
	Financing (1+2)	26.129	38.254	18.395	42.172	8.150		3.110	-0.987	-0.459	3.065	0.455	-4.096	4.075	1.503	0.412	
1	Domestic and foreign financing (net)	17.007	0.568	6.234	36.172	5.364		3.110	-0.987	-1.653	3.065	0.455	-4.093	2.483	1.503	0.412	
	Borrowing	76.436	40.445	48.246	36.172	32.098	0.000	10.979	2.105	0.330	4.865	1.525	3.010	5.703	2.463	1.119	
	Repayment	59.430	39.877	42.012	0.000	26.734		7.869	3.092	1.983	1.800	1.070	7.103	3.220	0.960	0.707	
2	Privatization receipts	9.122	37.686	12.161	6.000	2.786	0.000	0.000	0.000	1.194	0.000	0.000	0.000	1.592	0.000	0.000	

Note: Category lending in 2002, 2003 and 2004 includes repayment of guarantees

In the first nine months planned amount of grants for 2004 year was completely received.

Data that refer to plan are from the Law on changes and amendments to the Budget Law for 2004 year and that is the reason of little differences in comparison with the MONET 17

Source: Ministry of Finance of Montenegro and ISSP calculations

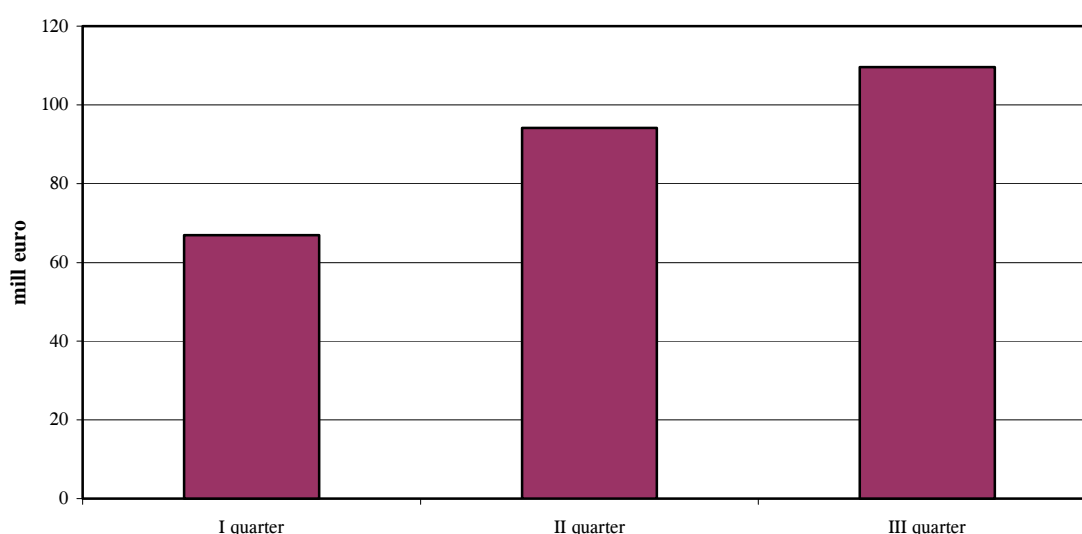
It's worth mention...

Box 1. Grants

Budget revenues, including grants, amounted € 276,591 million, which is, if we consider the same period last year 36.27% higher and shows 94.52% of execution planned for that period.

Total revenues¹ increased by 5.31% compared to the same period last year. If we consider the amount of collected taxes in the first three quarters of 2004, its execution is 93.3% of the plan.

Graph 2. Total budget revenues in the first three quarters of 2004.



Source: Ministry of finance of Montenegro, calculations of ISSP

Note: All data presented in million of euro

According to the presented graph, constant budget revenue growth is observed in the first three quarters of 2004. The lowest budget revenue was in the first quarter and the highest was in the third quarter of 2004.

Structure and execution of individual revenues

- *Personal income tax*- Compared to the plan, personal income tax shows execution of 86.9% in the first nine months of 2004. There was a decrease of personal income tax of approximately 3.5% when comparing executions in 2003 and 2004.
- *Turnover tax*- As the most important revenue category of budget, turnover tax increased by about 10% for the first three quarters in 2004. Considering turnover tax return quarterly in 2003 and 2004, there is a difference between executions for the first quarter.

¹ Total revenue consist category »Other taxes« which includes: motor vehicle tax, insurance services and games of chance tax.

Executions in 2004 are higher in comparison with the same in 2003.² Comparing the first three quarters in 2003 and 2004, turnover tax increased about 19.4% in 2004.

Actuality...

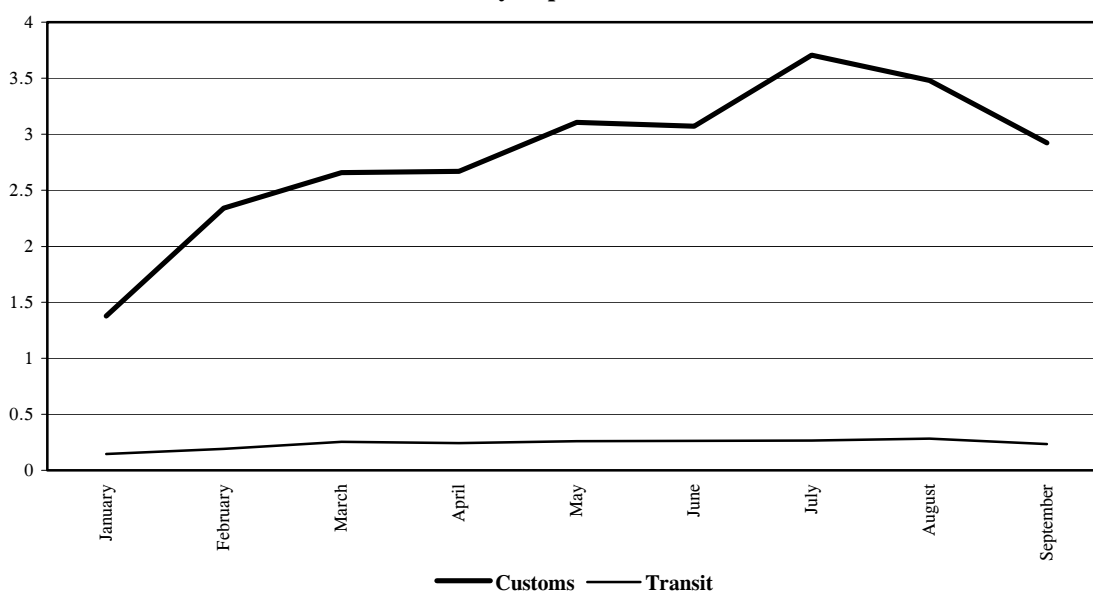
Box 2. VAT returning

The Government of Montenegro adopted the Statute of the return of a portion of value added tax collected from the citizens in retail on July 8, 2004. In this way, citizens are gaining the right of a refund, of a part of value added tax, as noted on fiscal bills, for products that citizens buy in retail. The refund rate is 15% of the value added tax on the fiscal bill. It was one way to solve the problem of the gray economy in Montenegro.

Source: Ministry of finance of Montenegro

- *Excise tax*– In the first nine months of 2004, execution was about 84% compared to the existing plan. Observing the same category in 2003 the situation wasn't much different (with some differences about 0.5%) in 2004.
- *Tax on international trade and transactions*– Quarterly, comparing executions in 2004 with 2003, the first quarter shows a decrease of about 45%, while the next two show increases of 28% and 34%. Current executions, compared to the quarterly plan in 2004 are 72%. *Custom tariffs* show execution of 71.6% compared to the existing plan for the first quarters in 2004. Comparing the existing category with the same period in 2003, it shows a decrease of about 5%. *Custom transit fees* increased about 20.6% when comparing 2004 with 2003. Executions, according to the plan for 2004, are 76.4%.
- *Non-tax revenues*– In the first three quarters of 2004, non-tax revenues are € 24.788 million, or 84.7% of planned for 2004.

**Graph 3: Fluctuations of customs and transit in the period
January-September 2004**



Source: Ministry of finance of Montenegro, calculations ISSP

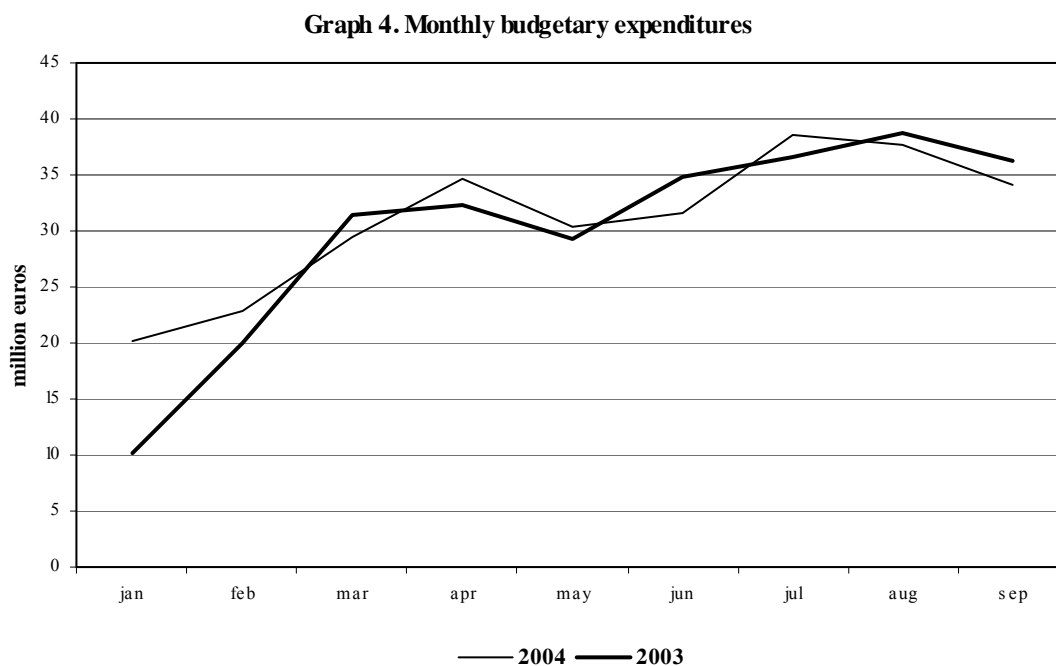
² The main reason for that is the fact that VAT was implemented starting from April 1st 2003. Because of that revenue in first quarter of 2003 is much lower than the same category in first quarter of 2004.

Grants

Foreign aid in the first quarter of 2004 is 5.53 million € (Second part of help from USAID), while in the second quarter, foreign aid amounted to € 0.04 million and in the third quarter there was none, which means that the amount of donations Montenegro received from the international community is € 5.947 million. Comparing the first three quarters in 2004 with the same period in 2003, grants decreased about 52.7%.

5.1.2. Budget expenditures and net lending in the first three quarters of 2004.

According to the plan for 2004, total budget expenditures for the first nine months of 2004 were planned at about € 345 million. At the end of September, total expenditures amounted to € 283.6 million, in other words they were about 18% lower than the planned level, but at the same time, they were about 5% higher in comparison with the same period of 2003. Expenditures in the first quarter amounted to € 73.4 million and increased by about 34% in the second quarter, amounting to € 98.1 million. Total expenditures are highly dependent on total revenues, and like revenues, they reached a peak in the third quarter, at € 112 million, which was approximately 53% higher as compared to expenditures from the first quarter.



Source: Ministry of Finance of Montenegro, calculations ISSP

Executions of expenditures category

The largest expenditures category – *wages and salaries* in the first three quarters of 2004 was at the level of € 112,1 million, which represented about 86% of the plan for the first nine months. In comparison with that period last year, wages and salaries were paid in amount larger about 23%. In the first quarter wages and salaries amounted to € 23,5 million, in the second quarter € 39,5 million, while in the third quarter they amounted to € 49,1 million what is the double amount in comparison with the first quarter and about 24% higher in comparison with the second quarter of the current year.

Higher execution of this category was caused by the payment of contributions, which, when compared to the same period last year, were paid in an amount 37% higher.

Like the greatest part of expenditures categories, expenditures for *goods and services*, were below the planned level for about 35%, and above the level from the same period in the last year for about 23%. Cumulated, expenditures for goods and services at the end of September amounted to € 31,1 million.

At the end of September, expenditures for *social insurance and social security transfers* represented about 28% of total expenditures and amounted to € 77.1 million. In the first three quarters of 2004 they amounted to € 24.5 million, € 25.4 million and € 27.2 million, respectively. Comparison of this category with the same period of 2003 is not relevant since this category also included funds for financing of the State Union in 2003, and this was not the case this year.

Expenditures for *subsidies for enterprises* in the first three quarters of 2004 amounted to € 6.1 million, which represented 82.3% of the plan and about 55% of this category's execution in 2003. The share of subsidies in the structure of total expenditures over the analyzed period was about 2.2%.

At the end of September, capital expenditures reached € 9.6 million, which represented 3.4% of total expenditures over the first ninth months of 2004.

Interest is one of the rare expenditures categories that executed, in the first three quarters, above the planned level as well as last year's level in nearly the same percentage, about 35%. In the first three quarters of 2004, cumulatively was paid € 17.7 million, from which € 2 million went to residents and € 15.6 million to non-residents.

At the end of September, *other non-interest expenditures* (including rent of government buildings, other related expenditures and other liabilities repayments) represented 57,5 % of the planned level. Comparison of this category with the same period of 2003 is not relevant since this category in 2004 year includes other liabilities repayments.

At the end of September, *reserves* amounted to € 11.1 million, which was 58% higher than execution in the previous year.

Net lending

At the end of September, total loans and credits amounted to € 12.8 million, which was almost double the planned level. From that amount, € 1.7 million went to public companies, € 1 million to other companies, and about € 2 million were other loans and credits. In addition to this, funds the Government had to pay based on given guarantees, about € 8 million, have been included, in whole, in this category. (see note below the table 5.1.). The Budget did not have any inflow of money from repayment of loans in this period.

5.1.3. Budget balance and financing

Total budget balance

Budget balance in the first three quarters of 2004 was negative. In the first quarter it was – € 6.5 million, in the second –4 million €, and in the third –€ 2,4 million. Cumulatively, it is – € 13 million.

Financing

The negative cash budget balance (budget deficit) in the first nine months of 2004 was financed through grants in the amount of € 6 million. The Government of Montenegro took credits of € 32.1 million, and repayed € 26,7 million, and the net liabilities amounted to € 5.4 miliona.

Box 3:

The measures of fiscal facilities that were established in 2004 (the cut in income tax rates and contribution rates on pensions and disability insurance and the decreased contribution for health insurance) created the possibility for the decline of Budget and Social Funds revenues. Because of that, the Montenegrin Parliament adopted “Law on Changes and Amendments to the Budget Law for 2004,” which provides higher transfers from the Budget to the Social Funds in order to cover their deficits; transfers to the Pension Fund for 2004 are planned in the amount of € 57.6 million, which is about 30% higher than the previous year. For the Health Fund, funds of € 7.1 million are planned, which is about 2 times higher than transfers in the previous year. Additionally, the Law also provides a reduction to certain expenditures categories from the Budget.

Estimation of the public spending level in 2005 must take in consideration the fact that the planned transfers to the Social Funds in 2004 are more than 45 % higher than those from 2003, and that from December 1st 2004, further reductions of the mentioned rates by another 5% are planned. With the projection of a relatively slower increase of public spending over the next year, it is necessary to take measures that rationalize the other expenditures categories by implementing reforms that will provide more efficient budget spending.

5.1.4 Treasury bills

It's worth mention...

Box 4. Treasury bills emission

The Government of Montenegro made a decision about treasury bills emission during a meeting organized on April 8, 2004. It will not have any influence on net-debt increase up to €15,000,000.

Treasury bills could be emitted in a series with expiration date of 28, 56, 91, and 182 days, starting in April 2004. They will be emitted in dematerialized form, in denomination of 500 euro and sold like discounted T-bills, by method of auction. Right for T-bills buying has all domestic, foreign legal and physical entities.

Source: Ministry of finance of Montenegro

Total number of T-bills auctions in January to September 2004 was 23. From the total number, nine auctions referred on 28-day T-bills; ten on 56-day T-bills; three on 91-day and one on 182-day T-bills. Total amount of supplied T-bills for the previous period was €182.2 million, while the total number of sold T-bills was €176.2 million.

28- day T-bills

The first quarter of 2004 is characterized with three auctions of 28-day T-bills. Proposed price of those T-bills was € 36.5 million while the interest rate was in interval from 10 to 10.72% (Table 5.2).

The second quarter of 2004 had three auctions of 28-day T-bills with price of 48 mill € with average interest rate of about 10.5%.

The third quarter of 2004 had three 28-day T-bills auctions with price of € 47.6 million and an average interest rate of about 10.2%.

56- day T- bills

The first quarter of 2004 had three 56-day T-bills auctions with price of € 14.5 million. Interest rates were in interval from 9 to 11% (Table 5.3).

The second quarter is characterized with four auctions of 56-day T-bills, with worthiness of € 15 million and average interest rates from 10.5%.

The third quarter of 2004 had three auctions of 56-day T-bills with price of € 15 million and an average interest rate of about 10%.

91- day T-bills

There were no auctions of 91-day T-bills in quarter 1 of 2004. In the second quarter one auction was held, with price of € 2 million and interest rate from 11%. The third quarter is characterized by two auctions from € 4.1 million and a constant average interest rate from 11% (Table 5.4).

182- day T-bills

In the first two quarters of 2004, there were no auctions of 182-day T-bills. The third quarter had one auction from € 3.5 million, with average interest rate from 10.8% (Table 5.5).

Table 5.2 Overview of 28-day T-bill auctions held in 2004

Number	Date of auction	Amount of issue	Total offered amount	Amount of sold T-bills	Date of maturity	Lowest interest rate	Highest interest rate	Weighted average
1	22.01.2004.	12	12	12.162	19.02.2004.	6	11	10.1
2	19.02.2004.	12.5	11.225	11.225	18.03.2004.	9.9	11	10.71
3	18.03.2004.	12	11.647	11.647	15.04.2004.	10	11	10.72
4	15.04.2004.	17	15.027	15.027	13.05.2004.	10	11	10.73
5	13.05.2004.	16	15.8405	15.8405	10.06.2004.	10	10.8	10.49
6	10.06.2004.	15	15	15.5555	08.07.2004.	9.98	10.5	10.45
7	08.07.2004.	15.5	15.132	15.132	05.08.2004.	10	10.7	10.48
8	05.08.2004.	16	16	16.559	02.09.2004.	10	10.5	10.45
9	02.09.2004.	16.1	16.1	18.8125	30.09.2004.	9	10.1	9.92

Source: Central Bank of Montenegro

Note 1: Categories represented in million €

Note 2: Annual interest rates

Table 5.3 Overview of 56-day T-bill auctions held in 2004

Number	Date of auction	Amount of issue	Total offered amount	Amount of sold T-bills	Date of maturity	Lowest interest rate	Highest interest rate	Weighted average
1	13.01.2004.	5.5	3.788	3.788	08.01.2004.	9.75	11	10.22
2	05.02.2004.	4.5	3.4035	3.4035	01.04.2004.	9	11	10.48
3	04.03.2004.	4.5	2.568	2.568	29.04.2004.	10.5	11	10.8
4	01.04.2004.	4	3.0955	3.0955	27.05.2004.	10	11	10.63
5	29.04.2004.	3	2.8735	2.8735	24.06.2004.	10.48	11	10.82
6	27.05.2004.	4	4	4.1975	22.07.2004.	10	10.95	10.57
7	24.06.2004.	4	4	4	19.08.2004.	10	10.5	10.19
8	22.07.2004.	4.5	4.499	4.499	16.09.2004.	10	10.75	10.41
9	19.08.2004.	5	5	7.1525	14.10.2004.	9.7	10.1	9.98

Source: Central Bank of Montenegro

Note 1: Categories represented in million €

Note 2: Annual interest rates

Table 5.4 Overview of 91-day T-bill auctions held in 2004

Number	Date of auction	Amount of issue	Total offered amount	Amount of sold T-bills	Date of maturity	Lowest interest rate	Highest interest rate	Weighted average
1	25.06.2004.	2	2	2	24.09.2004.	10.9	10.9	11
2	01.07.2004.	2	2	2.115	30.09.2004.	10.4	11	11
3	24.09.2004.	2.1	2	2	23.12.2004.	10.9	10.9	11

Source: Central Bank of Montenegro

Note 1: Categories represented in mill €

Note 2: Annual interest rates

Table 5.5 Overview of 128-day T-bill auctions held in 2004

Number	Date of auction	Amount of issue	Total offered amount	Amount of sold T-bills	Date of maturity	Lowest interest rate	Highest interest rate	Weighted average
1	16.07.2004.	3.5	3.5	3.5	13.01.2005.	10.8	10.8	10.8

Source: Central Bank of Montenegro

Note 1: Categories represented in mill €

Note 2: Annual interest rates

SOCIAL FUNDS

Table 5.6 Social funds revenues and expenditures for period January-September 2004³ (in million €)

Social funds	Revenues	Expenditures
Pension Fund	121.9	118.9
Health Fund	57.5	58.9
Employment Fund	8.8	8.3

Source : Social funds, Ministry of Finance

In the remainder of the chapter we will present a short analysis of revenue and expenditure executions in social funds (Pension, Health and Employment) during the first ninth months of 2004.

Pension Fund

At the end of the third quarter of 2004, total revenues of the Pension Fund were € 121.9 million, while expenditures were at € 118.9 million, level with last year.

In the structure of total revenues, the largest share (51.6%) was had by revenue contributions⁴ and amounted to € 62.8 million, which was approximately the same as in the first ninth months of 2003. The second largest revenue was related to transfers from Budget, whose share in total revenues was 39% and amounted to € 47.5 million. At the end of September, revenues from fees charged by the House for Settlements and Payments amounted to € 3.5 million. In the same period, the Pension Fund had revenues on the basis of withdrawn deposits from Jugopetrol at a level of € 2.7 million, which represented 2.2% of total revenues in the first ninth months of 2004.

As always, expenditures for pensions had the largest share of total expenditures, at 81% and they amounted to € 96.1 million. The second largest category in total expenditures was

³ Data for Health Fund are for the period January-August

⁴ Contributions from economic activity, non-economic activity, self employed workers, and agricultural workers

related to contributions to the Health Fund for pensioners' health insurance and amounted to € 12 million or 10.1 % of total expenditures.

Health Fund

At the end of August 2004, total revenues of the Health Fund amounted to € 57.5 million, which was approximately the same as revenues in the first eight months of 2003. At the same time, revenues were lower in comparison to expenditures, by € 1.4 million.

The largest revenue category was revenues from worker and employee contributions⁵, at the level of € 44.5 million. Revenues from Pension Fund contributions for the health insurance of pensioners represented 18% of total revenues in the analyzed period and amounted to € 10.6 million. The share of revenues from the Budget for unemployed persons represented 2.5%, while other revenues represented about 1% of total revenues.

Total expenditures of the Health Fund in the analyzed period were € 58.9 million. As always, the largest expenditure category was expenditures for regular activity⁶ at the level of € 54.3 million, which represented 92.2 % of total expenditures. In comparison with this figure, the other expenditure categories had much lower participation. The rest of expenditures were related to material expenditures and depreciation (3.3%), traveling expenditures and daily expense allowances (2.3%) and payments for social insurance during sick leave (1.1%).

Employment Fund

In the first three quarters of 2004, revenues of the Employment Fund (including transferred funds from the previous year) were about 14% lower than those in the same period of 2003⁷ and amounted to € 8.8 million. The execution of expenditures was also about 13% lower than in 2003 and amounted to € 8.3 million.

On the revenue side, the greatest share (32.7%) was had by contributions for employees⁸, while the subsidy from the Budget (for material support for unemployed and beginners) amounted to € 2.1 million, or about 24% of total revenues for the analyzed period. Revenues from repayment of loans given for self-employment were about 41% higher than in the same period of 2003 and amounted to € 1.9 million. Taxes on non-resident employment⁹ amounted to about € 1 million and the revenues on this basis, as expected, are mostly collected during the summer season (tax charging reached a peak in July and this one month accounted for about 30% of received payments of total charged taxes over the analyzed period).

⁵ Contributions from economic activity, non-economic activity, self-employed workers, and agricultural workers.

⁶ Ambulance and dispensary services, medicines, treatments in stationary health care facilities, dentists' services and other forms of health care.

⁷ Transferred funds from the previous year had an impact on the difference between total revenues in 2003 and 2004, because in 2004, revenues were about 6 times lower than those that were transferred from 2002 into 2003.

