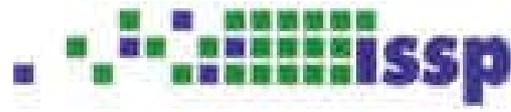


MONET



MONTENEGRO ECONOMIC TRENDS



April 2003

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

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ABOUT CEPS

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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

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Events

December 2002

05. *In Niksic the first branch office of the Opportunity Bank was opened.*
05. *Regional Conference about electricity in Montenegro and Southeast Europe.* Institute for Strategic Studies and Prognoses organized in Podgorica an International Conference about electricity whose main goal is the exchange of experiences and a better understanding of problems in the electricity sector in the Republic and in the Region.
06. *Adopt text of Constitutional Charter.* The Commission for writing the Constitutional Charter of State Union between Serbia and Montenegro unanimously adopted the text of the Constitutional Charter.
10. *Approved budget for 2003.* The budget expenditures in Montenegro in 2003 will be €431mn, €88mn or 25% more than last year.
12. *Montenegro Business Alliance (MBA) opened its Podgorica office.* Montenegro Business Alliance, which assembles Montenegrin small and medium business, opened an office in Podgorica. Two branch offices already exist in Kotor and Budva.
13. *Approved trade by shares (investment units) of Privatization Funds.* Commission for Securities adopted the regulation about issuing investment units of Funds and regulation about transformation Funds into Joint Stock Companies. These rules allow citizens who entrusted their investment units to the Funds to trade them.
17. *Industrial production increase in November.* According to Republic Statistical Office data, industrial production in Montenegro in November continued its upward trend that began in July. Production in November 2002 was 17% higher compared with an average monthly production last year, and 10% higher compared with the same month last year.
17. *Inflation in Montenegro 18%.* According to an announcement of the Statistical Office in Montenegro, the average level of prices in Montenegro in the first eleven months of 2002 were 18% higher than compared to the same period of 2001.
17. *Montenegro Business Alliance opened its branch office in Herceg Novi.*
18. *Agreement on half of the text of the Constitutional Law between Serbia and Montenegro.* Constitutional Commission in Belgrade put together half of the text of the Constitutional law for implementation Constitutional charter.
18. *Loss in Niksic Brewery as a consequence of strike.* In 2002, Niksic's brewery "Trebjesa" registered a loss in the amount of €1.5mn and a decrease in production by 40% compared to 2001. The main cause was the strike in the Brewery.
22. *Presidential elections held in Montenegro.* Presidential elections in Montenegro failed. About 46% of the Montenegrin citizens came to the polls, slightly below 50% plus one citizen required by the Law. The elections will be repeated in February.
23. *Privatization of Niksic's Ironworks.* Board of directors in Niksic's Ironworks accepted privatization plans of the factory and adopted the Information Memorandum, which will be delivered to the Privatization Council. After that, the international tender will be announced. Two Ironworks, one from Italy and one from Greece, are interested in the purchase of Niksic's Ironworks.
30. *European Agency for Reconstruction defined the Budget for 2003.* European Agency for Reconstruction defined the budget for 2003. Of the total budgeted amount, Montenegro will receive €12mn.

January 2003

- 04. Inflation rate projected at 8% in 2003.** *The Central Bank of Montenegro announced that the inflation rate in Montenegro in 2003 is projected to be 8%. The underlying inflationary factors were the expected growth in the price of electricity, an increase in the minimum wage and a new tax laws.*
- 06. Electricity contracts signed.** *Electricity Company in Montenegro signed contracts to purchase about 1.3 billion kilowatt-hours of electricity with three companies: London's EFT, British Sempra Energy Aurora and Croatian Montmontaza.*
- 06. At the Economic Faculty the traditional Christmas Lecture about Economics was held.**
- 16. Average price level higher by 17.4%.** *According to the Montenegrin Statistical Office, the average price level in Montenegro in 2002 was 17.4% higher than in 2001. Retail prices in December 2002 were 9.4% higher than in December 2001.*
- 19. Tourism revenues in 2002 at \$102.7mn.** *According to the announcement of the Ministry of Tourism, tourism revenues in 2002 amounted to over \$102 mn or 22.4% higher than last year.*
- 25. 95% of old foreign currencies savings of Montenegro Bank and Jugobanka returned to the customers.** *Central Bank in Montenegro announced that on January 22 the Settlement and Payment Office paid 95% of old savings in foreign currencies of the Montenegro Bank and Jugobanka from Podgorica (both of which went bankrupt). Total amount that was paid is €1,823,811.74, and the number of savers that took advantage of this payment is 4,641.*
- 28. Increase in industrial production in December 2002.** *According to the Republic Statistical Office, industrial production in Montenegro in December of 2002 increased by 20.9% compared to an average level of monthly production in 2001, by 3.3% compared to November same year and by 1.6% compared to December of 2001.*
- 29. Constitutional Charter and Law for Constitutional Charter Implementation adopted.** *Parliament of the Republic of Montenegro adopted the Constitutional charter of the State Union between Serbia and Montenegro and Law for Constitutional Charter Implementation.*
- 29. Regional Business Center opened in Bar.** *National Agency for Development Small and Medium Companies signed the contract with the Municipality of Bar for opening a Regional Business Center.*

February 2003

04. *International Tender for sale of the Montenegro Banka completed.* The tender for sale of the Montenegro Banka which was opened by the Tender Commission of the Privatization Council, resulted in only a single offer coming from the Nova Ljubljanska Bank.
04. *The State Union between Serbia and Montenegro was formed.* The deputies from the Federal Parliament adopted the Constitutional Charter and law for its implementation. This law abolishes the name 'Yugoslavia', and introduces the name 'State Union of Serbia and Montenegro'.
05. *Ten offers for privatization of eleven Hotels.* On tender for privatization of eleven Hotels came ten offers – nine for Hotels "Budvanska rivijera" and one for sale "Ulcinjska rivijera". Privatization Council opened these offers.
06. *Announced tenders for "Livnica" and "Optel".* Agency for Reconstruction and Foreign Investments announced a tender for sale of the 87% of Niksic's "Livnica" shares and about 28% Pljevlja's "Optel" shares by batch sale method.
08. *Increase in tourism revenues in Montenegro in 2002.* According to the Statistical Office, the number of foreign tourists that visited Montenegro last year was 25% larger than in 2001, while the number of domestic tourists was 9% lower. Revenues from tourism until the end of November 2002 were 32.5% higher compared with the same period in 2001 and amounted to € 112.5mn.
08. *Repeated Presidential Elections in Montenegro.*
10. *Presidential Elections in Montenegro failed again.* Elections for President in Montenegro failed for the second time. Just 47.7% of the Montenegrin citizens came to the polls, so the law for selection of President of Republic was not fulfilled. This Law requires a turnout of at least 50% plus one citizen that possess passive electoral rights. In view of the second failure, the 50% turnout requirement has been lowered to 25%.
12. *Privatization revenues at € 71.4 mn.* According to the Privatization Council of Montenegro, the total value of shares and company assets sold to investors amounted to €71.4 mn last year. The sale of shares and company's assets on Public tender accounted for 96% of this figure (or €68.5 mn).
11. *European Bank for Reconstruction and Development became shareholder in the Euromarket bank.* European Bank for Reconstruction and Development and the Euromarket Bank signed two contracts worth €4.5 mn. The EBRD will invest €1.48 mn. in the Euromarket bank and extend a credit line for small and medium businesses worth € 3 mn.
13. *The Law about Indirect Elections of Deputies was adopted in the Parliament of Serbia and Montenegro.*
13. *Trade of securities at €130 mn. in 2002.* According to the Commission for Securities, trade with securities in 2002 reached the amount of € 130 mn. € 14.3 mn of that was realized on the stock exchange, €3.6 mn were related to presents and inheritance, exchange between Investment Funds accounted for €25.2 mn, trade with treasury bills of Central bank accounted for €58.6 mn and total emission for €29.9 mn.
18. *Industrial production in January 2003.* Statistical Office in Montenegro announced that in January 2003 industrial production was 17.2% higher than in the same month last year. Compared to December 2002, industrial production decreased by 23.6%.

19. ***“Mercur” gave the best offer for “Mogren” and “Imobilia” for “Belvi”.*** Tender Commission of Privatization Council made a ranking of the received offers for buying seven Hotels on the Montenegrin coast. The offer of Budva’s company “Imobilija” was ranked the highest by the Tender Commission. The Commission ranked the offer of “Mercur” from Budva as the best for buying Hotel “Mogren”,
20. ***Trade deficit amounted to € 434 mn in 2002.*** According to the Central Bank of Montenegro, the value of imports in 2002 was \$739 mn, which is 15% more than in 2001. Montenegrin export in 2002 was \$305 mn, 46% more than in 2001. The resulting trade of goods deficit was \$434 mn.
25. ***Increase in petrol price.*** The newly privatized Jugopetrol announced a price increase of its fuel products. The increase will amount to 14% for diesel oil and 6% for gasoline
25. ***The Charter about Human and Minority Rights was adopted.*** Constitutional Commission, after eight months, finished its work by adoption of the Charter about human and minority rights and citizens’ freedom.
26. ***Agreement about Cooperation between Employers’ Unions in Montenegro and Albania.*** Union of Employers in Montenegro, Confederation of Employers in Albania and Union of Industrial and Trade Chambers of Albania, signed an agreement of long-term cooperation in Albania.
28. ***Wages of employees in the education sector to increase by 8%.*** Ministry of Science and Education announced that wages for employees in education will increase by 8%, and that their coefficients will increase by 10%.

Executive Summary

First section

The average level of **industrial output** was 0.74% higher in 2002 than in 2001, while the average annual growth of industrial output was 1.2%. *Processing industries* (with 60% share of aluminum output) registered an average annual growth rate of about 2.3% in 2002 compared to 2001. Considerable improvement (16% average annual growth) has been registered in the sector of *electricity, gas and water supply* thanks to higher electricity generation. The *mining and stone extracting industry* has registered an average annual growth rate of about 17%.

The number of **tourists** in 2002 has dropped slightly compared to 2001, albeit the share of foreign tourists among the total tourist population is constantly increasing. The level of *transport* services was lower in 2002 than in 2001, mainly due to slumps in road and sea transportation.

Real GDP increased in 2002 by less than 1% which represents a slow-down over 2000 and 2001 where the growth amounted to 4%. Joint ISSP/USAID real growth forecasts predict 1.5% growth in 2003 and above 4% growth for 2004-2006.

Official **unemployment** rates have not improved during 2002 and have been in excess of 40%. However, the ISSP household surveys indicate that the actual unemployment was about 20% in 2002 and was lower than in 2001. No data on average **wages** have been available after June 2002. Nominal wages have been fairly stable in the first half of 2002, while real wages were deteriorating due to high price growth. Annual dynamics of real wages was negative since March 2001 until June 2002.

Inflation has been falling throughout 2002 and 2003, the annual dynamics of the CPI (cost-of-living) fell from 18% in January 2002 to 8.4% in December 2002 and further down to 7.2% in February 2003. The lower price growth of food, tobacco and alcohol, transport and telecommunications, and accommodation are the main factors that helped to lower inflation. Inflation forecasts are burdened with serious uncertainty concerning the effects of VAT introduction, extent of increased tariffs in view of the harmonization with Serbia, and world oil prices. 2003 year-end inflation forecasts range from 8% to 17% on an annual basis.

The **budget policy in 2002** can be considered rather restrictive. Both expenditures and revenues were below the planned level. The budgetary expenditures were roughly in line with total revenues (including grants) and lower revenues forced the Government to reduce some expenditure categories or postpone its obligations. The overall budget balance in 2002 (excluding grants), calculated as the difference between total revenues and total expenditures and net lending, was - €24.3 million on a cash basis, which represented close to 2% of GDP. If grants are included the budget balance turns positive and amounts to €2.6 million on a cash basis.

The **Budget for 2003** represents numerous changes in comparison with previous budgets. The new tax laws (e.g. VAT) changed the system of tax collection on the revenue side and added new obligations for the Union budget and a new method of transfers to the extra-government units on the expenditure side. In line with projected revenues and expenditures, the overall budget deficit, excluding grants for 2003, is predicted to exceed €70 million. As grants are planned to amount to €23.2 million, a deficit of €47 million remains, this is projected to be financed through privatization receipts as well as domestic and foreign credits.

Money supply aggregates, M1 and M2 have been fairly stable throughout 2002, mostly due to the stability of cash estimation held constant at €310 million since January 2002. Roughly 75% of M2 is cash, over 20% are demand deposits and less than 2% are term deposits. Positive tendencies have been observed for household deposits as the total amount of deposits has more than tripled in 2002 and the share of longer-term deposits has grown visibly throughout the year. Loans have also increased visibly over the same period.

The turnover and number of transactions in 2002 indicates that the Montenegrin **capital market** is expanding, primarily thanks to the secondary market whose size was negligible last year. The majority of turnover (58%) was associated with emissions in the primary market, while the vast majority of transactions involved shares of the Mass Voucher Privatization process and took place in the secondary market.

Montenegrin **foreign trade** continues to be highly concentrated in a few sectors. In 2002, it was concentrated in oil and oil derivatives, fruit and vegetables and construction materials on the imports side¹, and aluminum, oil and oil derivatives (re-export) and transportation equipment on the export side. Partners in the region (especially Serbia and Kosovo) visibly increased their share in foreign trade in 2002.

The **current account** deficit in Montenegro in 2002 amounted to €166 million or 14% of GDP, which is less than in 2001 when the deficit amounted to €199 million (or 19% of GDP). Total revenues were equal to €704 million, or 12% more than in 2001, while expenditures were equal to €871 million or 5% more than in the previous year. The current account deficit in 2002 was partly balanced by the surplus in the capital and financial account in the amount of €106 million.

Real GDP growth was positive in all countries in **Southeastern Europe** in 2002, albeit it fell on average by about 0.5 percentage point in comparison with 2001. The growth rates ranged from 0% in Macedonia and less than 1% in Montenegro to 6% in Albania. In 2002 industrial output was slightly up and inflation was down as compared to 2001. Unemployment was stable and trade as well as current account balances worsened across the region.

Second Section

Economic Reform Agenda 2002-2006 in Montenegro

The paper takes a close look at the Economic Reform Agenda 2002-2006 in Montenegro. It includes a thorough discussion of the goals, expectations, specific targeted macroeconomic parameters (such as GDP growth, inflation, etc.), pillars of the program (such as entrepreneurship and investment), and it provides a detailed list of the areas in which reforms should take place.

Barriers to doing business in Montenegro

In 2002 the Center for Entrepreneurship and Economic Development (CEED) from Podgorica maintained the second “Barriers to Doing Business in Montenegro” survey. The study identifies barriers that are blocking business development in Montenegro, and offers recommendations for their elimination. The main findings of this study are presented in the articles. It can be interesting to all who strive to eliminate the existing barriers for business development in Montenegro and especially to those who currently disregard the obstacles and strive for the best results in their area of business.

Bolder strokes

In this issue you have the opportunity to read the article “Bolder strokes” by Richard W. Rahn published in April in the Washington Times. Mr. Richard W. Rahn is a senior fellow

¹ excludes trade with Serbia

of the Discovery Institute, and an adjunct scholar of the Cato Institute. The article is about tax debate in USA but it has more general message explaining what should be the role of the government in all times and in all places.

Accountability of private sector and efficient information allocation in corporate governance

The paper poses important questions about the accountability in the private sector. Will directors of private companies adhere to opportunistic behavior and what will be the forces to prevent or encourage them to attempt that? On the one hand, the invisible hand of the free market creates schemes to prevent it (takeovers for example). On the other, regulators are more and more becoming aware of this and they seem to be guided by the idea that reputation will be sufficient to prevent opportunistic behavior. Auditing practice had been founded on this principle. The main issue is whether directors' discounting of future allows reputation to enter the game.

Minimum wage in Montenegro – a dangerous concept

The minimum wage policy in Montenegro goes beyond the standard provisions and has many more far-reaching consequences for the economy that are not commonly found in other countries. There are a number of links between the minimum wage and the average wage in the economy where the causality strongly runs from the minimum wage to the average wage level. These links include (but are not limited to) formulating many wages in the economy as multiples of the minimum wage and linking the fringe benefits with the minimum wage. This introduces considerable rigidities in the labor market, increases the labor cost, and thus impedes investment and hinders economic growth. Therefore, the policy concerning the minimum wage in Montenegro should be verified as soon as possible and many links between this wage and other wages and benefits in the economy should be dismantled.

Why is Montenegrin inflation so high?

Consumer price inflation in Montenegro has stood at double-digit levels on an annual basis from February 2000 until November 2002. This is particularly surprising since the country has adopted the DM as its currency in January 2000 and switched to the euro 2 years later. The paper takes a detailed look at disaggregated price changes to conclude that there are many examples of monopolistic behavior and price hikes that take place whenever importers and/or retailers can take advantage of initial cognitive problems. A clear example of such behavior is the price hikes that followed the introduction of the euro and, more recently introduction of the VAT.

Economic Freedom in Montenegro

Main feature of the transitional institutional framework is a gap between old inefficient institutions from the socialistic period and the needs for establishing new rules and institutions coherent with the free market-based economy. "Social engineering" is necessary in order to establish new rules. Regardless of inherited problems, overrunning of low level of efficiency is possible only on basis of the principles of the openness and free property rights exchange. Access to sound money, low level of the regulation, minimal governmental action and free international exchange of goods and services are the most important principles in building new institutional framework.

Electricity Futures Market

The article has very interesting subject that has attracted a lot of attention in the last few years, the economic efficiency of non-petroleum energy markets, such as coal, electricity and gas. It analysis the basic characteristics of this markets and establishing of the model. In addition this article is trying to give the answer to the question "is it possible to implement this model in montenegro".

PART 1

Chapter 1. Output

Table 1.1. GDP, Industrial Production and Tourism

GDP (4)		INDUSTRIAL PRODUCTION							TOURISM					
		Total (1)		Process ing industri es (1) annual change in %	Electri city, gas and water (1) annual change in %	Mining and stone extracti ng (1) annual change in %	Alumin um product ion (2) (ton)	Electricity generation (3) (in MWh)	Persons	Annual change in %	of which foreign			
1990= 100	annual change in %	persons	annual change in %								share in total in %			
1990	89.0	100.00												
1991	70.0	86.75	-13.0			102 256	2 963 675							
1992	61.0	69.80	-19.66			89 165	2 312 621							
1993	39.0	39.66	-42.84			38 104	1 694 769							
1994	39.0	36.00	-6.35			10 574	1 997 483							
1995	46.0	35.51	1.28			26 071	1 504 302							
1996	57.0	52.82	50.99			51 178	3 102 091							
1997	61.0	53.63	2.98			80 600	2 276 868							
1998	64.0	54.04	2.03			76 737	2 713 936							
1999	58.0	49.71	-6.37			80 936	2 711 929							
2000	60.3	51.34	4.63			95 526	2 698 019	448 187		73 559				
2001	62.7	50.29	-0.33	1.4	-3.5	10.4	108 123	2 492 993	555 040	6.1	108 808	27.7	20.8	
2002	63.2	50.66	1.23	2.3	16.0	17.0	116 482	2 194 516	533 715	4.4	134 282	25.9	24.8	
2001-Q1		53.18	14.92	2.1	8.3	-10.9	26 060	952 441	35 067	90.5	7 075	114.6	6.7	
2001-Q2		48.50	-18.15	-0.3	6.6	21.4	26 610	524 536	97 744	102.2	19 901	114.0	7.4	
2001-Q3		44.69	-2.48	2.3	-11.2	-12.7	27 778	267 701	387 023	139.7	74 561	173.1	6.7	
2001-Q4		54.78	29.97	-1.1	-2.1	6.5	27 675	748 315	35 206	95.7	7 271	106.2	6.9	
2002-Q1		45.17	-15.62	-0.6	-15.3	10.7	26 619	507 743	33 292	94.9	6 988	98.8	7.0	
2002-Q2		45.69	-4.29	1.5	-13.9	5.5	29 513	265 271	118 958	121.7	31 122	156.4	8.5	
2002-Q3		51.87	12.84	1.0	38.8	7.4	30 105	501 282	352 718	91.1	88 573	118.8	9.0	
2002-Q4		59.91	11.53	1.2	11.6	-0.9	30 245	920 220	28 747	81.7	7 599	104.5	8.9	
Jul- 00		54.02	14.60					161 006	113 228		16 223		14.3	
Aug- 00		46.18	-4.50					108 614	118 655		18 211		15.3	
Sept- 00		49.51	8.10					134 046	45 120		8 645		19.2	
Oct - 00		58.82	33.10					248 821	14 072		2 362		16.8	
Nov- 00		60.29	26.60					278 970	10 438		2 164		20.7	
Dec-00		50.28	-16.60					309 611	12 268		2 318		18.9	
Jan- 01		47.70	-7.31				8 877	311 502	11 520	-13.1	1 990	-2.2	17.3	
Feb- 01		54.05	7.07				8 285	312 837	10 953	-18.6	2 009	-6.9	18.3	
Mar- 01		57.78	8.00	6.3	25.0	-32.8	8 898	328 102	12 594	4.7	3 076	55.0	24.4	
Apr- 01		46.17	-9.10	3.8	-29.1	-55.7	8 832	188 910	12 768	-3.9	3 594	39.2	28.1	
May- 01		52.03	17.90	3.1	84.1	89.1	9 184	199 982	26 328	1.7	5 243	-27.2	19.9	
Jun - 01		47.30	-3.00	-9.9	4.8	159.4	8 594	135 644	58 648	3.8	11 064	44.1	18.9	
Jul - 01		42.90	-14.60	-2.1	-41.2	-51.5	9 177	94 796	161 832	42.9	28 991	78.7	17.9	
Aug-01		45.04	-0.30	17.1	-38.5	-44.0	9 374	66 872	165 750	39.7	31 727	74.2	19.1	
Sep-01		46.12	-2.20	6.0	-21.0	-18.6	9 227	106 033	59 441	31.7	13 843	60.1	23.3	
Oct-01		50.83	-10.10	-3.5	-31.7	2.0	9 580	169 916	15 744	11.9	3 271	38.5	20.8	
Nov-01		53.57	-9.70	-14.0	-1.3	3.6	8 793	275 357	9 820	-5.9	2 083	-3.7	21.2	
Dec-01		59.95	19.40	7.5	13.7	52.5	9 302	303 042	9 642	-21.4	1 917	-17.3	19.9	
Jan- 02		39.69	-16.00	-5.6	-39.6	52.9	7 949	186 203	10 450	-9.3	1 928	-3.1	18.4	
Feb-02		45.24	-17.20	-1.4	-57.2	51.8	8 644	131 239	11 648	6.3	2 573	28.1	22.1	
Mar-02		50.58	-12.80	1.3	-40.8	-8.4	10 026	190 301	11 194	-11.1	2 487	-19.1	22.2	
Apr-02		47.75	3.20	14.4	-39.2	57.1	9 682	110 477	15 584	22.1	3 848	7.1	24.7	
May-02		40.92	-21.60	-4.0	-81.0	-18.4	10 088	36 512	34 190	29.9	8 302	58.3	24.3	
Jun -02		48.41	2.20	2.8	-4.6	10.6	9 743	118 282	69 184	18.0	18 972	71.5	27.4	
July-02		53.49	24.50	9.6	103.1	61.9	10 187	171 070	151 284	-6.5	31 992	10.4	21.1	
Aug-02		47.50	5.20	-11.6	150.6	23.4	9 995	136 702	137 230	-17.2	34 621	9.1	25.2	
Sep-02		54.63	18.20	11.1	95.7	-18.6	9 923	193 510	64 204	8.0	21 960	58.6	34.2	
Oct-02		59.82	17.40	4.0	75.7	2.7	10 216	289 604	21 921	39.2	5 764	76.2	26.3	
Nov-02		58.98	10.00	7.8	9.1	35.6	9 840	284 397	6 826	-30.5	1 835	-11.9	26.9	
Dec-02		60.93	1.60	-0.6	19.7	-46.5	10 189	346 219	7 984	-17.2	1 878	-2.0	23.5	
Jan- 03		46.55	17.20	13.1	42.3	-29.9	10 200	337 645						

Sources (1): Statistical Office of Montenegro; (2): Aluminum Combine Podgorica;(3): Power Plant of Montenegro (EPCG); (4) GDP in constant prices, excluding informal economy; GDP estimates up to 1998 made by ISSP and based on Social Product estimates as published by the Statistical Office of Montenegro; from 1999 - ISSP estimates using comparable methodology;
Annual and quarterly data related to industrial production and tourism are period averages.