⁸ Paid by the employers as a part of tax on wages.

⁹ According to the Decree of Employment of Non-residents, employers are obliged to pay tax in the amount of € 2.5 per day for every non-resident employee, which goes to the Employment Fund

At the end of September, about 34% of total expenditures, or € 2.8 million, was spent on support for the employed and the unemployed, administrative expenditures for employees amounted to € 1.9 million, and preferential credits for self-employment amounted to € 1.3 million, or about 16% of total expenditures. Credits for self-employment had the greatest impact on the lower level of cumulative expenditures in this period (above mentioned) in comparison to 2003, because they were approximately 40% lower than those in the same period last year. The rest of expenditures were related to material expenditures and other administrative costs.

6. MONEY

- *Monetary aggregates have shown a rising trend during the first eight months of 2004.*
- *Total household deposits reached €60.3 million at the end of August 2004.*
- *Total amount of loans approved by Montenegrin banks in August was €239.6 million.*
- *The total amount of loans provided to privately owned companies reached a level of € 137 million in August, while total loans provided to individuals were € 63.2 million.*

Table 6.0. Monetary aggregates, end of the month, in 000 EUR

	2003	2004							
	XII	I	II	III	IV	V	VI	VII	VIII
M0	284,909	287,193	280,347	281,275	279,117	281,920	283,695	288,879	299,300
Banks' deposits with CBM-Payment Operations	34,909	37,193	30,347	31,275	29,117	31,920	33,695	38,879	49,300
Estimate of cash in circulation	250,000	250,000	250,000	250,000	250,000	250,000	250,000	250,000	250,000
M1	386,121	391,052	382,434	387,310	389,670	389,576	393,308	410,620	441,157
M0	284,909	287,193	280,347	281,275	279,117	281,920	283,695	288,879	299,300
Demand deposits in EUR	83,148	84,268	85,445	90,508	94,638	91,435	98,495	109,231	127,275
Demand deposits within banks in EUR	82,688	82,445	83,518	89,168	93,181	89,423	94,889	105,902	124,534
Demand deposits within CBM-Payment Operations in EUR	460	1,823	1,927	1,340	1,457	2,012	3,606	3,329	2,741
Demand deposits in other currencies	18,064	19,591	16,642	15,527	15,915	16,221	11,118	12,510	14,582
M11	402,586	400,366	391,913	394,775	396,409	398,675	399,198	416,972	449,369
M0	284,909	287,193	280,347	281,275	279,117	281,920	283,695	288,879	299,300
Demand deposits in EUR	98,776	91,992	93,954	97,531	100,908	100,043	103,921	115,080	135,069
Demand deposits within banks in EUR	97,894	89,923	88,621	95,050	99,376	96,127	99,425	110,357	131,637
Demand deposits within CBM-Payment Operations in EUR	882	2,069	5,333	2,481	1,532	3,916	4,496	4,723	3,432
Demand deposits in other currencies	18,901	21,181	17,612	15,969	16,384	16,712	11,582	13,013	15,000
M2	460,837	470,602	465,199	467,799	473,032	480,053	485,328	503,033	536,084
M1	386,121	391,052	382,434	387,310	389,670	389,576	393,308	410,620	441,157
Term deposits in EUR	71,229	75,811	78,422	75,681	77,120	84,555	85,872	86,265	82,996
Term deposits in other currencies	3,487	3,739	4,343	4,808	6,242	5,922	6,148	6,148	11,931
M21	494,290	489,035	483,563	485,177	487,620	496,274	497,293	516,633	551,146
M11	402,586	400,366	391,913	394,775	396,409	398,675	399,198	416,972	449,369
Term deposits in EUR	88,203	84,916	87,293	85,580	84,969	91,677	91,947	93,513	89,846
Term deposits in other currencies	3,501	3,753	4,357	4,822	6,242	5,922	6,148	6,148	11,931

The Montenegrin Central Bank prepared a new methodology of monetary aggregates. The new methodology is more adjusted to the specific Montenegrin monetary situation, in which the Central bank does not have issuing function.

As the new methodology is aimed to monitor the amount of Euros in Montenegro, all deposits of non-banking deposits are included in monetary aggregates. Monetary aggregates, according to the new methodology, are defined as follows:

Monetary basis (M0) comprises banks' deposits with the CBM payment Operations (banks' giro accounts and appropriated reserve requirements, excluding the part banks keep as treasury bills) and the estimated amount of cash in circulation.

Monetary aggregate M1 is comprised of M0, demand deposits by the non-banking sector with banks, and the CBM-Payment Operations, in EUR and other currencies, excluding deposits by the central government. **Monetary aggregate M11** comprises M1 increased for the central government's demand deposits in EUR and other currencies.

Monetary aggregate M2 includes M1 and non-banking sector's term deposits with banks, in EUR and other currencies, excluding deposits by the central government. **Monetary aggregate M21** comprises M11 increased by the central government's term deposits in EUR and other currencies.

As shown in the table, all monetary aggregates experienced a rising trend from December 2003 until the end of August 2004. The monetary base increased during the observed period by 5%, M1 by 16.33%, and M2 increased by 11.5%. If we include the central government's deposits, the growth rates are lower. Thus, the M11 aggregate increased by 11.61% during the observed period, while the M21 aggregate increased by 11.5%. The only component that recorded a decrease during the period from December 2003 to August 2004 is demand deposits in other currencies. This category recorded a decrease of 19.28% (without the central government's deposits). On the other side, term deposits in other currencies recorded significant growth of 242.2% as part of M2 and 240.79% as part of M21. The category that recorded the most significant increase during the observed period is demand deposits in EUR within CBM-Payment Operations without central government's deposits, of 495.87%.

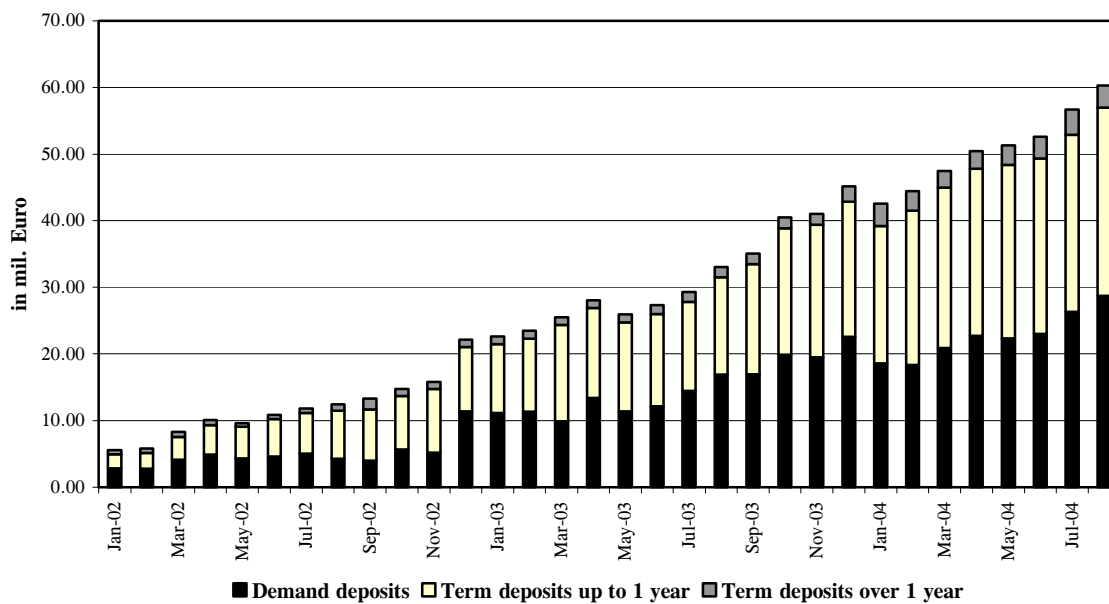
6.1. DEPOSITS OF HOUSEHOLDS

Table 6.1: Deposits of households (in million €)

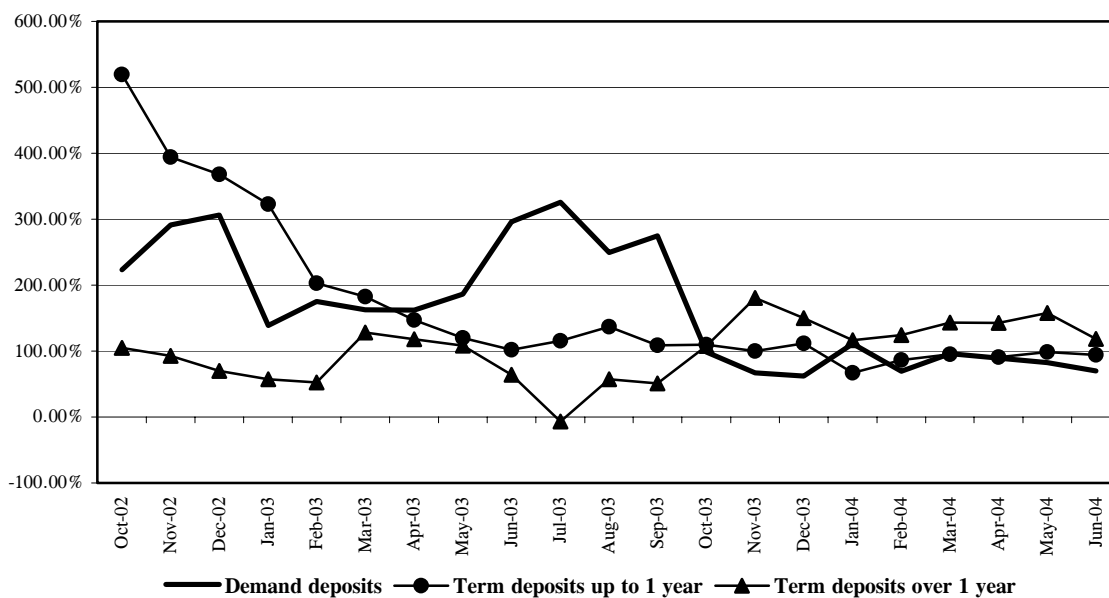
in mil €	1. Demand deposits			2. Term deposits up to 1 year			3. Term deposits over 1 year			Total (1+2+3)
	Total	€	Other curr- encies	Total	€	Other curr- encies	Total	€	Other curr- encies	
Dec-00	2,035	0,932	1,103	0,428	0,063	0,366	0,002	0,000	0,002	2,465
Oct-01	1,751	0,894	0,857	0,655	0,554	0,102	0,057	0,055	0,002	2,463
Nov-01	2,092	1,179	0,913	0,809	0,668	0,141	0,466	0,465	0,001	3,368
Dec-01	3,517	2,379	1,138	1,557	1,332	0,225	0,550	0,549	0,001	5,624
Jan-02	2,844	1,985	0,859	2,090	1,755	0,335	0,617	0,594	0,023	5,551
Feb-02	2,791	1,714	1,077	2,336	1,909	0,427	0,702	0,679	0,023	5,829
Mar-02	4,139	3,358	0,781	3,418	1,853	1,565	0,741	0,680	0,061	8,298
Apr-02	4,874	4,135	0,739	4,443	2,525	1,918	0,773	0,711	0,062	10,090
May-02	4,329	3,813	0,516	4,732	2,815	1,917	0,525	0,463	0,062	9,586
Jun-02	4,629	4,212	0,417	5,609	3,013	2,596	0,615	0,553	0,062	10,853
Jul-02	5,036	4,579	0,457	6,089	3,394	2,695	0,702	0,640	0,062	11,827
Aug-02	4,269	3,802	0,467	7,217	5,184	2,033	0,928	0,906	0,022	12,414
Sep-02	3,984	3,183	0,801	7,669	4,798	2,871	1,663	1,497	0,166	13,316
Oct-02	5,686	4,730	0,956	8,012	6,140	1,872	1,038	1,012	0,026	14,736
Nov-02	5,205	4,310	0,895	9,515	6,772	2,743	1,099	1,065	0,034	15,819
Dec-02	11,370	5,154	0,869	9,650	6,823	2,827	1,127	1,090	0,037	22,147
Jan-03	11,122	8,965	2,405	10,326	7,562	2,764	1,188	1,170	0,018	22,636
Feb-03	11,339	7,248	3,874	10,926	8,138	2,788	1,194	1,179	0,015	23,459
Mar-03	9,887	7,650	3,689	14,446	10,744	3,702	1,166	1,142	0,024	25,499
Apr-03	13,409	6,186	3,701	13,466	10,421	3,045	1,179	1,153	0,026	28,054
May-03	11,379	8,604	4,805	13,368	10,752	2,616	1,199	1,174	0,025	25,946
Jun-03	12,133	6,798	4,581	13,848	10,624	3,224	1,340	1,292	0,048	27,321
Jul-03	14,433	7,508	4,625	13,386	10,554	2,832	1,463	1,385	0,078	29,282
Aug-03	16,917	9,682	4,751	14,576	11,618	2,958	1,522	1,405	0,117	33,015
Sep-03	16,967	11,465	5,425	16,512	13,563	2,949	1,554	1,439	0,115	35,033
Oct-03	19,863	11,836	5,131	18,983	15,935	3,048	1,633	1,522	0,111	40,479
Nov-03	19,502	14,034	5,829	19,851	16,082	3,769	1,658	1,547	0,111	41,011
Dec-03	21,180	13,133	6,369	20,872	17,276	3,596	1,966	1,885	0,081	44,018
Jan-04	18,560	14,712	3,847	20,639	18,110	2,529	3,331	2,307	1,024	42,530
Feb-04	18,359	15,007	3,352	23,115	19,269	3,846	2,987	2,653	0,334	44,461
Mar-04	20,865	18,034	2,831	24,108	22,228	1,880	2,525	2,156	0,369	47,498
Apr-04	22,730	20,495	2,235	25,102	20,628	4,474	2,647	2,163	0,484	50,478
May-04	22,314	20,316	1,998	26,104	21,635	4,451	2,914	2,386	0,528	51,332
Jun-04	22,986	20,623	2,363	26,393	22,711	3,682	3,254	2,581	0,673	52,633
Jul-04	26,320	23,207	3,113	26,592	22,149	4,443	3,770	3,106	0,664	56,682
Aug-04	28,716	24,039	4,677	28,277	23,110	5,167	3,327	2,691	0,636	60,320

Source: Central Bank of Montenegro, reports of various banks

Graph 6.1. Deposits of households



Graph 6.2. Annual change of deposits



Source: Central Bank of Montenegro

Note: Since December 2002, transaction deposits are included in the structure of demand deposits.

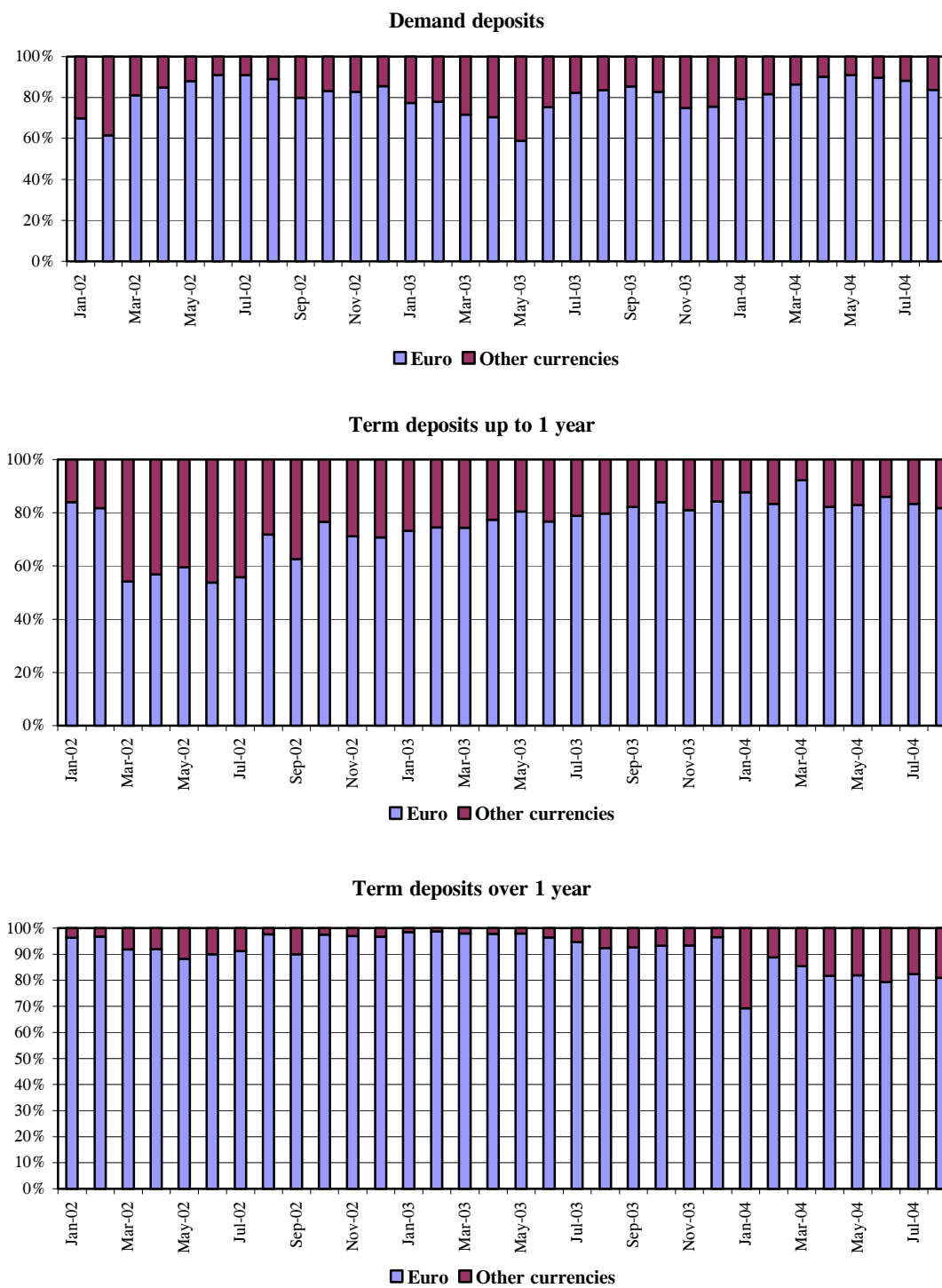
Total household deposits increased in the second quarter of 2004, which is actually a continuation of an increasing trend that began in 2003. However, the growth rates of almost all categories of deposits are decreasing and becoming more stable. At the end of August 2004, total deposits of households amounted to € 60.32 million, and were 82.7% higher than in the same month last year. The average annual growth rate of total deposits in Q2 of 2002 was 90%.

The increase of total household deposits was mainly caused by an increase of term deposits up to 1 year. However, the highest annual rates of increase in the second quarter of 2004, same as in the first quarter, were for term deposits over one year (average quarterly rate was 136.8%). The highest individual annual increase of term deposits over one year was achieved in July 2004 amounting to 157.7%, while the increase in May, June, and August was 143.0%, 142.8%, and 118.6%, respectively (average annual increase in the first quarter amounted to 149%). Growth of these deposits is still primarily a result of the increase of deposits in other currencies, which registered growth rates in the amount of 2,012%, 1,302%, 751% and 443% in May, June, July and August, respectively. Demand deposits also recorded positive annual growth rates (average growth rate in the second quarter was 85%), with a strong increase in demand deposits in euro. Demand deposits in euro were higher in June 2004 by 394.79% as compared to June of 2003. This increase continued in consecutive months with 312.64% in July and 274.56% in August. Negative annual growth rates were recorded in the demand deposits in other currencies category in the second quarter of 2004, of -0.8% in April and -17% in May.

The structure of household deposits shows that, on average, the highest share is held by term deposits up to 1 year (50%), while the share of demand deposits is a bit lower (average Q2 2004 44%). By month, these portions are similar, with the share of demand deposits in total household deposit at 43%, 46% and 47% in June, July and August respectively. On the other hand, the share of term deposits up to 1 year was 50%, 47% and 47%, in the same months. The lowest share in total deposits of households in the second quarter of 2004, similar to the first, was held by term deposits over 1 year (6.3%, 1.7% and 2.5%, respectively). The share of these deposits in August 2004 was 5.5%.

The following graphs present the majority of all categories of deposits denominated in euros.

Graph 6.4 Currency structures of households deposits



6.2. LOANS

Table 6.2. Loans in 2002, 2003 and first quarter of 2004 (in million Euros)

	Loans	1. Banks and financial institutions	2. Non Financial Institutions and other clients.				Total	3. Government Municipalities and Agencies	4. Funds
			2.1 Privately owned local companies	2.2. Publicly owned organizations	2.3. Individuals	2.4. Other			
Mar-02	82.990	1.533	59.855	8.607	3.027	3.371	74.86	6.597	
Jun-02	94.078	0.314	71.36	6.687	5.098	3.562	86.707	7.057	
Sep-02	99.162	0.128	67.498	5.639	11.99	3.63	88.757	10.277	
Dec-02	124.663	0.788	70.305	8.448	22.032	2.559	103.344	20.531	
Jan-03	134.900	1.098	78.323	10.027	23.171	2.676	114.197	19.605	
Feb-03	147.152	0.872	82.178	15.155	25.461	2.357	125.151	21.129	
Mar-03	144.055	0.535	84.018	13.683	25.895	2.167	125.763	17.757	
Apr-03	155.119	0.525	91.327	14.24	29.014	1.989	136.57	18.024	
May-03	164.737	0.771	96.381	18.342	30.352	2.177	147.252	16.714	
Jun-03	168.48	1.167	100.206	17.954	30.503	2.309	150.972	16.341	
Jul-03	168.295	0.832	103.911	13.761	31.358	2.385	151.415	16.048	
Aug-02	165.245	0.652	104.921	12.297	32.256	1.951	151.425	13.168	
Sep-03	168.306	0.93	103.699	14.353	36.362	2.494	156.908	10.468	
Oct-03	178.909	0.379	108.014	15.021	42.865	2.347	168.247	10.283	
Nov-03	185.865	0.577	114.677	13.328	46.778	2.29	177.073	8.215	
Dec-03	200.898	1.625	116.289	12.414	47.671	2.566	178.94	20.333	
Jan-04	200.149	1.850	110.638	15.401	48.088	7.327	181.454	15.621	1.224
Feb-04	209.167	0.525	120.020	14.963	50.770	7.073	192.826	14.402	1.414
Mar-04	216.264	0.279	121.168	13.945	57.231	7.936	200.280	14.112	1.593
Apr-04	227.902	0.046	127.717	13.464	60.075	9.046	210.302	15.795	1.759
May-04	237.481	0.343	133.802	14.364	62.382	10.395	220.944	14.889	1.304
Jun-04	238.030	0.406	136.664	14.018	63.580	10.928	225.190	10.153	2.280
Jul-04	235.726	0.336	132.687	14.202	64.221	12.104	223.214	9.858	2.318
Aug-04	239.629	0.021	137.453	11.701	63.221	12.493	224.869	9.442	5.296

Source: Central Bank of Montenegro

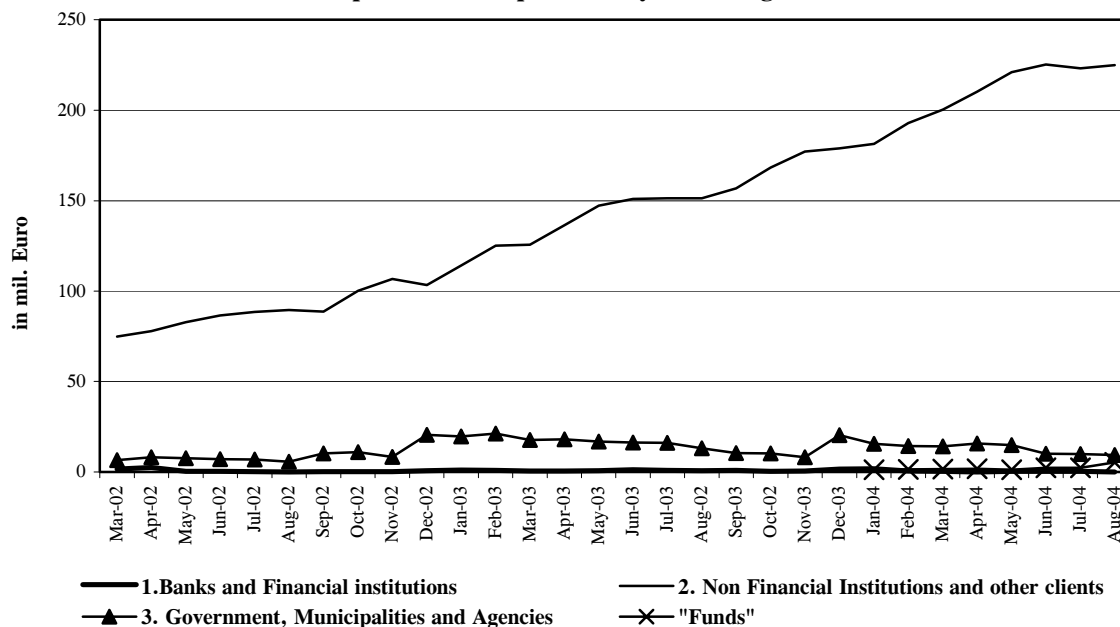
Data presented in table 6.2 show that total loans provided by Montenegrin banks continued to increase in the second quarter of 2004, after which they recorded a insignificant decline in July (of almost 1%) and then again continued to increase in August 2004 and reached the level of €239.6 million. Average annual growth rate of total loans was 46.8% in Q1 and 44.12% in Q2. Annual growth rates were 40% and 45% in July and August 2004.