1. OUTPUT

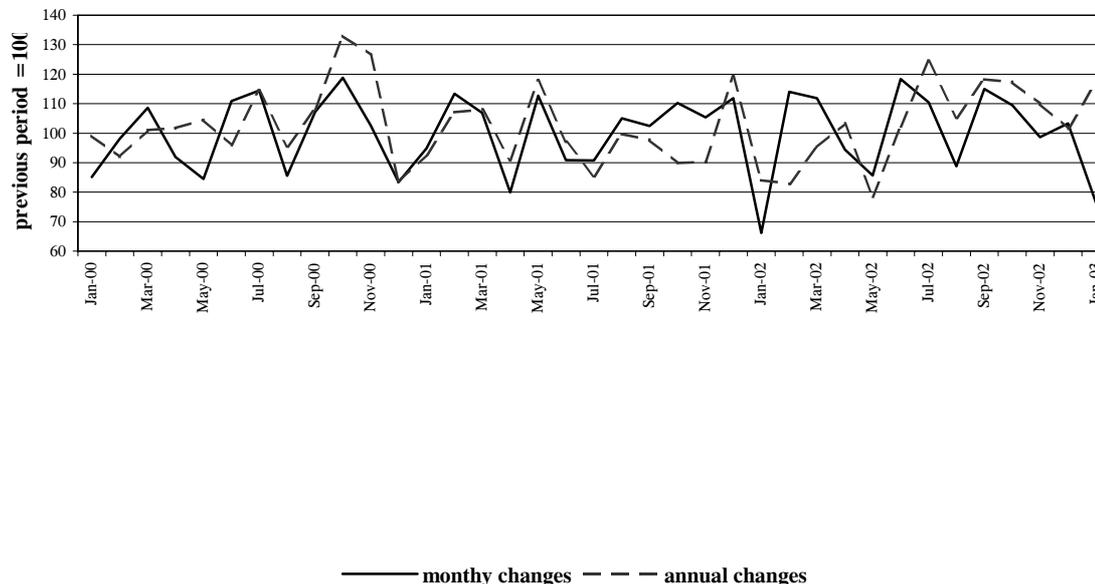
1.1. GENERAL PRODUCTION TRENDS

In 2002 the average annual industrial production growth was 1.2%, resulting in an average level of industrial production in Montenegro 0.74% higher than in 2001 (see table 1.1). Total industrial output was declining in the first half of 2002 and increased in the second half of the year, primarily due to the increase in electricity production. January of 2003 was marked by a seasonal fall of the output index (vis-à-vis December) due to lower electricity production and the lower number of working days.

Annual dynamics of industrial output has been positive since June 2002, albeit fluctuating highly in the range of 1.6 to 24.4%. This positive trend has continued in the beginning of 2003 with the annual growth rate at 17.2% in January 2003.

Monthly and annual changes of industrial production in Montenegro are presented in the graph below. The graph makes clear that industrial production fluctuates heavily whether growth rates are expressed monthly or annually. This seriously complicates any inference about the longer-term trends and perspectives. In the following sections we will try to take a closer look at the composition of industrial production and developments in tourism.

Graph 1.1: Monthly and annual change of industrial production



source: Montenegrin Statistical Office

note: Monthly changes refer to indices with previous month equal to 100 and annual changes refer to indices with analogous month of the previous year equal to 100.

1.1.1. Industry

The *processing industry*, which represents 71.2% of total industrial production, registered an average annual production growth of 2.3% in 2002 compared with 1.4% in 2001 (see table 1.1). This points to a slow, but consistent recovery in industrial output. Similar to total industrial output, production of processing industries is extremely variable, with month-to-month (absolute) changes in dynamics ranging from 2.7 to 23 percentage points in 2002.

Investigating the output at specific industry levels reveals the source of this variability. Over 60% of the output from within the processing industries is generated in the sector of raw metals, specifically aluminum, whose production fluctuates heavily both on a monthly and annual basis. Food and production of non-metal materials both account for approximately 10% of the processing industries' output, while the remaining 14 industries account for less than 20% of total output of processing industries.

Output developments in the 17 processing industries vary radically. Average annual growth in 2002 ranged from -28% for the wood industry (with a weight of 4% in the total index) to almost 500% in the case of machinery (with a weight of 0.3%). Recently, the annual dynamics of the index of processing industries output behaved in a very chaotic way; after stabilizing at a level of about 10% in the 2nd quarter of 2002, it fell to -0.6% in December and rose to a level of 13% in January 2003.

The second industrial sector, *electricity, gas and water*, accounts for 21.6% of total industrial production. It registered an average annual growth of 16% in 2002, a considerable improvement over 2001 when the analogous figure was -3.5%. As was the case with processing industries, the annual dynamics of output in this sector also fluctuates heavily from month to month, mostly due to fluctuations in electricity output. Accordingly, from August until November 2002 the annual dynamics fell from 150% in August to 9% in November and began to rise again afterwards. The annual growth of electricity production amounted to 20% in December 2002 and 42% in January 2003.

The *mining and stone extracting industry*, which represents about 7.2% of total industrial production, has registered a steady growth rate for the second year in a row. The average annual growth of the index amounted to 17.0% in 2002 and to 10% in 2001. However, in December 2002 and January 2003, this sector registered a serious fall in annual dynamics, -47% and -30% respectively.

1.1.2. Services

Tourism services

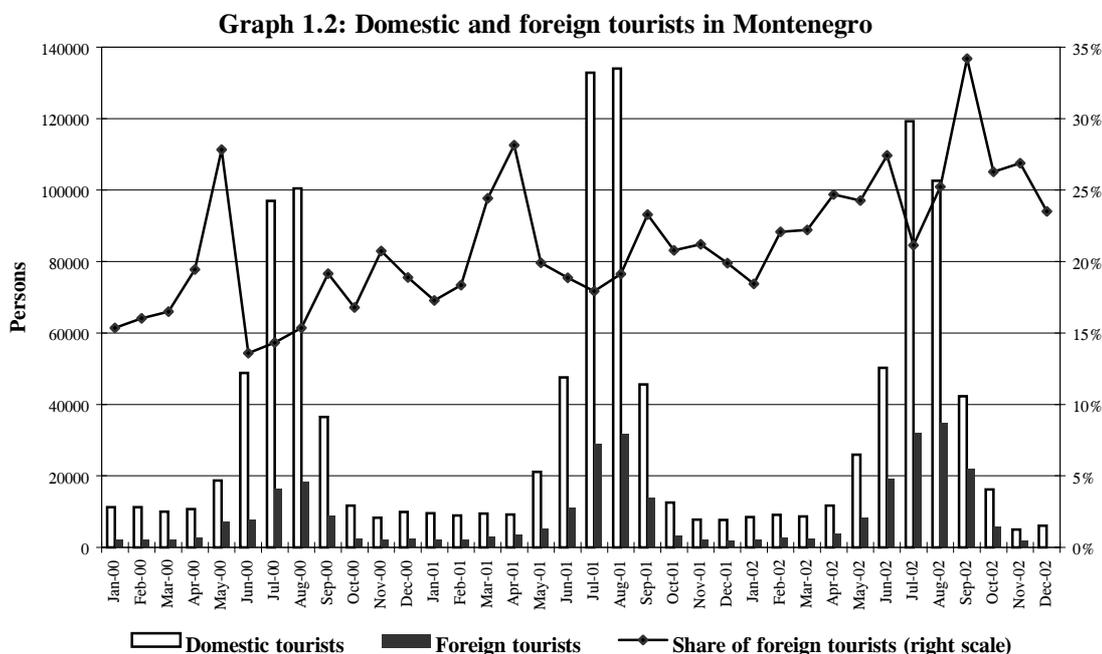
Tourism is consistently becoming ever more important for the Montenegrin economy in recent years, albeit this process is rather slow. The following two graphs, Graph 1.2 and Graph 1.3, present the dynamics of this process over the last 2 years. Graph 1.2 depicts the total number of tourists, both domestic and foreign, for a 12-month period ending with the months marked on the axis¹; this graphic also displays the proportion of foreign² tourists within this mix. Additionally, graph 1.3 presents annual growth rates of the number of tourists in cumulative periods since the beginning of each year vis-à-vis analogous periods of the preceding year.

The total annual number of tourists has been growing steadily in 2001 while the process has been halted during the summer season of 2002. At the same time, the share of foreign tourists in the total number of tourists has been consistently going up from about 16% in 2000 to 25% currently. Both of these findings represent a positive trend for Montenegro as it shows that the tourism sector is becoming less dependent on domestic visitors and it manages to attract more and more tourists from abroad. The newly passed law on tourism (see Monet 12) should facilitate further reforms in the sector and modernization of the

¹ For example entry for Dec-00 presents number of tourists for the period January – December 2000.

² Domestic tourists are defined as tourists from Montenegro, Serbia and Kosovo.

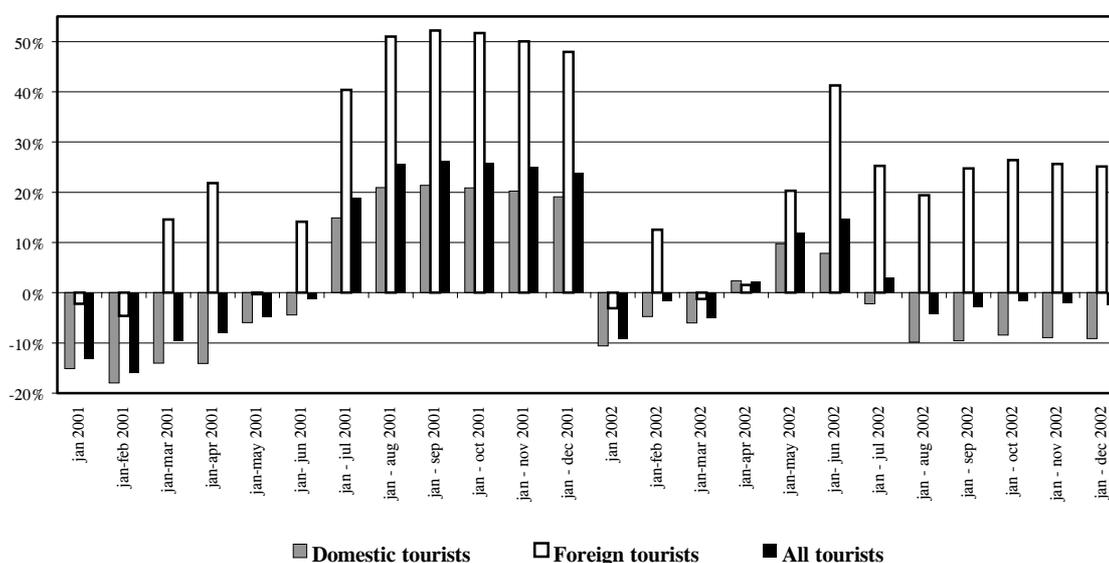
facilities as to attract even more foreign tourists in the future. Thus, we estimate that both trends that are currently observed, i.e. a slow but consistent increase in the number of tourists as well as a growing share of foreign tourists, will continue in the future and will contribute to further expansion of this sector of the economy.



source: Montenegrin Statistical Office

Graph 3 allows for a better evaluation of the Montenegrin tourism industry. It presents the growth rates of tourism, showing total tourists as well as a separate figure for both foreign and domestic tourists over cumulative periods beginning with January each year. This detailed graphic clarifies that the current slow down of tourist visits is entirely due to the fall in domestic tourists. While domestic tourist visits were 9.1% lower in cumulative period January – December 2002 compared to the analogous periods in 2001, the number of foreign tourists grew by 25%. This once again points to the growing importance of foreign tourists for the Montenegrin tourism sector and indicates that opening up for foreign tourists can visibly mitigate negative tendencies in the domestic market.

Graph 1.3 : Annual growth rates of number of tourists
(compared to analogous periods of preceding year)



source: Montenegrin Statistical Office

In line with the number of visits, foreign tourists were the most important source of the revenue growth. According to the balance of payments statistics (see table 8.2) *revenues from tourism* increased in 2002 by 18% compared to 2001. Estimated revenues in 2002 from visits by foreign tourists increased by 52%, while the analogous figure in the case of tourists from Serbia was -4%.

Transport services

Transport activities in Montenegro in 2002 were lower as compared to 2001, as a consequence of the decrease in all sectors of transportation- sea, road, railway and air transport. Railway transportation of passengers in the period of January-December 2002 was 11% lower than during the analogous period in 2001, while the railway transportation of goods increased by 28%. In the same period of 2002 air transportation of passengers registered an 8% fall when compared to the 12 months of 2001. The analogous rates of change were: -10% and -3% for the road transportation of passengers and goods respectively and -99% for the sea transportation of goods. The reasons behind such a radical slump in sea transport are the fundamental problems of Montenegrin sea-transport companies, especially *Jugooceanija- Kotor*.

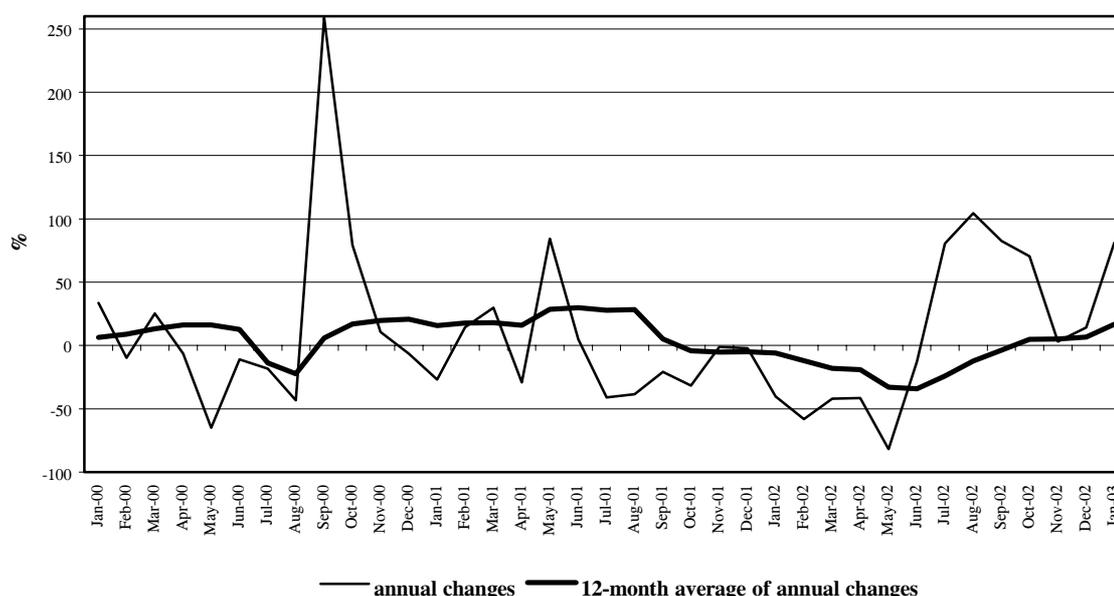
Despite the lower level of transportation activities in the country, *transportation revenues* from Serbia and abroad in 2002 were 25.3% higher than in 2001 (see Balance of Payments in table 8.2).

1.2. LEADING INDUSTRIAL PRODUCERS

The Montenegrin Power Company (Elektroprivreda Crne Gore), one of the most important industrial producers in Montenegro increased its production by 6.6% in 2002.

Perucica Hydro Plant has also increased its production, especially since September 2002. In January 2003 the output of this plant exceeded the planned level by 62.8%. Another plant, *Piva Hydro Plant* has increased its production rapidly in the last four months as well. Nevertheless, the level of production in January was 26.5% below the planned one.

Graph 1.4: Electricity production



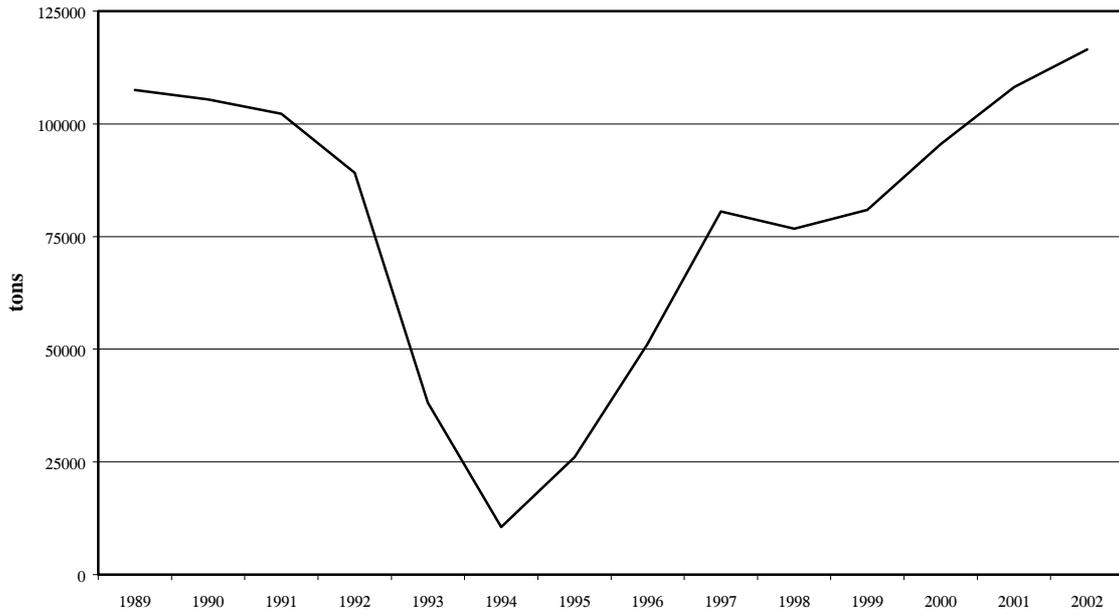
source: Montenegrin Statistical Office, EPCG

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

The output of the *Aluminum Combine Podgorica (KAP)* has been increasing steadily since 1994. Total aluminum production grew in 2002 by 7.7% compared to 2001. In 2002, annual changes of aluminum output were in the range of 5-10% and rose to 28% in January 2003. The reason for this increase was better cooperation with suppliers (electricity supplier, bauxite mines and railway), higher external demand as well as eliminating the payment arrears.

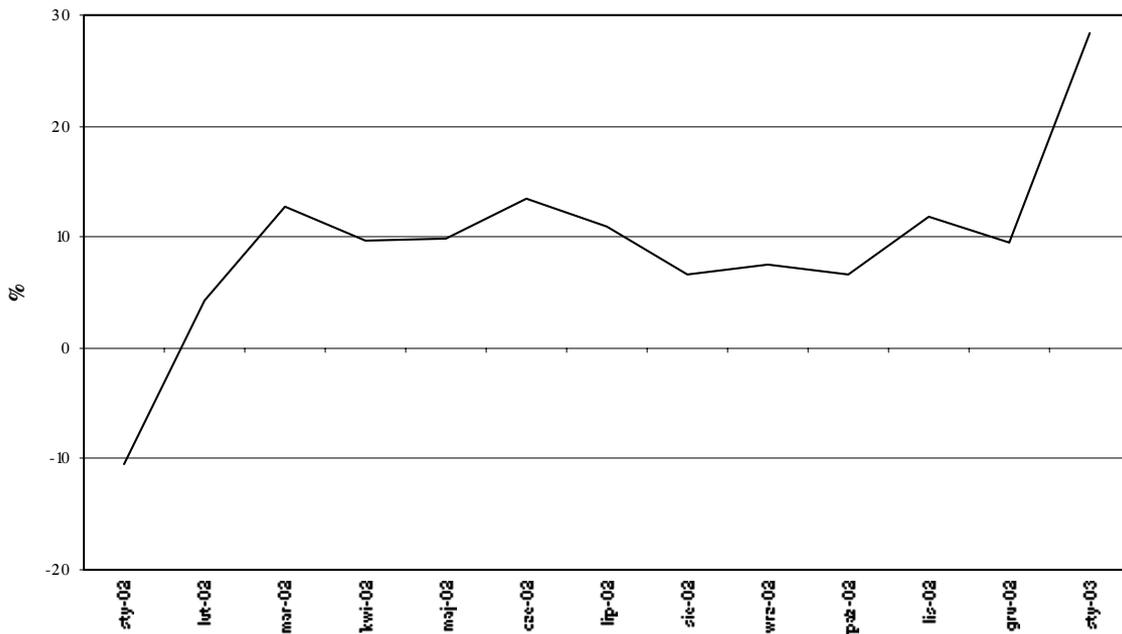
Graph 1.5 presents total annual aluminum output since 1989 and graph 6 presents recent data on annual changes of monthly aluminum production.

Graph 1.5: Total annual aluminum production



source: KAP

Graph 1.6: Annual changes in aluminum production



source: KAP

1. 3. FORECASTS

1.3.1. Industrial production

We forecast industrial production to increase in 2003 and register positive annual growth throughout the year. The main growth factors in 2003 will be as follows:

- Good outlook for electricity production (mainly because of substantial rainfall and better economic situation of the sector). Electricity accounts for roughly ¼ of the total industrial production.
- Growth in aluminum production expected due to good export prospects. Aluminum production contributes about 1/6 of total industrial production.
- Steady output growth and good export prospects will contribute to sizeable increase in the sector of machines and devices according to production plans of many factories.

1.3.2. GDP

Table 1.2: GDP - Historical Developments and Forecasts.

Year	GDP (current prices in €million)		Nominal Growth rate (%)		Real Growth rate (%)	
2001	1049.0		26.50%		3.98%	
2002	1221.3		16.43%		0.84%	
forecasts	ISSP/ USAID forecast	IMF forecast	ISSP/ USAID forecast	IMF forecast	ISSP/ USAID forecast	IMF forecast
2003	1,327.60	1,403.0	8.70%	12.15%	1.49%	4.19%
2004	1,420.80	1,450.0	7.02%	3.35%	4.06%	-
2005	1,515.70	1,515.7	6.68%	4.53%	4.30%	-
2006	1,606.64	-	6.00%	-	4.20%	-

Source: Statistical office and ISSP estimations unless stated otherwise; informal economy excluded

Data presented in the table above represents developments in the Montenegrin GDP³ in 2001 and 2002 as well as two sets of forecasts for the period 2003-2006. Real GDP growth slowed down from 4% in 2001 to less than 1% in 2002 but is due to pick up somewhat in the coming years.

The two forecasts of real GDP growth for 2003 differ significantly. The forecast that was jointly developed by ISSP and USAID is much less optimistic than the IMF forecast. In the IMF forecast, many assumptions were made regarding economic reforms that will take place in 2003 which are expected to boost the economy; however, our forecast is based on the less optimistic judgment as to the reforms that could be carried out this year and consequently, the growth prospects are predicted to be smaller.

³ Expenditure approach for measuring GDP. Informal economy excluded.

Chapter 2. Employment

Table 2.1. Labor force and unemployment

	Population at the end of the quarter (or year)	Total Employed Persons (1)	Number of Unemployed (2)	Unemployment rate	Total labor force	Unemployment rate in% **	Unemployment rate* %
	Official data				ISSP estimates		
1991	620,326	144,045	58,144	28.8	268616	21.6	
1992	627,976	134,205	64,632	32.5	274068	23.6	
1993	633,608	130,901	62,818	32.4	280287	22.4	
1994	636,966	128,835	58,210	31.1	267528	21.8	
1995	640,766	125,090	59,045	32.1	265753	22.2	
1996	644,812	124,264	60,225	32.6	275356	21.9	
1997	648,655	120,604	63,995	34.7	272208	23.5	
1998	652,554	117,450	68,373	36.7	265942	25.7	
1999	656,532	114,317	75,303	39.5	275687	27.3	
2000	660,533	114,686	83,583	42.4	298663	27.8	
2001	633,693	114,130	81,561	41.7	318677	24.8	22.3
2002		113,593	80,865	41.5	321411	23.7	18.0
1998-Q1	649,134	117,791	66,118	36.0	266323	24.8	
1998-Q2	650,095	117,265	68,895	37.0	266252	25.9	
1998-Q3	651,069	118,475	69,065	36.8	264707	26.1	
1998-Q4	652,059	117,450	69,414	37.1	266488	26.0	
1999-Q1	653,546	116,228	71,415	38.1	269923	26.5	
1999-Q2	654,540	115,737	74,087	39.0	274034	27.0	
1999-Q3	655,535	115,113	76,716	40.0	278104	27.6	
1999-Q4	656,532	114,317	78,993	40.9	280686	28.2	
2000-Q1	657,530	113,000	83,126	42.3	295889	28.5	
2000-Q2	658,529	112,890	84,344	42.7	294315	29.0	
2000-Q3	659,530	114,698	85,037	42.9	307891	27.9	
2000-Q4	660,533	114,686	81,826	41.6	317899	25.7	
2001-Q1	661,537	113,859	81,950	41.9	328610	25.1	
2001-Q2	662,543	113,914	82,620	42.0	329359	24.6	
2001-Q3	663,550	114,402	81,255	41.4	331228	24.4	
2001-Q4	633,693	114,130	80,723	41.4	331228	23.9	
2002-Q1	665,569	113,715	81,085	41.6	339444	23.7	
2002-Q2	666,581	113,785	81,541	41.7	344849	23.4	
2002-Q3	667,594	113,877	80,935	41.5	346323	25.1	
2002-Q4		113,593	79,898	41.3	345890	23.4	
<i>Jan-01</i>		<i>114,536</i>	<i>81,238</i>	<i>41.5</i>	<i>324676</i>	<i>25.0</i>	
<i>Feb-01</i>		<i>113,500</i>	<i>82,158</i>	<i>42.0</i>	<i>329048</i>	<i>25.0</i>	
<i>Mar-01</i>		<i>113,542</i>	<i>82,453</i>	<i>42.1</i>	<i>332106</i>	<i>24.8</i>	
<i>Apr-01</i>		<i>113,663</i>	<i>83,091</i>	<i>42.2</i>	<i>330993</i>	<i>25.1</i>	
<i>May-01</i>		<i>113,943</i>	<i>82,629</i>	<i>42.0</i>	<i>328778</i>	<i>25.1</i>	
<i>June-01</i>		<i>114,137</i>	<i>82,140</i>	<i>41.8</i>	<i>328305</i>	<i>25.0</i>	23.6
<i>July-01</i>		<i>114,106</i>	<i>81,823</i>	<i>41.8</i>	<i>328003</i>	<i>24.9</i>	
<i>Aug-01</i>		<i>114,024</i>	<i>80,686</i>	<i>41.4</i>	<i>326882</i>	<i>24.7</i>	21.9
<i>Sep-01</i>		<i>115,077</i>	<i>80,350</i>	<i>41.1</i>	<i>326558</i>	<i>24.6</i>	
<i>Oct-01</i>		<i>114,755</i>	<i>80,660</i>	<i>41.3</i>	<i>329016</i>	<i>24.5</i>	21.4
<i>Nov-01</i>		<i>114,170</i>	<i>80,440</i>	<i>41.3</i>	<i>330943</i>	<i>24.3</i>	
<i>Dec-01</i>		<i>113,464</i>	<i>81,069</i>	<i>41.4</i>	<i>333723</i>	<i>24.3</i>	
<i>Jan-02</i>		<i>113,594</i>	<i>80,385</i>	<i>41.7</i>	<i>335889</i>	<i>23.9</i>	
<i>Feb-02</i>		<i>113,597</i>	<i>81,360</i>	<i>41.7</i>	<i>339718</i>	<i>23.9</i>	
<i>Mar-02</i>		<i>113,953</i>	<i>81,510</i>	<i>41.8</i>	<i>342726</i>	<i>23.8</i>	19.6
<i>Apr-02</i>		<i>114,180</i>	<i>81,961</i>	<i>41.8</i>	<i>344268</i>	<i>23.8</i>	
<i>May-02</i>		<i>113,461</i>	<i>81,622</i>	<i>41.6</i>	<i>345022</i>	<i>23.7</i>	
<i>June-02</i>		<i>113,715</i>	<i>81,041</i>	<i>41.5</i>	<i>345257</i>	<i>23.5</i>	
<i>July-02</i>		<i>114,422</i>	<i>81,166</i>	<i>41.6</i>	<i>346353</i>	<i>23.5</i>	13.7
<i>Aug-02</i>		<i>113,684</i>	<i>80,830</i>	<i>41.6</i>	<i>346218</i>	<i>23.4</i>	
<i>Sep-02</i>		<i>113,526</i>	<i>80,809</i>	<i>41.4</i>	<i>346398</i>	<i>23.4</i>	
<i>Oct-02</i>		<i>113,676</i>	<i>80,183</i>	<i>41.3</i>	<i>345974</i>	<i>23.2</i>	20.7
<i>Nov-02</i>		<i>113,679</i>	<i>79,894</i>	<i>41.2</i>	<i>345887</i>	<i>23.5</i>	
<i>Dec-02</i>		<i>113,425</i>	<i>79,616</i>	<i>41.5</i>	<i>345810</i>	<i>23.5</i>	

Source (1): Monthly Statistical Review, published by Statistical Office of Montenegro

Source (2): Employment Office

* Unemployment rate calculated from the ISSP Household Quarterly Survey (first survey was conducted in June 2001)

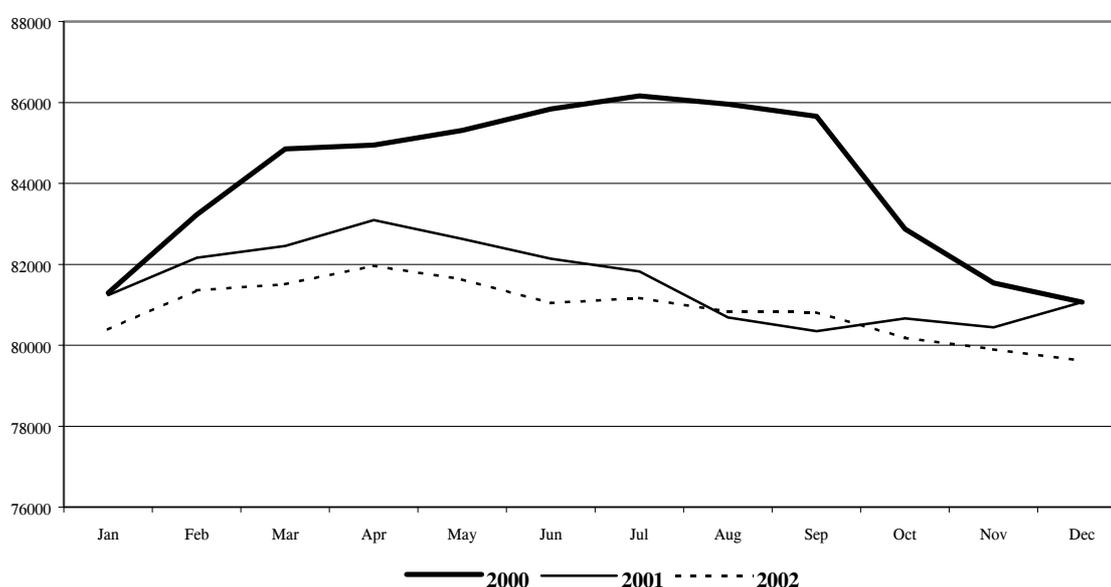
** Revised ISSP estimates based on the Household survey from Statistical Office of Montenegro, ISSP Household survey and official number on employment and unemployment

2. EMPLOYMENT

2.1 Employment and unemployment.

The most recent official data on the number of employed and unemployed in the Montenegrin economy is not surprising. There is a continuation of the trend observed over the past two years where we experience temporary fluctuations in employment without any significant changes in the long-term. After a significant increase throughout 2000, unemployment stabilized again at the end of the year and has shown signs of a gradual decline, evidenced in Graph 2.1.

Graph 2.1: Number of unemployed persons (2000-2002)



Source: Employment Office of Montenegro

Analyzing changes in employment and unemployment on a month-to-month basis can be misleading due to visible seasonality in the data. In the first half of 2002, employment was increasing, but on an annual basis it was declining, so in 2002 the number of employed persons (annual average) decreased by 0.3% compared to 2001. On the other hand the number of unemployed decreased as well: it was 0.9% lower in 2002 than in 2001. This paradox (a decline in both employment and unemployment) may be explained by the change in the criteria that jobless persons must fulfill in order to qualify as officially unemployed. The new Employment Law established a stricter definition of the unemployed person whereby a person who fails to show up and register at the Employment Office¹ on a specific day, will be automatically deprived of the status of an unemployed person and will be removed from the register. Those deprived of that status drop out of the labor force as well and might influence any measures of the unemployment rate.

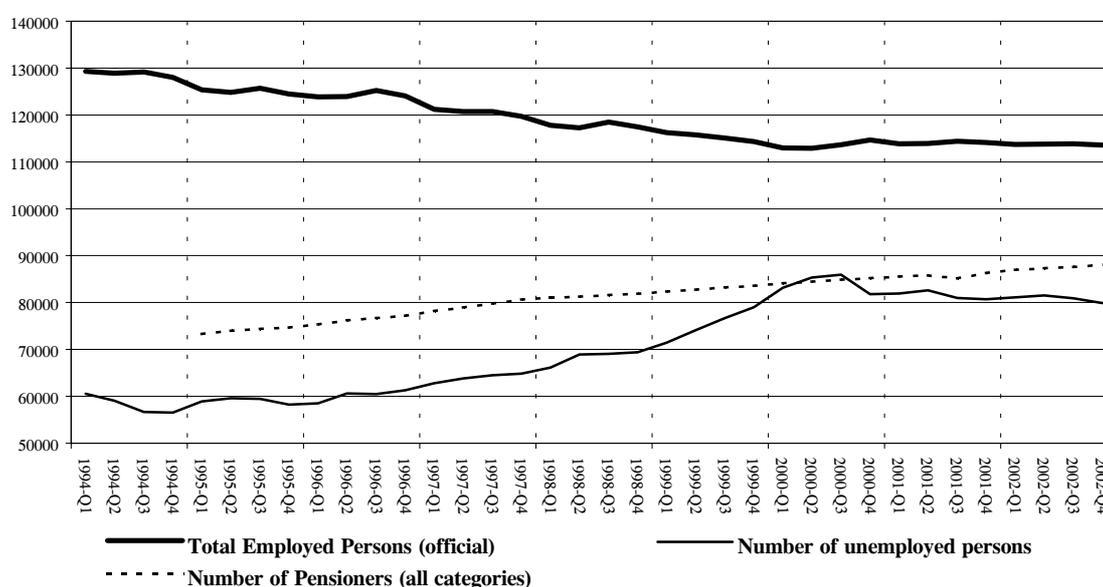
¹ The unemployed are obliged to register at the EO regularly every three months on a specific day.

The resulting official unemployment rate in 2002 was 41.5% and was marginally lower than in 2001 (41.7%). Analysis of the data leads to the conclusion that the situation in the Montenegrin economy has not visibly improved during the last year and is rather alarming. Official data implies that only one in six Montenegrins has a job, and it would follow that each employee therefore supports five other persons.

However, a different picture emerges from unofficial studies done within the ISSP Household Survey. In contrast to the official unemployment figure of 41%, the ISSP survey indicates that unemployment was actually much lower, just 18%². Also, as evidenced in the survey, the unemployment rate was actually lower in 2002 compared to 2001, when it was 22.3%. So, in contrast to official data, which point to stabilization of unemployment at a very high level, alternative sources indicate some signs of a moderate improvement.

What are the employment prospects for 2003? It is very likely that employment will shrink in 2003 mainly due to the Government plans to reduce the number of employees in public administration by 3,000 persons. Currently there are roughly 37,000 people employed in the government at the central and local level, which accounts for more than 30% of the officially employed in the economy. Consequently the category 'salaries and compensation to employees' constitutes the biggest expenditure category in the budget and the lay-offs are envisaged to be one of the ways to cut expenditures. However it is still unclear whether the government will implement its lay-off plans and if so, whether the private sector will be able to absorb the 3,000 laid-off persons. Thus, the possible impact of this plan on the number of unemployed in the economy is hard to estimate at this point.

**Graph 2.2: Number of persons employed, unemployed and pensioners
(official, 1994-2002)**

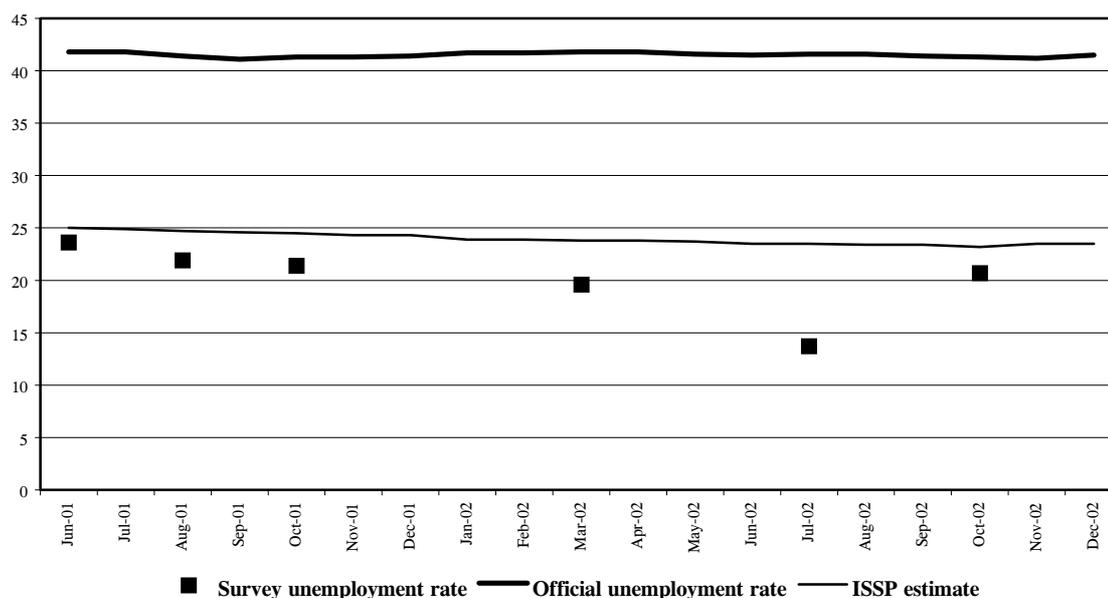


Source: Statistical Office of Montenegro, Employment Office, Fund PIO

In the following graph we present three alternative indicators of the unemployment rate: the official one, the rate from the ISSP survey and the rate estimated by the ISSP. The graph makes clear that the official rate is almost double the other two alternative rates.

² The average rate from 3 ISSP Household Income – Expenditures survey No. 4,5 & 6.

Graph 2.3. Unemployment rate 2001-2002 (in % of the labor force)



Source: ISSP Household Surveys, issues 4,5&6, Statistical Office, Employment Office

The official unemployment rate is calculated from the official data on the number of employed and unemployed in the economy. The second rate, the ISSP estimate is calculated using the official data as well as results of the household surveys (Labor force survey FSO and ISSP Household Survey). The third rate is obtained from the ISSP Household Income-Expenditures Survey.

As can be seen in the graph the official unemployment rate has been fairly stable since June 2001, while the other two rates are exhibiting a declining trend. There are obvious complications when comparing these three series, and as the household rate is only available for 6 months, one must be very cautious in making use of this series, especially since the months for which data are available are different for each year (with the exception of October). Additionally, in view of the seasonality of unemployment, the data should only be compared between the same months. These problems notwithstanding, the unemployment rate based on the survey is the only one to detect a significant seasonal drop in unemployment in the summer of 2002, most likely to be explained by seasonal jobs in tourism. More details, along with the geographical differences in unemployment, are presented in table 2.2.

Table 2.2. Unemployment by regions (2002)

Region	Unemployment rate (%)		
	March	July	October
North	19.7	19.7	26.9
Center	19.6	14.1	19.3
South	18.0	8.6	16.3
Total	19.6	13.7	20.7

Source: ISSP Household Surveys, issue No.4, 5&6

In the end of the first quarter of 2002 the unemployment rate stood at 19.6%, while in October (beginning of the fourth quarter) it rose to 20.7%. During the summer season the unemployment rate fell significantly, albeit the fall was not equal in all regions. The seasonal drop was greatest in the Southern region, while the data indicates no effect in the Northern region.

Chapter 3. Wages

Table 3.1: Wages

	Minimum wage	Average gross wage (official)	Total social contributions and tax on gross wage	Average disposable wage	Average pension (paid)	Ratio Min. Wage / Average Disposable Wage (%)	Average disposable wage*	Total labor cost
Official data IN DINARS						ISSP estimates IN DINARS		
1994	65	292.7	154.1	139		47		406
1995	128	637.8	330.8	307	280	42		873
1996	243	1349.0	689.7	659	600	37		1826
1997	332	1801.4	922.5	879	738	38		2445
1998	453	2503.8	1276.1	1228	1073	37		3391
1999	663	3159.3	1227.3	1932	1581	34		4356
1995-Q1	100	480.3	247.3	233		43		661
1995-Q2	118	571.0	295.3	276		43		785
1995-Q3	132	677.0	353.0	324		41		923
1995-Q4	160	822.7	427.3	395		40		1123
1996-Q1	200	1011.3	528.3	483		41		1384
1996-Q2	230	1274.3	654.0	620		37		1726
1996-Q3	257	1451.3	738.7	713		36		1961
1996-Q4	285	1659.0	837.7	821		35		2234
1997-Q1	302	1537.3	788.7	749		40		2102
1997-Q2	323	1691.7	864.0	828		39		2306
1997-Q3	340	1896.0	962.3	934		36		2565
1997-Q4	363	2080.7	1075.0	1006		36		2807
1998-Q1	387	2027.3	1038.7	989		39		2763
1998-Q2	440	2417.7	1232.3	1185		37		3277
1998-Q3	463	2654.7	1349.7	1305		36		3581
1998-Q4	520	2915.3	1483.7	1432		36		3942
1999-Q1	563	2510.7	977.3	1533		37		3492
1999-Q2	575	2646.7	1026.0	1621		35		3666
1999-Q3	607	3144.7	1225.3	1919		32		4291
1999-Q4	908	4335.3	1680.3	2655		34		5976
IN EURO						IN EURO		
2000	37.0	150.9	55.5	96.4	83.5	38		218
2001	42.0	176.2	68.5	108	97	39	174	249
2000-Q1	32.4	126.3	42.5	83.7	67	39		186.9
2000-Q2	35.3	149.0	53.2	95.8	84	37		214.5
2000-Q3	39.4	155.1	59.1	100.2	88	39		228.1
2000-Q4	40.9	173.0	67.3	105.7	95	38		242.8
2001-Q1	40.9	170.9	66.6	104.3	96	39		240.3
2001-Q2	40.9	173.5	67.7	105.8	96	38		244.3
2001-Q3	40.9	177.9	68.7	109.2	101	37		250.4
2001-Q4	46.0	182.5	71.1	111.5	101	41		259.1
2002-Q1	46.0	178.5	69.7	108.9	103	42		254.2
2002-Q2	46.0	193.1	76.2	116.9	108	39		270.9
2002-Q3	50.0				112			
2002-Q4	50.0				112			
Jan-01	40.9	166.2	64.4	101.7	96	40		234.9
Feb-01	40.9	173.8	68.0	105.8	96	39		243.5
Mar-01	40.9	172.8	67.5	105.3	96	39		242.4
Apr-01	40.9	171.8	67.0	104.8	96	39		242.3
May-01	40.9	173.3	67.5	105.8	96	39		244.2
Jun-01	40.9	175.4	68.5	106.9	96	38	176.0	246.5
Jul-01	40.9	174.4	68.0	106.3	101	38		245.4
Aug-01	40.9	176.9	67.0	109.9	101	37	171.0	250.4
Sep-01	40.9	182.5	71.1	111.5	101	37		255.3
Oct-01	46.0	181.5	70.6	111.0	101	42	175.0	258.0
Nov-01	46.0	182.5	71.1	111.5	101	41		259.1
Dec-01	46.0	183.6	71.6	112.0	101	41		260.3
Jan-02	46.0	166.5	65.0	101.7	101	45		239.7
Feb-02	46.0	181.3	70.7	110.6	104	42		257.5
Mar-02	46.0	187.8	73.3	114.5	104	40	186.0	266.2
Apr-02	46.0	194.0	78.3	115.7	104	40		270.1
May-02	46.0	191.0	74.5	116.4	110	40		274.4
Jun-02	46.0	194.5	75.8	118.7	110	39		273.4
Jul-02	50.0				112		208.2	
Aug-02	50.0				112			
Sep-02	50.0				112			
Oct-02	50.0				112		204.2	
Nov-02	50.0				112			
Dec-02	50.0				112			

Minimum wage is the lowest wage that employers are obliged to pay. Average gross wage includes employee's part of social contributions and payroll tax. Total labor cost includes average net wage and all benefits, as well as social contributions and payroll tax. Average disposable wage indicates the actual amount that employees receive.

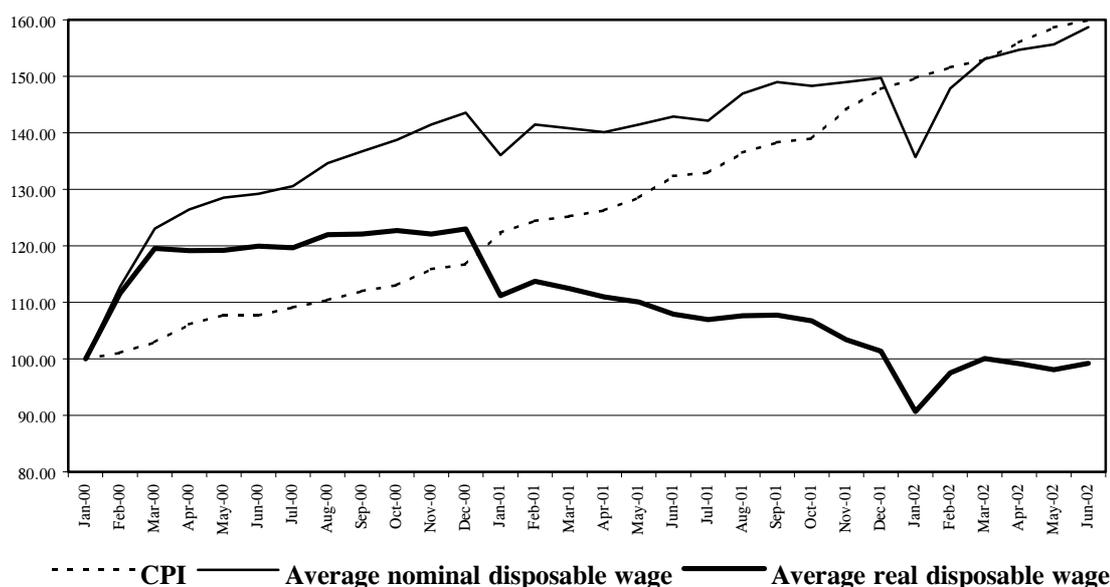
*Average wage is calculated from the ISSP Household Survey. The first survey was conducted in June 2001; up to now six surveys have been published.

3. WAGES

In 2002, the average disposable wage in the economy was €199.5 according to the ISSP Household Surveys. Official data on wages are not available for the period after June 2002, but the household survey estimates the level of salaries to be at €204 in October.

Due to the unavailability of recent data on wages, in this issue we will focus on the developments in real wages in the last couple of years. Expressing wages in real terms is very important since it allows us to examine the real purchasing power of incomes adjusted for price changes in the economy. Graph 3.1 presents indices (base period in Jan-00) of the average disposable nominal wage, Consumer Price Index and the average real disposable wage for the period January 2000 – June 2002. The next graph (Graph 3.2) presents the annual dynamics (annual rate of change) of the same indices, i.e. annual growth of nominal wages, annual inflation and annual growth of real wages.