Important individual loans categories – loans to privately owned companies and loans to individuals, in annual terms recorded positive growth rates. Loans to privately owned companies recorded an average annual growth rate of 51% in the second quarter of 2004. The annual growth rates of this category in the first two months of Q3 were 47.42% and 48.5% respectively. The total amount of loans provided to privately owned companies reached a level of € 137 million. The average annual growth rate of loans to individuals in Q2 of 2004 was 107%, while growth rates in July and August were 104.8% and 96%. Total loans provided to individuals in August 2004 were € 63.2 million. It could be noted that growth rates of both categories are decreasing with small fluctuations. It is expected that in the future these two categories will also show rising but stable growth.

The category of loans to other clients is a category that recorded a significant increase in annual growth rates. The average annual growth rate of this category in Q2 was 368% while annual growth rates in July and August 2004 were 407.5% and 540.3%.

On the other hand, two categories that continued their declining trend are loans to banks and financial institutions and loans provided to the Central government and municipalities. These two categories recorded annual growth rates in August 2003 of -96% and -28%, respectively.

Graph 6.5 Loans provided by Montenegrin banks



The structure of loans in the first seven months of 2004 hasn't shown significant fluctuations. In all analyzed months, the largest share of total loans were given to privately owned companies (average Q1 56%, average Q2 56.6%, and in the first two months of Q3, an average of 56.8%) and loans to households (average Q1 25%, average 26.4% in Q2, and 26.8% in the first two months of Q3). The minority share is related to loans to banks and financial institutions (average Q1 0.4%, average 0.1% in Q2, and 0.07% in the first two months of Q3).

As mentioned in the previous issue of MONET, in 2004, one new category of loans were introduced – loans to funds. This category made, on average, 0.7% of total loans in the first quarter of 2004, 0.8% in the second quarter, and 1.5% in the beginning of the third quarter. Loans to funds had an increasing trend and increased during all eight months of 2004 except for the fluctuation in May (when they decreased by approximately 15% compared to the previous month). At the end of August 2004, this category reached the highest level during the observed period, at € 5.3 million.

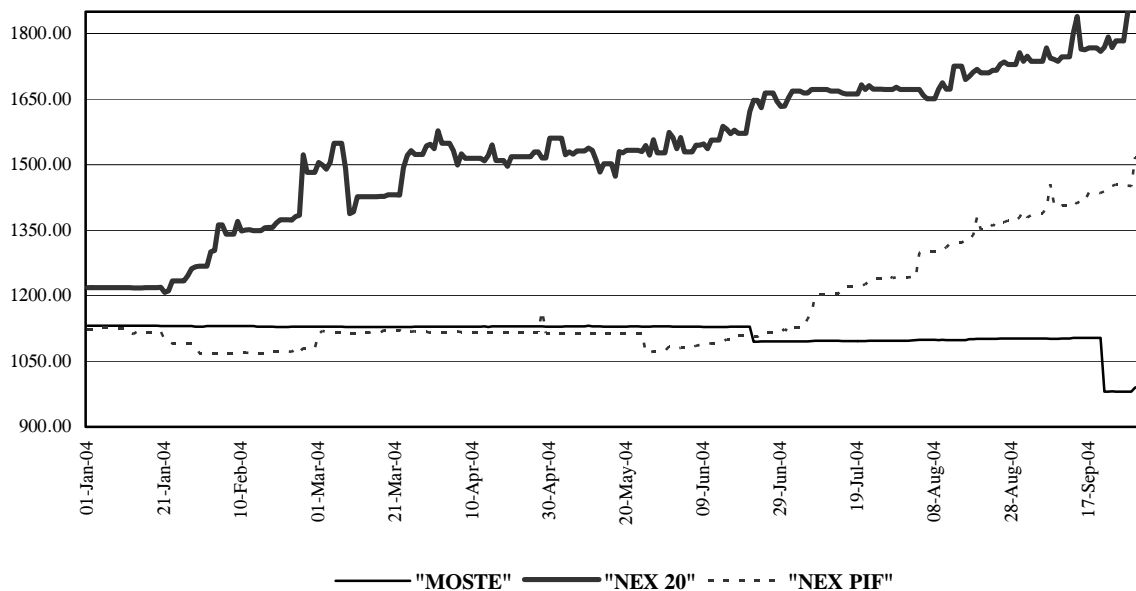
7. CAPITAL MARKET¹

- *NEX Montenegro Stock exchange indices registered value increases, while the Montenegroberza index displayed a stable trend.*
- *Total turnover showed a negligible decrease.*
- *Total number of transactions increased.*

7.1. INDICES²

Graph 7.1 presents the trends of the Stock exchange indices in Montenegro for the first nine months of 2004. In the following text we analyze the trends of the specific indices.

Graph 7.1 Stock exchange indices in Montenegro



Source: NEX Montenegro and Montenegroberza

MOSTE – Montenegroberza index continued with its trend from the first quarter of 2004, remaining fairly stable from January to September of 2004 without significant oscillations. Throughout the entire analyzed period, the value of the index was above its initial value, with the exception of the end of September 2004 when the index value decreased to approximately 14% lower than the beginning of the year (from 1,131 at the beginning of January to 990 at the end of September). The decreased price of shares of Hipotekarna Bank³ had an impact on the overall decreased index value.

At the end of September 2004, both indices of the NEX Montenegro Stock exchange registered an increase in value compared to the beginning of the year.

¹ Two stock exchanges operate in Montenegro: Montenegroberza and NEX Montenegro.

² In Montenegro there exists three stock exchange indices: MOSTE (Montenegroberza), NEX PIF and NEX 20 (NEX Montenegro)

³ Source: Montenegroberza Stock exchange

After several oscillations at the beginning of March, the NEX 20 index had an ascending trend throughout the first nine months of 2004. The value of the index was between 1,219 (at the beginning of January 2004) to 1,980 (on September 30th 2004). At the end of September, the value of the index was 62% higher than it was at the beginning of the year. Compared to the initial value of the index at its inception, September 2004 found its value to have increased by approximately 98%. The greatest influences on the increased index value were the increased share prices of Telekom, then Budvanska Rivijera and Zetatrans.

The other index of the NEX Montenegro Stock exchange - NEX PIF, had a primarily stable trend until the beginning of July. During this period, the value of the index was around 1,100 index points. From the beginning of July, the value of the index started to increase and continued to do so until the end of September when the index registered its highest value in this period (1,517 points), which is approximately 35% higher compared to the beginning of the year and about 50% higher compared to its initial value. The increased value of the index was influenced by an increase of the investment units of the HLT Fund, Atlas Mont Fund, Eurofund and Trend Fund.

Table 7.1. Stock Exchange trade in Montenegro

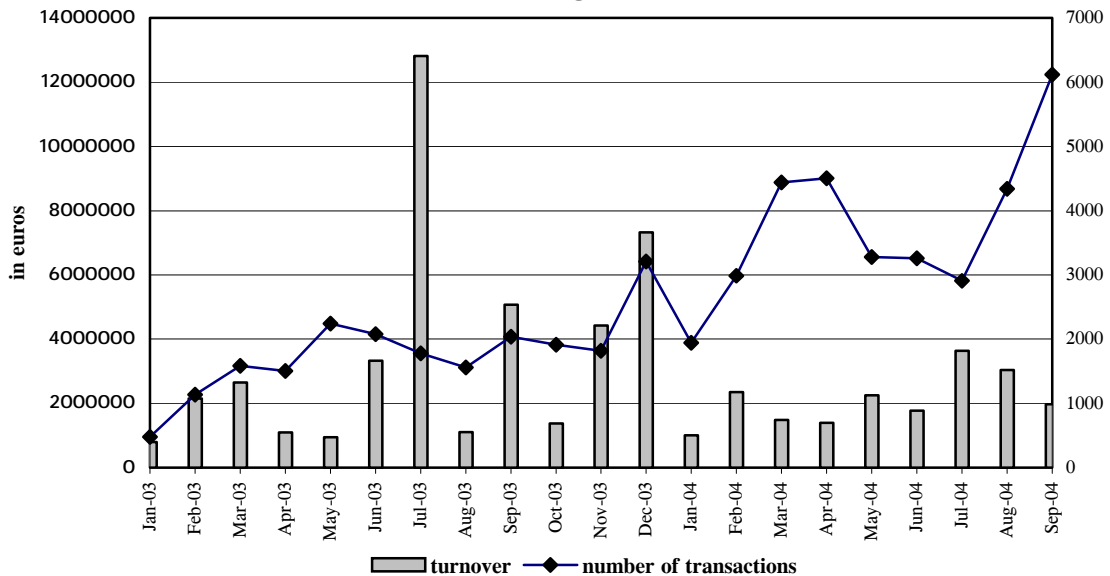
MONTH	MONTENEGROBERZA				NEX MONTENEGRO				TOTAL			
	TURNOVER (in €)			Number of transactions	TURNOVER (in €)			Number of transactions	TURNOVER (in €)			Number of transactions
	Primary	Secondary	Total		Primary	Secondary	Total		Primary	Secondary	Total	
Jan-03	130.123	73.770	203893	105	0	588.673	588.673	374	130.123	662.443	792.566	479
Feb-03	1.459.751	511.390	1.971.141	351	0	175.566	175.566	782	1.459.751	686.956	2.146.707	1.133
Mar-03	2.170.818	174.930	2.345.748	414	0	298.291	298.291	1.167	2.170.818	473.221	2.644.039	1.581
Apr-03	0	496.648	496.648	236	0	603.269	603.269	1.268	0	1.099.917	1.099.917	1.504
May-03	0	204.256,8	204.257	283	989	740.889	741.878	1.955	989	945.146	946.135	2.238
Jun-03	723.937,5	951.350,97	1.675.288	685	723.938	922.216	1.646.154	1.393	1.447.876	1.873.567	3.321.442	2.078
Jul-03	0	11.244.22311.244.223	478	478	0	1.568.723	1.568.723	1.298	0	12.812.946	12.812.946	1.776
Aug-03	0	259.073,63	259.074	301	0	841.434	841.434	1.258	0	1.100.508	1.100.508	1.559
Sep-03	246.895,6	959.449,6	1.206.345	364	0	3.863.012	3.863.012	1.672	246.896	4.822.462	5.069.357	2.036
Oct-03	270.983,7	149.686,2	420.670	303	0	1.449.375	1.449.375	1.610	270.984	1.599.061	1.870.045	1.913
Nov-03	300.000	1.719.988,8	2.019.989	774	0	2.405.935	2.405.935	1.044	300.000	4.125.924	4.425.924	1.818
Dec-03	3.497.227	892.158,97	4.389.386	1.699	1.265.954	1.669.419	2.935.373	1.510	4.763.181	2.561.578	7.324.759	3.209
Total 03	8.799.736	17.636.926	26.436.662	5.993	1.990.881	15.126.802	17.117.683	15331	10.790.617	32.763.728	43.554.345	21.324
Jan-04	230.000	464.477,4	694.477,4	389	0	314.863	314.863	1.555	230.000	779.340	1.009.340	
Feb-04	0	530.885,3	530.885,3	639	0	1.822.403	1.822.403	2.347	0	2.353.288	2.353.288	2.986
Mar-04	780	1.008.168	1.008.948	1.853	0	474.788	474.788	2.589	780	1.482.956	1.483.736	4.442
Apr-04	0	429.683	429.683	2.082	0	960.508	960.508	2.424	0	1.390.191	1.390.191	4506
May-04	0	547.176	547.176	1.470	0	1.701.167	1.701.167	1.812	0	2.248.343	2.248.343	3.282
Jun-04	0	1.001.662	1.001.662	1.698	1.584	767.002	768.586	1.563	1.584	1.768.664	1.770.248	3.261
Jul-04	0	2.628.140	2.628.140	1.292	1.000	1.009.365	1.010.365	1.617	1.000	3.637.505	3.638.505	2.909
Aug-04	0	961.001	961.001	2.377	0	2.072.318	2.072.318	1.962	0	3.033.319	3.033.319	4.339
Sep-04	0	985.597	985.597	3.070	0	989.159	989.159	3.048	0	1.974.756	1.974.756	6.118
Total-04	230.780	8.556.790	8.787.570	14.870	2.584	10.111.573	10.114.157	18.917	233.364	18.668.363	18.901.727	33.787

Source: Montenegroberza and NEX Montenegro

7.2 TURNOVER ON STOCK EXCHANGES

Total turnover and the number of transactions realized on the Montenegrin Stock exchanges during 2003 and the first nine months in 2004 are presented in the next Graph.

Graph 7.2 Total turnover and number of transactions on Montenegrin Stock exchanges



Source: Montenegroberza and NEX Montenegro

Total turnover realized in the first 9 months of 2004 amounted to €18.9 million. Compared with the same period last year, total turnover has significantly decreased (approximately 36%). However, the decrease in turnover was not caused by decreased activities on the Montenegrin Stock exchanges; but rather, the reason lies in the privatization of Montenegrobank. In fact, in July 2003, Montenegrobank was sold to Ljubljanska bank from Slovenia and this transaction was realized on Montenegroberza in the amount of €10.6 million, accounting for approximately 43% of the total turnover realized in 2003. Therefore, in order to get a “clearer” picture of the Montenegrin capital market, turnover from 2004 should be compared to turnover in 2003, without the notified transaction. If we exclude trade with Montenegrobank shares from our analysis, we can conclude that turnover in the first 9 months of 2004 showed a negligible decrease compared to the same period in 2003 – around 2%.

Total number of transactions realized in the first nine months on the Montenegrin Stock exchanges was 33,787, which is 234% higher as compared to the same period in 2003. The number of transactions varied per month, with the highest number of transactions being realized in September (6,118) and the lowest in January (1,944).

Total turnover also varied per month, with the highest being realized in July (€3,638,505) and the lowest in January (€1,009,340). The average monthly turnover amounted to €2,100,192.

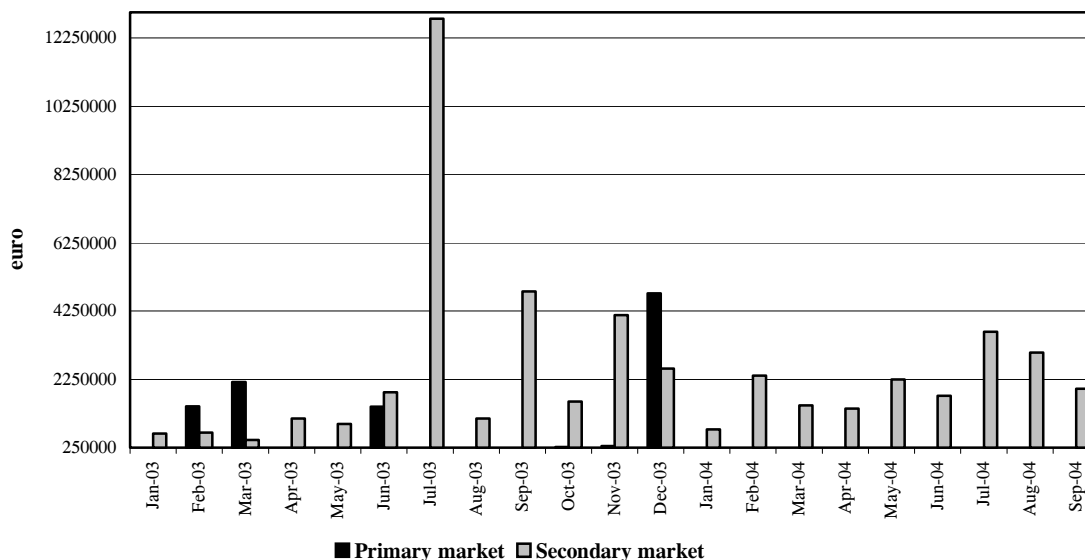
The majority of total turnover (98.7%) was realized on the secondary market and the rest (1.3%) on the primary market.

7.2.1. Trade on primary market

Turnover on the primary market in 2004 has significantly decreased as compared to last year. Total turnover on the primary market in the analyzed period of 2004 amounted to €233,346, which is significantly lower than turnover in the same period last year – 22 times lower.

In the two years prior to this one, turnover on the primary market was significantly higher; the reason for this is that in the previous two years, banks and insurance companies issued their shares because of the legal adjustment for the level of prescribed capital. Namely, according to the Law on Banks⁴, the level of founding capital cannot be lower than €2.5 million. According to the Law, banks are obligated to adjust their assets with this amount.

Graph 7.3 Total turnover on primary and secondary market



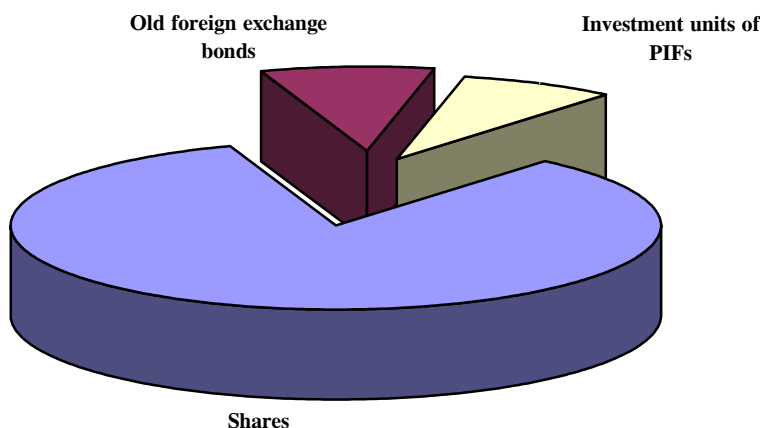
Source: Montenegroberza and NEX Montenegro

The majority of turnover on the primary market was realized on Montenegroberza (98%), with the rest (2%) being realized on NEX Montenegro. No turnover was realized on the primary market in the months of February, April, May, August, and September of 2004.

7.2.2. Trade in the secondary market

The majority of turnover in the first 9 months of 2004 was realized on the secondary market, €18,668,363 or 98.7%. Compared to the same period last year, total turnover on the secondary market decreased by 23%; However, if we disregard the transaction with Montenegrobank shares, total turnover on the secondary market during the analyzed period in 2004 actually increased by approximately 35%.

Graph 7.4 Structure of trade on the secondary market



Source: Montenegroberza and NEX Montenegro

⁴ Official Gazette , no 52/00, 53/00 and 47/01

The majority of turnover on the secondary market was related to turnover of shares (83.7%). Trade with investment units of PIFs amounted to €1,439,585, representing approximately 7.7% of total turnover on the secondary market, whilst trade with old foreign exchange bonds amounted to €1,581,208, or 8.5% of total turnover on the secondary market.

Trade with shares

In 2004, shares of approximately 70 companies⁵ were traded on the NEX Montenegro stock exchange, but a full 40% of total turnover was realized by shares of only five companies: Plus Komerc, Napredak, Telekom, Jugopetrol and TUP Južni Jadran. Table 7.2 shows turnover and share prices realized by trade with shares of these companies.

Table 7.2. Companies with the highest turnover on the NEX Montenegro

Company	January –September 2004.			
	Max price	Min price	Turnover in €	Quantity
PLUS KOMERC A.D. NIKŠIĆ	2,7448	2,7448	1.064.461	387.810
TELEKOM CRNE GORE A.D. PODGORICA	1,6000	0,7500	1.312.063	1.309.022
JUGOPETROL A.D. KOTOR	3,4999	2,7000	596.908	202.454
NAPREDAK A.D KOTOR	0,0189	0,0189	434.700	23.000.000
TUP JUŽNI JADRAN A.D MELJINE	1,2000	0,6000	389.381	329.338

Source: NEX Montenegro

On Montenegroberza was traded with shares of around 60 companies, but a full of 40% of total turnover was realized by shares of next companies: PKB Herceg Novi, Plantaže, Albatros, Businessmontenegro and Primorje Tivat. Table 7.2 shows turnover and share prices realized by trade with shares of these companies.

Table 7.3 Companies with the highest turnover on the Montenegroberza

Company	January –September 2004.			
	Max price	Min price	Turnover in €	Quantity
HTP ALBATROS ULCINJ	4,1634	4,1600	863.207	279.820
PLANTAŽE A.D PODGORICA	0,0643	0,0505	840.498	13.018.275
HTP PRIMORJE A.D. TIVAT	2,000	1,990	491.655	245.976
PKB HERCEG NOVI A.D. ZELENKA	2,3001	2,000	460.916	206.249
BUSINESSMONTENEGRO A.D.	625,00	625,00	210.000	336

Source: Montenegroberza

Trade with investment units of Privatization Investment Fund⁶

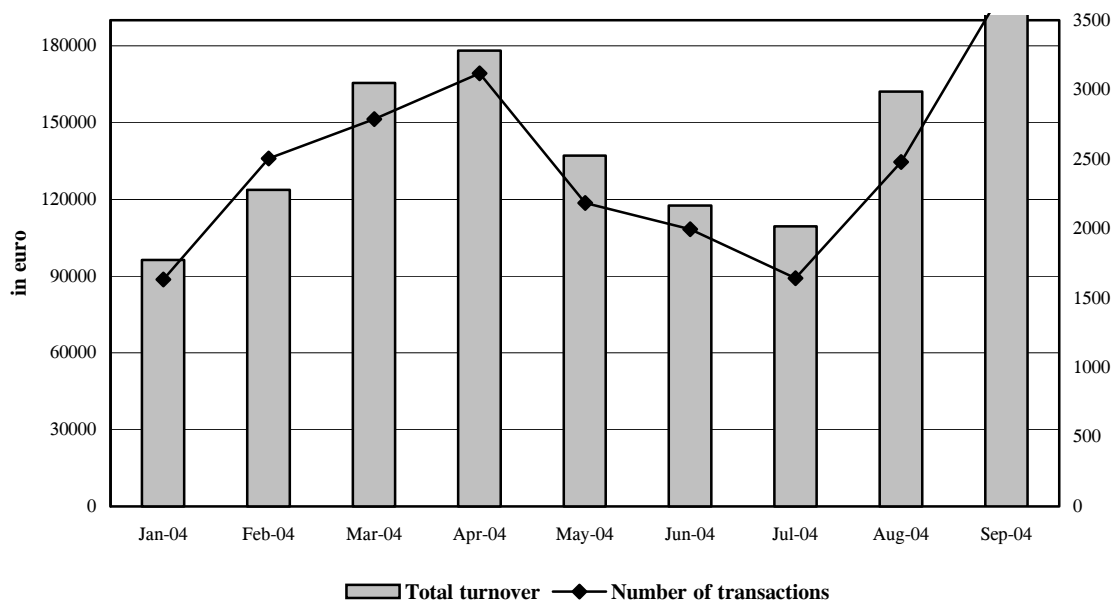
Investment units of all six Privatization Funds were traded in the first nine months of 2004 in both Montenegrin stock exchanges. During this period, 22,113 transactions were realized, of which 12,574 occurred in the NEX Montenegro stock exchange and 8,985 in Montenegroberza. It is important to note that the number of transactions realized with

⁵ Excluding shares that offer the Development Fund, the Pension Fund and the Employment Office of Montenegro

⁶By transferring voucher points to privatization funds in the third phase of the MVP program, 237,316 citizens became fund shareholders (For more details see MONET 8, Comment 11).

investment units of PIFs represents approximately 65% of the total transactions realized in both stock exchanges during the analyzed period. Total turnover amounted to €1,090,111 (€464,062 on *Montenegroberza* and €624,049 on *NEX Montenegro*).

Graph 7.5 Monthly turnover with investment units of PIFs



Source: *NEX Montenegro* and *Montenegroberza*

Trade with shares of old foreign currency saving bonds

Turnover related to the old foreign currency saving bonds during the first 9 months of 2004 amounted to €1,581,208, which is more than two times lower as compared to the same period last year. In the period from March to July there was no trade with old foreign currency saving bonds. In November 2003, the Parliament adopted the Law on Settlement of Obligations and Claims related to Foreign Debt and Frozen Foreign Exchange Savings⁷, which put out of power the Decree on the Purchase of Shares with Old Foreign Currency Savings⁸. As a consequence of this change, old foreign currency saving bonds weren't issued until the end of June 2004, when the Decree on Conversion of Citizens Old Foreign Currency Saving into Bonds (Official Gazette RoM, no 42/04) and the Decision on Issuing Bonds of the RoM according to the Old Foreign Currency Savings (Official Gazette RoM, no 42/04) were adopted. With their adoption, the market became "richer" for 14 series of the old foreign currency saving bonds. Total nominal value of this series is € 150 million. In July of 2004, trade with old foreign currency saving shares began.

In *Montenegroberza*, 1 euro of old foreign currency savings was sold between €0.66 and €0.95, while in the *NEX Montenegro* 1 euro of old foreign currency savings was sold for between 0.42 and 0.93 euro.

⁷ Official gazette of RM, No 55/03

⁸ For details see MONET 14, chapter Capital market

Chapter 8. External Sector

Table 8.1 Imports and Exports in 2003 and 2004 (euros 000)

Sector	Exports						Imports					
	2003		Jan-June 2003		Jan-June 2004		2003		Jan-June 2003		Jan-June 2004	
	total in euros	as % of total	total in euros	as % of total	total in euros	as % of total	total in euros	as % of total	total in euros	as % of total	total in euros	as % of total
0 Live animals	1,200	0	0	0	0	0	13,818	0.00	4,800.00	0.00	1,700	0
1 Meat and meat products	84,587	0.04	39,097.25	0.00	25633.18	0.02	14771496	3.90	8003982.10	4.23	8215841	3.41
2 Milk products and eggs	332,287	0.17	317858.70	0.30	114396.91	0.08	5932481	1.64	2816267.92	1.49	2544553	1.05
3 Fish and fish products	105,142	0.05	39335.50	0.04	26348.00	0.02	2781321	0.78	1115836.88	0.59	1867876	0.77
4 Cer. and cereal products	839,048.50	0.43	746641.55	0.70	238908.01	0.18	6721570	1.56	1761693.72	0.93	8560693	3.55
5 Vegetables and fruits	4,376,604.41	2.27	922736.93	0.86	725857.03	0.54	12366830	3.48	12212604.30	6.45	7105012	2.95
6 Sugar, sugar products and honey	190,650.80	0.10	120711.00	0.11	17679.02	0.01	6276695	1.64	2326442.48	1.23	4048178	1.68
7 Coffee, tea, cocoa and spices	377,759.71	0.20	208725.00	0.19	46260.81	0.03	7426166	2.02	3120189.65	1.65	6614902	2.74
8 Animal fodder (except cereals)	118,765.30	0.06	10533.60	0.01	422953.60	0.31	862,301	0.23	462973.45	0.24	738,935	0.31
9 Various nutrition prod.	285,963.93	0.15	261912.94	0.24	3841.44	0.00	6072798	1.59	2961187.72	1.56	4134529	1.71
11 Beverages	4,139,066.78	2.14	1625686.84	1.52	1965552.03	1.45	4224847	1.18	1623025.17	0.86	2314293	0.96
12 Tobacco and tob/ prod.	7,260,924.49	3.76	1166587.60	1.09	4214093.83	3.11	2584249	0.71	899404.03	0.47	2443785	1.01
21 Raw leather and pelt	1,708,982.38	0.89	1040753.13	0.97	1780340.18	1.31	36,300	0.01	36300.25	0.02	0	0.00
22 Oil grain	7,380,339	3.82	0.00	0.00	0.00	0.00	45,290	0.01	17094.30	0.01	45,298	0.02
23 Natural rubber	0	0.00	0.00	0.00	0.00	0.00	7,479	0.00	0.00	0.00	5,354	0.00
24 Cork and wood	2,719,606.96	1.41	1168773.53	1.09	953181.82	0.70	616388	0.17	312044.81	0.16	279347	0.12
25 Cellulose and paper pulp	82,349.99	0.04	25274.59	0.02	49970.38	0.04	466,450	0.13	474449.70	0.25	0	0.00
26 Textile fibers and textile byproducts	42,163.50	0.02	0.00	0.00	10217.75	0.01	513246	0.14	155592.33	0.08	334224	0.14
27 Compost and minerals	1,464,728.65	0.76	613836.51	0.57	1482699.51	1.09	403647	0.11	228294.32	0.12	236027	0.10
28 Metal ores (nickel, aluminum and copper)	3,211,901.84	1.66	1685021.13	1.57	1982351.22	1.46	1023818	0.29	846061.55	0.45	364107	0.15
29 Animal and plant prod.	189,385.83	0.10	76168.00	0.07	19805.96	0.01	1319003	0.38	336606.34	0.18	618818	0.26
32 Mineral coal, coke and briquettes	6,073.04	0.00	0.00	0.00	1057.30	0.00	8,454	0.00	0.00	0.00	52	0.00
33 Oil and oil derivates	12,932,695.92	6.70	7450579.41	6.95	203026.03	0.15	42346523	10.86	25255284.50	13.33	22477924	9.32
34 Nat. and industrial gas	0	0.00	0.00	0.00	0.00	0.00	403336	0.11	127438.55	0.07	203449	0.08
35 Electricity	0	0.00	0.00	0.00	0.00	0.00	11800480	2.83	0.00	0.00	0	0.00
41 Animal oil and fat	0	0.00	0.00	0.00	0.00	0.00	55,910	0.02	34744.65	0.02	617	0.00
42 Solid an. oils and fats	17,902	0.01	17902.00	0.02	1195.80	0.00	978867	0.28	598126.59	0.32	365543	0.15
43 An. and veg. fats and oils	85,400.38	0.04	29270.00	0.03	57547.00	0.04	21205	0.01	1052.05	0.00	13412	0.01
51 Org. chemical products	12,182.12	0.01	4526.00	0.00	7176.00	0.01	263570	0.06	94442.09	0.05	307163	0.13
52 Inorg. chemical prod.	39,420.46	0.02	29311.98	0.03	1774810.34	1.31	3670519	1.07	1555546.53	0.82	2609563	1.08
53 Products for painting	824,569.61	0.43	128207.00	0.12	474790.30	0.35	2414799	0.66	1207816.30	0.64	1529440	0.63
54 Med. and pharm. prod.	74,261.75	0.04	16555.00	0.02	66130.40	0.05	6518410	1.90	3327395.38	1.76	5990337	2.48
55 Ether oils, perfumes and other products	486,265.51	0.25	555106.66	0.52	192835.16	0.14	14036459	3.87	6394827.98	3.38	10868900	4.51
56 Fertilizers (except unprocessed)	0.00	0.00	0.00	0.00	0.00	0.00	171,088	0.05	7190.00	0.00	279,964	0.12
57 Unprocessed plastics	20,928.07	0.00	0.00	0.00	2439.30	0.00	319173	0.09	194791.34	0.10	238742	0.10
58 Molded plastics	21,887	0.01	156.00	0.00	0.00	0.00	2846053	0.76	1636106.89	0.86	2225192	0.92
59 Chemical substances and products	5,371.32	0.00	3845.54	0.00	128630.65	0.09	3417859	0.94	1728201.18	0.91	2631997	1.09
61 Leather and leather products, pelts	0	0.00	0.00	0.00	0.00	0.00	5474	0.00	821703.97	0.43	8494	0.00
62 Rubber products	261,631.96	0.14	69091.35	0.06	122605.12	0.09	3319284	0.92	1271253.97	0.67	2862096	1.19
63 Cork and wood products	175,240.44	0.09	104177.63	0.10	28680.04	0.02	2851399	0.78	1407480.69	0.74	2568307	1.06
64 Paper, cardboard and cellulose products	183,326.90	0.09	215530.23	0.20	43333.19	0.03	9136826	2.67	5103662.81	2.69	6802115	2.82
65 Yarn, tissue and textile products	32,320.10	0.02	22711.00	0.02	217027.44	0.16	2774549	0.70	1393059.40	0.74	2218650	0.92
66 Const. materials (cem., glass, sand etc.)	128,802.05	0.07	66894.70	0.06	85189.24	0.06	16958008	4.50	8372946.32	4.42	13796523	5.72
67 Iron and steel	5,762,324.48	2.99	2992496.63	2.79	7130533.96	5.26	9513695	2.69	3370262.42	1.78	3864432	1.60
68 Ferrous metals	107,863,371.98	55.88	68679935.27	64.06	91139074.85	67.18	1780703	0.47	693178.79	0.37	1540113	0.64
69 Metal products	5,939,291.57	3.08	2455658.53	2.29	2325810.85	1.71	10258189	2.72	4354460.16	2.30	7146409	2.96
71 Ind. machi. and devices	2,241,134.51	1.16	269746.03	0.25	701399.44	0.52	1801922	0.51	1081124.26	0.57	927954	0.38
72 Spec. purpose mac.	827,212.18	0.43	228949.04	0.21	728234.53	0.54	6727163	1.83	2952873.43	1.56	6690877	2.77
73 Mach. for metal proc.	12,159.19	0.01	0.00	0.00	46754.06	0.03	1109492	0.29	265638.55	0.14	1017258	0.42
74 Indu. mach. for gen. use	762,559.01	0.40	271740.24	0.25	680278.02	0.50	12247446	3.32	7278287.45	3.84	11543249	4.78
75 Machines for offices and data processing	88,721.90	0.05	256329.24	0.24	29524.14	0.02	7834606	2.09	3587220.90	1.89	4796796	1.99
76 Telecomm. equipment	150,386.20	0.08	9708.34	0.01	236046.08	0.17	21004199	5.64	13528994.02	7.14	9474363	3.93
77 Elect. mach. and equip.	536,489.13	0.28	304139.57	0.28	250242.09	0.18	18250323	4.97	8755421.76	4.62	11929075	4.94
78 Vehicles	1,130,473.03	0.59	753400.18	0.70	589950.91	0.43	34757007	9.14	14853799.82	7.84	26641242	11.04
79 Other transp. equipment	14,751,792.00	7.64	10743860.34	10.02	12648569.07	9.32	12923020	3.70	12093371.83	6.38	1367018	0.57
81 Prefabricated buildings	72,909.45	0.04	21161.67	0.02	68958.96	0.05	2626262	0.72	1027896.35	0.54	1995372	0.83
82 Furniture and parts	449,362.23	0.23	219522.79	0.20	188570.53	0.14	7596155	2.08	3694550.32	1.95	5547248	2.30
83 Traveling equipment	3,186.10	0.00	515.80	0.00	0.00	0.00	751094	0.21	209864.07	0.11	478450	0.20
84 Clothing	436,948.20	0.23	175188.41	0.16	182596.08	0.13	5137215	1.42	2416013.39	1.28	4178742	1.73
85 Footwear	815,824.47	0.42	435290.75	0.41	119110.18	0.09	4246535	1.21	1894577.57	1.00	3031252	1.26
87 Scientific instruments	504,865.82	0.26	2057.45	0.00	41661.30	0.03	2764274	0.66	2527223.49	1.33	1779479	0.74
88 Cameras and clocks	163,208.57	0.08	86769.20	0.08	69923.15	0.05	1357910	0.36	519189.04	0.27	1234299	0.51
89 Other finished products	295,425.69	0.15	509710.01	0.48	960371.81	0.71	10768822	2.89	4074967.02	2.15	7587442	3.15
93 Special transactions	14,376.42	0.01	12359.75	0.01	39661.00	0.03	1,744	0.00	0.00	0.00	1,900	0.00
TOTAL	193,041,759	100	107,212,058	100	135,663,835	100	371435679	0	189426836.85	100.00	241244919.65	100.00

Source: Central Bank of Montenegro

8. EXTERNAL SECTOR

- *Ferrous metals (aluminium) was the key export in the first half of 2004 (68.2%);*
- *Oil and oil derivatives was the most dominant import in the first half of 2004 (9.3%);*
- *Considering imports by country of origin, the most dominant were Bosnia and Herzegovina, Slovenia, Germany and Austria during the months of January - June 2004;*
- *Considering exports by country of destination, the structure continues to be dominated Switzerland, Italy, Greece (due to the export of aluminium) as well as Bosnia and Herzegovina;*
- *The current account deficit in Montenegro in the first half of 2004 amounted to US \$135.2 million a nominal increase of 46.4% compared to the first half of 2003.*

8.1. FOREIGN TRADE

8.1.1 Foreign Trade Structure by Goods

The divisional structure of imports and exports by goods is given for 2003, as well as for the first six months of 2004 (see Table 8.1). Data, according to SITC¹, was obtained from the Central Bank of Montenegro and covers foreign trade with all countries, excluding Serbia.

With respect to **imports** in the first half of 2004, oil and oil derivatives accounted for the highest share of total imports (9.3%). However, its share is less than in the same period of 2003 when it accounted for 13.3%. Vehicles, in the first six months of 2004, ranked second with a share of 11% in total imports, which is more than in the corresponding period of 2003 (7.8%).

Other key imports in 2003 were construction materials (5.7% of total imports in the first half of 2004 compared to 4.4% in the same period of 2003), electrical machines and equipment (4.9% in the first six months of 2004 and 4.6% in the first six months of 2003), industrial machines for general use (4.8% in the first half of 2004 and 3.8% in the corresponding period of 2003); ether oils, perfumes and other products (4.5% in the first half of 2004 and 3.4% in the first half of 2003), cereal and cereal products (3.6% in the first half of 2004 and 0.9% in the same period of 2003), meat and meat products (3.4% in the first six months of 2004 and 4.2% in the same period of 2003) and other finished products (3.2% in the first half of 2004 and 2.2% in the corresponding period of 2003). Total imports within these sectors accounted for about 50.3% of all imports in the first six months of 2004.

With respect to **exports** by sector, the most dominant sector in total exports is still “ferrous metals” (aluminium), whose share amounted to 67.2% in the first six months of 2004 compared to 64.1% in the corresponding period of 2003. Other dominant sectors on the exports side were: other transportation equipment (9.3% in the first half of 2004 and 10% in the same period of 2003) and iron and steel, which ranked third with a share of 5.3% in total exports, higher than its share in the same period of 2003 (2.8%). The fourth most dominant export sector in the first six months of 2004 was tobacco and tobacco products, whose share increased to 3.1% in total exports in the first half of 2004 as compared to 1.1% in the same period of 2003.

¹ Standard International Trade Classification

Chapter 8. External Sector

On the other hand, oil and oil derivatives was one of the dominant export sectors in the first half of 2003, representing 7% of exports, but it participated only 0.2% in total exports in the first half of 2002. The reason behind this could be linked to the higher oil prices as well as to the fact that there are no longer any re-exports to Kosovo.

However, combined, the above mentioned export sectors accounted for 85.1% of total exports in the first half of 2004.

8.1.2 Foreign Trade Structure by Country of Destination and Origin

Foreign trade structure by countries is presented in Table 8.2

Table 8.2. Foreign trade structure by country

Country	Imports			Exports		
	2003	Jan-Jun 2003	Jan-Jun 2004	2003	Jan-Jun 2003	Jan-Jun 2004
	in % of total imports			in % of total exports		
Bosnia and Herzegovina	8.5	3.5	12.4	9.4	4.7	5.3
Croatia	6.6	11.3	3.4	1.8	2.6	3.0
Slovenia	12.1	11.6	12.7	1.2	1.7	1.0
Italy	13.4	13	14	11.3	9.7	37.7
Greece	11.9	13.4	5.1	3.1	1.9	15.1
Germany	7.6	3.6	7.1	0.6	1	1.1
Cyprus	4.5	4.1	2.2	3.4	1.6	2.0
Hungary	1.9	1.9	2.1	1.4	0.9	1.5
Virgin Islands	0.7	0.3	0.8	2.5	1	0.9
Albania	0.4	0.8	0.4	1.2	0.6	2.5
Austria	6.2	4	6.1	0.0	0.05	0.1
Gibraltar	0.1	0.8	0	0.0	0	0.0
Great Britain	3.9	6.5	1.4	0.1	0.2	0.4
Liechtenstein	0.2	0.04	0.1	0.0	0	0.0
Switzerland	2.9	2.5	2.7	57.3	62.5	17.2
USA	1.7	2.2	2.7	0.2	0.1	0.7
Other	17.4	20.46	26.8	6.5	11.45	11.5
Total	100.0	100.0	100.0	100.0	100.0	100.0

Source: Central Bank of Montenegro

With respect to export and import of goods, according to their origin or assignment, data are provided for 2003 in its entirety and for the first six months of 2004. Data comes from the Balance of Payment statistics and do not include Serbia (see table 8.2). With respect to Montenegrin imports, according to the country of origin, the former Yugoslav republics have had a significant share of total imports in the first half of 2004, particularly, Bosnia and Herzegovina, whose share of imports rose to 12.4% in the first six months of 2004 compared to 3.5% in the corresponding period of 2003. This increase can be explained by the fact that the Free Trade Agreement between Serbia and Montenegro and Bosnia and Herzegovina (BiH) came into force, which had an impact on both imports from and exports to BiH. The share of imports from Slovenia increased to 12.7% in the first six months of 2004 from 11.6% in the same period of the preceding year. The share of imports from

Croatia declined in the first half of 2004 to 3.4% from 11.3% in the corresponding period of 2003.

With industrialized countries being dominant in total imports, several of them increased their share of total imports in the first half of 2004. This is particularly the case for Germany, whose participation in total imports increased from 3.6% in the first half of 2003 to 7.1% in the first half of 2004.

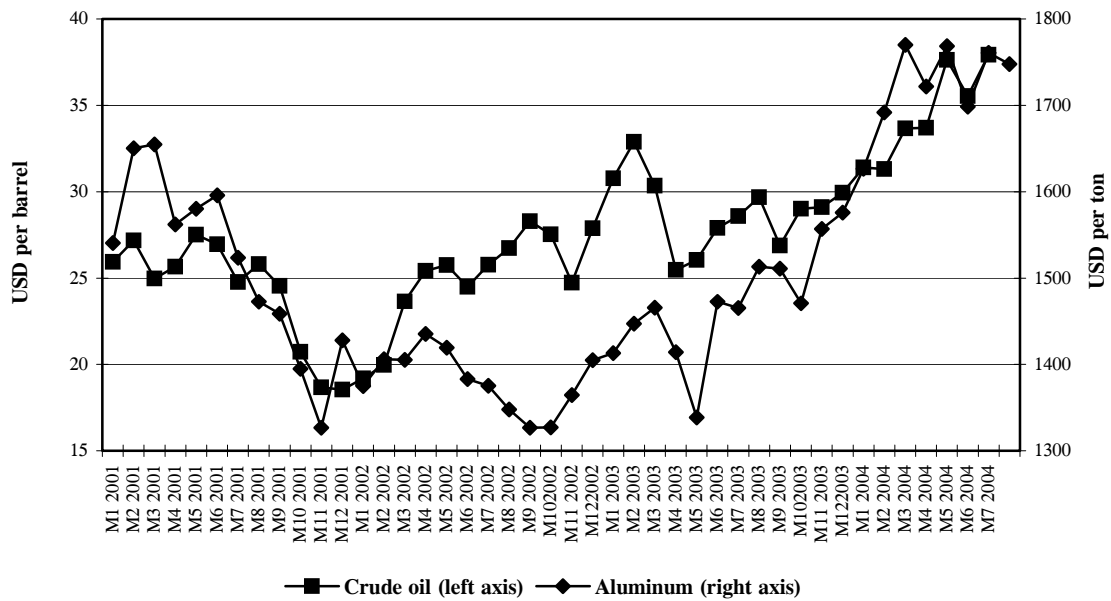
Italy's share of total imports increased from 13% in the first half of 2003 to 14% in the corresponding period of 2004. Imports from Austria accounted for 6.1% of total imports in the period January-June 2004, an increase of 2.1 percentage points from the same period of the previous year. Imports from Switzerland accounted for 2.7% in the first half of 2004, nearly the same participation as in the corresponding period of 2003. Imports from the USA were 2.7% in the first six months of 2004 compared to 2.2% in the same period of 2003.

Considering exports by country of destination, the structure was dominated by exports of aluminium to Italy and Switzerland. While the share of aluminium export to Switzerland was much lower in the first half of 2004 (17.2%) as compared to the same period of the previous year (62.5%), the share of export to Italy significantly rose to 37.7% in the first half of 2004 compared to 9.7% in the corresponding period of 2003. Of total Montenegrin exports in the first half of 2004, the share exported to Greece rose to 15.1% from 1.9% in the same period of the previous year; this overall increase is the consequence of much higher exports of aluminium to this country. Exports to Bosnia and Herzegovina (BiH) accounted for 5.3% of total exports in the first six months of 2004, compared to 4.7% in the same period of 2003. Exports to Croatia increased slightly, going from 2.6% in the first half of 2003 to 3% in the same period of 2004. In the first six months of 2004, Albania had a significant share of total exports (2.5%), followed by Cyprus (2.0%), Germany (1.1%), Slovenia (1.0%) and the Virgin Islands (0.9%). Exports to these countries accounted for 85.8% of total Montenegrin exports and the overall structure has changed in favor of Italy and Greece in the first half of 2004, while export to Switzerland has significantly decreased.

8.1.3 "TERMS OF TRADE"

Since the Statistical Office of Montenegro- *Monstat* does not calculate the full official terms of trade, the ISSP has estimated terms of trade as a ratio of the price level of the most important export and the price level of the most important imports in Montenegro. The highest share of imports consistently belongs to oil and oil derivatives (13.3% in the first half of 2003 and 9.3% in the first half of 2004), while on the exports side, aluminium accounts for the main share of all exports (64.2% in the first half of 2003 and 67.2% in the first half of 2004). Despite the fact that the ratio of prices of aluminium to prices of oil products does not precisely represent terms of trade, it is a good measure of profitability of Montenegro's foreign trade.

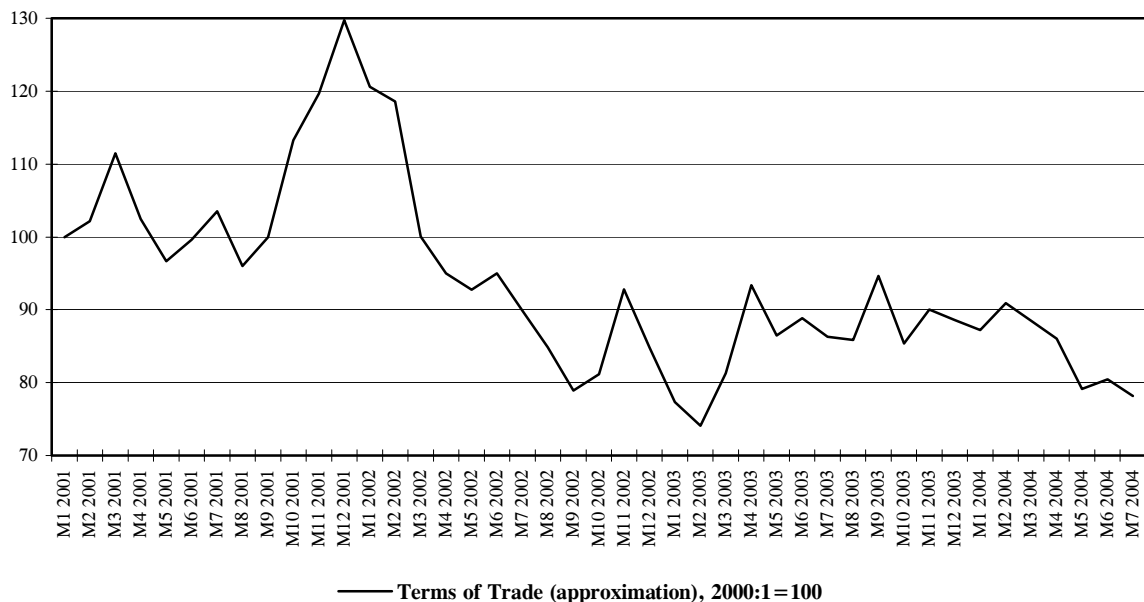
Graph:8.1 Price of crude oil and aluminium prices



Source: KAP (export prices), International financial statistics (IFS)- average crude oil prices, SPOT oil)

Graph 8.1 presents the export prices of aluminium (in \$ per ton), as provided by the Aluminium plant Podgorica (KAP), along with world prices of crude oil (\$ per barrel), as listed in the IMF’s International Financial Statistics.