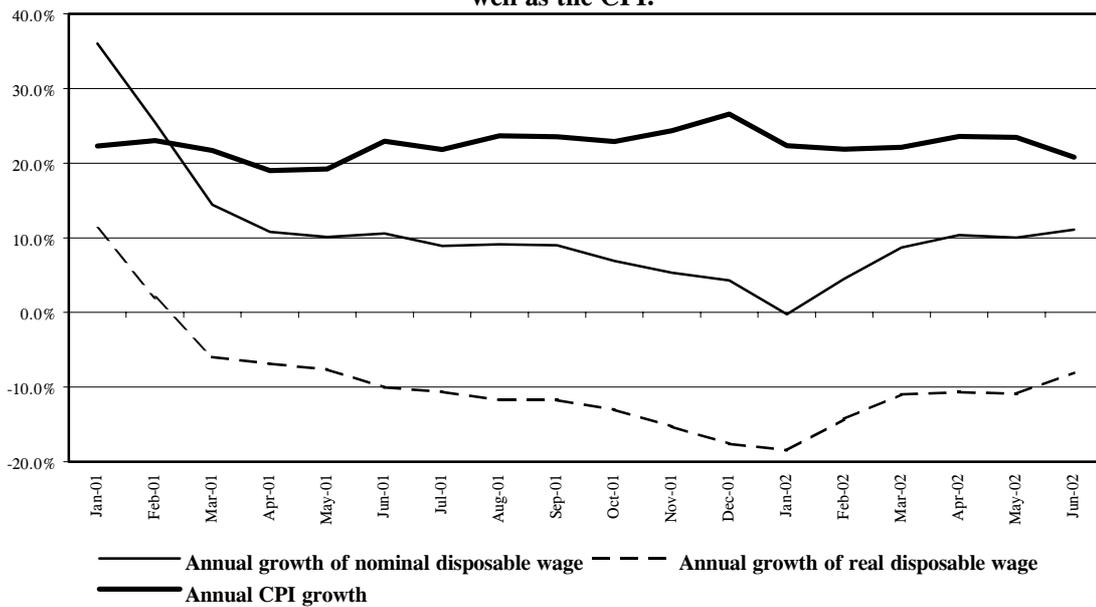
**Graph 3.1: Average nominal and real disposable wage and the CPI
(Jan-00 = 100).**



Source: Statistical Office of Montenegro and ISSP calculations

It is visible in Graph 3.1 that wages grew faster than prices during the initial months of 2000, which made it possible for real wages to expand. During the rest of 2000, growth rates of both series (nominal wages and CPI) equalized which led to the stabilization of real wages. A considerable erosion of real wages marks the years 2001 and 2002. While prices grew at a pace similar to that of 2000, nominal wages stabilized in the first half of 2001 and grew only moderately since then. Considerable drops in nominal wages, undoubtedly of a seasonal nature, were registered in January 2001 and 2002. January disposable wages are significantly lower than December wages (by 5-10%), due to changes in methodology in use by the Statistical Office.

Graph 3.2. Annual growth of nominal and real average disposable wages as well as the CPI.



Sources: Statistical Office of Montenegro and ISSP calculations

To capture the trend in the studied series, as well as to eliminate the problem of seasonality, graph 3.2 presents the three series transformed into annual growth rates for the period January 2001 – June 2002. The underlying story is very similar to the one given above for one-base indices. After the initial months of 2001 when nominal wage growth exceeded inflation (CPI growth), nominal wages slowed down considerably (to reach 0% growth in January 2002), while prices grew at a constant pace exceeding 20% on an annual basis. This brought about a marked disparity between the dynamics of nominal and real wages, pushing the real wages growth below 0 in March 2001 and keeping it negative until June 2002.

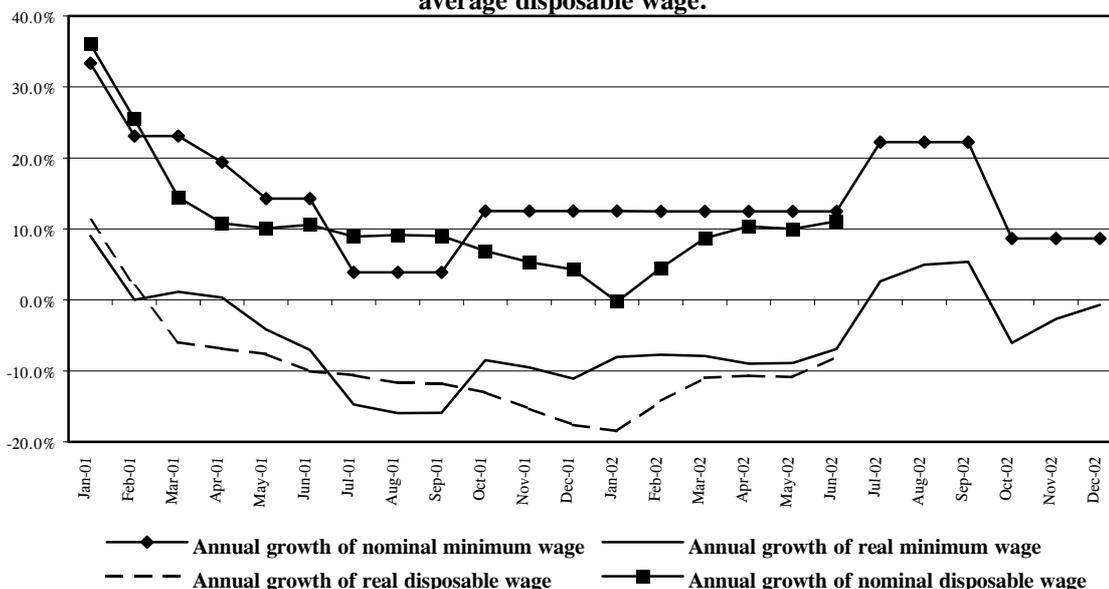
While real wage dynamics was negative until June 2002 (which is where our sample ends), the trend had reversed in January 2002, and the growth rate has been rising since then. Therefore, it will be very interesting to see if this positive tendency continued in the second half of 2002 and in the beginning of 2003 when wage data for this period becomes available. If nominal wages continued to grow at a rate comparable to that achieved in the first half of 2002 this would imply positive and rising real wage dynamics as annual inflation declined substantially since June 2002.

One way of estimating the average disposable wage for the period after June 2002 is to look at the minimum wage. One of the features of the Montenegrin system of wages is a strong correlation between minimum and average wage in the economy. This relationship occurs for 2 reasons. First, because minimum wage is part of a total wage bill in the economy, there will always exist a positive relationship between the two. In Montenegro, it is additionally strengthened by the fact that a sizeable share of employed persons do in fact earn minimum wage. Second, a specific feature of the Montenegrin wage system is the fact that the minimum wage is used as a benchmark for other wages in the economy in that these salaries are expressed as multiples of the minimum wage. This scheme does not concern several of the biggest and most profitable Montenegrin companies like *Telecom*, *Promonte* or *Monet* that set their internal minimum wages at higher levels and thus are not affected by changes in the level of the official minimum wage (for example Telecom’s minimum wage is

100€). However, for the vast majority of employers, the minimum wage is binding. Thus, whenever its level increases, the wage bill in enterprises rises and consequently, the average wage in the economy goes up as well.

To illustrate this, graph 3.3 presents the annual dynamics of minimum and average disposable wage both nominal and real. The graph shows that the dynamics of minimum and average wages in the economy are highly correlated. Therefore, the dynamics of the minimum wage can serve as an approximation of the dynamics of the average wage, for which no data are available after June 2002. If indeed, the dynamics of the average wage series will be similar to that of the minimum wage, we should expect a positive real growth in average wages in the 3rd quarter and a possible drop in the 4th quarter.

Graph 3.3. Annual growth of nominal and real minimum wage and real average disposable wage.



Source: Statistical Office of Montenegro and ISSP calculations

Chapter 4. Prices

Table 4.1. Price evolution

Consumer Price Index (Cost of Living Index ¹)							Retail Price Index (total)		
	CPI total			Food, tobacco and beverages annual changes	Goods less food, tobacco and beverages annual changes	Services annual changes	1994= 100	monthly changes	annual changes
	1994= 100	monthly changes	annual changes						
DIN PRICES									
1994							100		
1995	185	6.2	83.7				206	6.5	100.1
1996	344	3.4	89.7				379	3.3	89.1
1997	432	1.4	26.5				456	1.1	20.8
1998	562	3.1	29.8				582	2.9	27.5
1999	888	6.2	56.6				931	7.1	58.0
DM (until Dec 2001) and EURO (from Jan 2002)									
2000	1886	3.4	36.1		23.3		1.9	102.4	1886
2001	2267	1.8	21.8		16.5		2.1	23.6	2267
2002	2677	0.7	16.8		13.7		0.8	20.3	2677
2000 Q1	1744	9.6	102.5		20.7		1685.3	2.9	132.3
2000 Q2	1867	1.5	14.5		21.2		1764.6	1.4	116.5
2000 Q3	1924	1.3	14.3		22.5		1838.6	1.6	108.6
2000 Q4	2006	1.4	13.2		28.6		1931.3	1.7	52.1
2001 Q1	2111	1.6	19.9		16.6		2063.1	2.0	22.4
2001 Q2	2197	1.9	20.7		16.0		2136.9	1.7	21.1
2001 Q3	2314	1.5	23.1		16.7		2297.4	2.4	24.9
2001 Q4	2445	2.2	23.5		16.7		2432.3	2.3	25.9
2002-Q1	2576	1.1	19.6		11.3		2574.1	1.1	25.5
2002-Q2	2690	1.5	19.4		13.9		2665.3	1.3	24.7
2002-Q3	2706	0.1	16.3		14.3		2708.0	0.4	17.9
2002-Q4	2738	0.3	11.8		15.3		2745.1	0.3	12.9
Jan-01	2083	2.5	19.7	18.2	22.0	25.3	2037	3.7	22.0
Feb-01	2118	1.7	20.0	18.2	22.7	26.1	2069	1.6	23.3
Mar-01	2133	0.7	20.0	18.2	22.7	26.4	2084	0.7	21.9
Apr-01	2149	0.8	20.0	18.2	22.7	26.4	2100	0.8	20.6
May-01	2188	1.8	19.9	18.1	22.7	26.4	2121	1.0	20.0
Jun-01	2254	3.0	22.2	18.4	22.7	50.8	2189	3.2	22.7
Jul-01	2263	0.4	22.4	18.3	22.7	54.1	2242	2.4	23.9
Aug-01	2325	2.7	23.4	19.9	22.7	53.9	2302	2.7	25.3
Sep-01	2355	1.3	23.5	19.9	22.9	53.6	2348	2.0	25.6
Oct-01	2367	0.5	23.5	19.9	22.8	53.6	2360	0.5	25.0
Nov-01	2454	3.7	23.4	19.9	22.7	53.6	2426	2.8	24.9
Dec-01	2516	2.5	23.8	19.9	24.5	53.4	2511	3.5	27.9
Jan-02	2547	1.3	18.3	17.2	18.2	27.6	2554	1.7	25.4
Feb-02	2580	1.3	18.0	18.1	16.2	22.8	2577	0.9	24.5
Mar-02	2602	0.9	18.3	18.6	16.4	21.1	2592	0.6	24.4
Apr-02	2653	2.0	19.7	20.1	18.2	20.7	2634	1.6	25.4
May-02	2698	1.7	19.4	19.4	18.7	21.9	2670	1.4	25.9
Jun-02	2719	0.8	19.1	19.6	18.5	16.4	2692	0.8	23.0
Jul-02	2691	-1.1	17.6	17.4	19.2	14.4	2694	0.1	20.2
Aug-02	2701	0.4	15.8	14.6	19.8	14.4	2703	0.3	17.4
Sep-02	2726	0.9	15.5	13.9	20.9	13.0	2727	0.9	16.1
Oct-02	2731	0.2	15.1	13.0	21.5	13.0	2735	0.3	15.9
Nov-02	2734	0.1	11.1	7.6	20.0	13.6	2749	0.5	13.3
Dec-02	2748	0.5	9.2	8.0	11.5	12.6	2751	0.1	9.6
Jan-03	2762	0.5	8.4	7.5	11.1	6.8	2774	0.8	8.6
Feb-03	2765	0.1	7.2	5.9	10.7	6.9	2787	0.5	8.2

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.

Monthly changes refer to rates of change vis-à-vis previous month, annual changes refer to rates of change vis-à-vis same month of the preceding year.

¹ Cost of Living Index (*Indeks Troškova Života*) is the official name of the CPI in Montenegro.

4. PRICES

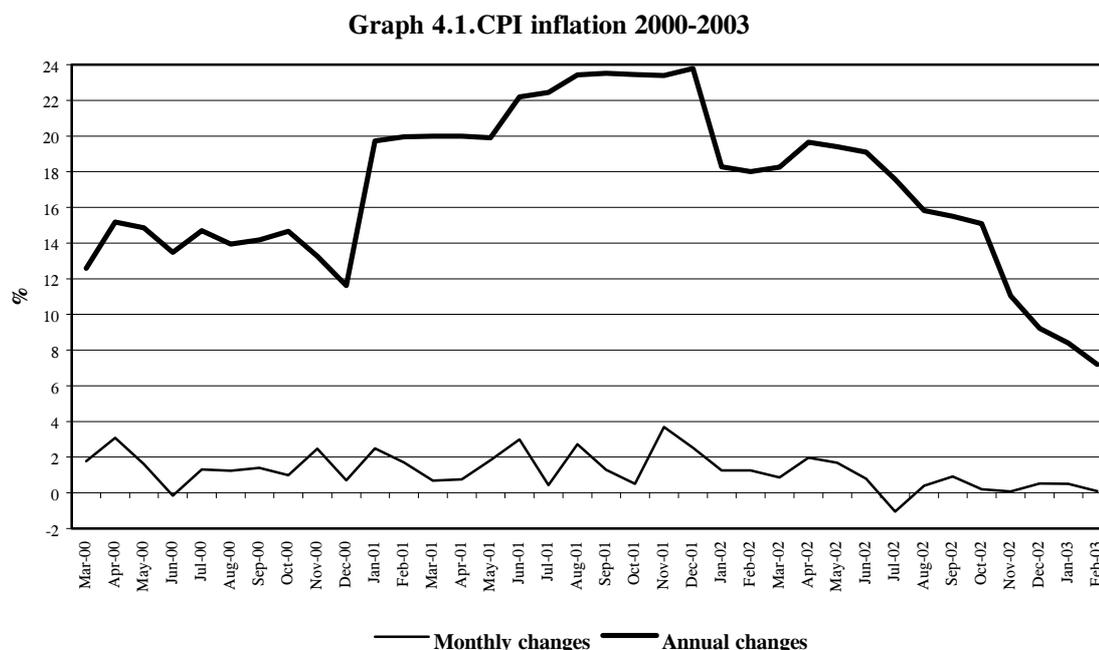
In this chapter we will present the main trends in consumer prices in 2002 and January 2003. Also, we will try to provide answers to the following questions:

- What were inflation developments in 2002 measured by various inflation indices?
- Which groups of products and services were leading the inflationary process and which of them were slowing it down?
- How did the price of the consumer basket change during 2002?
- What is the inflation outlook for 2003?

4.1. CONSUMER PRICE INDEX

4.1.1 General inflation outlook

Inflation trends reversed in 2002: while 2001 was marked by steady inflation growth, 2002 saw the continuous decline in price dynamics. The annual inflation rate in January 2002 stood at 18.3% while 12 months later it was 10 percentage points less and amounted to 8.4%. Since the peak in April (19.7%), the annual inflation rate has continued to fall yielding the year-end inflation of 9.5% and dropping down to 7.2% in February 2003 (see graph 4.1).

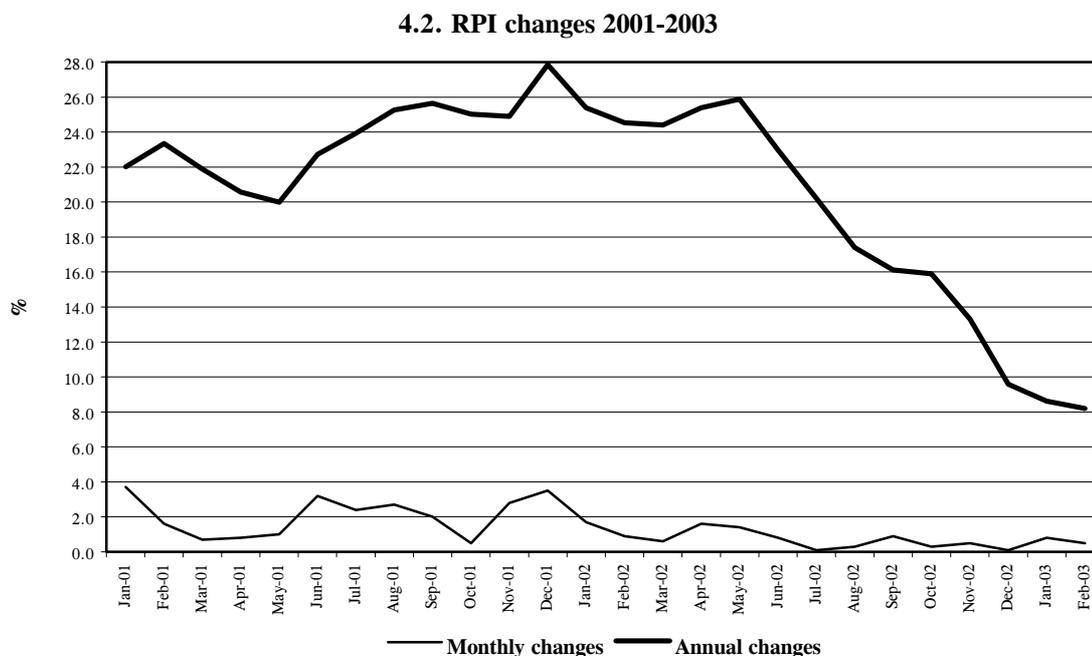


source: Statistical Office of Montenegro - Monstat

The introduction of the euro in January 2002 exerted an upward pressure on prices in Montenegro, as many retailers took advantage of the confusion following the currency change. Consequently, during the first months of 2002, the annual CPI dynamics stabilized

above 18% and it only began to fall after the initial euro shock wore off, which we estimate to have taken place around mid-year.

Price developments look similar when measured by the alternative measure of prices used by the Statistical Office of Montenegro, i.e. the Retail Price Index (RPI)². After stabilizing at the level of 24-26% in the first months of 2002, the annual dynamics of RPI entered a falling trend in May and dropped below 10% by year-end and further to 8% in February 2003 (see Graph 4.2).



source: Statistical Office of Montenegro - Monstat

On a monthly basis, CPI increased only 0.1% in November 2002, 0.5% in both December 2002 and January 2003 and 0.1% in February 2003. The analogous figures for the RPI are: 0.5%, 0.1%, 0.8% and 0.5%. The relatively low price growth during those months (in spite of the holiday season) points to significant disinflationary tendencies in the economy. We will investigate them in the next section in more detail.

² The structure of weights in the RPI is based on the shares in the volume of sales while CPI is weighted by survey data on consumption expenditures.

4.1.1. Disaggregated price changes

Table 4.2 Annual changes 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 Weight (until Dec 2002)	100	60.38	6.51	8.2	9.3	5.68	4	5.93
Consumption Weight (from Jan 2003)	100	58.61	7.71	8.01	10.51	5.24	4.2	5.72
2002								
Jan	18.28	13.9	49.61	9.08	47.92	4.78	12.63	17.86
Feb	18	14.96	48.94	9.84	33.22	6.69	14.02	17.58
Mar	18.25	15.5	49.05	9.52	32.9	6.32	16.43	16.14
Apr	19.66	17.21	48.24	14.2	32.41	4.21	22.11	15.96
May	19.41	16.3	50.53	14.57	32.5	5.41	24.68	16.03
Jun	19.09	16.5	51.44	12.87	32.85	7.17	24.8	8.49
Jul	17.57	13.99	51.48	13.49	33.27	7.67	21.23	8.65
Aug	15.83	10.97	51.83	13.86	33.43	8.09	23.29	8.33
Sep	15.5	11.69	33.6	15.51	31.82	8.06	25.79	8.85
Oct	15.09	10.84	33.15	17.49	31.86	7.94	25.53	8.97
Nov	11.05	7.88	5.57	14.39	31.62	8.33	23.6	9.55
Dec	9.22	8.34	5.27	13.99	7.29	10.27	26.39	8.04
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

source: Statistical Office of Montenegro (Monstat)

Table 4.2 presents annual changes of price levels for 7 major CPI components whose weights sum up to 100%, i.e. cover the entire consumption basket. The system of weights was updated beginning with January 2003 to account for the implicit³ changes in the consumption structure. One of the features of the consumption structure of Montenegrin households is a very high percentage of expenditures related to food purchases, namely: 59%. The remaining 41% of total expenditures are spent on accommodation (10.5%), clothing and footwear (8%), tobacco and beverages (7.71%), traffic vehicles, transport and telecommunication services (5.7%), hygiene and personal care (5.24%) and education and culture (4.2%).

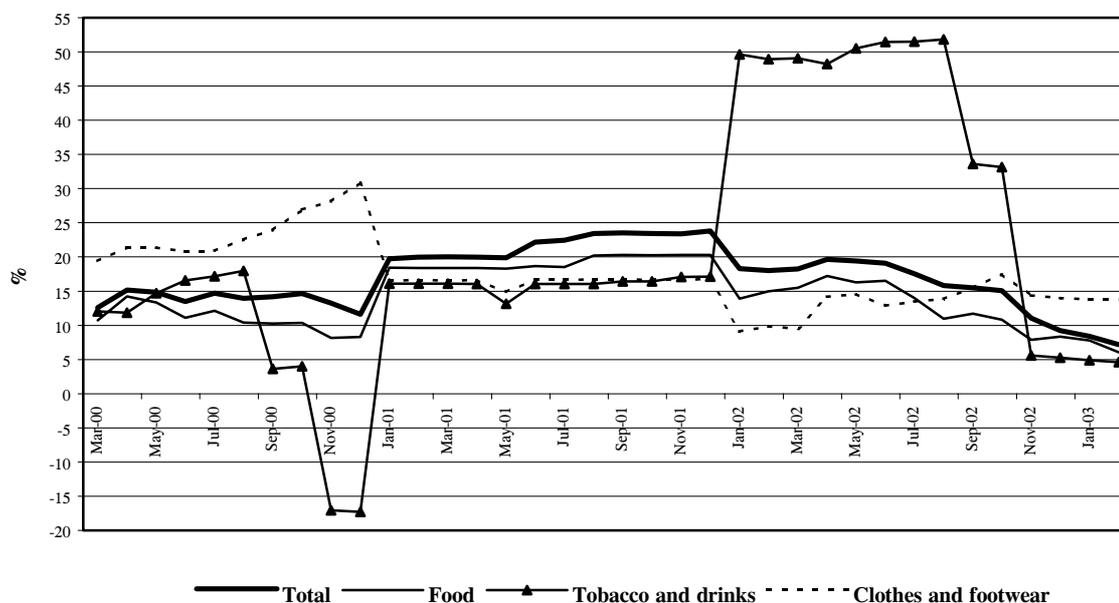
Due to the high weight of food in the consumption basket, price changes of food dominate the developments in Montenegrin inflation. Consequently, the currently observed slowdown of inflation is mostly due to declining dynamics of food prices. For more than three years now, prices of the food component have registered a lower annual dynamics than the total index, although the difference has not been large and has narrowed to 0.8% in February 2003. Of all food products, cereal products as well as fresh and processed fruits registered the highest annual dynamics (21% and 15% in February respectively). Prices of cereal products (like bread and pastry dough) increased significantly in March and April 2002 and even though recent months brought their stabilization, the annual growth is still very high

³ This is an update based exclusively on the statistical effect of relative price changes and not based on new household expenditure survey. Weights of basket elements whose relative price rose in recent years were adjusted upwards.

and contributes significantly to the overall inflation. On the other hand, prices of meat and meat products grew only by 3.3% on an annual basis and prices of dairy products actually fell on an annual basis by -0.5% (in February 2003). As mentioned above, inflation in food prices has come closer to the total CPI inflation in recent months and thus will not exert strong disinflationary pressures in future months.

With the exception of May 2002 when prices of tobacco products increased by 2.13%, no change was registered for tobacco prices on a monthly basis in 2002 and 2003. Thus, their annual dynamics fell significantly throughout 2002 from 90% up until August of 2002 and down to 2.13% on an annual basis in February 2003. This was one of the most rapid disinflation factors contributing to the slowdown of CPI growth in 2002 (tobacco had 3.5% weight in the consumer basket until January 2003 and 4.8% from February 2003). The dynamics of beverage prices (mostly alcohol) was fluctuating within a range of 10-14% in 2002 and fell below 9% in February 2003. Jointly, the growth rate of prices of tobacco and beverages declined significantly throughout the year: it was 50% in January 2002 and just 4.6% 13 months later.

Graph 4.3. Annual inflation: CPI total and disaggregated 2000-2003



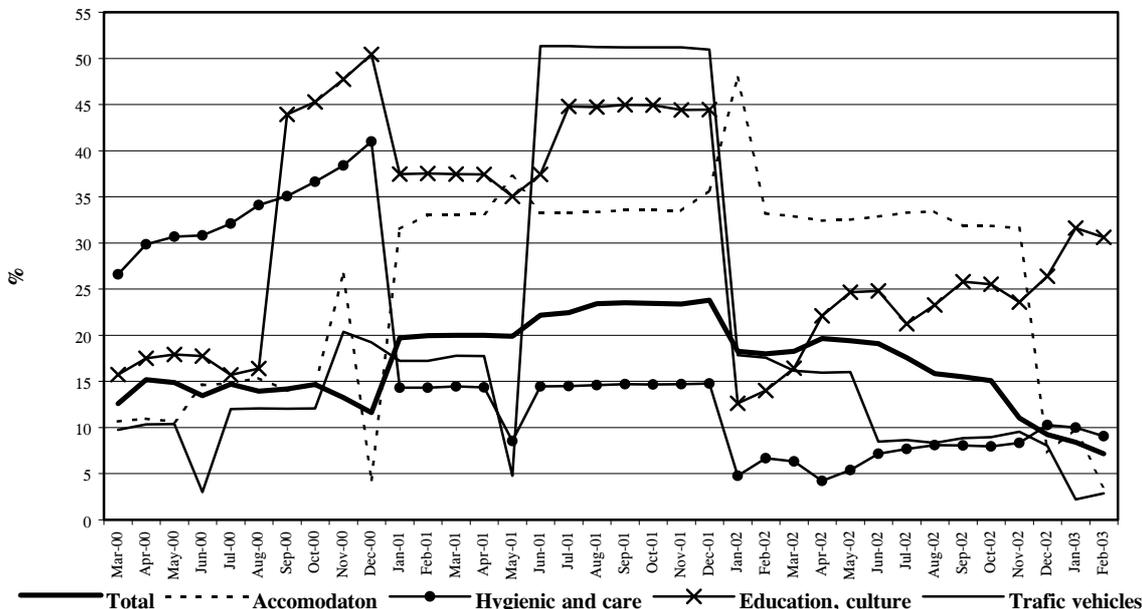
source: Statistical Office of Montenegro (Monstat)

The annual growth rate of prices of clothing was fluctuating within the range of 7-11% in 2002 and has been falling consistently since October 2002 (when it amounted to 11%) down to 7% in February 2003. Prices of footwear grew much faster in 2002, when the annual dynamics exceeded 12% for all months and increased to over 20% in September to stay at this level until now (precisely 23% in February 2003). Since October 2002, the joint dynamics of these prices has exceeded the total CPI inflation and this deviation has been widening recently (amounting to over 6 percentage points in February) which indicates a pro-inflationary pressure that clothing and footwear exert on the general price level.

Prices in the accommodation component of the CPI (incl. furnishings and utilities) have registered relatively high dynamics until November 2002 but they fell significantly since then and are now below the CPI dynamics. The reason for such a substantial drop in dynamics lies in the fact that prices of electricity (with 5.5% weight in total basket or more

than half of the entire accommodation category) have not been adjusted since December 2001 and hence their annual dynamics has stood at 0% since December 2002. However, a 23% increase announced to take place in April 2003 will raise the annual dynamics of this category and will push it again above the CPI dynamics.

Graph 4.4. Annual inflation: CPI total and disaggregated 2000-2003



source: Statistical Office of Montenegro (Monstat)

Prices of hygiene and personal care items have constituted a relatively strong disinflationary factor throughout 2002. Their annual dynamics has dropped below that of CPI in January 2001 and has remained there through the end of 2002 when the trend reversed. From December 2002 until February 2003, the dynamics of this component has slightly exceeded the total inflation. Pharmaceuticals continue to be the fastest growing product group in this category, their annual growth was approximately 30% throughout 2002 and fell down to 17% in February 2003.

Within the category ‘education and culture’, the highest dynamics was registered in the case of books and newspapers (52% and 57% annual growth in February 2003, respectively) and tickets for sports and cultural events (46%). Both components have been responsible for the increase in dynamics of the entire category that has been observed since January 2002. Other educational goods and services have registered price growth rates close to total CPI inflation.

The annual dynamics of the last category, traffic vehicles, transport and telecommunication services, registered a significant drop in January and February 2003, where it currently stands at 2,86%. The dynamics of this category fluctuated within the range of 16-17% from January till May 2002 and within the range of 8-9.5% during June-December 2002. The main disinflation factors for this category were the declining dynamics of prices of fuel and telecommunication services and the slight deflation of prices of traffic vehicles. However, announced fuel price increases by Jugopetrol effective in March 2003 will raise the dynamics of the price of this category and will bring it closer to the CPI dynamics.

In total, prices of food, tobacco and beverages (representing 67% of the basket) have seen a continuous decline in annual dynamics throughout 2002 and during the first 2 months of

2003 (see table 4.1). Annual inflation of the remaining goods (25% of the basket) have also slowed down during the period concerned, albeit has continued to register much higher rates: in the range of 16-22% in 2002 and around 11% since December 2002. Prices of services (8%) have registered the deepest decline in annual dynamics throughout 2002 and 2003. Annual inflation fell from about 27% in January 2002 down to 7% in February 2003.

To sum up, the currently observed slowdown in inflation is mostly due to lower growth of prices of food products and the significant decline of tobacco price dynamics. Strong disinflationary tendencies are also the result of falling price dynamics of items related to apartment maintenance (mainly electricity) and transport and telecommunication (mainly fuel and telecommunication services).

4.2. CONSUMER BASKET CHANGES

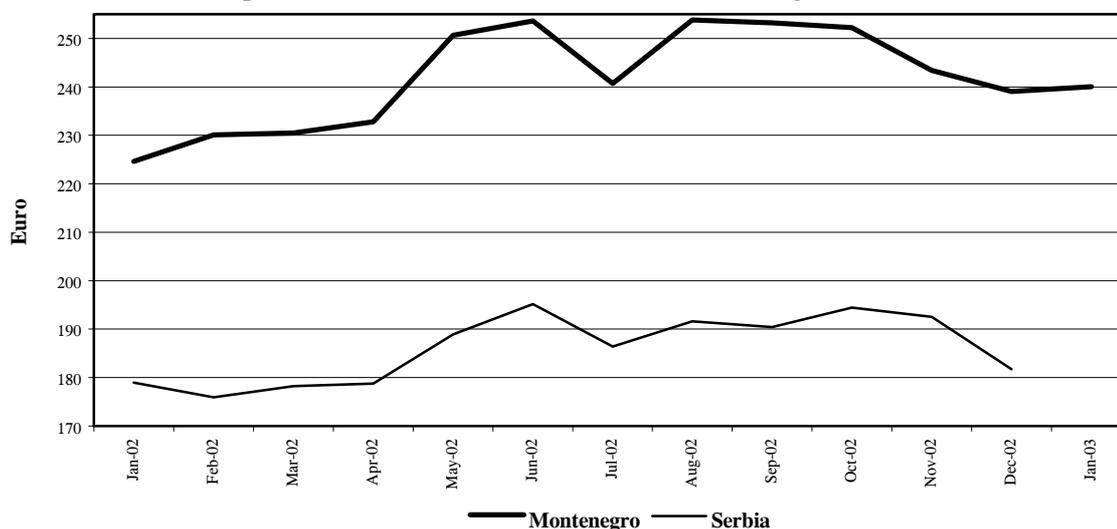
	Consumer basket in €
Dec-01	217.42
Jan-02	224.61
Feb-02	230.11
Mar-02	230.47
Apr-02	232.82
May-02	250.62
Jun-02	253.63
Jul-02	240.7
Aug-02	253.8
Sep-02	253.22
Oct-02	252.22
Nov-02	243.40
Dec-02	239.02
Jan-03	240.06
Feb-03	242.10

The cost of the consumer basket, which consists of the group of basic food products in the quantities appropriate for a four-member family, was equal to €242 in February 2003. This represents an annual increase of 5.2% and is roughly in line with the annual food price inflation, which stood at 6% in February 2003.

Among the prices that grew most on an annual basis were prices of fresh sweet cabbage (50% growth), onion, carrot, pears and prunes (growth from 34% to 44%). Some other products, like cauliflower and trout registered annual price declines.

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. Graph 4.5 presents the cost of the basket containing the same quantities of the same foodstuffs for Montenegro and Serbia. The cost of the basket is visibly seasonal in both cases (drops in the summer months) and moves relatively closely together. The cost of the basket has been roughly 40-50 euro higher in Montenegro than in Serbia throughout the year 2002.

Graph 4.5. Cost of the consumer basket in Montenegro and Serbia



source: Statistical Office of Montenegro and Serbian Statistical Office

4.3. INFLATION FORECAST

Inflation forecasts for 2003 are complicated by the fact that there is considerable uncertainty regarding many factors that will have an impact on consumer prices in 2003. We identified three major areas of uncertainty:

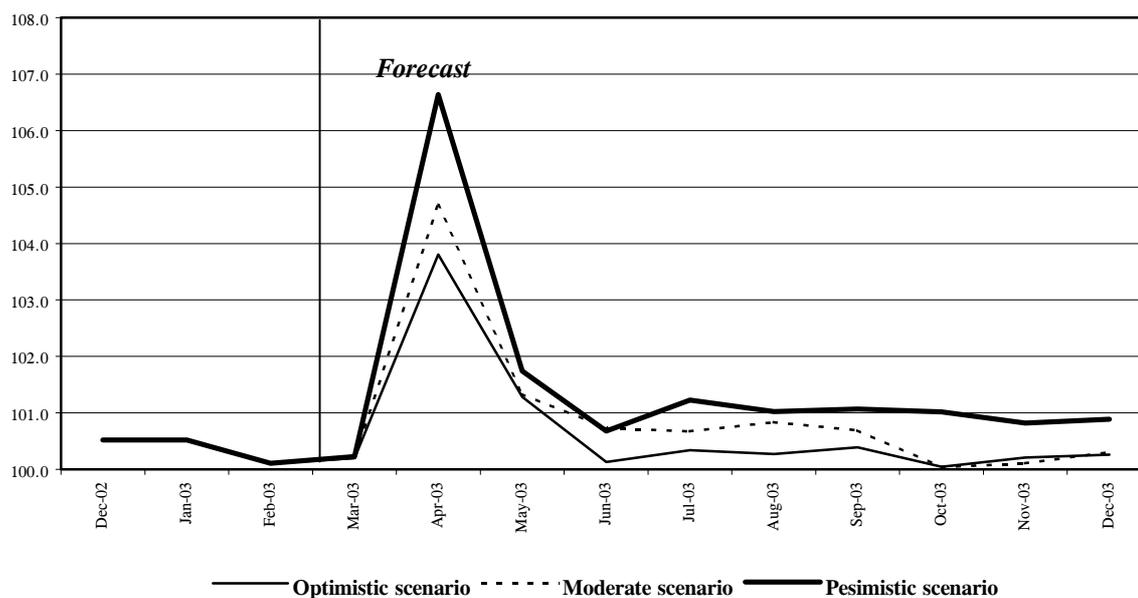
- 1) Prices of all consumer goods will be affected by the level of tariff negotiated in the process of tariff harmonization between Serbia and Montenegro. This harmonization will undoubtedly imply tariff increases for Montenegro (as current Montenegrin tariffs are on average 3-4 times lower than Serbian tariffs), but it is not sure yet, how large the increase will be. Taking into account different alternative scenarios of the tariff increase, one can estimate the size of the upward shock on a price level to be in the range of 1.5 – 9%. Another unknown related to the tariff increase, is the exact timing of the introduction of the new, higher tariff. This moment is of crucial importance in predicting CPI dynamics in 2003.
- 2) There are many unknowns regarding the introduction of the VAT planned for April 2003. The Budget Law for 2003 does not project a significant increase in tax revenues due to the VAT introduction (see budget comment), which would suggest that the burden of indirect taxes should not force producers to increase their prices. However, the size of this effect is extremely difficult to estimate at this point. The effect will be different for various goods reflecting different original revenue tax rate (coupled with uniform VAT rate), various other sectoral differences and different demand elasticity. The higher transparency of the VAT system will support better compliance by the Ministry of Finance, making it likely that prices will go up somewhat. Last but not least, various producers and retailers might take advantage of the confusion and uncertainties related to the new tax and raise their prices even though their tax burden will not be higher. This situation might be somewhat close to the euro introduction, where for no substantive reasons many prices in Montenegro went up.
- 3) World oil prices have been quite unstable in recent months and will most likely continue to behave so in view of the war in Iraq. *Jugopetrol*, the local major fuel producer and retailer, already announced a 10% increase of gasoline prices effective in March 2003 and further increases are very likely in the future weeks. This will have a substantial effect on the retail prices of gasoline in Montenegro and these prices, in turn, will have an impact on virtually all prices in the economy. Directly, prices of gasoline will have an effect on the CPI (and other price indices) because gasoline and diesel oil are among the goods purchased by households (with a weight of about 2%). Indirectly, prices of fuel will influence the cost of transportation, and through this, the level of all prices in the economy. Thus, the uncertainty regarding the tendency of world oil prices translates directly into the uncertainty regarding growth in consumer prices.

Our forecast takes into account the certain electricity price increase at the level of 23% effective in April 2003. All other factors are much less clear. Therefore our forecast will be conditional on the degree of accumulation of negative, pro-inflationary factors throughout 2003. We will capture this accumulation in 3 alternative scenarios: positive, moderate and pessimistic.

Graphs 4.6 and 4.7 present the forecast of monthly and annual CPI dynamics until the end of 2003. Forecasts were generated by assuming specific paths of monthly growth rates for 25 CPI groups and then cumulating them to arrive at annual growth rates. The three forecast scenarios refer to assumption regarding numerous risk factors, most important of which are as follows:

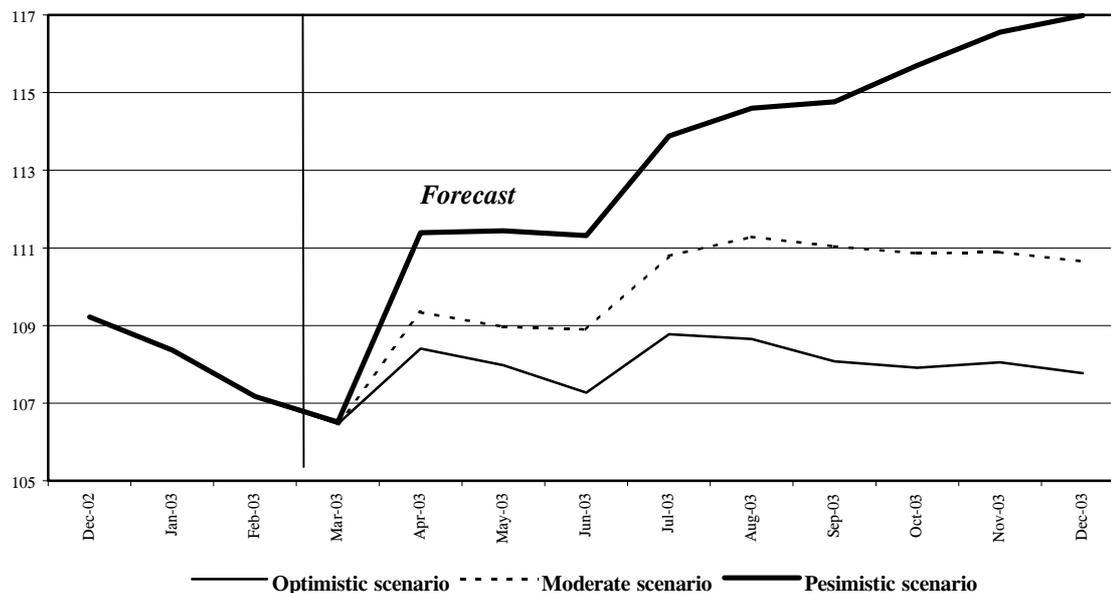
- **Timing and magnitude of tariff increases** (pessimistic scenario assumes that the effect of tariff increase will be felt beginning in June and will amount to few percentage points throughout the third and fourth quarter; optimistic scenario assumes that no important tariff changes will take place in 2003)
- **Magnitude of the VAT effect** (pessimistic scenario assumes a shock of 3-4 percentage points in the 2nd quarter due to the VAT introduction; optimistic scenario assumes 1.5 percentage points)
- **Magnitude and spillover effect of fuel price increases** (pessimistic scenario assumes consistently rising prices of fuel in the 2nd and 3rd quarter and a relatively high influence of these increases on other prices in the economy; optimistic scenario assumes only slight increases with a moderate effect on other prices).

Graph 4.6 Forecasts of monthly CPI change (3 alternative scenarios)



Source: MONET

Graph 4.7 Forecasts of annual CPI change (3 alternative scenarios)



Source: MONET

As a result of the uncertainty associated with different scenarios, the range of numerical values of forecasts is relatively large. Average monthly inflation for the period March-December 2003 is predicted at a level of 0.7% (optimistic scenario), 1% (moderate scenario) to 1.5% (pessimistic scenario). Compounding monthly forecasts, we obtain annual inflation forecast for the year-end 2003 at a level of 7.8%, 10.7% and 17%, respectively.

5. BUDGET

In this issue of MONET for the first time we present the budgetary data calculated according to the IMF's Government Finance Statistics Manual. The IMF methodology allows for a better presentation of consolidated budgetary statistics with special focus on the overall budget balance (with and without grants), items related to financing such as privatization receipts and net borrowing, as well as net lending in the expenditure portion of the budget. Section 5.2 includes a brief overview of the T-bills market. Section 5.3 describes the budgetary situation of the various social funds. Section 5.4 presents the first estimates of the consolidated central government budgets for 2002 and 2003.

5.1 CENTRAL BUDGET EXECUTION IN 2002

The data for the central budget in 2001-2003 are presented in table 5.1. Part A of the table presents the value of total revenues and grants. Part B presents total expenditures and net lending. Subsequent rows present the overall budget balance with and without grants and financing items, expressed in euros. At the end of the table total revenues, total expenditures and the overall budget balance are expressed as a percent of GDP.

Table 5.1 Central Budget Revenues and Expenditures, 2001-2003

	2001		2002														2003			
	Plan	Execution	Plan	Execution												Plan				
				Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec		Jan-Dec			
A	Total revenue and grants (1+2)	219.5	233.1	298.8	9.7	25.8	22.8	22.8	16.0	18.4	23.4	30.6	21.4	19.7	19.1	23.6	253.3	384.2		
1	Total revenue (1.1+1.2)	188.9	221.2	269.7	9.7	14.3	22.3	22.8	16.0	18.4	23.4	22.5	21.4	18.4	16.6	20.6	226.4	361.0		
1.1	Current revenue (1.1.1+1.1.2)	188.9	221.2	269.7	9.7	14.3	22.3	22.8	16.0	18.4	23.4	22.5	21.4	18.4	16.6	20.6	226.4	361.0		
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)	170.8	188.0	208.6	9.0	12.9	20.9	21.0	13.3	17.5	20.9	20.6	18.9	16.7	15.3	18.4	205.5	331.4		
1.1.1.1	Personal income	55.2	56.7	67.9	2.8	3.7	5.1	5.1	4.2	4.8	5.0	5.7	6.2	5.0	4.5	5.7	57.9	76.2		
1.1.1.2	Turnover (retail sales) tax	55.8	58.5	61.9	3.4	5.4	5.3	6.5	4.2	3.6	3.9	4.5	4.6	3.9	3.4	3.5	52.3	98.3		
1.1.1.3	Excises	34.0	35.7	33.7	1.0	1.5	4.6	3.1	3.1	5.5	8.5	4.0	5.2	3.6	5.2	5.4	50.8	86.3		
1.1.1.4	Taxes on international trade and transactions	17.7	27.3	32.9	1.4	1.8	5.0	3.5	1.0	1.1	1.4	4.7	1.6	2.7	0.9	1.9	27.1	52.0		
1.1.1.4.1	Custom tariffs	10.5	13.9	18.2	0.0	0.2	3.0	2.3	0.4	0.0	0.2	3.6	0.6	1.7	0.2	1.1	13.3	30.0		
1.1.1.4.2	Custom transit fees	7.2	13.4	14.7	1.4	1.7	2.0	1.2	0.6	1.1	1.2	1.2	1.0	1.1	0.6	0.8	13.8	22.0		
1.1.1.5	Other taxes	8.2	9.9	12.1	0.3	0.4	0.9	2.9	0.7	2.6	2.0	1.7	1.3	1.4	1.3	1.8	17.3	18.6		
1.1.2	Nontax revenues	18.0	33.2	61.1	0.7	1.4	1.4	1.8	2.7	0.9	2.5	1.9	2.5	1.7	1.3	2.3	21.0	29.6		
1.2	Capital revenue	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
2	Grants	30.7	11.9	29.1	0.0	11.5	0.5	0.0	0.0	0.0	0.0	8.1	0.0	1.3	2.5	3.0	26.9	23.2		
B	Total expenditure and net lending (1+2)	228.6	259.3	328.1	5.3	23.4	21.2	23.7	12.4	19.6	20.5	29.2	21.0	24.2	17.6	32.7	250.7	431.2		
1	Total expenditure (1.1+1.2)	225.8	252.6	316.6	5.3	22.0	19.6	22.6	10.7	18.7	19.8	28.2	21.0	23.8	17.6	32.6	241.7	422.8		
1.1	Current expenditure (1.1.1+1.1.2)	207.6	233.3	299.9	5.0	21.5	17.8	21.9	10.0	17.6	19.1	27.5	20.4	22.8	16.5	30.3	230.5	400.8		
1.1.1	Interest	0.5	0.6	23.6	0.0	0.0	0.0	0.1	0.0	3.8	0.2	0.1	2.5	0.2	0.3	6.0	13.1	25.5		
1.1.2	Non-interest (1.1.2.1+1.1.2.2+1.1.2.3+1.1.2.4+1.1.2.5+1.1.2.6)	207.1	232.7	276.3	5.0	21.5	17.8	21.8	9.9	13.8	18.9	27.4	17.9	22.6	16.3	24.4	217.4	375.3		
1.1.2.1	wages and salaries	117.6	108.5	134.8	1.7	12.6	8.9	13.0	3.1	7.1	10.1	12.8	8.1	10.2	7.1	11.3	105.9	152.0		
1.1.2.2	goods and services	39.2	55.4	54.3	1.5	3.0	5.9	2.8	3.3	3.1	4.6	4.1	2.5	2.8	3.9	4.2	41.8	43.8		
1.1.2.3	Social Insurance and Social Security Transfers	31.5	45.3	44.9	0.4	3.1	0.9	3.5	1.9	1.9	1.6	6.4	5.2	5.8	2.1	3.0	35.7	149.5		
1.1.2.4	Subsidies to enterprises	11.4	12.2	26.0	1.1	1.4	1.0	1.3	0.7	0.8	1.3	1.9	1.3	2.3	2.4	2.6	18.2	16.8		
1.1.2.5	Reserve	4.9	6.5	11.9	0.2	1.0	0.8	1.0	0.7	0.8	1.0	1.9	0.7	1.2	0.5	3.0	12.8	9.5		
1.1.2.6	Other non - interest expenditure	2.6	4.8	4.5	0.1	0.3	0.2	0.3	0.2	0.2	0.2	0.4	0.1	0.3	0.3	0.3	3.0	3.8		
1.2	Capital expenditure	18.3	19.3	16.8	0.3	0.5	1.8	0.7	0.7	1.0	0.7	0.7	0.6	0.9	1.0	2.2	11.2	22.0		
2	Net lending	2.8	6.7	11.5	0.0	1.4	1.6	1.1	1.7	0.9	0.7	1.0	0.0	0.4	0.0	0.2	9.1	8.4		
	Lending	2.8	14.0	11.5	0.0	1.4	1.6	1.1	1.7	0.9	0.7	1.0	0.0	0.4	0.0	0.2	9.1	8.4		
	Repayment	0.0	7.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
	Overall budget balance excluding grants (cash) (A-B-2)	-39.8	-38.1	-58.5	4.4	-9.1	1.1	-0.9	3.6	-1.2	2.9	-6.7	0.4	-5.8	-1.0	-12.1	-24.3	-70.2		
	Overall budget balance (cash) (A-B)	-9.1	-26.2	-29.3	4.4	2.4	1.6	-0.9	3.6	-1.2	2.9	1.4	0.4	-4.5	1.5	-9.1	2.6	-47.0		
	Financing (1+2)	16.5	26.1	28.8	-2.7	-1.9	-2.3	0.2	0.3	-0.2	0.2	-1.6	1.7	6.4	-1.4	35.2	33.8	47.0		
1	Domestic and foreign financing (net)	11.8	17.0	4.8	-2.7	-1.9	-2.3	-0.5	0.3	-1.0	-0.9	-1.6	1.7	5.8	-7.6	6.8	-3.9	23.7		
	Borrowing	39.1	76.4	20.1	0.0	0.6	1.1	2.2	2.9	2.2	2.1	1.9	2.4	10.5	3.3	15.9	45.1	24.0		
	Repayment	27.3	59.4	15.3	2.7	2.4	3.4	2.7	2.6	3.2	3.0	3.5	0.7	4.7	10.9	9.1	48.9	0.3		
2	Privatization receipts	4.7	9.1	24.0	0.0	0.0	0.0	0.7	0.0	0.8	1.1	0.0	0.0	0.5	6.2	28.4	37.7	23.3		
A	Total revenue and grants (1+2) as % of GDP		22%															21%	29%	
B	Total expenditure and net lending (1+2) as % of GDP		25%																21%	32%
	Overall budget balance (cash) (A-B) as % of GDP		-2%																0%	-4%

Source: Ministry of Finance

Chapter 5. Budget

The following table, table 5.2 presents specific revenue categories executed in 2001, 2002, and 2003 as part of total revenues, as well as a percent of the planned levels. Additionally, the table contains figures from the 2002 budget execution as a percent of the 2001 execution. Analogous figures are given for specific categories of expenditures.