Graph 8.2: Terms of trade in Montenegro (Approximation)



Source: ISSP’s calculation based on data from KAP and International Financial Statistics

Graph 8.2 presents an approximation of the Montenegrin terms of trade. The series has been set equal to 100 in 2001. The graph shows that Montenegrin terms of trade have improved in 2001, deteriorated in 2002, recovered somewhat in 2003, and then deteriorated in 2004 due to the oil price increase. In July 2004, they were at a level of 78.15 points (compared to 100 in 2000:1).

8.2. BALANCE OF PAYMENTS

8.2.1 Current account

The current account deficit in Montenegro in the first half of 2004 amounted to \$ 135.2 million, a nominal increase of 46.4% compared to the first half of 2003. Total revenues were equal to \$ 410.7 million, an increase of 50.1% compared to the first half of 2003. On the other hand, total expenditures of the current account in the first six months of 2004 amounted to \$ 546.3 million, a nominal increase of 49.2% compared to the same period of the previous year, when it amounted to \$ 366.1 million.

Goods trade

Total trade of goods (imports plus exports) was \$ 685.2 million in the first half of 2004, representing a 52% increase compared to the total trade of goods in the first half of 2003. Exports decreased by 66% compared to the same period of the previous year, while imports increased by 45.7%. Overall, the ratio of exports to imports was 52.3%, or 6.4 percentage points higher than in the corresponding period of 2003.

Exports in the first half of 2004 increased, primarily due to the increase of exports to Serbia and Kosovo, as well as due to the increase of exports of aluminium. Namely, exports to Serbia and Kosovo amounted to \$ 69.1 million in the first six months of 2004, an increase of 47% compared to the same period in 2003, while exports of aluminium increased by 69.9%.

Imports from Serbia and Kosovo amounted to \$ 124.2 million, an increase of 25.8%. One reason for the increase of total imports in the first six months of 2004 was the import of oil and oil derivatives, which increased by 40.9% compared to the corresponding period in 2003.

Balance of services

The net balance of services in the first half of 2004 was in surplus and amounted to \$ 18.2 million, a nominal increase of 17.3% compared to the same period of 2003. This increase is the result of increased transportation revenues, by 56.7%, as well as increased revenues from tourism, by 22.1%. However, the balance of financial services is still negative, but it does not have a significant impact on the total balance of services.

Income

The surplus of income amounted to \$ 47.8 million, a nominal decrease of 10.9% in the first half of 2004 compared to the same period in 2003. This decrease is mostly due to a 133% increase of total income expenditure compared to the corresponding period in 2003.

Transfers

The net balance of transfers in the first six months of 2004 was in surplus, amounting to \$ 13.2 million, an increase of 142.9% compared to the corresponding six months of 2003. This increase of the surplus is primarily due to higher foreign assistance, which increased by 59.9%, going from \$ 8.9 million in the first half of 2003 to \$ 14.2 million in the first half of 2004.

8.2.2 Capital and financial account

Capital account

Data on capital and financial transactions are, up to now, rather limited due to the ongoing process of adopting international standards, which would allow for proper registration of these transactions. Consequently, capital account transactions have not been registered in Montenegro at all since 2001.

Financial account

In the financial account of Montenegro, “*foreign direct investments*” still make up the most significant position, amounting to \$ 37.5 million in the first half of 2004, which represents an increase of 367.7% compared to the same period of 2003. The main reason for the increase of foreign direct investments is the privatization process.

“*Other investments*” in the first half of 2004 amounted to \$ 46.7 million, an increase of 194.5%, mostly due to the increase of foreign loans. *Net portfolio investments* were positive in the first six months of 2004 and amounted to \$ 917,000, a significant increase from the \$ 189,000 they amounted to in the corresponding period of 2003.

Additionally, the Central Bank of Montenegro includes in the financial account two items: “*change in net foreign asset of commercial banks*” and “*change in CBM foreign reserve assets.*” The position of “change in net foreign asset of commercial banks” was \$ 57.5 million in the first half of 2004, while it was \$ 48.7 million in the same period of 2003. The change in CBM foreign reserve assets remained negative (\$ 2.4 million) in the first half of 2004 but was lower than in the first half of 2003 (\$ 7.3 million).

Net errors and omissions

The total balances of the current, as well as capital and financial accounts, was \$ 4.97 million in the first half of 2004. This represents a vast improvement over the same period last year when this balance amounted to \$ 26.92 million. This surplus of the current, capital and financial account is set explicitly equal to the position “*net errors and omissions*”, in order to achieve the balance of payments equilibrium.

Table 8.3 Balance of Payments of Montenegro 2001-2004 (in \$ 000)

	2001.	2002.	2003.	Jan- June 2003	Jan-June 2004	Change in 2004 (in %) compared to the same period of 2003
CURRENT ACCOUNT BALANCE	-175,016	-154515	-114033	-92,389	-135,249	46
Total current account revenues	565685	654635	729268	273,654	411,065	50
Total current account expenditures	740701	809150	843301	366,043	546,314	49
GOODS AND SERVICES BALANCE	-349,9	-306255	-285644	-151,471	-196,296	30
GOODS BALANCE	-436644	-401590	-407556	-166,953	-214,449	28
Total export of goods	210,8	305065	304884	141,820	235,401	66
Export of goods excl. trade with Serbia and Kosovo and aluminum	46,53	51075	77780	28,923	54,390	88
Export of aluminum	141485	157641	121672	65,878	111,901	70
Export to Serbia and Kosovo	22785	96349	105432	47,019	69,110	47
Total import of goods	647444	706655	712440	308,773	449,850	46
Import of goods excl. oil, electricity and trade with Serbia and Kosovo	358815	390600	358097	165,876	271,680	64
Import of electricity	33327	46159	52920	24,006	25,617	7
Import of oil and oil derivatives	152757	100259	55686	20,125	28,353	41
Import from Serbia and Kosovo	102545	169637	245737	98,766	124,200	26
SERVICES BALANCE	86744	95335	126584	15,482	18,153	17
Total revenues from services	134549	166392	217137	54,205	75,555	39
Total expenditures for services	47805	71057	90551	38,723	57,402	48
Total Transportation Revenues	25422	30297	39753	16,004	25,084	57
Transport official data about revenues	23648	27501	33610	14,148	22,223	57
Transport revenues from Serbia	1774	2796	10268	1,856	2,861	54
Total Transportation Expenditures	17965	20830	29485	12,228	16,204	33
Transport official data about expenditures	16705	16822	17154	9,731	10,786	11
Transport expenditures to Serbia	1,26	4008	3531	2,498	5,418	117
Balance of transportation services	7457	9467	10268	3,776	8,880	135
Total Revenues from Tourism	94,91	117474	154161	29,735	36,312	22
Revenues from tourists abroad (estimate)	36345	58299	69976	16,285	22,467	38
Revenues from tourists from Serbia	58565	59175	84185	13,450	13,845	3
Total Expenditures to Tourism	4496	7573	11496	4,833	3,878	-20
Expenditures for tourism abroad	4346	6046	9156	3,755	3,007	-20
Expenditures for tourism in Serbia	0,15	1527	2340	1,078	871	-19
Balance of tourism	90414	109901	146665	24,902	32,434	30
Revenues from Financial Services	3667	2,54	3219	1555	1782	15
Commission fee	3622	2139	1770	824	1,481	80
Commission fee on Serbian import/export (estimate)	0,045	0,401	1449	731	301	-59
Expenditures to financial services	2858	3151	7623	4,112	3636	-12
Commission fee	2788	2661	5216	3,452	2,916	-16
Commission fee on Serbian import/export (estimate)	0,07	0,49	1407	660	720	9
Balance of financial services	0,809	0,619	-4404	-2557	-1854	-27
Revenues from other Services	10,55	12061	20002	6,911	12,377	79
Expenditures for other services	22486	37003	41947	17,550	33,684	92
Balance of other services	-11936	-24942	21945	-10,639	-21,307	100
INCOME BALANCE	41631	70162,78	112825	53,173	47,512	-11
Income revenues	77,72	94150,076	141738	67,267	80325	19
Compensation of employees	36578	43820	97479	35,846	66,697	86
Revenues from Serbia for physical persons	39702	50329	43616	31,421	13,628	-57
Received dividends	0,152	0,000	0,004	0,004	0,016	300
Interest revenues	1288	0,149	0,639	0,454	0,277	-39
Investment abroad		0,927				
Income Expenditures	36089	23987,296	28913	14,095	32,813	133
Compensation of employees	30043	2983	3815	1,381	2,337	69
Expenditures for physical persons in Serbia	0,103	0,296	1210	534	945	77
Interest expenses	2048	13056	13775	9,852	16,967	72
Paid dividends	3895	7948	10113	2,328	12,564	440
CURRENT TRANSFERS BALANCE	133253	82318	55114	5,452	13,242	143
Current transfers to Montenegro	142616	91973	65511	9,904	19,491	97
Transfers to Montenegro from abroad	10175	5189	3657	1,046	5,331	410
Foreign assistance	62262	39784	27663	8,858	14,160	60
Foreign assistance financial and material (NGO, humanitarian)	70179	0,047	34191			
Expenditures	9363	9655	10397	4,452	6,249	40
Transfers from Montenegro abroad	9363	9655	10397	4,452	6,249	40
CAPITAL AND FINANCIAL ACCOUNT BALANCE	10658	67933	130479	65,472	140,219	114
CAPITAL ACCOUNT	0	0	0	0	0	
FINANCIAL ACCOUNT	10658	67933	130479	65,472	140,219	114
Direct investment	9522	84329	46704	8,022	37,521	368
Equity capital	4218	73861	44913	8,022	37,521	368
Reinvested earnings and undistributed branch profits	5304	10468	1791			
Portfolio investment-net	-0,011	-201	1133	189	917	385
Other investments	-5453	16424	41321	15,868	46,736	195
Loans	2,62	23533	55768	19,363	97,358	403
Repaid loans	8073	7109	14447	3,495	50,622	1,348
Change in Net Foreign Assets	6,6	-22830	39480	48,672	57,448	18
Change in CBM for. reserve assets (term deposits of CBM in for. banks)	0	-9789	-7405	-7,279	-2,402	-67
BALANCE OF CURRENT ACCOUNT AND CAPITAL AND FINANCIAL ACCOUNT	-164358	-86582	16446	-26,918	4,970	-118
NET ERRORS AND OMISSIONS	-164358	-86582	16446	-26,918	4,970	-118

9. REGIONAL COMPARISON

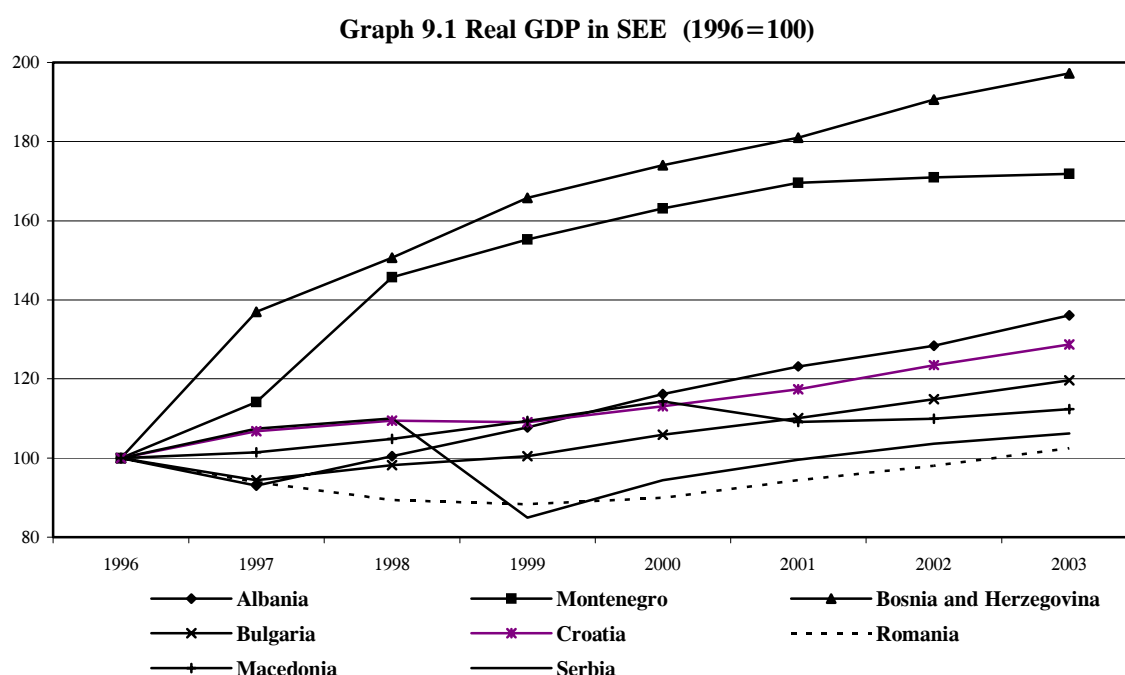
- The annual growth rate of industrial output was positive in all SEE countries.
- CPI inflation in 2004 fell on an annual basis in several SEE countries (Montenegro, Macedonia and Albania) compared to the end of 2003.
- The highest unemployment rates were still registered in Bosnia and Herzegovina, Macedonia, Serbia and Montenegro, and the lowest were in Romania and Bulgaria.

This chapter presents a brief outlook on the most recent macroeconomic developments of South Eastern Europe (SEE).

9.1 MACROECONOMIC INDICATORS

The real GDP growth rate in South Eastern European countries in 2003 was similar to that of 2002. Real GDP growth rate in 2003 is estimated at 6% in Albania, 4.5% in Romania, 2.5% in Serbia and 0.5% in Montenegro. Official GDP growth rate in 2003 was 3.5% in Bosnia, 4.3% in Croatia, and 2.2% in Macedonia.

Graph 9.1 presents the cumulative real GDP index for most countries in the region starting in 1996.



Source: IMF, Vienna Institute, central banks web sites and ISSP

Industrial output in 2004 continued its growth. The most obvious changes of industrial production growth were in Serbia and Macedonia. The average level of industrial production in the first seven months of 2004 increased in Serbia by 7.6%, while it declined in Macedonia by 19.7% compared to the same period of 2003. Annual growth rates in 2004 were positive in Serbia (7.7% in July), Montenegro (0.2% in August), Romania (4.2% in July), Bosnian Federation (9.7% in June), as well as in Bulgaria and Croatia.

CPI inflation in 2004 fell on an annual basis compared to the end of 2003 in several SEE countries. The most pronounced decline took place in Romania (3.7% in June 2004 vs. 15.3

at year-end 2003), followed by Montenegro (0.8% in August 2004 vs. 6.1% at year-end 2003), Albania (2.6% in May 2004 vs. 3.3 at year-end 2003). On the other hand, CPI inflation rate increased in Serbia (12.2% in August vs. 9.9% year-end 2003), Croatia (2.5% in June vs. 1.8% at year-end 2003) and Bulgaria (6.6% in May 2004 vs. 4.7% at year-end 2003).

Table 9.1: Macroeconomic indicators of SEE countries

		Albania	Bosnia and Herzegovina/ Republika Srpska	Bulgaria	Croatia	Macedonia	Montenegro	Serbia	Romania
Real annual GDP growth (change in %)	2001	6.5	4.5	4.0	3.8	-4.5	4.0	5.5	5.0
	2002	4.7	5.5	4.3	5.2	0.7	0.8	4.0	3.8
	2003*	6.0	3.5	4.3***	4.3	2.2	0.5	2.5**	4.9***
Annual change of industrial production (in %)	2001	6.5	12.2/-12.9	1.6	6.0	-23.2	-2.7	0.0	8.4
	2002	2.0	9.2/-2.5	6.5	5.7	13.7	0.7	1.7	6.0
	2003	-	2.0/-1.6 (Mar)	15.6	4.0	0.5 (Nov) 6.5 (Jan-Nov)	2.4	-3.1	3.2
	2004		9.7 (June) 13.7 (Jan-June) / -1.0 (June) 9.0 (Jan-June)	1.8 (Jan-Mar)	2.8 (Jan-May)	-8.8 (July); -19.7 (Jan-July)	0.2 (Aug) 11.6 (Jan-Aug)	7.7 (July); 7.6 (Jan-July)	4.2 (June) 3.9 (Jan-June)
Annual inflation rate (CPI, in %)	2001	3.5	3.2	4.8	2.6	1.2	24.0	38.7	34.5
	2002	2.1	0.3	3.8	2.3	2.2	9.2	1.8	22.5
	2003	3.3	0.3	4.7	1.8	-1.1 (July) 0.3 (Jan-July)	6.1 (Dec)	9.9	15.3
	2004	2.6 (May)	0.2 (Mar)	6.6 (May)	2.5 (June)	1.4 (Feb-04)	0.8 (Aug)	12.2 (Aug)	3.7 (June)
National currency (per €)	Currency name	Lek	Convertible Mark; BAM	Leva	Kuna	Denar	Euro	Dinar	Lei
	2004 (related to €)	134.43 (Dec-03)	1.956 (Aug)	1.958 (Sept)	7.38 (June)	60.97 (July)	-	73.74 (Aug)	40,754 (June-04)
	Annual change in %	2.3	-	-	-2.09	0.01	-	12.9	7.1
Unemployment rate (in %)	2001	15.4	39.9/ 40.2	17.3	22.2	30.5	24.8	27.7	8.8
	2002	15.8	42.7/ 38.2	16.3	22.3	31.9	23.7	31.3	8.4
	2003	16.0	43.1/36.6 (Mar)	13.5	19.1 (Dec)	36.7 (Apr)	21.6 (Dec)	30.2 (Dec)	7.2
	2004	-	-	12.6 (May)	18 (May)	-	19.9 (Aug)	31.9 (July)	6.5 (June)
Trade balance (as % of GDP)	2001	-22.6	-59.0	-11.6	-18.9	-15.3	-33.9	-26.1	-13.2
	2002	-17.5	-59.2	-10.2	-23.5	-8.8	-29.6	-34.8	-8.6
	2003	-	-55.7	-12.0	-23.9	-	-19	-32.3**	-8.9
Current account balance (as % of GDP)	2001	-5.3	-24.3	-6.5	-3.7	-6.9	-17.1	-5.5	-5.9
	2002	-9.5	-30.9	-4.5	-7.1	-14.2	-14.8	-8.2	-4.5
	2003	-9.1	-29.6	-7.0	-7.1	-	-8.0	-12.9**	-4.6

Sources:

- Data for Montenegro are from ISSP database
- Data for other countries are from their central banks
- Data for Bosnia and Herzegovina in 2003 are from IMF
- **www.dfat.gov.au;
- ***www.insse.ro

Unemployment rates in SEE countries were not much changed, but they declined in several countries at the beginning of 2004 as well as in 2003. These countries are Romania (6.5% in June 2004 vs. 7.2% at year-end 2003), Croatia (18% in May 2004 vs. 19.1% at year-end 2003) and Bulgaria (12.6% in May 2004 vs. 13.5% at year-end 2003). The highest unemployment rates were still registered in Bosnia and Herzegovina, Macedonia, Serbia and Montenegro. Romania and Bulgaria continue to be the countries with the lowest unemployment rates in the region.

In almost all of the SEE countries, the current account deficit (as a percent of GDP) was nearly the same in 2003 as in the previous year. It increased in Serbia and Bulgaria as percentage of GDP compared to 2002. Furthermore, Bosnia and Herzegovina, Albania, Serbia and Montenegro continue to be the countries with the highest current account deficits (as a % of GDP), while Romania and Croatia continue to have the lowest current account deficits in 2003.

PART 2

COMMENT 1

EUROPEAN UNION FISCAL RULE ¹

Milorad Katnic, Ministry of Finance of Montenegro

Fiscal rules are defined as a combination of fiscal goals and a set of regulations that precisely define what a country should do to achieve its established goals (Halleberg 2001). This permanent restriction of fiscal policy, expressed in terms of summary indicators - fiscal performance, budget deficit, lending, and debt are the main components of this restriction (Kopits and Symanski 1998.).

The main reason for formulating fiscal rules in the European Union is to set long term maintenance of public finances; this discussion began after the significant growth of public debt in the '80's and early '90's of the previous century in most countries of the EU. Another contributing factor for setting fiscal rules is the problem of moral hazard within the EU. Particularly, since the fiscal policies of one country within the EU influence other members, by setting and implementing fiscal rules, the risk of (mis)use of one country's fiscal politics might prejudice the loss of another country. Finally, the control of inflation conditions that are created by the European Central Bank are tenable, stable, and consistent with fiscal policies of member countries, and by establishing the European Monetary Union (EMU), conditions are created to more easily set rules within the EU rather than to initiate reforms on a national level; reforms which can be blocked much easier because of reconstituted interests.²

Fiscal rules within the EU are mostly settled by the Maastricht Agreement and Stability and Growth Pact (accepted in 1997), which are united by two regulations from the Ecofin Council³ and two European Commission's resolutions (European Council)⁴. According to the established rules, country members of the EU have to accommodate their short range budget position so that it can be close to balance, or positive, and ensure that the maximal sum of the budget deficit is limited to 3% of GNP. The larger deficit can be discussed only if the excess has been caused by exceptional circumstances, if it is short range, and close to its regular level. According to the Stability and Growth Pact, exceptional circumstances are relational with unforeseen events that are not under the control of the country but that have significant influence on the financial position of the budget or on sudden and significant cyclic deteriorations.

¹ Most of this text represents a part of the Master thesis plan "Analysis and summary of public debt."

² "It is necessary to notice that fiscal rules are established in specific historical situations when there used to be urgent necessity top quirk in trends of rapidly growing public debts and need for a rapid reconstitution of credibility for new currency in its initial phase."-European economic Advisory Group (2003) "Report on the European economy 2003".

³ Ecofin Council is one of the nine configurations that the Council of Ministers EU is dealing with and together with Agriculture Council presents the most important configurations for making the most important decisions for the Union. Ministers of finance and economy, who are meeting each other monthly, represent Ecofin. Ecofin covers EU policies in many fields, including budget policy and public finances. Besides, Ecofin, together with European Parliament, prepares and adopts EU annual budget.

⁴European Commission (EC) is the Administrative organ of the EU institutional system that has the right to give law programs and to present them to Parliament and Council. As a Union administrative organ, it is competent for the implementation of European legislation (regulations, decisions), budget and programs accepted by Parliament and Council. Presidents represent country members, after previously being accepted by the European Parliament EC or premiers of country EU members elect president and members of Commission.

On the Commission's recommendation, the Ecofin Council brings a formal decision if the deficit is oversized. An annual decrease of GDP of more than 2% is automatically approved as "sudden," and a decrease of GDP between 0.75% and 2% can be approved only after Council deliberation. Council can also discuss the cumulative loss of output compared to previous trends in cases where member countries have an "oversized deficit." If the member country does not assume corrective action in order to eliminate its "oversized deficit," according to Council recommendations it will be asked to pay an annual uninterested deposit that is 0.2 to 0.5% of its GDP. If the "oversized deficit" lasts for a long time, the deposit is converted in a penalty that is distributed among other member countries.

The second fiscal rule refers to the rate of public debt. It is prescribed by an agreement that overall public debt should not be greater than 60% of GDP, and if it is, a share of this debt in GDP should be reduced to a satisfactory level. This rule must be interpreted so that the government does not permit public debt to rise above 60% of GDP. Formally, there is no clause that permits irreverence of this rule, but there are also no financial sanctions for infraction of this rule.

According to the present fiscal rules in the EU, the budget balance is more important than the level of debt. As mentioned before, financial sanctions are connected to infraction of the rule related to the level of the budget deficit but not to the criteria connected to the level of public debt. Policy like this is accessible to critics because the level of debt is a more relevant indicator if the rules are directional in keeping long-term fiscal stability and price stability. Since long-term debt is determined by the accumulated sum of debts during that time, the goal of the budget balance implicitly defines the goal for long term debt. According to the first fiscal rule, if the goal is to have the "budget close to balance" or "positive," then for a cyclically balanced budget, the long-term goal for government is to have "net debt to be null." On the other hand, the present budget situation is a better indicator than the debt level for predicting future budget effects. Practically, focusing on the budget balance rather than debt in the Maastricht Agreement is probably motivated by the large dispersion in levels of debt among the European Monetary Union members, making it difficult to establish unique criteria and achieve corporate goals that can be controlled and sanctioned.

Under the impact of the Stability and Growth Pact, during the 1990's, most EU countries established fiscal rules related to expenses. These rules vary by country as to

- the type of expense category they cover,
- the definition of rules (in real or nominal terms, or as a percent of growth rate),
- the time period they refer to, and
- the closure and control mechanisms.