Table 5.2 Composition of central budget revenues and expenditures

	2001			2002				2003 plan		
	in millions euro	as % total revenue	as % of the plan	in millions euro	as % total revenue	as % of the plan	as % of 2001 execution	in millions euro	as % total revenue	
A	Total revenue and grants									
(1+2)	233.1		110.1	253.3		84.8	108.7	384.2		
1	Total revenue (1.1+1.2)	221.2	100.0	120.2	226.4	100.0	84.0	102.4	361.0	100.0
1.1	Current revenue (1.1.1+1.1.2)	221.2	100.0	120.2	226.4	100.0	84.0	102.4	361.0	100.0
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)	188.0	83.0	110.3	205.5	90.7	98.5	109.3	331.4	91.8
1.1.1.1	Personal income	56.7	25.0	102.7	57.9	25.6	85.2	102.2	76.2	21.1
1.1.1.2	Turnover (retail sales) tax	58.5	25.8	104.9	52.3	23.1	84.5	89.5	98.3	27.2
1.1.1.3	Excises	35.7	15.7	105.0	50.8	22.4	150.7	142.4	86.3	23.9
1.1.1.4	Taxes on international trade and transactions	27.3	12.0	154.2	27.1	12.0	82.4	99.4	52.0	14.4
1.1.1.4.1	Custom tariffs	13.9	6.1	132.0	13.3	5.9	73.3	95.8	30.0	8.3
1.1.1.4.2	Custom transit fees	13.4	5.9	186.9	13.8	6.1	93.6	103.2	22.0	6.1
1.1.1.5	Other taxes	9.9	4.4	121.3	17.3	7.7	143.3	174.9	18.6	5.1
1.1.2	Nontax revenues	33.2	17.0	214.3	21.0	9.3	34.3	63.1	29.6	8.2
1.2	Capital revenue	0.0			0.0				0.0	0.0
2	Grants	11.9	6.5	48.0	26.9	11.9	92.3	225.6	23.2	6.4
			as % total expenditure			as % total expenditure				as % total expenditure
B	Total expenditure and net lending (1+2)									
(1+2)	259.3		114.5	250.7		76.4	96.7	431.2		
1	Total expenditure (1.1+1.2)	252.6	100.0	111.8	241.7	100.0	76.3	95.7	422.8	100.0
1.1	Current expenditure (1.1.1+1.1.2)	233.3	92.4	112.4	230.5	95.4	76.9	98.8	400.8	94.8
1.1.1	Interest	0.6	0.2	133.6	13.1	5.4	55.6	2,108.3	25.5	6.0
1.1.2	Non-interest (1.1.2.1+1.1.2.2+1.1.2.3+1.1.2.4+1.1.2.5+1.1.2.6)	232.7	92.2	112.3	217.4	90.0	78.7	93.4	375.3	88.8
1.1.2.1	wages and salaries	108.5	43.0	92.2	105.9	43.8	78.6	97.7	152.0	36.0
1.1.2.2	goods and services	55.4	21.9	141.0	41.8	17.3	76.9	75.4	43.8	10.4
1.1.2.3	Social Insurance and Social Security Transfers	45.3	18.0	144.0	35.7	14.8	79.6	78.8	149.5	35.4
1.1.2.4	Subsidies to enterprises	12.2	4.8	107.5	18.2	7.5	69.9	148.3	16.8	4.0
1.1.2.5	Reserve	6.5	2.6	132.1	12.8	5.3	107.5	197.9	9.5	2.2
1.1.2.6	Other non - interest expenditure	4.8	1.9	191.3	3.0	1.3	67.0	62.5	3.8	0.9
1.2	Capital expenditure	19.3	7.6	105.0	11.2	4.6	66.8	58.0	22.0	5.2
2	Net lending	6.7	3.7	341.9	9.1	3.8	79.0	135.1	8.4	2.0
	Lending	14.0	5.6	511.9	9.1	3.8	79.0	65.0	8.4	2.0
	Repayment	7.3	1.9	plan was 0	0.0				0.0	

Source: Ministry of Finance

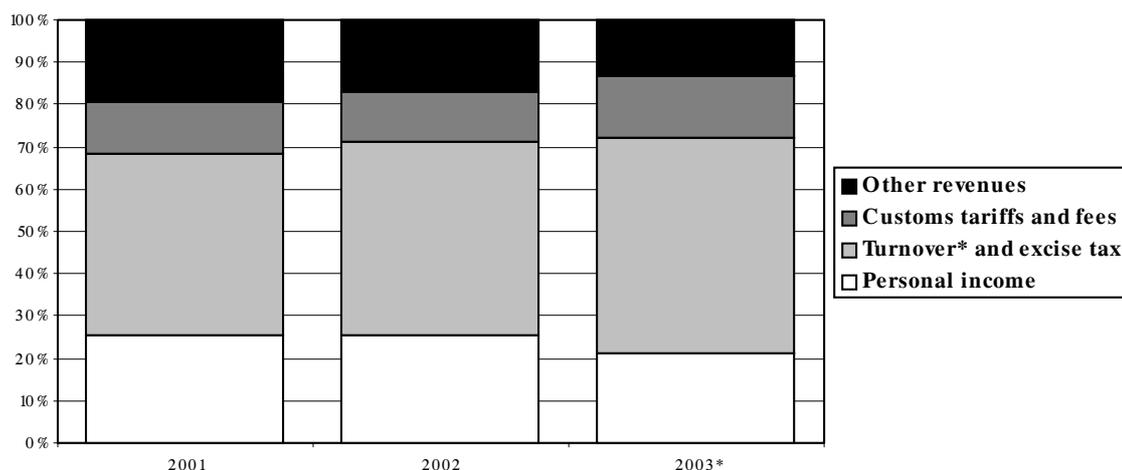
5.1.1 Budget revenues and grants

Total budget revenues (excluding grants) in 2002 were equal to € 226.4 million, which represents 17.4% of the estimated GDP¹. All categories of budget revenues (except for excises and other taxes) were executed below the planned level. Consequently, total budget revenues were over 16% below the planned level. In our opinion, this was due to at least three factors. First, the budgetary plan assumed an overly optimistic forecast of economic activity and hence the tax collection was overestimated. Second, the failure to integrate parts of the gray economy into the official economy resulted in lower than expected revenues. Third, the implementation of some new tax laws that were supposed to raise revenues (such as VAT) was postponed and some other tax laws that were implemented did not bring the expected results in the form of higher revenues.

Compared to the central budget revenues executed in 2001, central budget revenues in 2002 were almost at the same level.

Composition of budget revenues and executions

Graph 5.1 Composition of central budget revenues in 2001-2003
(data for 2003 from the budget proposal)



* from April 2003 turnover tax will be replaced by VAT

Source: Ministry of Finance

Turnover tax (including excises) and personal income tax represented more than 70% of total budget revenues in 2002 (see graph 5.1). These categories together with revenues from taxes on international trade and transactions represented 82% of total revenues.

- Turnover tax (without excises) represented more than 23% of total revenues. They reached €52.3 million, which was 15% (or €10 million) below the planned level. On the other hand, excises exceeded the planned amount by the highest percentage. They were close to €51 million, which represented 150% of the planned amount. This was probably due to stricter control and improved efficiency in collection of these duties. The share of this category in total revenues exceeded 22%.
- Personal income tax reached €58 million (15% less than planned), and accounted for almost 15% of total revenues. The highest component of this category was payroll

¹ GDP at current prices, ISSP estimation.

taxes, which exceeded €51 million. The main reason for lower revenues from personal income tax was the difficult economic situation in 2002. In particular, the reasons include strikes, a large number of public companies that fail to pay salaries and taxes on net wages, as well as gray economy practices in the labor market.

- Collection of taxes on international trade and transactions (custom tariffs and custom transit fees) exceeded €27 million (18% less than the planned level). This category contributed about 12% to total revenues. While custom tariffs and custom transit fees were projected at €18.2 and €14.7 million respectively, they were executed at almost the same level, i.e. €13.3 and €13.8 million respectively.

Other taxes (corporate income tax as well as property and real estate tax) represented almost 6% of total revenues (€13.3 million). The execution of this category exceeded the plan by more than 43%, mostly thanks to higher revenues from corporate income tax (plan was exceeded by 56%).²

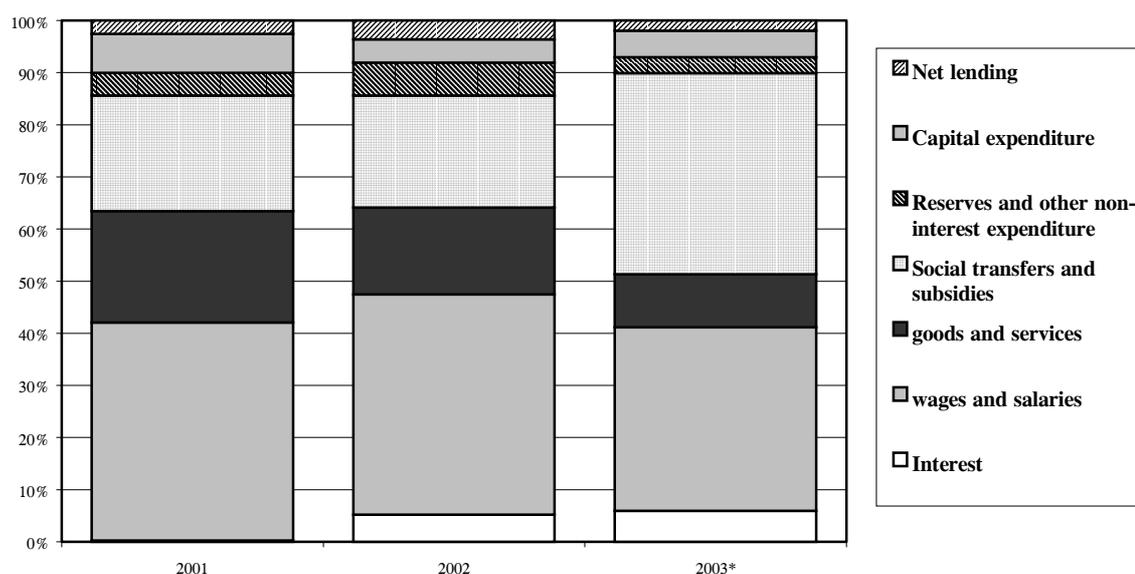
Non-tax revenue (fees, fines and other revenue) represented 9.3% of total revenue (a fall of 66% compared to the planned amount). This was mainly due to a very low execution of the revenue from activities of government bodies (€3.5 million vs. €42 million planned). With this revenue category centralized in the budget for the first time in 2002, the Government was overly optimistic in their planning and expected revenues at a much higher level.

Grants

At the end of 2002 total foreign aid (grants) was close to €27 million and was below the planned level by more than 8%. Foreign aid represented almost 12% of total revenues.

5.1.2 Budget expenditures and net lending

Graph 5.2. Composition of central budget expenditures in 2001-2003
(data for 2003 from the budget proposal)



Source: Ministry of Finance

² Profit tax is calculated and paid in advance based on the previous year financial results. So advances in 2002 were based on taxes paid in 2001. Therefore, higher revenues do not necessarily mean higher profitability of enterprises in the same budget year.

Lower than expected budget revenues normally have an effect on the level of budget expenditures. The Ministry of Finance was thus forced to implement restrictive expenditure policies. Due to this, all expenditure categories (except reserves) were executed below the planned level either because they were reduced in the course of the year or there was a delay in the payment of some obligations. Consequently, total budget expenditures including net lending, in 2002, were close to €250 million (19.3% of GDP), which represented 76.4% of the planned level. Expenditures with net lending were €8.6 million smaller in comparison with 2001.

Composition of budget expenditures and executions

- The largest expenditure category in 2002, wages and salaries, represented almost 44% of total expenditures. In line with the unplanned rise in the minimum wage (by 8%) in July, one would expect this category to increase accordingly³. However, the budgetary data indicate that at the end of 2002 expenditures for wages and salaries amounted to €105.9 million, or 21.4% below the planned level. Within this category, the item “net wages” was executed above the planned level, while taxes, contributions and other liabilities were executed below the plan. It indicates that payment of net wages has been the highest priority throughout the year for the government.
- The second largest expenditure category was expenditures for goods and services. This category amounted to close to €42 million, and represented 17.3% of total expenditures. This category was executed 23.1% below the planned level and by €1 million less than in 2001.
- Social Insurance and Social Security transfers represented 14.8% of total expenditures and were 20% lower than the planned level.
- Subsidies to enterprises represented 7.5% of total expenditures (€18.2 million) and were 30% below the planned level.
- Other non-interest expenditure (rents of government buildings and other expenditures), reached €3 million in 2002 (33% below the planned level). This category represented 1.25% of total expenditures.
- A reserve fund which was set up to finance elections, provide support to exporters and development of small and medium size businesses was the only expenditure category which exceeded the plan. This category amounted to close to €12.8 million, or about €1 million more than planned.
- In 2002 the Montenegrin Government started to pay interest on the old foreign debt (debt accrued before 1990) to non-residents. While the Government does not yet have a clear picture as to the level of the debt (some negotiations with creditors are not yet finished), it projected the maximum amount of interest on international debt at €23 million (total interest was planned in the amount of €23.6 million). At the end of 2002, expenditures for interest to non-residents reached €12.5 million.

³ Wages in Montenegro are closely linked with the minimum wage. Thus, minimum wage increase increases all other wages (especially in the public administration). See article in Part II for details.

- Capital expenditures (mainly investment and maintenance of existing objects) represented 4.6% of total expenditures and amounted to €16.8 million (33% less than planned).

Net lending

In 2002, net lending (net credits given by the government) was €9.1 million. The plan foresaw €11.5 million for lending and nothing for repayments in 2002 (and also in 2003). This means that the government does not expect repayments for the credits it is giving which makes credits close to subsidies.

5.1.3 Budget balance and financing

Overall budget balance

Overall budget balance excluding grants in 2002, calculated as the difference between total revenues and total expenditures and net lending, was - €24.3 million on a cash basis, which represented close to 2% of GDP. If grants are included the budget balance turns positive and amounts to €2.6 million on a cash basis.

Financing

The budget balance was financed through privatization receipts. Privatization receipts in 2002, amounted to €37.7 million, €14 million in excess of the plan thanks to the privatization of *Jugopetrol*.

Jugopetrol Privatization

	Revenues from Jugopetrol privatization	Expenses
	€60 millions has been paid	About 40 Millions to Central Government Budget
	€5 million will be paid once Jugopetrol accounts are audited	<i>of which €7.5 millions (Ministry of Finance estimation) will be spent for the reimbursement of households' currency savings from Former Yugoslavia period</i>
		About €18.6 million to Pension Fund
		About €6.2 million to Employment Fund
		About €0.76 millions to Fund for Development
Total	€65 million	€65 million

Source: daily newspaper *Vijesti*, October 19 and November 5.

Positive cash balance and larger privatization receipts allowed the government to reduce net liabilities vis-à-vis the financial. Namely, net financing, in 2002, was negative which means that repayments exceeded the borrowing by €3.9 million.

Generally, the budget policy in 2002 can be considered restrictive. Revenues and grants were below the planned level. The budgetary expenditures were roughly in line with the total revenues (including grants) and lower revenues forced the Government to reduce some expenditure categories or postpone its obligations. This cash-based discipline along with the

larger privatization receipts allowed the Government to reduce its liabilities and deposit⁴ some additional funds for the next year.

5.2 TREASURY BILLS⁵

Throughout the year the Government has attempted to solve liquidity problems by issuing T-bills. As we can see from the tables (Table 5.3 and Table 5.4), this measure has become permanent. Throughout 2002, the Government continued to issue 28-day T-bills, and as of February 2002 began issuing 56-day T-bills. In 2002, the Central Bank, on behalf of the Ministry of Finance, held 13 auctions of 28-day T-bills and 11 auctions of 56-day T-bills.

Commercial banks were the major buyers of the bills. Even though the T-bill interest rate was generally below the rate the banks could earn by giving loans (or investing their funds otherwise), the banks had an interest to purchase T-bills. According to the new Central Bank regulation, banks can keep up to 10% of the required reserves in T-bills.

The value of issued T-bills in the last months of 2002 has increased significantly. In January 2002, the value of emissions of 28-day T-bills was €2.5 million while in December 2002, this value amounted to €6.6 million. Additionally, emissions of 56-day T-bills, which were offered in the amount of €2 million when they began in February, have been going up throughout the year to reach €3 million in December. The increased supply of the bills pushed the interest rate up, however, it still remained below the market interest rate. The average weighted interest rate on 28-day T-bills increased from 7.05% in January 2002 to 8.14% in December, and for 56-day T-bills, the rate went from 7.5% in February to 8.13% in December. The government should keep in mind that the continuous expansion of T-bill emission will gradually increase the total budget burden, which might have a negative impact on its credibility.

In subsequent tables we present an overview of the 28-day and 56-day T-bill auctions, which were organized through February 5.

⁴ These deposits were mostly thanks to Jugopetrol privatization receipts.

⁵ Issuing and repayment of T-bills are the so-called “flying positions” which means that they are collected and repaid during the same fiscal year. Including these positions would increase both the budget revenues and expenditures side. That is why the Ministry of Finance does not include these positions in the budget.

Chapter 5. Budget

Table 5.3. Overview of 28-day T-bill auctions

No.	Date of auction	Date of maturity	Amount of issue in mil €	Total offered amount in mil €	Amount of sold T-bills in mil €	Interest rate %		
						Lowest	Highest	Weighted average
1.	04.09.2001	03.10.2001	2.556	3.364	2.556	4.2	8	6.5
2.	02.10.2001	31.10.2001	3.579	2.669	2.669	6	8.95	6.89
3.	30.10.2001	28.11.2001	3.579	3.093	3.093	6	8.5	6.83
4.	27.11.2001	26.11.2001	3.579	4.714	3.579	6	8.95	7.31
5.	26.12.2001	24.01.2002	3.579	4.049	3.579	6	8.95	7.14
6.	23.01.2002	21.02.2002	2.5	2.794	2.5	6	8.95	7.05
7.	20.02.2002	21.03.2002	2.5	4.260	2.5	6	8.95	7.05
8.	20.03.2002	18.04.2002	2.5	3.070	2.5	6	8.5	7.02
9.	17.04.2002	16.05.2002	2.5	3.5	2.5	6	8	7.02
10.	15.05.2002	13.06.2002	2.5	2.864	2.5	6	8	6.99
11.	12.06.2002	11.07.2002	2.5	2.770	2.5	6	8	6.92
12.	10.07.2002	08.08.2002	3	2.870	2.870	6	8.5	7.13
13.	07.08.2002	05.09.2002	3.5	2.905	2.905	6	7.5	7.37
14.	04.09.2002	03.10.2002	3.5	3.492	3.492	6	8	7.53
15.	03.10.2002.	31.10.2002.	4	2.792	2.792	6	7.5	7.36
16.	30.10.2002.	28.11.2002.	6	4.467	4.467	6	8.25	7.41
17.	27.11.2002.	26.12.2002.	6	5.077	5.077	7.5	8.25	7.79
18.	25.12.2002.	23.01.2003.	6.6	5.774	5.774	7.5	9	8.14
19.	22.01.2003.	20.02.2003.	7	5.912	5.912	7.5	9	7.99

Source: Central Bank of Montenegro.

Note: Interest rates are expressed in annual terms.

Table 5.4. Overview of 56-day T-bill auctions

No.	Date of auction	Date of maturity	Amount of issue in mil €	Total offered amount in mil €	Amount of sold T-bills in mil €	Interest rate %		
						Lowest	Highest	Weighted average
1.	06.02.2002	04.04.2002	2	0	0	-	-	-
2.	06.03.2002	02.05.2002	3	1.085	1.085	6.5	8.5	7.5
3.	30.04.2002	27.06.2002	2	0.8	0.8	6.5	7.5	6.88
4.	29.05.2002	25.07.2002	2	1.5	1.5	6.5	8	7
5.	26.06.2002	22.08.2002	1	0.560	0.560	6.5	7.5	6.61
6.	24.07.2002	19.09.2002	2	3.120	2	7.5	8	7.72
7.	21.08.2002	17.10.2002	2.5	1.560	1.560	7.5	8	7.8
8.	18.09.2002	14.11.2002	3	1.387	1.387	7.5	8	7.82
9.	16.10.2002.	12.12.2002.	3	1.750	1.750	7.5	9.5	7.96
10.	13.11.2002.	09.01.2003.	3	1.670	1.670	7.5	9.0	8.04
11.	11.12.2002.	06.02.2003.	3.5	2.350	2.350	6	9.5	8.13
12.	08.01.2003.	06.03.2003.	3	1.670	1.670	7.5	9	8.13
13.	05.02.2003.	02.04.2003.	3.	2.250	2.250	8	9.5	8.38

Source: Central Bank of Montenegro

Note: Interest rates are expressed in annual terms.

5.3 SOCIAL FUNDS IN 2002

5.3.1 Pension Fund

At the end of 2002 total revenues of the Pension Fund reached €153.4 million. Expenditures amounted to €154.3 million and the resulting deficit was €0.9 million.

Revenues from contributions represented close to 61% of total revenues. In addition to these contributions the Pension Fund was financed through redirected budgetary funds from taxes, tariffs and excises (€46.8 million or 30% of total revenues), as well as from revenues from special taxes (€6.3 million or 4% of total revenues) and revenues from fees charged by the House for Settlements and Payments in the amount of €4.2 million⁶.

Expenditures for pensions represented almost 80% of total expenditures. Expenditures for contributions to the Health Fund for pensioners' health insurance (in the amount of €21.7 million) represented 14% of total expenditures. Other expenditures (material expenses, cost related to payments of pensions and other expenses) represented 6% of total expenditures.

5.3.2 Health Fund

Total expenditures of the Health Fund in 2002 exceeded revenues by almost €12 million. Total revenues amounted to €82.1 million while total expenditures reached almost €94.1 million.

In the structure of revenues, the highest share of revenues came from contributions of workers and employees⁷ and reached a level of nearly €59 million or 72% of total revenues. The second largest revenue category, revenue from contributions from the Pension Fund, were close to €22 million and represented 27% of total revenue. Other revenues represented 1% of total revenues.

Expenditures for regular activities⁸ amounted to €86.6 million and represented 92% of total expenditures. Other expenditures were related to payments for social insurance during sick leave (€2.4 million), other cost during patients' sickness (€2.9 million) and material expenditures (€1.4 million).

5.4.3 Employment Fund⁹

Total revenues of the Employment Fund amounted to €15.6 million and expenditures reached the level of €11.8 million, which resulted in a surplus of €3.8 million. Close to 36% of total revenues were a result of selling the shares of companies that the Fund was given during the first stage of mass privatization, 25% of total revenues were contributions for workers and employees (paid by employers as part of the tax on wages) and the remaining 39% were from other sources.

⁶ Until 2003 revenues from different sources were directed to separate accounts. In the plan for 2003, the subsidy for the Pension Fund is to be directly transferred from the budget.

⁷ Contributions from economic activity, contributions from non-economic activity, contributions from self employed workers and contributions from agricultural workers.

⁸ Ambulance and dispensary services, medicines, treatments in stationary health care facilities, dentists' services and other forms of health care.

⁹ The Employment Fund has been set up to register the unemployed, pay unemployment benefits, assist the unemployed, provide training and stimulate self-employment.

On the expenditure side, the Fund spent almost 20% on support for the unemployed and the employed (including unemployment benefits and salaries to bankrupt enterprises), 40% for preferential credit for self-employment and the rest on administrative and material costs.

Table 5.5. Revenues and expenditures of the social funds

Social funds	Revenues	Expenditures
Pension Fund	153.36	154.272
Health Fund	82.114	94.076
Employment Fund	15.624	11.77

Source: Ministry of Finance

5.4 CONSOLIDATED CENTRAL GOVERNMENT BUDGET FOR 2002 AND 2003

The Budget Law for 2003 represents numerous structural changes in comparison with budget laws in previous years. These changes are a consequence of the implementation of new tax laws. The new tax laws changed the system of tax collection on the revenue side and added new obligations for the Union budget and a new method of transfers to the extra-government units on the expenditure side. As a result the central budget structure as given in the Budget Law for 2003 is not comparable with central budget structures from previous years.

Therefore, we attempted to compile the statistics for the consolidated government sector¹⁰ for both 2003 and 2002. These figures are based on official statistics of the central budget and budgets of the 3 social funds. In our calculations we made several assumptions concerning transfers, between budget and funds as well as amongst funds in 2003. Because the final figures are not official estimates, we do not guarantee their accuracy. However they are correct in showing the tendencies and trends in the budget policies. The consolidated statistics are presented in table 5.6.

The main features of the consolidated budget in 2003 are:

- Higher tax revenues due to new tax laws (centralization of tax revenues and resulting expectations of higher revenues),
- Lower level of grants,
- Higher expenditures due to an increase in expenditures for wages, new contributions for the federal budget and new system of transfers to social funds,
- Negative budget balance.
- Plans for financing the budget deficit through grants, privatization receipts and borrowing from the World Bank, the EU and domestic banks.

¹⁰ Without municipalities for which we could not get appropriate data.

Table 5.6. Consolidated Central Government Budget for 2002 and 2003.

	2002 execution			2003 Plan			
	million euro	in % of total	in % of GDP	million euro	in % of total	in % of GDP	in % of 2000 execution
A Total consolidated gov. revenue and grants (1+2)	474.9	100.0	38.9	534.8	100.0	40.3	113
1 Total consolidated gov. revenue (1.1+1.2+1.3)	448.0	94.3	36.7	511.6	95.7	38.5	114
1.1 Tax revenue (1.1.1+1.1.2+1.1.3+1.1.4)	277.8	58.5	22.7	331.4	62.0	25.0	119
1.1.1 Personal income	57.9	12.2	4.7	76.2	14.2	5.7	132
1.1.2 Consolidated turnover and excise taxes	163.6	34.4	13.4	184.6	34.5	13.9	113
1.1.2.1 Turnover (retail sales) tax (1.1.2.1.1+1.1.2.1.2)	107.9	22.7	8.8	98.3	18.4	7.4	91
1.1.2.1.1 central budget	52.3	11.0	4.3	0.0	0.0	0	0
1.1.2.1.2 PIO, army, railways and roads	55.6	11.7	4.6	0.0	0.0	0	0
1.1.2.2 Excises (1.1.2.2.1+1.1.2.2.2)	55.7	11.7	4.6	86.3	16.1	6.5	155
1.1.2.2.1 central budget	50.8	10.7	4.2	0.0	0.0	0	0
1.1.2.2.2 PIO	4.9	1.0	0.4	0.0	0.0	0	0
1.1.3 Consolidated taxes on international trade and transactions (1.1.3.1+1.1.3.2)	38.9	8.2	3.2	52.0	9.7	3.9	134
1.1.3.1 Custom tariffs (1.1.3.1.1+1.1.3.2)	25.1	5.3	2.1	30.0	5.6	2.3	119
1.1.3.1.1 central budget	13.3	2.8	1.1	0.0	0.0	0	0
1.1.3.1.2 PIO	11.8	2.5	1.0	0.0	0.0	0	0
1.1.3.2 Custom transit fees	13.8	2.9	1.1	22.0	4.1	1.7	159
1.1.4 Other taxes	17.3	3.7	1.4	18.6	3.5	1.4	107
1.2 Nontax revenues	21.0	4.4	1.7	29.6	5.5	2.2	141
1.3 Revenues of the Pension, Health and Employment funds (1.3.1+1.3.2)	149.3	31.4	12.2	150.6	28.2	11.3	101
1.3.1 Contributions to the funds	140.8	29.6	11.5	143.2	26.8	10.8	102
1.3.2 Other nontax revenue of the funds	8.5	1.8	0.7	7.4	1.4	0.6	87
2 Grants	26.9	5.7	2.2	23.2	4.3	1.7	86
B Total consolidated expenditure and net lending excluding transfers (1+2)	488.6	100.0	40.0	581.9	100.0	43.8	119
1 Consolidated expenditure excl. transfers (1.1+1.2)	476.1	97.5	39.0	570.2	98.0	42.9	120
1.1 Interest	13.1	2.7	1.1	25.5	4.4	1.9	195
1.2 Consolidated non-interest expenditure (1.2.1.1+1.2.2+1.2.3.1+1.2.4+1.2.5+1.2.6+1.2.7+1.2.8)	463.0	94.8	37.9	544.7	93.6	41.0	118
1.2.1 wages and salaries (1.2.1.1+1.2.1.2)	105.9	21.7	8.7	152.0	26.1	11.4	143
1.2.1.1 wages and salaries excl. transfers to the funds	90.9	18.6	7.4	105.6	18.1	8.0	116
1.2.1.2 social contributions on wages	15.0	3.1	1.2	46.4	8.0	3.5	309
1.2.2 goods and services	41.8	8.5	3.4	43.8	7.5	3.3	105
1.2.3 Social Insurance, Social Security and other transfers (1.2.3.1+1.2.3.2)	108.3	22.2	8.9	149.5	25.7	11.3	138
1.2.3.1 Social Insurance, Social Security Transfers, expenditures for the army, railways and roads without budget transfers to the funds	51.5	10.6	4.2	97.1	16.7	7.3	188
1.2.3.2 Total transfer to funds (1.2.3.2.1+1.2.3.2.2)	56.8	11.6	4.7	52.4	9.0	3.9	92
1.2.3.2.1 budget transfers to the funds	3.7	0.8	0.3	52.4	9.0	3.9	1,422
1.2.3.2.2 Transfers from account 84 and other special turnover taxes	53.1	10.9	4.3	0.0	0.0	0.0	0
1.2.4 Total expenditures of funds (1.2.4.1+1.2.4.2+1.2.4.3)	233.7	47.8	19.1	246.2	42.3	18.5	105
1.2.4.1 PIO (excl. transfers to HF)	132.5	27.1	10.9	141.0	24.2	10.6	106
1.2.4.2 HF	94.1	19.3	7.7	96.6	16.6	7.3	103
1.2.4.3 Emplt Fund (excl. transfers to HF and lending for selfemployment loans)	7.1	1.4	0.6	8.6	1.5	0.6	122
1.2.5 Subsidies to enterprises	18.2	3.7	1.5	16.8	2.9	1.3	92
1.2.6 Reserve	12.8	2.6	1.0	9.5	1.6	0.7	74
1.2.7 Other non - interest expenditure	3.0	0.6	0.2	3.8	0.7	0.3	127
1.2.8 Capital expenditure	11.2	2.3	0.9	22.0	3.8	1.7	196
2 Net lending (2.1-2.2)	12.4	2.6	1.0	11.7	2.0	0.9	94
2.1 Lending (2.1.1+2.1.2)	13.7	2.9	1.1	13.0	2.2	1.0	95
2.1.1 central budget	9.1	1.9	0.7	8.4	1.5	0.6	92
2.1.2 emplt fund (selfemployment loans)	4.6	0.9	0.4	4.6	0.8	0.3	100
2.2 Repayment (2.2.1+2.2.2)	1.3	0.3	0.1	1.3	0.2	0.1	100
2.2.1 central budget	0.0	0.0	0.0	0.0	0.0	0	0
2.2.2 emplt fund (repayment of selfemployment loans)	1.3	0.3	0.1	1.3	0.2	0.1	100
Overall consolidated budget balance excluding grants (cash) (A-B-2)	-40.5	-8.5	-3.3	-70.3	-13.1	-5.3	174
Overall consolidated budget balance (cash) (A-B)	-13.6	-2.9	-1.1	-47.1	-8.8	-3.5	346
C Financing (1+2)	40.3	8.5	3.3	56.2	10.3	4.2	139
1 Domestic and foreign financing (net) (1.1-1.2)	-3.1	-0.6	-0.3	32.9	6.1	2.5	-1,057
1.1 Borrowing (1.1.1+1.1.2)	45.8	9.7	3.8	33.2	6.2	2.5	72
1.1.1 Budget	45.1	9.5	3.7	24.0	4.5	1.8	53
1.1.1.1 Foreign	0.0	0.0	0.0	20.5	3.8	1.5	0
1.1.1.2 Domestic	45.1	9.5	3.7	3.5	0.7	0.3	8
1.1.2 PIO + Emplt Fund	0.8	0.2	0.1	9.2	1.7	0.7	1,227
1.2 Repayment	48.9	10.2	4.0	0.3	0.0	0.0	1
2 Privatization receipts (2.1+2.2)	43.4	9.1	3.6	23.3	4.4	1.8	54
2.1 Budget	37.7	7.9	3.1	23.3	4.4	1.8	62
2.2 Emplt Fund	5.7	1.2	0.5	0.0	0.0	0.0	0
Memorandum items:							
Nominal GDP	1,221.3			1,327.6			

Source: Ministry of Finance

5.4.1 Consolidated Revenues

According to the budget plan for 2003, total budget revenues including social funds¹¹ are projected at €511.6 million (or 38.5% of GDP¹²), which represents 114 percent of 2002 revenues (when it amounted to 36.7% of GDP). If we include foreign aid, revenues go up to €534.8 million or 40.3% of GDP (or 113% of the 2002 value).

The Ministry of Finance projected an increase in revenues mostly due to the introduction of new tax laws (VAT Law, Personal Income Tax Law) as well as changes in the system of collection and evidence of the taxes on international trade and transactions.

As a result, the Ministry of Finance planned increases of revenues from: the turnover and excise taxes, taxes on international trade and transactions as well as the personal income tax.

- Personal income tax is projected to reach €76.2 million, which represents an increase of 32% in comparison to the 2002 execution (or 1 percentage point increase in terms of GDP).
- The largest systemic changes in the central budget took place in the case of turnover and excise taxes. Previously, a large part of the revenues was directly transferred to the Pension Fund, army, railways and roads. In 2003, all of those revenues are directed to one central account. The sum of turnover, excise and VAT taxes was projected at €184.6 million (or 13.9% of GDP), which represents an increase of 13% over the amount executed in 2002. This increase is mostly due to the projected positive effect of the VAT introduction in April 2003¹³, both in terms of better compliance and broadening the tax base.
- Custom tariffs were projected to reach €30 million in 2003, which represents 119% of executions in 2002¹⁴. Custom transit fees were projected at €22 million (159% of executions in 2002). This category of revenues is bound to have a different outcome than the projection since the Government did not take into account the tariff increase connected with the tariff harmonization with Serbia¹⁵. The source of the revenue increase, according the budget law, comes from nominal GDP growth, improvements in customs office operations and the resultant decrease in smuggling activities.

The question remains as to whether the executions can meet the projected levels and, even more importantly, what effects will the planned tax changes have on the Montenegrin economy?

Beside the value of turnover, the size of revenues from VAT will mostly depend on the degree to which the Government succeeds in transferring parts of gray economy onto official channels. Basic preconditions for the successful VAT introduction include necessary improvements in the efficiency of custom and tax administrations and better control of turnover.

The execution of the planned revenues from the personal income tax in 2003 (projected at a higher level than 2002 execution) seems rather difficult. Successful collection of this

¹¹ Without transfers between the budget and the funds as well as between the funds.

¹² ISSP projection for 2003.

¹³ According to VAT Law uniform tax rate will be 17%. The current turnover tax rates range from 15% to 24%.

¹⁴ Prior to 2003 almost 50% of tariff revenues was directly transferred to the Pension Fund.

¹⁵ The increase in revenues is conditioned on the new tariffs becoming effective before the end of 2003.

revenue in line with the projections will be very much dependent on the overall economic situation i.e. employment increase, reduction in gray economy, as well as employers' discipline in paying salaries and taxes on salary. In our opinion, the new progressive personal tax system (introduced in July 2002) has and will continue to have a detrimental effect on the labor market by discouraging employment and encouraging the gray economy practices in the labor market. Also the progressive tax system, being much more complex, requires more resources at the administrative level, is much less transparent and encourages fraudulent practices.

Currently, in view of the harmonization of economic systems of Montenegro and Serbia, the level of the common customs tariff rates is of crucial importance for the future of the Union. The common customs regime is still subject to negotiations and remains an open issue. However, undoubtedly, the harmonization of tariff regimes in Serbia and Montenegro will imply a tariff increase in Montenegro. It is very likely that raising tariff rates will lead to higher budget revenues in the short term (and hence over-executing this revenue category¹⁶); however, it is important to keep in mind the indirect effects and long-term consequences of such a policy. The possible detrimental effects of a tariff increase include (but are not limited to) an increase in the general level of prices, increase of manufacturing costs, losses in international competitiveness, expansion of the gray economy and corruption. In our view the net effect of increasing tariffs is negative and the increase in custom tariff revenues does not make it any more acceptable. International aid (grants) projected for 2003 is lower than in 2002. Total grants are planned to reach €23.2 million (€3.7 million less than in 2002) or 1.7% of GDP.

5.4.2 Consolidated Expenditures

The consolidated expenditure side of the 2003 budget involves significant structural changes, including a new budget line for financing contributions to the federal budget and the new system of transferring budgetary funds to the social funds (especially the Pension Fund). The unplanned increase of the minimum wage raised the projected expenditures for wages and salaries in 2003.

Total expenditures in 2003 were projected at €582 million, which represents 44% of GDP in 2003. This is a 19% increase over the euro value of expenditure executions in 2002 when they amounted to 40% of GDP.

- The largest expenditure category, expenditures for wages and salaries were budgeted at €152 million, and represents 26% of total planned expenditures or 11% of GDP. Planned expenditures for this category are 43% higher than executed in 2002 and 13% higher than the 2002 plan. This increase is a result of the July 2002 increase to minimum wage from 46 to 50 euro and growth of employment in public administration in 2002¹⁷.
- Expenditures for goods and services are planned in the amount of €43.8 million (105% of last year's executions) and represent 7.5% of total expenditures and 3.3% of GDP.

¹⁶ Assuming the tariff increase will take place well before the end of 2003.

¹⁷ There are plans to cut employment in public administration in 2003 by 3,000 (see chapter on employment). However, this is not accounted for in the budget where wages in administration are estimated based on an unchanged number of employees.

- 2003 marks the first year that the budget plan includes the contribution to the federal budget (covering, among other things, army and state administration) at the level of €40 million. These expenses in the Budget Law are part of the expenditure category ‘Social Insurance and Social Security Transfers’ and account for about 1/3 of this category. In our consolidated budget statistics presented in table 5.6 this expenditure line is included in the category 1.2.3.1 that also includes social insurance and social security transfers. As a result of inclusion of federal budget expenses, the projection of this category in the 2003 budget is 88% higher than the 2002 execution.
- While the total transfer to the social funds projected for 2003 is at the 2002 level, the structure of these transfers has undergone significant changes. Prior to 2003, the majority of transfers were directed to the so-called ‘account 84’ and were not formally a part of the central budget. Beginning with the Budget Law of 2003, all transfers to the funds are registered in and go through the central budget. The majority of the €52.3 million projected in the budget for this purpose was transferred to the Pension Fund (82%), while the Employment Fund and the Health Fund received about 10% and 6 % respectively.
- A more restrictive policy can be observed in the area of subsidizing companies and lending, which is a good sign. Subsidies to enterprises are projected at €16.8 million (3% of total expenditures), which is almost 8% less than in 2002. Most of these subsidies are subsidies for the agricultural sector as well as road and railway transport companies (for development of infrastructure). Similarly, lending was planned below last year’s executed levels and amounts to €11.7 million (or 6% less than in 2002).
- Capital expenditures are planned to reach €21.2 million euro (almost 100% higher than 2002 execution), which represents 3.8% of planned consolidated expenditures.
- Expenditures for interest are planned in the amount of €25.5 million (4.4% of planned consolidated expenditures) of which €25 million are related to interest on old international debts. This is almost double the amount executed in 2002.
- Other non-interest expenditures were projected at a level of €3.8 million and accounted for less than 1% of planned consolidated expenditures.

The level of budget expenditures in Montenegro is determined to a considerable degree by the level of the minimum wage, whose increases have multiplicative effects on many expenditure categories (See also comment on wages as well as article in the second part on the importance of minimum wage in Montenegro). Thus, any upward adjustments of the minimum wage pose a direct threat to the budget’s viability. An increase of the minimum wage leads to higher expenditures on wages and other benefits to employees, social security transfers and transfers to the Pension Fund to cover a higher deficit. Therefore, it seems absolutely necessary to dismantle the minimum wage benchmark system and do away with all the law-granted links between the minimum wage and other wages and benefits that introduce rigidity in the Montenegrin economy and pose substantial threats to the budget’s viability. As long as these links are in place, any responsible budget policy in Montenegro must involve, in addition to tight fiscal measures, a restriction on the minimum wage increase along with the necessity to reduce the number of public servants.

5.4.3 Overall budget balance and financing

In line with projected revenues and expenditures, the overall budget deficit, excluding grants for 2003, is predicted to exceed €70 million. As grants are planned to amount to €23.2 million, the remaining deficit of €47 million is projected to be financed through privatization receipts as well as domestic and foreign credits. Privatization receipts are projected at €23.3 million, foreign credits from the World Bank and the EU in the amount of €20.5 million and domestic credit from banks is planned to amount to €3.2 million. Additionally, Pension and Employment Funds are planning to borrow €9.2 million in the domestic market.

Budgetary planning in Montenegro is a hard compromise between enormous needs of the society and the state on one hand and the rather limited resources on the other. The current economic situation and the challenges ahead of Montenegro call for a quick creation of a sound and entrepreneur-friendly economic environment with a lower tax burden (encouraging better compliance), liberal trade regime (without quotas and with low custom tariffs), and lower redistribution of income. In our view, in the near future it will be necessary to push public policy in Montenegro towards the higher level of economic freedom, which is one of the key preconditions for economic growth and development.

6: MONEY

6.1. MONETARY TRENDS

Table 6.1.M1 and M2 money aggregates (in million Euros)

	2002										
	III	IV	V	VI	VII	VIII	IX	X	XI	XII	
1 Cash	310	310	310	310	310	310	310	310	310	310	310
2 Demand deposits included in M1	100	101	99	90	96	115	110	124	105	89	
2 a Deposits at the banks	49	47	49	39	54	66	60	82	73	47	
2 b Deposits at ZOP	51	54	50	51	42	49	50	42	32	42	
3 Deposit money excluded from M1	77	60	57	54	72	70	60	85	92	100	
3 a Banks	42	29	25	24	35	38	27	46	45	34	
3 b Government and government institutions	35	31	32	30	37	32	33	39	47	66	
4 Total demand deposits	177	161	156	144	168	185	170	209	197	189	
5 Term deposits	3	3	3	4	4	6	6	7	8	8	
6 M1 (1+2)	410	411	409	400	406	425	420	434	415	399	
7 M2 (5+6)	413	414	412	404	410	431	426	441	423	407	

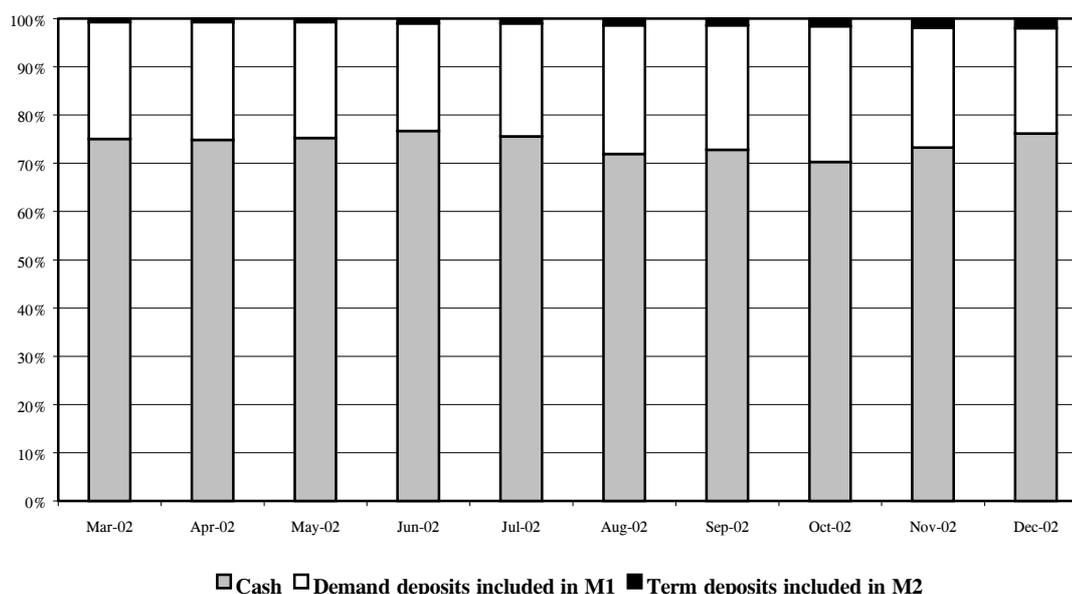
Source: Central bank of Montenegro

Table 6.1 presents the estimates of M1 and M2 money aggregates. The measures of money supply referred to as M1 and M2 were estimated according to the commonly accepted international definition, however, foreign currency deposits were excluded¹. M1 encompasses cash in circulation as well as total demand deposits excluding deposits of the banking sector, government, and government institutions, as well as deposits in foreign currencies. M2 consists of M1 and term deposits from which the same categories as in the case of demand deposits were excluded. Due to the fact that some of the data used for these estimations comes from the balance sheets of the banks, they are available only from March 2002 when banks introduced the new accounting standards. The other part of the deposit data comes from the ZOP², which holds one part of the deposits of enterprises.

¹ Central Bank of Montenegro plans to include foreign currency deposits in the money supply aggregates in the near future.

² ZOP stands for The House of Clearing and Settlement and served as the agent through which all internal payment system in Montenegro used to be done. It is currently in the process of transformation after which all payments will be done through banks.