In most cases these are ex-ante rules – defining aims that would help to keep expenses under control while defining, or establishing, a budget. Goals, defined by these rules, tend to cover a wide spectrum of expense categories. In most countries, these rules are defined at the level of the central country and the mechanisms of implementation and penalties are generally less developed because the rules are more established on political dues rather than on legislature. As specified in European Commission documents, many of these rules that are accepted in EU countries miss some basic feature, or characteristic, making them not completely credible, though not to be ignored when there is disagreement between goals and effects.⁵

⁵ More details "European Commission (2003)" "Public Finances in EMU - 2003", European Economy 3/2003, "Expenditure rules in EU Member States".

Many authors criticize European Union fiscal rules, “resenting” them for being rigid and arbitrary, and because of that, their credibility will “evaporate” and they will become untenable. More frequent are economic-political arguments, also within the European Commission, that focus on fiscal policy and present fiscal rules defined by the Stability and Growth Pact.⁶ In 2001, Portugal violated the rule of maximal allowed budget deficit. The same situation occurred with Germany in 2002 and 2003, and it is predicted that in France the budget deficit will not raise from the exceeded zone, over 3% budget deficit, before 2006. This is how it typically occurs, with one disadvantage following another, a rapid increase of the deficit in France during 2002, 2003, and planned in 2004 increased the public debt, which had already exceeded 60% of GDP during 2003, the amount that according to the rules of the Stability and Growth Pact should not have been achieved. According to requests from France and German authorities for not applying sanctions due to infractions of the EU fiscal rules, many commentators have ironically concluded that if these requests were met, fiscal rules would be applied only in cases where they are not infringed, and that Germany and France, countries that are unified in Europe, would become partners in “crime” and in disuniting the Stability and Growth Pact. On the other side, many economists have infraction of the Stability and Growth Pact clauses saluted as “rejection of unnecessary ironworks from which it should be rejected many years ago.”⁷ However, there is the question of what are the alternative instruments that would enable the establishment of financial order if the present fiscal rules are rejected, especially because of the threat of public finances from the field of pensions and health care. Some economists suggest a redefinition of fiscal rules in order to establish a “golden rule” (i.e. the budget deficit can be used just for financing investments and the government debt must be less than 40% of GDP during the economic cycle), while others insist on establishing rules connected to budget expenses. There are also supporters of defining more strict rules, which would be in accordance with public obligation and the level of public debt.

Box 1: Gold fiscal rule?

The “Golden rule” in public finances is the idea that a country can finance investments through debits, apropos lending should be allowed for public investments. A rule like this was formally stored in the German Statute. Besides Germany, Great Britain has also recently accepted a rule like this, one that allows deficit financing net investments only if the overall net debt is held at a level that is less than 40% of GDP. A critical question in judgment of future impacts on the budget from projects of public investing is: “Do these projects have positive effects, apropos measuring benefits and expenses of these projects?” Is a future base that will finance debt expenses being provided through investments, so that in the future it will not be necessary to increase taxes or decrease expenses because of investing like this? This type of judgment can lead to possible discrimination among public investment projects. On the other hand, assignment and initiation of a golden rule on these postulates would have a significant theoretical and practical limitation that significantly precludes its use. First of all, it’s very difficult to measure future incomes that would be generated by investment. This evaluation would be undoubtedly arbitrary. It is very hard to involve all direct and indirect expenses. Moreover, classification of public incomes among

⁶ Critics of fiscal rules defined by the Stability and Growth Pact object to them because of reducing budget flexibility, do not sanction politically motivated fiscal policies, discourage public investments, are focused on short term liabilities, ignore long term stability est.

⁷ Paul de Grauwe wrote for Financial Times in 2002: "Stability and Growth Pact is vote for European bureaucrats mistrust in strength of democratic institutions in member countries. It is pretty surprising that EU countries allowed this to happen, and that they are conciliated to be controlled by European institutions, that is not imposed even on banana countries by International Monetary Fund " –resumed from “Revisiting the Stability and Growth Pact: grand design or internal adjustment?” EC Economic Papers, 2003.

current and future investments is a little ambitious. For example, are educational expenses to be classified as public investments in human capital? Why would a decrease of tax that stimulates private investments be treated in any way other than direct government investment? Accepting the golden rule would create a powerful impulse for requalification of many items in the budget.

In fact, the “golden rule” can be defined as a way that future generations bear expenses of infrastructure projects that will result in benefits for them. Also, it is well known that efficiency arguments (tax balance) suggest financing of the deficit in the early phase of development: a country starting with a low capital level has a great necessity to construct an infrastructure that has the flexibility to do that.

In contrast to the authors who seek a complete reversal of the fiscal rules as defined by the Maastricht Agreement and Stability and Growth Pact, a significant number of referent authors⁸ believe that the present EU fiscal rules represent a valuable institutional frame that should be used in the future because the restitution of other alternatives would require new and higher costs. Starting with the fact that a present frame exists, they believe that there are intense reasons to continue its further construction and believe that its continuation would preserve the credibility of the fiscal rules. Authors of the mentioned study specify that the most important fiscal rules clause is one that is related to deficit overflow and eventual sanctions, so in that sense they notice two preferable changes:

- Higher respect to public debt level - low indebted countries are allowed to have higher budget deficits than high indebted countries,
- Depolarization of the decision process if a single country has violated rules.

Arguments begin from the fact that existing fiscal rules do not allow countries with low public debt to pick complete benefits from that situation. As the main benefit of lower public debt, it should be mentioned that the process of opening the area for maneuvers in stabilization policy allows for higher deficits in recessions than would be possible under other conditions.

According to the present fiscal rules, there is a connection between the debt level and the range for stabilization policy, but it's more implicit than explicit. It is connected to the condition that countries that have debt share of over 60% of GDP are not allowed to increase that share, representing a limitation for countries that have overran this limit, yet there is not a clause for countries with lower debt.

As it is mentioned further in this study, and what can be noticed in the “European Commission, 2002b”, recent Commission propositions that are connected to the interpretation of the Stability and Growth Pact are highly related to debt questions. At first, it is stressed that the change of debt criteria should have been discussed very seriously, and a connection should be made to redundant budget deficit. Second, the Commission suggests that member countries with debt lower than 60% of GDP should be allowed the possibility to make a temporary variation from “close to balance or positive” according to their defined goal, if these variations issue from “massive structural reforms” that are implemented in order to promote growth. The third proposition is related to allowing for “a little long-term variation” from “close to balance or positive” for member countries with debt lower than 60% of GDP. A problem of more complicated rules can be opened by implementing these propositions because of larger discretionary decision-making.

⁸ For more details: European economic Advisory Group (2003) “Report on the European economy 2003”.

Box 2: Deficit levels consistent to stable debt share in GDP

Apart from the influence of the primary budget balance, the rate of economic growth, the dynamic of interest rates, the exchange rate, the inflation rate, etc. also influence public debt stabilization. The table below displays the maximal budget deficit on different levels of public debt and growth rate, consistent only if the debt share in GDP does not change.

Table 1: Deficit levels consistent to stable debt share in GDP

Nominal growth rate	DEBT SHARE IN GDP				
	60	70	80	90	100
	Deficit levels consistent to stable debt share in GDP				
3%	1,7	2	2,3	2,6	2,9
4%	2,3	2,7	3,1	3,5	3,8
5%	2,9	3,3	3,8	4,3	4,8

Source: European economic Advisory Group (2003) "Report on the European economy 2003".

Logically, as shown in the table, a higher economic growth rate allows for keeping the public debt share in GDP with a higher budget deficit. Therefore, at a nominal growth rate of 3%, if the public debt level were stabilized at 60%, the deficit level shouldn't be over 1.7% of GDP, while at a nominal growth rate of 5%, the budget deficit can reach 2.9% of GDP. Also, it is simple to see that as the public debt level is tenable on a higher level, the possible maximum deficit is higher. Therefore, in order to keep public debt level at 60% of GDP when the nominal growth rate is 3%, budget deficit is limited to 1.7%, while under the same conditions, when it is necessary to keep public debt level at 100% of GDP, budget deficit can achieve 2.9% of GDP. When the economic growth is higher or the real debt interest rate is lower than in the past, it will be necessary to lower the primary surplus in order to stabilize debt proportion.

There is also an indirect connection between the size of the public debt and the stabilization policy through interest rates. For example, at an interest rate of 4%, public debt decreased from 50% to 25% of GDP and would decrease interest rate costs, as a share in GDP, by 1% (from 2% to 1%). Under the same conditions, it will result with budget improvement. In the same way, it can be argued that there is a positive correlation between low debt and powerful budget position, because the low debt can be kept only through low deficits or through surpluses from the past.

The authors of the "Report on the European economy 2003" believe that in the fiscal frame, reform is much better to be focused directly on the budget deficit level, through clear and transparent rules. One way to formulate it is to qualify the possible deficit level with the public debt level, permitting low indebted countries to hold higher deficits as compared to high indebted countries. Precisely, low indebted countries can have a budget deficit that is higher than 3% of GDP. Technically, a connection between the deficit limit and the debt level can be created using a different "upper limiting" deficit for different debt level intervals. Another suggestion that permits carrying higher deficits for low indebted countries leaving "upper limiting" deficits at the same level for high indebted countries, is presented in the next table's second column. An alternative to this would be the scheme as presented in the third column, where an increase of the permitted deficit for low indebted countries is connected to a decrease of the permitted deficit for high indebted countries. The proposition presented as Rule 2 may appear to be the least politically real, but it seems that it leads to a higher connection between long and short term in favor of fiscal discipline. With the rule formulated like this there will be more fiscal discipline and more flexibility.

Table 2: Possible way of “attachment” deficit and debt level

Debt level (as %GDP)	"Upper limiting" deficit (as%GDP)		
	Rule 1	Rule 2	Countries classified toward debt level
> 105	3.0	0.5	Italy
95 - 105	3.0	1.0	Belgium, Greece
85 - 95	3.0	1.5	
75 - 85	3.0	2.0	
65 - 75	3.0	2.5	
55 - 65	3.0	3.0	Portugal, France, Germany, Austria, Bulgaria
45 - 55	3.5	3.5	Norway, Sweden, Spain, Hungary
35 - 45	4.0	4.0	Ireland, Great Britain, Finland, Denmark, Slovakia, Poland
25 - 35	4.5	4.5	Čzeck Republic, Slovenia
< 25	5.0	5.0	Luxemburg, Estonia, Latvia, Lithuania, Romania

Source: European economic Advisory Group (2003) “Report on the European economy 2003”.

Finally, some economists believe that there is no problem with the rules except for within the institutions that would take care of fiscal discipline. There is also the opinion that problems causing fiscal deficits should be sold with fiscal rules, apropos set rules that would face causes not consequences.

Whatever happens, “preliminary empirical analysis indicates that existing rules do not have significant influence on trends in countries expenses.”⁹ Although, in consolation, “even weak rules can be useful as fiscal policy leaders and signals for participants in the budget process in discovering budget components that provoke mostly preoccupation.”¹⁰

⁹ European Commission (2003) “Public Finances in EMU - 2003”, European Economy 3/2003, page 125.

¹⁰ The same.

COMMENT 2

THE EFFECTS OF THE VAT RATE INCREASE

Ivana Vojinović, ISSP

The International Monetary Fund and the World Bank took in consideration possible increase of VAT rate to 18% because they did not trust the capability of Montenegro to independently resolve its deficit problem, which was caused by the reduction of employers' payroll taxes and contributions to pension and health care. The distrust was mainly in the dynamic budget projections by which broadening the tax base will increase tax revenues, which was, at the same time, the reason why this incentive tax policy was implemented. What effects would the VAT rate increase have on the Montenegrin economy?

BRIEF HISTORY OF VAT IN MONTENEGRO

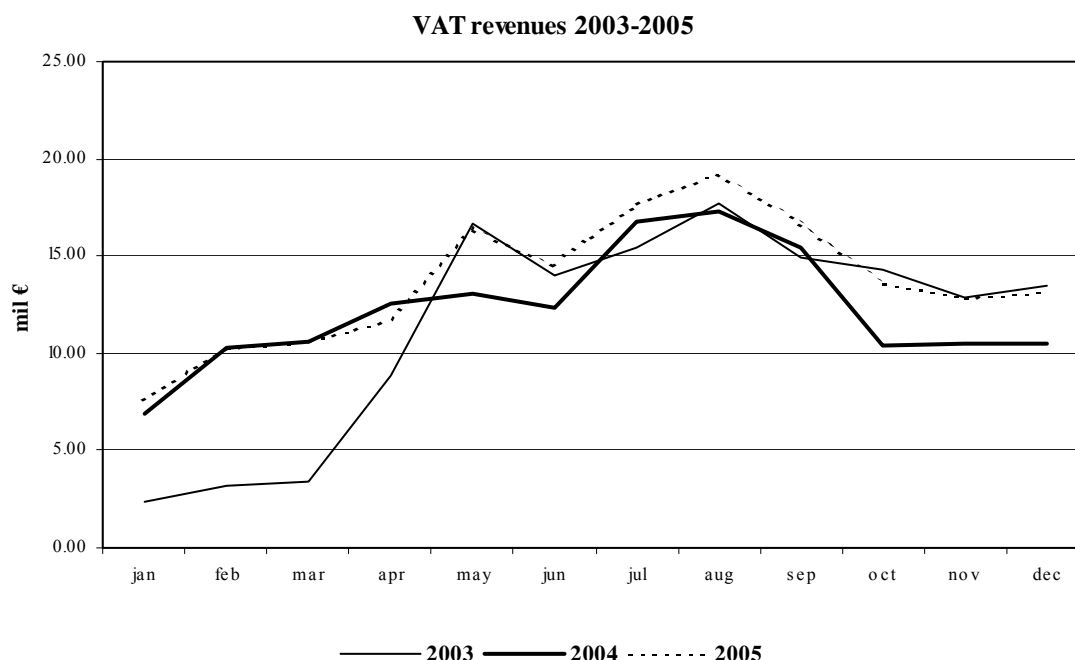
Implementation of the Value Added Tax Law began on April 1st of 2003. The flat rate of 17%¹¹ was adopted. The VAT introduction represented a brave act because it had to be done quickly; this is better appreciated when considering that western countries were preparing for the introduction of VAT for ten years.

The VAT introduction represented the most progressive and the most noticeable incidence in the Montenegrin tax system. It had far reaching effects on the overall economy. One of the measures for evaluation of this tax is revenue adequacy. In 2003, it was anticipated that VAT revenues would amount to € 77.3 million. However, actual revenues were € 117.4 million (152% of the planned level). Altogether with revenues from tax on turnover of goods and services, which was in force until April 2003, the category turnover tax /VAT executed € 137.2 million and comprised over 40% of original revenues in 2003. With € 117 million, or € 40 million of "surplus" in the VAT collection in comparison with the plan of € 77 million, the Government managed to pay wages and salaries, taxes and contributions for its employees. At the end of October 2004, € 125.6 million of VAT revenue was collected, which represents about 40% of budget revenues and 86% of planned VAT revenue for this year and it is likely that the planned amount will be completely executed by the end of the year. VAT turned out to be a stable source of budget finances because it significantly improved budget liquidity, and at the same time was the mechanism for transition from the gray economy to legal channels.

This change in the tax system generated intervention in the price sphere. If we take a few steps back, we might conclude that this process started a few years ago when price liberalization came into the force. That liberalization represented one of the most painful, but at the same time necessary, measures in the transition period. The VAT introduction was only one of a series of inflationary impulses in the transition period. The 2003 year, in which VAT was introduced, showed that its introduction generated an increase of retail prices. It is not certain that VAT was the key factor in the price increase, but on the other

¹¹ One of the preconditions for membership in the European Union is harmonization of tax systems (in the case of VAT is set a threshold of 15%). The European Union sets rules and influences not only the policies of its members and those that will soon become that, but also other European countries and because of that it might be said that in recent years, VAT policy was mainly under the influence of harmonization in the European Union.

hand, it is sure that some portion of the price increase was created under its impact. With the VAT introduction, prices of many staple foods and household goods became more expensive even though the effective tax rate increased only marginally (most goods went from a 15% turnover tax rate to a 17% flat VAT rate) or did not increase at all. On the other hand, the VAT meant a lower effective rate for many products (coffee, cigarettes, alcohol and many household appliances), however, no price cut was registered for these products.



Note: 2003 includes category of turnover tax / VAT, data for 2005 are ISSP calculations

IS VAT THE PROPER INSTRUMENT TO MEET INCREASING DEMAND FOR BUDGET EXPENDITURES?

Analysis of the VAT rate increase should not solely focus on budget revenues because it is necessary to foresee the impact that the increased rate is going to have; will it be worse or better than some other alternative. It is necessary to understand the overall effects. Firstly, we should pose the question, is the enlarged fiscal burden going to annul VAT's efficiency in the Montenegrin economy by stimulating tax evasion and leading to the distortion of relative prices?

The experiences of a great number of countries show that it is dangerous to use VAT, as well as any other tax, for short-term purposes; particularly that which relates to fast rate changes, thus it is better to keep VAT out of the short-term fiscal management. After all, pressure on the nominal increase of budget revenues created inflation in all transition countries. It is necessary to mention that despite the VAT rate increase, the share of this tax revenue in GDP has not increased in many countries (for example France, Germany, Austria). Almost no country managed to cross the threshold of 10% of GDP (which represents the VAT share of GDP in Montenegro).

The VAT introduction represented a barrier for Montenegrin entrepreneurs with regards to developing their businesses and in the recent period, requests were made from the private sector to change some legal provisions, including a rate reduction. When considering a VAT rate increase, two different reactions of entrepreneurs are possible.

One portion of entrepreneurs might decide to stay in the legal sphere and try to compensate its profit loss by increasing the prices of goods and services, which will ultimately have consequences on Montenegrin citizens. Therefore, a VAT rate increase in the short-term would be a relatively strong inflationary incentive. Most likely, these entrepreneurs, being led by past experience when VAT was introduced and prices rose, will raise their estimated profit risk by increasing the prices of goods and services. Due to entrepreneurs' uncertainty regarding the effects of a rate increase on their liquidity, costs, and consequently on profit margins, Montenegrin citizens will be forced to accept higher prices. In this case, the increased VAT rate is merely an instrument for the increase of goods and services prices. The reduced demand for these goods and services will reduce production and consumption in Montenegro and endanger the profitability of future investments.

On the other hand, some entrepreneurs will be disabled by the enlarged fiscal burden and will no longer be able to operate through legal channels. For that reason, the level of workers in the gray economy is going to grow (the gray economy is the main indicator of a system's inefficiency), which will lead to reduced budget payments.

POSSIBLE SCENARIOS OF VAT REVENUES IN 2005

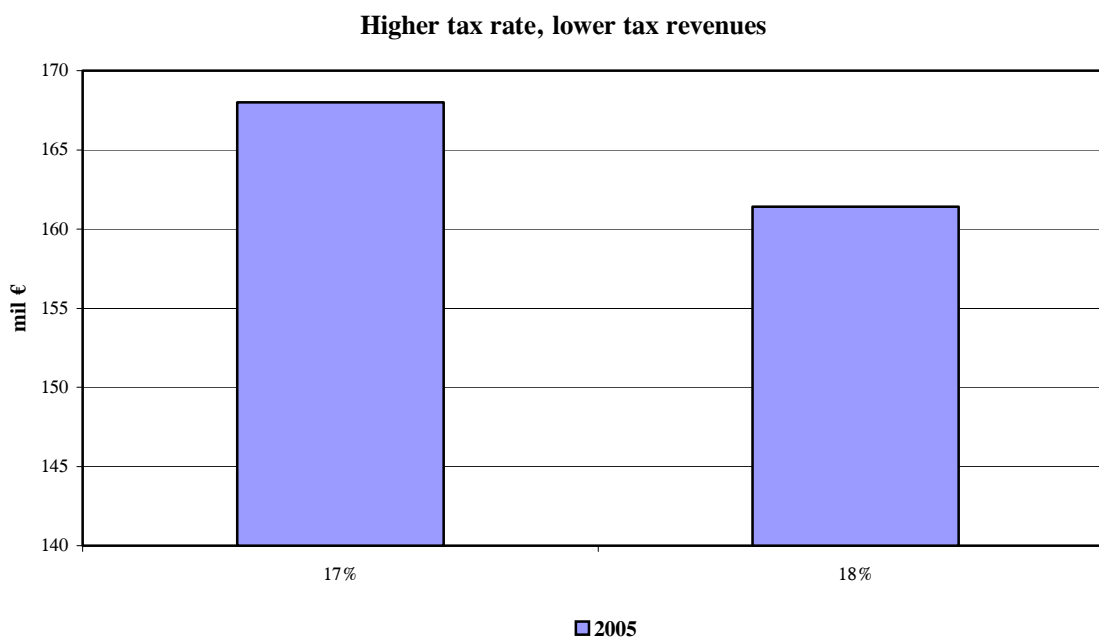
In order to estimate VAT revenues in the coming year, we must start with the assumption that at the end of 2004, planned revenue of € 146.6 million will have been executed (although it is likely that this plan will be exceeded).

Scenario I: Starting from the above mentioned basis, projected rate of inflation and VAT rate of 17%, we will presume that economic activity, primarily value added in the production and turnover of goods and services in 2005, is going to be on the same level as 2004 and that further legalization of the gray economy will not take place (which is not a realistic projection when we consider all of the positive changes that VAT introduction created in the Montenegrin economy). With this, we come to the estimation of VAT revenues increasing by about 4 %.

Scenario II: Certainly, a more realistic and more optimistic scenario is that the value added in the production and turnover of goods and services in the next year will grow at the GDP growth rate of about 4.46%, the trend of reducing the gray economy will continue, and efficiency in VAT collection will improve (the assumption is that revenues on this basis will increase by about 5%). With these assumptions, total VAT revenues will grow by about 14% in comparison with 2004 and would amount to about € 168 million.

Scenario III: If illegal activities do not increase, despite the rate increase to 18%, budget revenues will increase in comparison to 2004 by about 10%, but at the same time, they will be about 4% lower than those estimated in scenario II.

Scenario IV: If, however, the VAT rate increase reduces the number of legally registered entrepreneurs and weakens revenue collection by about 5%, then the Montenegrin budget would reach approximately the same revenue as in scenario I (by which, the efficiency of an increased rate in higher revenue collection would be annulled).



By taking into consideration the specialties of the Montenegrin economy, it is most realistic that scenario II will be reached in practice, and fortunately, this scenario is also the best current solution for both entrepreneurs and the budget.

CONCLUSION:

The worst of all solutions is that Montenegro ends up with a tax base erosion, tax evasion, and an increase of non-formal businesses. VAT is created to be neutral and its use in economic management in any way that is not considered neutral is certainly not recommended.

Instead of that, the goal should be to broaden the tax base, which will offset a likely drop in budget revenues (however, a short-term deficit does not merit such coercion by the IMF and WB) and will provide strong development of the private sector. In addition to broadening the tax base, covering the budget deficit will require tighter discipline on the expenditures side -- especially in the wage and salary policy, direct and indirect transfers to enterprises, and the high costs of administration. Simply, Montenegro is trying to imitate the success of countries such as Ireland, Estonia, and Russia in slashing tax rates. Without tax cuts, economic opportunity in Montenegro is severely limited. The VAT rate increase and other similar requests of international financial institutions obstruct Montenegro on its journey to economic prosperity. The international institutions' attitude toward the Montenegrin initiative brings up an important, and often overlooked, point in developing economics: *reform sustainability*. Only reforms coming from inside a country - not those imposed by outside institutions, are sustained. For that reason, conditions imposed by the IMF and WB are rarely sustained. Therefore, if there is real coercion about the future of Montenegro, these institutions should support the pro-market initiatives instead of imposing its own solutions, which probably will not work in practice.

References:

1. *Guidelines for Fiscal Adjustment*, IMF, Washington D.C, 1995
2. *The Heritage Foundation: 2002, 2003 Index of Economic Freedom*
3. *Mc Dermott C. John, Wescott Robert: Fiscal reform that works*, IMF, Washington D.C, 1996
4. *Nemec Juraj, Wright Glen: Javne finansije, Magna agenda, Beograd, 1999*
5. *Tanzi Vito, Schuknecht Ludger: Reconsidering the fiscal role of the Government, The American Economic Review, Volume 87, 1997*
6. *Tanzi Vito, Howell H. Zoe: Tax policy for emerging markets, IMF Working paper, 2000*
7. *Vukotić Veselin: Makroekonomski računi i modeli, CID, 2001.*
8. *Tait A. Alan: Value Added Tax, IMF, Washington D.C, 1988*
9. *91st Annual Conference on Taxation, National Tax Association, Washington D.C, 1999*
10. *Montenegrin Economic Trends, ISSP*
11. *World Tax Overview, DFK International, 2001*

COMMENT 3***THE LAW ON MORTGAGE******Jelena Janjušević, ISSP***

In order to insure certain requirements, real estate could be burden with the pledge due on the behalf of the creditor (mortgage) that is authorized to, within the regulation, to require the settlement of his requirement from the value of the real estate, before the creditors that don't have mortgage on it and before the creditors that received mortgage on that real estate after him, regardless of the change of the owner of that burden real estate.

In the previous legal framework in Serbia and Montenegro, mortgages were regulated by the Law on Property Rights, the Law on Executive Procedure, and the Law on State Measure, as well as Cadastre and the Right on Real Estate Subscription. Our practice detected deficiencies and defects within these laws, which is extremely expressed in the market economy. In a market economy, to develop bank services, a precise and detailed definition of the mortgage is required, as it is one of the most used instruments for creditor protection. With regards to, it was necessary to harmonize the previous regulation with European and international standards and conventions from this area, thus the Montenegrin Government adopted the Law on Mortgage.

PREVIOUS REGULATION DEFECTS

There were many problems in practice related to the realization of mortgage rights, and they were most expressed in the banking sector. Analysis of the banking practice showed that creditors did not receive satisfactory protection, which stimulated the need for credit to be protected by mortgage. Legal defects refer to the impossibility of the client paying his obligation, therefore, the creditor is deserving of adequate repayment in speedy procedure. What does this mean? If, for example, the bank approves credit over a 5-year period and the client doesn't pay his obligations determined within the Loan Contract, the creditor (bank) could remunerate this claim from the mortgage, which is used as an instrument for credit protection. This can be done in two ways: by public sale or direct deal. The creditor could realize this right after 5 years because the Agency for Real Estate doesn't allow for a creditor to receive ownership on real estate, in the case of non-paying annuities, until the term on which credit was approved has passed.

In that case, the resources of the creditor are captured and the leverage, which is one of the elements in the interest rate calculation, increases, and together with it, interest rates increase. These regulations were in opposition with the interests of the creditors who were not given adequate protection as well as the interest of the clients that could not get credits with the lower interest rate.

Additionally, the previous regulations disabled the efficient satisfaction of the mortgage creditors because the estate couldn't be sold for less than two-thirds of the estimated value without approval of the mortgage client. This solution is opposite to international standards and principles of the market economy. Considering of this problem leads to the creation of a more favorable legal framework for banking services in Montenegro and the adoption of

solutions that are harmonized with market economy principles, which improve economic growth in Montenegro through the increased crediting.

Also, it is necessary to provide much better conditions for foreign investments and adequate legal protection for domestic and foreign investors so that they can realize a mortgage and protect their own rights quickly and efficiently.

Therefore, protection of the client's rights and equalization of his rights with the creditor's rights should be considered. After all, the autonomy of willness exist in both – the creditor and the client in the moment of contract ratification, and creditor couldn't start with the mortgage realization before the client is announced about this action and giving him possibility to pay his debt, as well as possibility to use "legal medicines"¹² in order to protect his rights.

Two years ago, the Law on Pledge, which regulates mobile pledges introduced extra judicial sale in our legal system for the first time. In line with those decrees and positive experiences, as a one of the significant news extra judicial sale is proposed, which is harmonized with international standards.

THE LAW ON MORTGAGE

To address the notified problems, the Government of Montenegro adopted *The Law on Mortgage*¹³ on July 26th 2004. This law regulates the rights, obligations and relations between mortgage creditor and client, the volume and types of the mortgages, the procedure of remuneration, as well as all other issues necessary for efficient functioning of the mortgage right, especially as it relates to the extra judicial execution, which was introduced by the Law on Mortgage as well.

The Law on Mortgage regulates the object of the mortgage and that mortgage could be determined on the future real estate that still doesn't exist (it is not constructed). This article of the Law allow client to obtain faster desirable loans.

The Law allows that one mortgage could be an instrument of protection for some future requirements that might, or might not be developed; i.e. which are developed after the realization of a certain condition.

The law on Mortgage introduced one innovation. Evidence on mortgages is presented on the Internet page of the Agency for Real Estate. This improves notification of third persons on subscribed mortgages, and in that way, stimulates crediting (resources for the realization of this idea are not significant and help from foreign donors is expected). Therefore, the period of construction of the Internet page of the Agency for Real Estate has been set for one year, after which, every subscribed mortgage will be presented.

The requirement could be remunerated in two ways: in extra judicial sale and in judicial sale, in accordance with the Law on Executive Procedure, which is determined in the contract between creditor and client. The creditor could start an extra judicial sale of the

¹²«The Law medication» is a legal instrument which requires decision making second degree and third degree of the Court and Management, that could be used before the decision validity (regular: complaint, protest) or after the decision validity (extraordinary: revision, requirement for legality protection)

¹³ Official Gazette, no. 52/04

real estate, which is burdened by mortgage, after passing the term of 15 days from the moment the creditor announced to client that he will start remuneration. An extra judicial sale cannot be conducted prior to 30 days from the day of the announcement on sale subscription. The mortgage creditor and the client can arrange that this 30-day period be shortened, if every condition related to the announcement on sale is fulfilled. The law assumes that complaining, which could derogate the right on mortgage remuneration in extra judicial procedure, does not prolong the sale process unless the mortgage client has proof that the requirement protected by mortgage was remunerated, the credit did not expire, the procedure regulated by law was injured, or that the mortgage wasn't subscribed according to law.

Adoption of the Law on Mortgage should provide:

- Efficient remuneration of the mortgage creditor,
- Faster remuneration of the requirements,
- Better conditions for crediting, i.e. lower interest rates by decreasing risk coefficient,
- Decreased transaction cost – for the creditor and for the potential client.

With adoption of the Law on Mortgage, together with the existing Law on Pledge and Law on Fiduciary Property Right Transfer, the legal framework in the system of requirements protection of Montenegro is almost finished. However, great part of the capital still stays “captured” in the real estates. This capital doesn't create profit and economic growth. Transferring this capital in mortgage bonds, the property could turn faster into the capital by issuing security on the base of the mortgage land or real estate – *mortgage bond*, which could be traded. This simplifies the bank's position, and according to that influence on creation of the better crediting condition. Exactly that is the one of the failures of the existing Law on Mortgage. However, the Law on Mortgage just began its implementation, it is still early to establish its effects.

COMMENT 4

DETERMINANTS OF UNEMPLOYMENT IN MONTENEGRO

Ana Krsmanović, ISSP

Labor market reform is one of the key areas within a country's pro-market reform. Liberalization in other areas of the economy while maintaining a rigid labor market creates a serious unbalance in the economy and creates a "narrow throat" of economic recovery and successful reforms. Also, taxes are an important factor that influences the fluctuations of economic activity.

In economic theory, different opinions are held on the influence of taxes and employment protection on the labor market. Pro-social oriented economists claim that regulations on the labor market are necessary, as well as more detailed specified rights of workers. On the other hand, there are economists who think that the labor market should be minimally regulated and the majority of rights and commitments should be left to employers and employees to negotiate. Likewise, there are different opinions on the impact of taxes on unemployment, i.e. should the government "take" more to finance the social policy in a better way or with more money, and to spend more on unemployed and to stimulate employment. According to some, government intervention is necessary, while others claim that the more the government takes, the less money remains for investment and job creation.

With Montenegro as an example, we will see how and whether Government intervention influences a decrease in unemployment.

1. UNEMPLOYMENT IN MONTENEGRO

Unemployment in Montenegro is relatively high, over 20%. In the observed 10-year period, the lowest unemployment rate was recorded in 1998, while in 1994 the unemployment rate amounted to 23.2% and estimated unemployment for 2004 is 26.5%, a full 3 percentage points higher.

Table 1. Indicators on the Montenegrin labor market (1994-2004)

	Number of persons employed	Number of persons unemployed	Unemployment rate	Short-term unemployment rate ¹⁴	Long-term unemployment rate
1994 ¹⁵	175,291	52,941	23.2	12.8	10.4
1995	178,868	55,436	23.7	12.2	11.4
1996	183,483	56,477	23.5	11.3	12.2
1997	178,562	57,342	24.3	10.7	13.6
1998	180,365	50,693	21.9	8.8	13.2
1999	184,832	53,340	22.4	7.9	14.4
2000	181,762	54,949	23.2	7.1	16.1
2001	175,242	57,536	24.7	6.3	18.4
2002	177,617	57,688	24.5	5.0	19.6
2003	168,471	62,105	26.9	4.7	22.2
2004 ¹⁶	170,156	61,484	26.5	4.2	22.3

Source: ISSP internal documentation, Labor Force Survey, Federal Statistical Office –1995-2003

¹⁴ Long-term unemployment rate is estimated based on share of registered unemployed that are unemployed over 1 year in total number of registered unemployed. Short-term unemployment rate represents a difference between long-term unemployment rate and total unemployment rate.

¹⁵ Estimate based on existing data

¹⁶ Estimate under assumption that the unemployment will increase by 1% and unemployment decrease by 1%.

Besides high unemployment, the Montenegrin labor market is characterized by a high share of long-term unemployment. In 1994, the short-term unemployment rate amounted to 12.8% and the long-term rate was 10.4%, while in 2004, the short term unemployment rate was 4.2% and the long-term unemployment rate was 22.3%, or more than five times as high as the short term rate for this year. This situation is caused by the high degree of labor market rigidities and points to the serious problems on the labor market.

2. CHARACTERISTICS OF THE MONTENEGRIN LABOR MARKET

Determinants of unemployment could be classified into four categories¹⁷: direct rigidities on the labor market, treatment of unemployed, structure of wage bargaining, and taxes.

Direct labor market rigidities exist if the regulations are rigid and the labor standards are tight. Rigidity of legislation is measured by the **employment protection index**. This index is constructed by OECD and includes regulations related to hiring and firing. All countries are ranked from 0 (very flexible regulations) to 20 (very strict regulations). The value of this index for Montenegro was at 20 for the period up to 2002 and then lowered slightly to 19 in 2003 and 2004, due to insignificant liberalization of the Labor law¹⁸. **Labor standard index** was also introduced by OECD and measures the strictness of regulations related to several aspects of the labor market. The index is based on five characteristics: working hours, fixed term contracts, employment protection, minimum wage, and employees (participation in the work boards, company boards, etc.). Each of these characteristics is ranked from 0 (no regulations) to 2 (strict regulations) and the results are added up. The index has a value from 0 to 10. The labor standard index in Montenegro has been at a value of 8 for the period up to 2002 and then lowered slightly to 7 in 2003 and 2004. In OECD countries, the European countries of Italy, Spain, and Portugal have high values of these indicators, similar to Montenegro, while the U.S. and Canada have the lowest values among the OECD member countries. At the same time, the first group of countries (Italy, Spain, Portugal) is characterized by the highest unemployment rates among OECD members while the U.S. and Canada have the lowest unemployment rates.

The second category of determinants describes the system of social protection of the unemployed, and includes two indicators: replacement rate and active labor market policy. **Replacement rate** is a share of income that is replaced by compensation for the unemployed. In Montenegro, the replacement rate ranges from 33.8% in 1994 to 18.8% in 2004. Comparing data for Montenegro with OECD countries, Montenegro is similar to Italy, whose lowest replacement rate was 20%, while the highest replacement rate is in Sweden, at 80%. **Active labor market policy** pictures government activities that are aimed towards the inclusion of the unemployed into working activities (training for unemployed, assistance in job search, measures for persons with disabilities). Active labor market policy is measured as a percentage of total government expenditures on active policy per person in GDP per person of labor force. Estimated spending for this policy in Montenegro is 3% of GDP per person of labor force in 2004. The spending for active policy in Montenegro is similar to that in the U.S., which is the lowest level among OECD countries. Sweden spends the most – 60% of GDP per person of labor force.

¹⁷ Heitger, B.- The Impact of Taxation on Unemployment in OECD Countries, Cato Journal Vol. 22, No.2, 2002

¹⁸ Reduction in severance payment after firing from 24 to 6 average wages.

The third group of determinants of unemployment is related to wage bargaining in the economy. Indicator of **union density** reflects the share of union members in the total number of employed persons. Following two indicators are **degree of union coordination and degree of employers' coordination** in wage bargaining. For both indicators, the degree of coordination is ranked from 1 (low) to 3 (high). Within OECD, the Northern-European countries have the highest ranks; also, except for Switzerland and the UK, over 70% of the labor force is covered by union membership.

The last group of determinants is related to taxes. There are two alternative indicators: non-wage labor cost and tax wedge on the labor market. **Non-wage labor cost** is defined as the ratio between payroll taxes and wages. For Montenegro, this indicator has ranged from 111.1% in 1994 to 55.9% in 2004. **Tax wedge on the labor market measures** the difference between the total real cost of the labor force and take-home pay; thus, it is considered a better indicator of employers' real burden. In Montenegro, this indicator was 201.2% in 1994 and decreased to 97.6% in 2004. The reason behind its decrease is the shift from progressive to proportional taxation or from an average tax rate of about 31% to a flat rate of 19%. In 2002, progressive taxation was again introduced, but the average tax rate was about 14%. In OECD countries, total burden on the labor market is 51.8% among European member countries, while it is 37.3% for non-European member countries.

3. LABOR MARKET RIGIDITIES, TAXES AND UNEMPLOYMENT

In order to estimate the influence of labor market rigidities and taxation on unemployment in Montenegro we did not use all of the listed indicators. The reason for using fewer indicators is because the selected variables accurately describe the labor market in Montenegro.

To estimate the impact on unemployment, key explanatory variables are used: employment protection index (EPL), non-wage labor cost, tax wedge on the labor market, active labor market policy spending and union density. Table 2 shows obtained results.

EPL, tax wedge on the labor market, and active labor market policy have an important influence on **total unemployment**. All three variables have a positive impact on the unemployment rate, i.e. any increase in these variables causes an increase in the unemployment rate. Further, for every increase in employment protection or level of taxes on the market, unemployment will increase.

Table 2: Regressions for explanation of unemployment (total, short-term and long-term)¹⁹

Equation	OLS ⁽¹⁾	OLS	OLS
	LOG(STUR)	LOG(LTUR)	LOG(UNEMP)
C	-5.627583	0.149249	0.174125
	<i>Lag</i>	(0)	(0)
EPL	0.336933	0.063560	0.136342
	<i>Lag</i>	(0)	(-1)
TAX	0.012166		0.002353
	<i>Lag</i>	(0)	(0)
TAXWEDGE		0.001013	
	<i>Lag</i>	(0)	
UDEN		0.022648	
	<i>Lag</i>	(-2)	
ALMP			0.126998
	<i>Lag</i>		(0)

⁽¹⁾Ordinary least squares method, where STUR – short-term unemployment rate, LTUR – long-term unemployment rate, UNEMP – total unemployment rate, C- constant, EPL – employment protection index, TAX – non-wage labor cost, TAXWEDGE – tax wedge on the labor market, ALMP-active labor market policy spending, UDEN- union density

In the short-term, the unemployment rate positively influences EPL and non-wage labor cost; especially important was the impact that employment protection had. Of course, that means that every increase in labor market rigidities has, as a consequence, an increase in unemployment.

The EPL index and tax wedge on the labor market determine the long-term unemployment rate; they have a positive influence. Every increase in value of these two variables would lead to an increase in long-term unemployment. The third variable that has an important influence on unemployment is union density. This variable also has a positive influence - its increase increases unemployment.

The influence of rigid labor market regulations is known and has been proven through several surveys²⁰ - maintaining a high level of unemployment and an even higher share of long-term unemployment due to the strict regulations that keeps existing jobs. All of the consequences of rigid regulations are present in Montenegro²¹. The influence of high labor cost is simple – according to the commonly known economic logic of supply and demand, it follows that the higher the price, the lower the demand. Regarding the active policies on the labor market, its positive influence on the labor market is that the higher the amount aimed on active policy, the higher the taxes. Higher consumption of the government means higher taxes. An increase in the tax burden leaves less money for investments and therefore, fewer new jobs are created. The positive influence of union density is reflected through upward pressure on salaries, by which demand for labor decreases.

¹⁹ See Box 1 for details on estimated equations

²⁰ See OECD Economic Outlook 1999, www.oecd.org, and Tranzicija i tržište rada u Hrvatskoj, www.ijf.hr

²¹ MONET 15 - New Labor Legislation in Montenegro – Labor Law and Proposal of the General Collective Agreement

BOX 1. Estimated equations for unemployment

Short-term unemployment rate

Dependent Variable: LOG(STUNR)

Method: Least Squares

Date: 11/01/04 Time: 09:10

Sample: 1994 2004

Included observations: 11

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-5.627583	2.588717	-2.173889	0.0614
EPL	0.336933	0.134767	2.500120	0.0369
TAX	0.012166	0.002282	5.330837	0.0007
R-squared	0.883469	Mean dependent var		2.043661
Adjusted R-squared	0.854337	S.D. dependent var		0.398534
S.E. of regression	0.152104	Akaike info criterion		-0.701506
Sum squared resid	0.185085	Schwarz criterion		-0.592989
Log likelihood	6.858284	F-statistic		30.32572
Durbin-Watson stat	1.960940	Prob(F-statistic)		0.000184

Long-term unemployment rate

Dependent Variable: LOG(LTUR)

Method: Least Squares

Date: 11/02/04 Time: 14:08

Sample(adjusted): 1996 2004

Included observations: 9 after adjusting endpoints

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.149249	1.030632	0.144814	0.8905
EPL(-1)	0.063560	0.046665	1.362045	0.2313
TWLM	0.001013	0.000987	1.026670	0.3517
UDEN(-2)	0.022648	0.002838	7.980202	0.0005
R-squared	0.984232	Mean dependent var		2.803370
Adjusted R-squared	0.974770	S.D. dependent var		0.228516
S.E. of regression	0.036297	Akaike info criterion		-3.493063
Sum squared resid	0.006587	Schwarz criterion		-3.405407
Log likelihood	19.71878	F-statistic		104.0296
Durbin-Watson stat	2.526575	Prob(F-statistic)		0.000063

Total unemployment rate

Dependent Variable: LOG(UNEMP)

Method: Least Squares

Date: 11/02/04 Time: 15:02

Sample(adjusted): 1995 2004

Included observations: 10 after adjusting endpoints

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.174125	1.584203	0.109913	0.9161
EPL(-1)	0.136342	0.075584	1.803845	0.1213
TAX	0.002353	0.001096	2.146334	0.0755
ALMP	0.126998	0.036384	3.490463	0.0130
R-squared	0.782022	Mean dependent var		3.182740
Adjusted R-squared	0.673034	S.D. dependent var		0.065755
S.E. of regression	0.037599	Akaike info criterion		-3.434491
Sum squared resid	0.008482	Schwarz criterion		-3.313457
Log likelihood	21.17245	F-statistic		7.175257
Durbin-Watson stat	2.202854	Prob(F-statistic)		0.020715

4. EXAMPLE OF LABOR MARKET REFORMS IN IRELAND AND NETHERLANDS

The unemployment rate in the EU began to increase in the mid-seventies and reached a level of 10% in the mid-eighties. In the period up to 2002, average unemployment was between 8 and 11%, and in 2002, it amounted to 8.6%. In Ireland in 1987, the unemployment rate amounted to 17.5% and in 2002, it decreased to 4.4%. In the Netherlands, the unemployment rate decreased from 11% in 1983 to 2.6% in 2002.

4.1 Ireland

Due to the high unemployment rate (17%), strong wage growth, and low rate of GDP growth in the late eighties, Ireland has decided to reform their labor market. Reforms limited wage growth, decreased income taxes, reduced unemployment benefits, and implemented active labor market policy measures.

The most important initiative was a three-year pact on national wages, which was supported by the union, government and employers. According to this pact, the growth of national wages was limited to 2.5% annually in the period from 1988-1990. According to the national wage pact, Ireland decided to reduce income taxes; the marginal rate in the lowest income bracket was reduced from 35% to 29%, while in the highest income bracket, the rate went from 58% to 48%. Also, the government has increased expenditures on active labor market policy and the benefit replacement rate was reduced from 77% to 64%.

Results of reforms were, obviously, reduced unemployment, higher GDP growth rate, and increased productivity. According to some economists' estimates²², the greatest influence on these results was wage moderation and the decreased tax burden. A measure that did not have any positive influence was the increased spending on active labor market policies.

4.2 Netherlands

Reforms in the Netherlands labor market came to force after the agreement among employers, unions and the government – the Wassenaar agreement in 1982. Rapid wage growth, which was higher than productivity growth, diminished the companies' productivity, causing decreased investment and lower hiring. The agreement anticipated labor market recovery through the limitation of wage growth, decrease of unemployment benefits, and removal of barriers for part-time work.

According to the agreement, the link between wages and inflation was removed (wages were adjusted to inflation growth) and the minimal wage was frozen in nominal terms. Additionally, unemployment benefits were reduced, the replacement rate decreased from 80% to 70%, and the duration of benefits for younger workers decreased from 30 to 6 months. Removal of barriers for part-time work has allowed a large number of females to enter the labor force.

²² Blanchard, Nikell

The Wassenaar agreement resulted in a fast labor market recovery. Studies²³ have shown that the manner of wage moderation was key to the success of reforms, as well as cooperation of social partners – government, union and employers.

5. CONCLUSION

From the above estimations for Montenegro, one can conclude that a high degree of regulatory influences increase unemployment (results for OECD countries indicate the same conclusion²⁴). Rigid labor legislation actually maintains existing jobs and discourages the creation of new jobs. Also, high taxation of income discourages economic activity, which is best seen through the influence of taxes on unemployment – the higher the taxes the higher the unemployment.

If Montenegro wishes to solve their unemployment problem, it has to liberalize the labor market and reduce income taxes. Ireland and the Netherlands can serve as good examples for Montenegrin labor market reform, as they succeeded in reducing the unemployment rate in a relatively short period namely through labor market liberalization and income tax reduction.

Of crucial importance, as seen in the Ireland and Netherlands example, is the joint action by government, union, and employers. In order for labor market reforms to succeed, cooperation among social partners must exist; the determination of government to implement reform and the willingness of the union to support reforms are key to success.

Reference

1. **Blanchard Oliver, Giavazzi Francesco** – *Macroeconomic Effects and Deregulation in Goods and Labor Market*, National Bureau of Economic Research, Cambridge, February 2001. godine
2. **Biondić Iva, Crnić Silvia, Matinić Ana, vedran Šoškić**– *Tranzicija, zaštita zaposlenja i tržište rada u Hrvatskoj*, Ured za socijalno partnerstvo Republike Hrvatske, 2002
3. **Cazes, S. i Nesporova, A.** - *Employment Protection Legislation (EPL) and its effects on Labor Market Performance*, International Labor Organization, High-Level Tripartite Conference on Social Dialogue, Malta, 28 February-1 March 2003
4. **Delibasic, A.** – *Regulacija i deregulacija na tržištu rada*, *Preduzetnička ekonomija*, Volume 1
5. **Gujarati, D.** - *Basic Econometrics*, McGraw-Hill International Editions, 1995. godine
6. **Funck B. i L. Pizzati** - *Labor, Employment, and Social Policies in the EU Enlargement Process: Changing Perspectives and Policy Options*, Svjetska Banka, Washington, 2002.
7. **European Commission**–*Employment and labor market in Central European countries, 2001/1*
8. **Heitger, B.**– *The Impact of Taxation on Unemployment in OECD Countries*, *Cato Journal* Vol. 22, No.2, 2002
9. **Krsmanovic, A.** - *Uticaj radnog zakonodavstva na tržište rada u Crnoj Gori-Indeks zakonske zaštite zaposlenja- Preduzetnička ekonomija*, Volume 2, 2003
10. **Krsmanović, A.** - *New Labor Legislation in Montenegro – Labor Law and Proposal of the General Collective Agreement*, ISSP; MONET 15, 2003
11. **Nicoletti, G., Scarpetta S. i Boyland, O.** – *Summary Indicators of Product Market Regulation with an Extension to Employment Protection Legislation*, OECD, unclassified, 2000
12. **OECD**, *Employment Outlook 1999*.

²³ Nikell and van Ours

²⁴ See Heitger, B. - The Impact of Taxation on Unemployment in OECD Countries, *Cato Journal* Vol. 22, No.2, 2002

13. *Riboud M., Sánchez-Páramo C. i C. Silva-Jauregui-Does Eurosclerosis Mater? Institutional Reform and Labor Market Performance in Central and Eastern European Countries, Svjetska Banka, Washington, 2002.*
14. *Skupština Crne Gore -Zakon o radu (www.skupstina.cg.yu), 2003.*
15. *Službeni list RCG – Zakon o radu, 1995.*
16. *Službeni list RCG – Kolektivni ugovor, 1995.*
17. *Tille, C. i Zi, K.M. – Curbing Unemployment in Europe: Are There Lessons from Ireland and the Netherlands?, Federal Reserve Bank of New York, Current Issues in Economic and Finance, Vol. 7, No. 5, maj 2001.*
18. *Prokopijević Miroslav– Konstitucionalna ekonomija, € press, Beograd 2000. godine*
19. *Vukotić Veselin – Maroekonomski računi i modeli, CID, Podgorica 2001.*

COMMENT 5

PRICE REGULATION IN THE TELECOMMUNICATIONS SECTOR

Milica Vukotic, Economic Faculty, University of Montenegro

1. INTRODUCTION

There is an ongoing process of reform of the telecommunication sector in Montenegro. Agency for Telecommunication is preparing Law on Regulation of Tariffs of Telecommunications Operators. One of the most important aspects of regulation is regulation of prices. There are two main approaches to price regulation: price cap regulation and rate-of-return regulation (ROR). The goal of this paper is to shortly present the problem of regulation in this area as well as to describe rate-of return method of regulation. Price-cap method will be analyzed in one of the following issues of MONET.

2. WHY REGULATE TELECOMMUNICATIONS?

The last decade of the 20th Century saw unprecedented changes in the global telecommunications industry. Numerous state-owned telecommunications operators were privatized, and a wave of pro-competitive and deregulatory telecommunications policies swept the world. New market-based approaches to the supply of telecommunications services were introduced in scores of countries. The liberalization of telecommunications markets was motivated by various factors, including:

- Increasing evidence that more liberalized telecommunications markets were growing and innovating faster and serving customers better;
- The need to attract private sector capital to expand and upgrade telecommunications networks, and to introduce new services;
- Growth of the Internet, which caused data traffic to overtake voice traffic in many countries, and led to the introduction of many new service providers;
- Growth of mobile and other wireless services, which provided alternatives to fixed networks and introduced new service providers to telecommunications markets;
- Development of international trade in telecommunication services, which are increasingly provided by transnational and global service providers.

As market-based approaches were adopted during the 1990s, the number of national telecommunications regulatory authorities increased from 12 to over 90 around the world. To some this appears ironic. *Shouldn't the market-based supply of telecommunications be accompanied by less regulatory intervention, rather than more?*

The consensus answer around the world is yes- in the long run, but no in the short run. The successful transformation of monopolistic telecommunications markets into competitive ones requires regulatory intervention. Without it, viable competition is not likely to emerge.

Regulatory intervention is required for a variety of reasons. Typically, regulators must authorize or license new operators. They must often remove barriers to market entry by new operators. They must oversee interconnection of new entrants with incumbent operators.

Regulatory intervention may also be required to ensure competitive markets do not fail to serve high cost areas or low income subscribers.

3. APPROACHES TO PRICE REGULATION

Different approaches have been developed over the years to regulate telecommunications prices. Some, involving rules-based approaches, are designed to provide stability and certainty, as well as achieving regulatory objectives. Others have been more ad hoc and discretionary.

There are two main approaches to preventing monopolistic infrastructure firms from charging excessively high prices: price cap regulation and rate-of-return regulation (ROR). As aforementioned, this paper will focus on rate-of-return regulation. After detailed analysis of this method we will briefly analyze use of this method of regulation in different countries. Before we proceed with ROR regulations, we will give short overview of discretionary price settings.

3.1 Discretionary Price Setting

Traditionally, in many countries, price regulation was focused heavily on social objectives as well as financial or economic ones. This was particularly true where the government operated the telecommunications network. Under such circumstances, prices were usually set to promote consumer-to-consumer equity objectives. In many countries, there was little or no analysis of the economic impacts of such policies.

Where discretionary price regulation existed, or continues to exist, it is usually characterized by below-cost prices for connection, subscription and local calls. The shortfall is made up by higher-than-cost international call prices, and sometimes also high long-distance prices. The frequently stated objective of this type of pricing is to promote affordability of basic telephone services.

Discretionary price regulation approaches in many countries were interventionist. Often the government or the Minister in charge would micro-manage the PTT's pricing structure, severely reducing its ability to function as a normal business enterprise. In some cases, telephone prices were increased to make up government budget deficits, without extensive consideration of the economic or social impacts of such increases.

Discretionary Price Setting has most often resulted in non-efficient price structure.

3.2 Rate-of-Return Regulation

Rate of Return (ROR) regulation is a rules-based form of price regulation. Unlike discretionary price setting, ROR regulation provides an operator with relative certainty that it can meet its revenue requirement on an ongoing basis. The essence of ROR regulation is simple. First, the regulated operator's revenue requirement is calculated. Then the operator's individual service prices are adjusted so that its aggregate service revenues cover its revenue requirement.

In calculating the revenue requirement, the regulator first reviews the operating costs and financing (e.g. debt service) costs. Typically there is some regulatory scrutiny to ensure that the costs were necessarily and prudently incurred in order to provide the regulated services.

If not, they may be disallowed from the “rate base”. The operator will not be entitled to increase its prices or rates to recover such disallowed costs.

The next step in calculating an operator’s revenue requirement is to determine its rate of return. In order to allow the operator to remain financially viable, and to attract new capital for its operations, ROR regulation permits the operator to recover not only its direct operation and financing costs, but also a fair return on its base. The regulator determines an appropriate rate of return on capital for a given time period (typically one to three years). This return is generally based on a review of financial market conditions, plus any additional operator or industry-specific issue (industry or operator risk, operator specific taxation issues, etc.).

Based on the approved rate of return, a revenue requirement is calculated (i.e. total revenues that may be generated in a given period). The revenue requirement is to be recovered from the sum of all services provided. If an operator earns more than its allowable rate of return, the regulator will require price reductions to bring the operator’s rate of return down to the allowable level. Conversely, if the operator does not meet its allowable rate of return, it will request price increases to raise its revenues.

ROR regulation is designed to equate an operator’s total revenues with its total costs. It is generally not designed to equate revenue for any particular service to the cost of that service. As a result, it does not specifically address the structure of prices. In practice, where ROR regulation is applied, the structure of prices generally tends to fall somewhere between cost-oriented prices and the prices that result from discretionary price setting.

Thus, the basic idea of ROR regulation is that a regulated firm should be entitled to:

1. recoup its expenses dollar for dollar and
2. earn a reasonable profit on its invested capital.

Together these amounts are called the firm’s revenue requirement; this is the amount of money the firm must be permitted to charge its rate payers. Regulators determine the revenue requirement in advance, at the beginning of the year (or, to be more precise, at the beginning of the monitoring period, which can be shorter or longer than one year). The regulator’s task is to set the cost of service high enough for the regulated firm to remain an attractive investment, but not so high that investors are permitted to exploit ratepayers.

In any sensible rate-of-return regime, the firm must be permitted to recover dollar for dollar its out-of-pocket expenses, such as salaries and the day-to-day cost of running the utility. If this were not allowed, the utility would soon go bankrupt, and all would be worse off. Similarly, regulators must allow recovery of taxes, which are merely a specific category of expenses. Regulators must also allow the firm to recover its fixed up-front investment in capital (e.g. building, telephone poles, switches, wire, cable). Deciding exactly which costs should be included in the rate base is quite difficult, and has been the subject of considerable controversy.

Regulators could allow the firm the full costs of any investment on the day made (e.g. if a firm built a \$10 million building, regulators could allow the firm to add \$0 million to its revenue requirement). But doing so would overcompensate the firm; at the end of the year, it would leave the firm with \$10 million in hand, plus a building that, after a deduction for loss of value due to wear and tear or obsolescence, might still be worth, say, \$9 million. Thus, regulators do not allow this- capital investments must be depreciated in small amounts that mimic the underlying asset’s loss of value.

If regulators were to stop here, the firm's investors would simply get their investment back dollar for dollar. Regulators thus cannot stop here if they want to continue to count on investors to furnish the capital needed to run utilities. They must allow the firm a fair return on the base, that is, the total amount of capital the firm invested at a particular time. To entice investors to continue to invest, regulators must set the rate of return high enough to compensate for the risk involved. If they set the rate of return too low, investors will put their money in certificates of deposit or governments bonds instead of utilities' securities. Regulators calculate the rate base by taking the total original value of the assets in service, and subtracting the total amount of depreciation taken on these assets in years before the current year.

The above can be summed up in a brief equation:

$$RR = E + T + d + r(V-D) \quad (4.2.1)$$

RR- revenue requirement

E- operating expenses

T- taxes;

d- depreciation;

r- allowed return on capital

V- original value of the firm's capital equipment

D- accumulated depreciation.

The above equation can be written as:

$$RR = E + \text{fair return} \quad (4.2.2)$$

Where,

Fair return = allowed cost of capital (r) regulatory asset base (or rate base) (RB).*

This results in two problems. On one hand, it is a problem to set the rate level (i.e. the allowed revenue). On the other hand, it is not easy to determine rate structure (i.e. permissible price discrimination which achieves rate level).

Thus,

$$RR = E + r*RB, \quad (4.2.3)$$

How are expenses determined (E)? Company submits detailed cost breakdown of regulated company business. Occasionally excessive expenses can be disallowed e.g. CA nuclear plant, only 20% of cost allowed (company could have put in cheaper alternative technology).

Furthermore, we have already mentioned that one way to calculate the rate base is to subtract total (cumulated) amount of depreciation from the original assets' value. This method becomes problematic when inflation exists.

However, this is not the only way to calculate rate base. There are other, less frequently used methods of calculating of rate base. Rate base could be calculated as replacement cost (modern equivalent asset value), meaning the amount it would cost to replace an asset at current prices.

The rate base can also be calculated as fair valued cost, which is weighted value of previous two methods.

At the end, there is a market value as a way to calculate rate base. However this reflects past regulatory decisions and you are wanting to set rates going forward.

Finally, how the rate of return is calculated? What is the fair rate of return? One of the ways to solve this issue is use of weighted average cost of capital – WACC. Included in the WACC calculation are all capital sources including: common stock, preferred stock, bonds, and any other long term debt. WACC is calculated by multiplying the cost of each capital component by its proportional weighting and then summing:

$$r_{WACC} = \frac{E}{V} * r_e + \frac{D}{V} * r_d * (1 - T_c) \quad (4.2.4)$$

E- The market value of the firm's equity

D- The market value of the firm's debt

V= E + D

E/V- percentage of financing that is equity

D/V- percentage of financing that is debt

r_e – cost of equity

r_d – cost of debt

T_c – the corporate tax rate.

In the WACC formula, there is only one problematic part- r_e. However, it could be calculated relatively easy using the formula for calculating the stock price. Price of a stock (P) reflects the NPV of the dividend stream associated with that stock and the interest rate (r) used to get this is the cost of equity capital.

If dividends grow through time at a rate, g, then:

$$P = \frac{D_1}{1+r} + \frac{D_1(1+g)}{(1+r)^2} + \frac{D_1(1+g)^2}{(1+r)^3} + \dots, \quad (4.2.5)$$

This can be written as:

$$P = \frac{D_1}{r - g}, \quad (4.2.6)$$

From where r can be easily calculated as:

$$r = \frac{D_1}{P} + g. \quad (4.2.7)$$

This represents r_e from the equation (4.2.4).

Once again, it is important to note that the rate-of-return regulation speaks only to the revenue the firm must be permitted to earn. It has nothing to say about how the firm should be allowed to amass the amount.

3.2.1 Weaknesses of Rate of Return Regulation

At first blush, rate-of-return regulation may appear to be a perfect regime: a precise device for accomplishing the goals of rate regulation- to protect ratepayers from exploitation and to protect investors from confiscation. However, the apparent precision of rate-of-return regulation conceals a number of basic problems. They are:

Lack of incentive to minimize costs: In ROR regulation, the operator's prices are set at a level sufficient to cover its costs. This is why ROR regulation is often referred to as "cost plus regulation" (equation (4.2.3)). From a dynamic perspective, therefore, the operator has little incentive to reduce its rate base or its operating costs. In competitive markets, where the market determines price levels, an increase in costs will reduce profits. Therefore cost containment is a major objective of operators in a competitive market. The lack of incentive to minimize costs under the rate-of-return regulation is called X-inefficiency. It leads to another weakness of ROR regulation, which is:

Lack of Innovation/Productivity Improvement: In competitive industries, firms have little control over market prices. Thus, the only way in which they can increase their profitability is by decreasing their costs. One way of cutting costs is to implement new cost-saving technologies. Competition thus tends to spur constant technological innovation. Firms subject to rate of return regulation are not subject to any of these cost-reducing pressures, and therefore tend to innovate less than desirable. Indeed, such firms are under something of an incentive not to innovate, because implementation of untested technology risks regulatory disallowance (i.e., regulators may exclude overly innovative expenses from the rate base).

Capital Bias- The Aversch-Johnson effect: ROR regulation provides incentives to increase the amount of capital that the operator invests. The higher the capital expenditure, the higher the rate base, and the greater the total return the operator can earn (equation (4.2.3)). It therefore encourages the operator to use an inefficient input mix. The operator will have an incentive to use an inefficiently high capital/labor ratio for its level of output. This result is often referred to as the Aversch-Johnson effect, named after two economists who described it. The effect is an indication that productive efficiency is not being maximized, and of course high price consumers pay.

Cost of regulation: ROR regulation requires the operator and the regulator to spend significant amounts of time and money. The rate base must be repeatedly calculated by the operator and reviewed by the regulator; the cost of capital must be recalculated, and so on. Rate reviews or hearings must be held on a regular basis, incurring costs to the regulator, the operator, and other participants in the process. "Armies" of lawyers, economists, accountants, are needed in order this regulation to function. The society could have been in better off if these efforts were put in a more productive use.

Interventionist Nature of ROR Regulation: The regulator is required to review many aspects of the operation and management of the firm in a detailed manner. This includes scrutiny to prevent rate base "padding". Over time, this type of detailed regulation may place a regulatory burden on the firm that impedes its ability to function as a normal business enterprise.

The potential for anticompetitive behavior by regulated firms: Some anticompetitive behavior takes the form of nonprice favoritism; however, most is price related, including the pricing of competitive services at unreasonably low levels (competitive underpricing), the use of

revenues from less competitive services to financially support (cross-subsidize) more competitive services, and the overpricing of bottleneck services, including those used by competitors.

When a firm is subject to competition in at least one segment of the industry but still enjoys monopoly power in at least one other segment, it has strong incentives to use the revenue from one or more of its quasi-monopoly services to offset the cost of one or more of its quasi-competitive services, thereby allowing the firm to price the latter service(s) "below cost." Whether or not this practice qualifies as "cross-subsidizing" as that term is technically applied in the economics literature, it is certainly disturbing and potentially undesirable.

More generally, a problem exists whenever an integrated firm operating in both quasicompetitive and quasi-monopoly markets takes advantage of opportunities to shift costs from the former to the latter category, to overprice its less competitive services, and/or to underprice its more competitive services. A generic term for these practices, including those which fall within the strict definition of *cross-subsidization* and those which do not, is *anticompetitive pricing*, meaning that the integrated firm is strategically pricing its services to exploit the market power it has in the less competitive markets. The goal may be to deter competitive entry, to gain a competitive advantage, or to maintain dominance in a potentially more competitive market.

As long as these firms remain vertically integrated mixes of quasi-competitive and quasimonopoly operations, they will have incentives to engage in anticompetitive pricing.

Similarly, opportunities for cross-subsidization and competitive underpricing will continue to exist wherever the integrated firm provides both quasi-monopoly and quasicompetitive services using joint or common resources. The costs of these resources (e.g., personnel, equipment, services) are referred to as *joint or common costs*.

Thus, the main weakness is that it does not provide operators with a strong incentive to operate efficiently by reducing their operating costs. They can usually recover most if not all of their costs through rate increases, and they are not permitted to retain additional profits earned by reducing their costs. As a result, ROR regulation does not promote the efficiency objectives of price regulation as well as other forms of regulation.

The perceived inefficiencies of ROR regulation must be put into perspective. The reality is that operators in some industrialized countries performed relatively well under ROR regulation for nearly a century, taking advantage of gains in technology and sharing the benefits with their customers in the form of lower prices. Nevertheless, because of the identified weaknesses; many regulators in industrialized countries have been introducing forms of incentive regulation instead of ROR regulation.

Concerns about the inefficiencies of ROR regulation arose in industrialized countries after extensive networks have been constructed. The most important objective in many developing countries is to build infrastructure to meet unsatisfied demand. This will typically require a very large capital investment. As a result, the concern about ROR regulation emphasizing capital investment is not as significant a concern in developing countries. The political and economic environment in many developing countries minimizes differences between ROR and incentive regulation. In fact, any economically sustainable form of rules-based price regulation would be preferable to the ad hoc forms of discretionary price setting currently practiced in some developing countries.

3.3 ROR-Incentive Regulation

The term ROR-incentive regulation is generally used to describe variations on ROR regulation that were developed in different countries in order to avoid weaknesses of traditional ROR regulation. The idea of incentive regulation is almost as old as ROR method. First writings regarding this issue appeared prior to First World War²⁵, but they did not have significant impact. Up to 1960s similar ideas were not widely accepted. ROR-Incentive regulation is extensively used in many US states. It has enjoyed limited popularity in other parts of the world.

Thus, any scheme that attempts to avoid the main problem with rate of return regulation is a form of incentive regulation. The essential feature of incentive regulation is that the shareholders and/or managers of the regulated firm are better off if production costs are reduced, at least under some circumstances. Effectively, therefore, the term incentive regulation refers to methods under which the firm is paid to be more efficient.

Incentive regulation provides inducements and penalties that encourage an operator to meet regulatory goals.

The different types of incentive regulation generally share the following elements:

- The operator often participates in setting goals or performance targets;
- The operator is given more flexibility than under traditional ROR regulation. The regulator typically does not prescribe specific management actions. For example, the operator may be rewarded for reducing its operating costs but not told exactly how to reduce costs.
- The regulator restricts some activities of the operator.
- Rewards and penalties established by the regulator motivate the operator to perform efficiently.

3.3.1 Types of ROR-Incentive Regulation

In this Section, we summarize some of the incentive-based regulatory schemes that have been implemented in the US telecommunications industry. These forms of regulation typically replace traditional ROR regulation.

Banded Rate of Return

Under this form of incentive regulation, regulators establish a range (or band) of authorized earnings. Prices are set to generate earnings that fall within the authorized range. When only a narrow band of earnings is permitted, the operator's incentives are similar to those created by traditional ROR regulation. A broad band of earnings can create stronger incentives for the operator to reduce operating costs and improve operations. For instance, rather than set the rate of return at 12%, the operator might be allowed a return of between 10% and 14%.

Rate Case Moratoria

RCM can be implemented by agreements between a regulator and an operator to suspend regulatory scrutiny of the operator's earnings for a fixed period. This form of incentive

²⁵ R. Whitten, "Regulation of Public Service Corporations in Great Britain", Public Service Commission of New York, 1913.

regulation is often used at the beginning of a transition to price cap regulation. It gives the regulated operator an incentive to lower operating costs, since it may retain higher earnings during the transition period.

Earnings-Sharing

Under the earnings-sharing plan, the operator may retain higher earnings. However, earnings in a specific range are shared with consumers. Typically, these plans are set up with different sharing ranges based on prescribed ROR. These sharing ranges can differ substantially from plan to plan. In one example of this type of plan, the regulated operator keeps 100% of the earnings up to 10%, the operator and consumers split earnings between 10% and 14%. The operator's earnings are capped at 14%.

4. ROR IN PRACTICE

The rate-of-return approach is used in Canada, Japan, and the United States. Over the past decade or so, the price cap approach has become increasingly common internationally because it is thought to give firms stronger incentives to be efficient. It has been introduced in Great Britain in 1985. Price-cap regulation was developed to address weaknesses of traditional ROR regulation. As we could see, firms under the ROR regulation do not have an incentive to lower the costs. Price-cap regulation is not based on costs of individual companies. Indeed, price caps are recalculated each year based on change in inflation and productivity between telecommunication sector and the rest of the economy. Thus, if operator performs above average, measured by increase in productivity, it will enjoy profit increase which will not be taken away by regulatory company.

Since price-cap is not based on costs, it eliminates incentives for cross-subsidization. Moreover, issues regarding costs allocation are not resent since prices are not costs based.

Currently, it seems that price-cap regulation could significantly replace ROR regulation in the USA. FCC (Federal Communication Commission) has introduced price cap regulation for AT&T in 1989, and it seems clear that it will do the same for Bell. However, FCC regulates only one third of telecommunication companies in the USA. Other companies are regulated by state regulators. Though, there are different opinions about this issue. Still, in 1989, California, one of the most advanced states regarding to regulatory policies, has introduced price-cap regulation in 1989. Some other states have introduced either price-cap regulation or some similar methods.

The FCC has stated:

“We have every reason to expect, moreover, that the telecommunications industry will continue to be marked in the future by the same steady technological advancement it has demonstrated in the past. This will lead to greater competition than at the present. We conclude, therefore, that it is prudent to implement regulatory systems that are better able than rate of return to operate effectively in an environment marked by competition and technological change. “

4.1 How the Method of Regulation Influence Level of Risk Borne by Shareholders and Investors?

Given the fact that new investment is crucial for improvement of service quality, this is a very important aspect when one decides on regulatory mechanism he is going to use. This aspect can show that price cap regulation is not as powerful as it can seem. Latest studies show that investors bear the greatest risk under the price cap regulation, and smallest under the rate of return regulation.

In particular, a price cap subjects businesses to more risk. For example, under price cap regulation, if a firm's costs rise, its profits will fall because it cannot raise its prices to compensate for the cost increases—at least until the next price review, which may be several years away. Under rate of- return regulation, however, the business would seek—and typically be granted within a year or so—a compensating price rise, so its profits would not change much. But if the firm's costs fall, price cap regulation is more advantageous to the firm than rate-of-return regulation, because it would retain more of the resulting benefits as profits. Thus, under rate of- return regulation, consumers bear some of the risk that firms bear in price cap systems. This difference in impact means that firms subject to price cap regulation have a stronger incentive to lower their costs because they keep more of the cost savings than they would if they were subject to rate-of-return regulation. But the increased risk they bear tends to raise their cost of capital.

The following table shows methods of regulation used in various countries:

Country	Regulation	Beta
Canada	ROR	0.31
Japan	ROR	0.62
Sweden	Price cap	0.50
Great Britain	Price cap	0.87
USA	Price cap (AT&T)	0.72
	ROR (other)	0.52

The third column gives the value for beta. Betas are used by investors worldwide and are an important factor in their decision-making. A firm's beta measures the extent to which the firm's returns vary relative to those of a diversified portfolio of equity holdings. It indicates whether an investor with a diversified portfolio would take on more risk by investing in a particular firm. The higher the beta, the bigger the increase in the riskiness of the investor's portfolio.

Several studies that compared the betas of British firms subject to price cap regulation with those of U.S. firms subject to rate-of-return regulation found that the U.S. firms have lower betas, as expected. This is the consequence of afore-mentioned fact that firms under the price cap regulation bear part of the risk which under the ROR regulation is borne by consumers. It means that regulators need to take account of the effect of regulation on the cost the regulated firm has to pay investors for capital. Regulators using rate-of-return regulation can set the target rate of return lower than that earned by the average firm and still expect investors to be interested, because the returns are subject to less risk than those of an average firm. Regulators using price cap regulation need to give firms under their jurisdiction the opportunity to make somewhat higher returns, because those returns are riskier. If they don't, the firms will be unable to attract new investment capital, and the quality of their service will eventually suffer.

CONCLUSION

As it was stated earlier, the main goal of this paper was to describe ROR method of regulation, its advantages and weaknesses. In order to describe this method, we had to explain some other categories, including other methods of regulation. After the review of price-cap regulation, one should be able to make clear difference between these two methods, as well as to recognize advantages of both methods.

To conclude, ROR method has been introduced at the end of XIX century. It functioned very well for a certain period of time, under the conditions different from ones we have today. Due to the technological improvement and introduction of competition in telecommunication sector, weaknesses of ROR regulation became evident and new methods of regulation were introduced during the past two decades. However, ROR regulation should not be a priori rejected. Before decision making, the impact of the method of regulation should be examined in existing business environment. As we could see, some of the weaknesses of ROR regulation do not show up in developing countries.