Graph 6.1. Structure of money aggregates



Source: Central bank of Montenegro

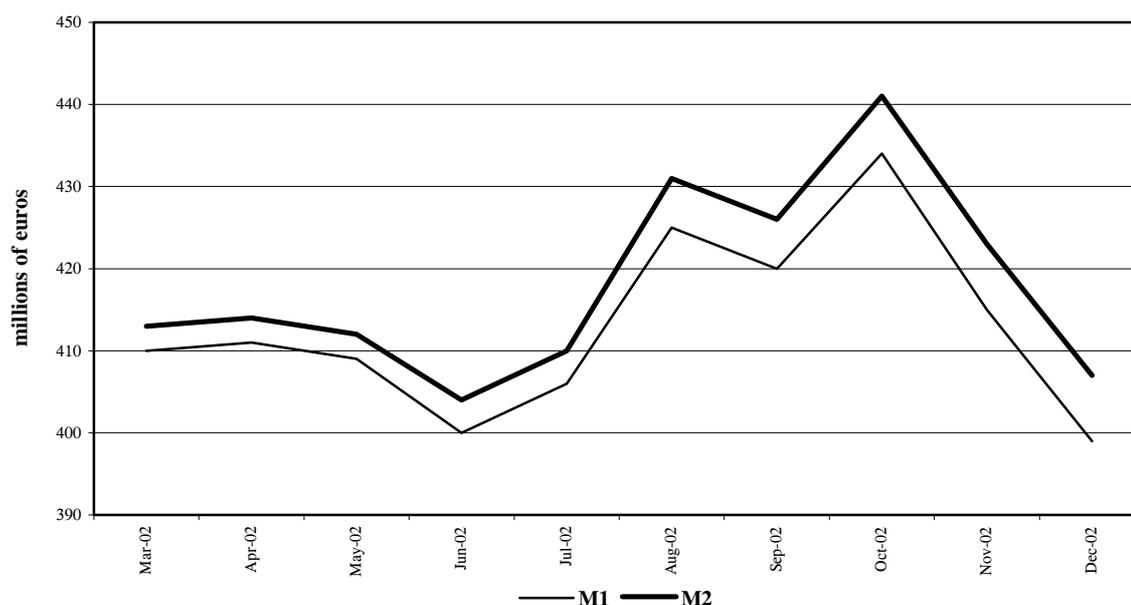
Note: $M1 = \text{cash} + \text{demand deposits}$; $M2 = M1 + \text{term deposits}$

Graph 6.1 presents the structure of the money supply for 10 months of 2002. It shows that term deposits still constitute a very small portion (less than 2%) of the M2 money supply in Montenegro and consequently, both M1 and M2 are very close to each other. However, term deposits registered an impressive rate of growth: growing from 3 million in March to 8 million in December. During the same period, demand deposits decreased by 11% even though the general trend for demand deposits is positive (December saw a decline but was preceded by a period of consistent growth from June to October). Cash continues to be the dominant money component. Accordingly, both monetary aggregates exhibited a very similar trend during the period in question. In percent of GDP, the 2002 year-end³ money supply was equal to 32.7% and 33.3% respectively for M1 and M2.

However, as is clear from the table, cash estimates were held constant throughout the year at 310 million euro. This figure was estimated by the central bank during the process of adoption of the euro in January 2002 (based on the cash that was converted) and is assumed unchanged because no further estimations have been made. Thus, it is very likely that it does not reflect the actual amount of cash in circulation for later months of 2002. One of the possible cash developments in the course of 2002 could be the decline in cash balances in connection with the observed rise in deposits (particularly demand deposits). This would suggest that as Montenegrins became more confident in their banking sector, they converted some of the cash they held into bank deposits.

³ We use the GDP estimate of 1221.3 million euro.

Graph 6.2. Trend of M1 and M2 money aggregates



Assuming that the early 2002 cash estimation continues to reflect the actual cash balances fairly well, the data supports that the Montenegrin economy is still a predominantly cash based economy, i.e. that the vast majority of transactions are done in cash. The future development of the banking sector and the policy of the Central Bank should focus on channeling cash balances to the banking sector in the form of demand and term deposits.

6.2. SAVINGS OF HOUSEHOLDS

The following table presents savings of households.

Table 6.2: Saving of households

Date	1. Demand savings			2. Term savings up to 1 year			3. Term savings over 1 year			4. Total (1+2+3)
	Euros	Other currencies	Euros	Other currencies	Euros	Other currencies	Euros	Other currencies		
31.12.'01.	3,517	2,379	1,138	1,557	1,332	225	550	549	1	5,624
31.01.'02.	2,844	1,985	859	2,090	1,755	335	617	594	23	5,551
28.02.'02.	2,791	1,714	1,077	2,336	1,909	427	702	679	23	5,829
31.03.'02.*	4,706	3,863	843	3,641	2,053	1,588	742	681	61	9,089
30.04.'02.*	5,455	4,610	845	4,623	2,689	1,934	774	712	62	10,852
31.05.'02.*	4,757	4,159	598	4,918	2,992	1,926	526	464	62	10,201
30.06.'02.*	5,080	4,596	484	5,975	3,368	2,607	616	554	62	11,671
31.07.'02.*	5,634	5,080	554	6,298	3,595	2,703	703	641	62	12,635
31.08.'02.*	4,269	3,802	467	7,217	5,184	2,033	928	906	22	12,414
30.09.'02.*	4,730	3,303	1,427	7,898	5,001	2,897	1,663	1,497	166	14,291
30.10.02.*	5,686	4,730	956	8,012	6,140	1,872	1,038	1,012	26	14,736
31.11.02.*	5,205	4,310	895	9,515	6,772	2,743	1,099	1,065	34	15,819
30.12.02.*	6,023	5,154	869	9,650	6,823	2,827	1,127	1,090	37	16,800
31.01.03.*	5,721	4,426	1,295	10,326	7,562	2,764	1,188	1,170	18	17,235

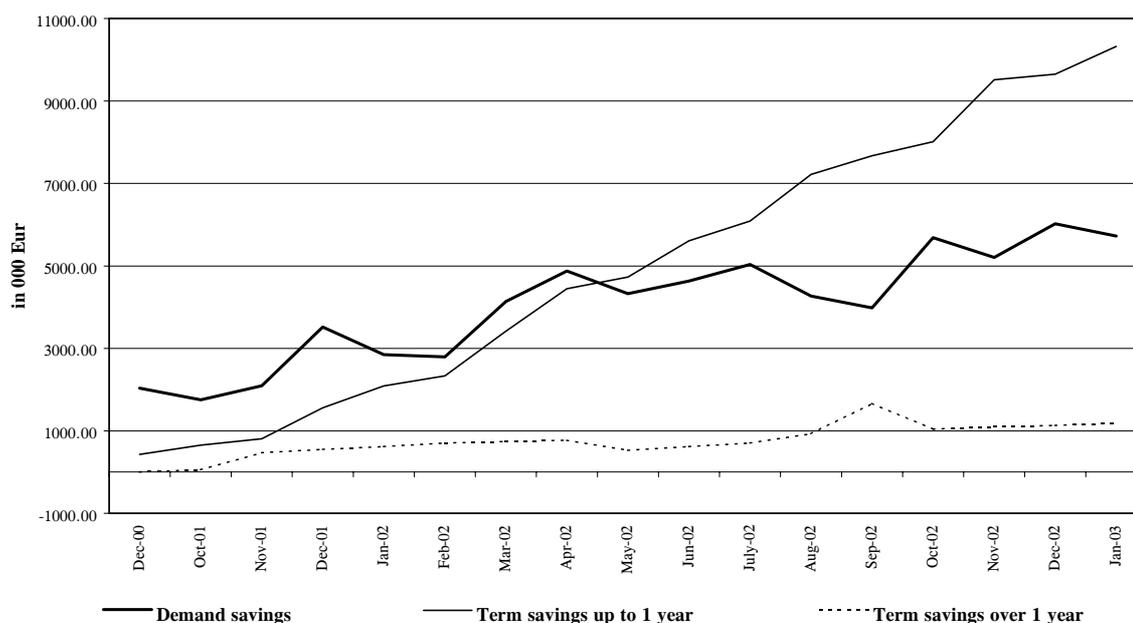
Source: Central Bank of Montenegro, reports of various banks

Analyzing M1 and M2 gives only a partial picture of monetary developments in Montenegro (as M1 and M2 contain only balances denominated in euro). By including foreign currency deposits we can better observe the changing structure of Montenegrin savings.

Savings of households continued to increase in 2002. The year-on-year growth of total household savings in the banking sector increased by 70.64 percentage points last year, from 128.10% in December 2001 to 198.74% in December 2002, and the growth was strongest in the first quarter. Household savings in January 2003 were 210.51% higher than in January 2002.

Term savings up to 1 year exhibited the highest growth during the last year. Their annual growth was 520% in December 2002 and 394% in January 2003. On an annual basis, savings over 1-year and demand savings⁴ increased by 105.04% and 71.27% respectively in December 2002 and by 101% and 95% in January 2003. .

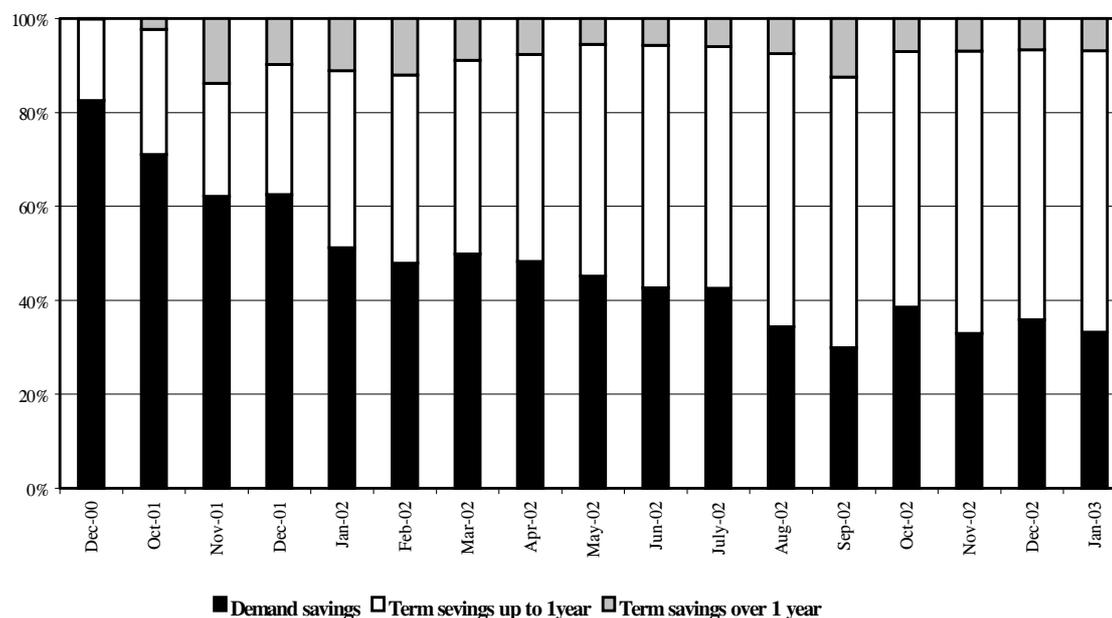
Graph 6.3. Savings of households



Source: Central Bank of Montenegro, reports of various banks

⁴ Demand savings and demand deposits are different categories. Category demand deposits includes demand savings, money on giro and current accounts (so-called transaction deposits) and other deposits.

Graph 6.4. Structure of total savings of households



Source: Central Bank of Montenegro, reports of various banks

At the end of 2000, demand savings accounted for 82% of total savings; this figure dropped to 62% at the end of 2001 and 35% by the end of 2002. The analogous figure for savings up to 1 year was 17% at the end of 2000, 27% at the end of 2001 and 57% at the end of 2002. Term savings over 1 year have been fluctuating in the range of 0.8% to 9.77% at the end of 2001 and reached 6.7% at the end of 2002. The fact that demand savings are declining as a share of total savings and term savings (both up to and over 1 year) are increasing indicates a higher credibility of the Montenegrin banking system and an increasing confidence of Montenegrin citizens in its well-being and stability in the future.

The currency structure of savings shows that in all categories the majority of savings are denominated in euro. The euro is the predominate currency used in all savings, accounting for 85.57% of demand savings, 70.7% of term savings up to 1 year, and 96.72% for over-1-year savings. This supports the belief that Montenegrin citizens have embraced the new currency and are gradually converting their savings from other currencies to euros.

6.3. LOANS

Table 6.3: Credits in 2002 (in thousand €)

	2002									
	III	IV	V	VI	VII	VIII	IX	X	XI	XII
Credits	82,990	88,479	90,774	94,078	95,584	95,282	99,162	111,269	115,329	125,453
1. Banks and Financial Institutions	1,533	2,493	392	314	92	36	128	130	210	1,188
2. Non Financial Institutions and Other Clients	74,860	77,811	82,693	86,707	88,572	89,597	88,757	100,256	106,735	104,212
2.1. Privately Owned Local Companies	59,855	62,298	66,034	71,360	69,501	68,262	67,498	70,800	74,731	72,129
2.2 Publicly owned Organizations	8,607	7,698	8,487	6,687	9,243	8,551	5,639	10,181	10,425	7,603
2.3. Individuals	3,027	4,295	4,591	5,098	6,404	9,657	11,990	14,714	17,284	21,962
2.4. Other	3,371	3,520	3,581	3,562	3,424	3,127	3,630	4,561	4,295	2,518
3. Government, Municipalities and Agencies	6,597	8,175	7,689	7,057	6,920	5,649	10,277	10,883	8,384	20,053

Source: Central Bank of Montenegro, balance sheets of the banks⁵

Note: Data present the stock of loans at the end of the month

During the period March-December 2002 total loans increased by 51.17% and reached a total of €125.45mn. The fastest growing components of total loans are loans to physical entities (625.54% growth) and loans to the Government, municipalities and agencies (203.97%). In 2002, the majority of loans (83%) are made to non-financial institutions and other clients. The majority of these loans (69%) are provided to privately-owned local companies. Loans provided to the government, municipalities and governmental agencies represent 16% of total loans, while loans to banks and other financial institutions account for less than 1%.

⁵ The loans data are from the balance sheet of the banks and they are available only from the March 2002 when banks started to use new accounting standards

7. CAPITAL MARKET

The turnover and number of transactions in 2002 indicates that the Montenegrin capital market is expanding, a concern to the secondary market whose size was negligible last year. In 2002, total turnover in the secondary market, on both stock exchanges¹ in Montenegro, was close to €6.1 million. On the primary capital market, trade amounted to approximately €8.3 million, yielding total turnover on both stock exchanges in 2002 of approximately €14.4 million. In 2002 the trade on both stock exchanges involved approximately 87 shares of Montenegrin companies and four shares of Privatization Investment Funds.

The most important reason for this expansion was the completion of the Mass Voucher Privatization program on March 4, 2002. As a result, 217 companies were privatized and approximately 390,000 Montenegrin citizens became shareholders of privatized companies directly or through the intermediation of six Privatization Investment Funds². Additionally, the last two years have witnessed the creation of the institutions and infrastructure necessary for the operation and development of the financial market, and specifically the capital market. In December of 2000 the Law on Securities was adopted. The Law enabled the establishment of the Securities Commission and Central Depository Agency. In addition to the existing *Montenegroberza* stock exchange, the new stock exchange: *NEX Montenegro*, with an electronic system of trade, was established in September 2001³.

The following comments will present the analysis of trade on both stock exchanges in 2002, separately for trade on primary and secondary markets.

¹ In Montenegro operated two stock exchange: Montenegroberza and NEX Montenegro.

² More about MVP process and results you can see in MONET 8, comment 12.

³ See Comment 3: "Institutions and infrastructure of the capital market in Montenegro" in MONET 9.

7.1 TOTAL TRADE ON STOCK EXCHANGES IN MONTENEGRO*Table 7.1 Stock exchange trade in Montenegro.*

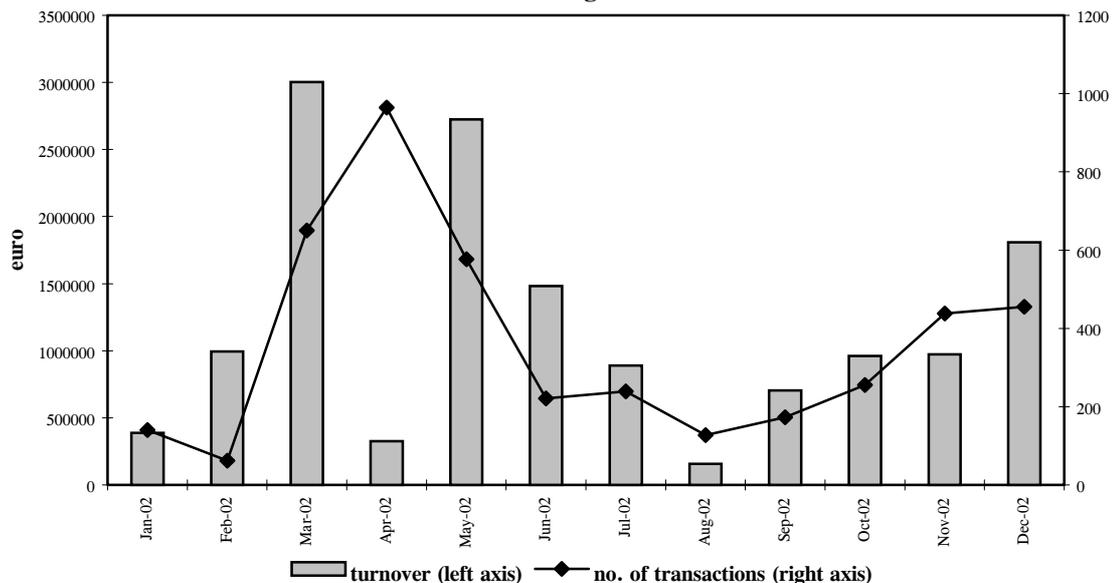
MONTH	MONTENEGROBERZA				NEX MONTENEGRO				TOTAL			
	TURNOVER			Number of transactions	TURNOVER			Number of transactions	TURNOVER			Number of transactions
	Primary	Secondary	Total		Primary	Secondary	Total		Primary	Secondary	Total	
jan-02	355787	16160	371946	136	14077	1022	15099	4	369864	17182	387045	140
feb-02	850591	76187	926778	58	20678	46526	67204	4	871269	122713	993982	62
mar-02	743416	88046	831462	169	2095271	75123	2170394	481	2838687	163169	3001856	650
apr-02	0	127580	127582	75	0	198092	198092	889	0	325672	325674	964
may-02	0	2648532	2648531	110	0	76702	76702	467	0	2725234	2725233	577
jun-02	818064	588184	1406248	32	0	77045	77045	189	818064	665229	1483293	221
jul-02	0	50953	50953	37	767250	72091	839341	202	767250	123044	890294	239
aug-02	0	6340	6340	20	0	151086	151086	107	0	157426	157426	127
sep-02	0	29714	29714	33	611528	62707	674235	140	611528	92421	703949	173
oct-02	53423	68960	122383	49	0	839944	839944	206	53423	908904	962327	255
nov-02	332195	304401	636596	86	188492	147879	336371	352	520687	452280	972967	438
dec-02	1479517	87557	1567074	139	0	241094	241094	316	1479517	328651	1808168	455
total 02	4632993	4092614	8725607	944	3697296	1989311	5686607	3349	8330289	6081925	14412214	4301
jan-03	130123	73770	203893	105	0	588673	588673	374	130123	662443	792566	479

Source: Montenegroberza and NEX Montenegro

As stated earlier, total trade on both stock exchanges in 2002 amounted to approximately €14.4 million, while a total of 4,301 transactions were completed. The majority of turnover (58%) is associated with emissions in the primary market, while the vast majority of transactions took place in the secondary market and are related to shares of the MVP process.

As shown in the next graph, both the monthly value of trade and the number of transactions fluctuate heavily.

Graph 7.: Total turnover and number of transactions on stock exchanges in Montenegro



Source: Montenegroberza and NEX Montenegro

The largest turnover (approximately €3 million) was registered in March and the lowest in August (approximately €150 thousand). The number of transactions follows the turnover trend, with the exception of February and April. The primary market in Montenegro is characterized by a small number of relatively large transactions (yielding high turnover) while the opposite is true for the secondary market, where there are many transactions of small value. Accordingly, because February was dominated with emissions in the primary market, the small number of transactions was accompanied by high turnover. Beginning in March, shares of MVP companies entered the secondary market and the trade related to those shares culminated in April, which was marked by a large number of transactions with relatively low turnover levels.

The latter part of the year showed a positive trend in both turnover and the number of transactions, with turnover growing from €157 thousand in August to €1.8 million in December and the number of transactions rising from 127 to 455.

In addition to the transactions that occurred on the stock exchanges, 2002 showed a substantial value of shares changing ownership outside of the stock exchange. This was done through the transfer of shares as gifts or inheritance (worth €3.6 million), exchange of Privatization Investment Fund shares (approximately €25.5 million), and transforming debt into shares, paying dividends in shares, or other forms of share payment (worth €29.9 million).

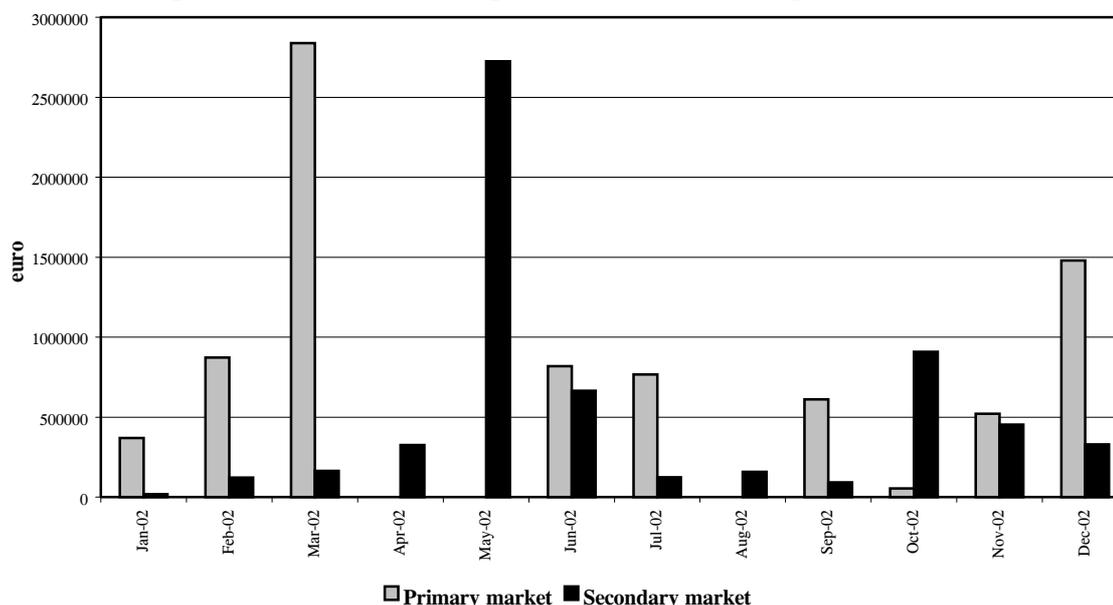
7.1.1 Trade on the primary market

Total turnover in the primary market in 2002 exceeded €8.3 million, which represented almost 58% of total turnover on both stock exchanges.

In the primary market the following emissions took place: six banks (Crnogorska Komercijalna, Beranska, Montenegro, Niksicka, Pljevaljska and Hipotekarna), Privatization Fund Moneta, two insurance companies (Swiss and Montenegro), *Monte Adria Broker* brokerage firm, and the Progas company. The largest turnover was associated with shares

of Crnogorska Komercijalna Banka (approximately €1.9 million) and Hipotekarna Banka (approximately €1.6 million)

Graph 7: Monthly turnover on primary and secondary capital market in 2002



Source: Montenegroberza and NEX Montenegro

The highest turnover in the primary market was registered in months when commercial banks issued shares. Consequently, the highest turnover was registered in March (approximately €2.8 million) when Komercijalna Banka entered the market as well as in December (approximately €1.5 million) when Pljevaljska Banka and Nicksicka Banka issued their shares. In April, May and August there were no emissions of new shares.

7.1.2 Trade in the secondary market

Total turnover in the secondary capital market, on both stock exchanges, in 2002, amounted to nearly €6.1 million, which represented about 42% of total turnover.

From March (when trade with shares from MVP started) until June a significant rise in turnover and transactions can be observed⁴. On the other hand, summer months (July, August and September) brought a slow-down of trade activity, after which trade picked up again in the fourth quarter.

Trade related to mass privatization accounted for the majority of transactions and dominated the turnover in the secondary market. On the NEX Montenegro stock exchange trade is concentrated in a few companies. Among 65 companies that were active in the market in 2002, roughly 60% of turnover was related to trade of shares of six companies (C-Vracar, Stampa, Telekom, Juzni Jadran, Ribnjak and Jugopetrol). The following table presents these companies along with the data on maximum and minimum price, total turnover and the number of shares traded in 2002.

⁴ The largest turnover in the secondary market in 2002, which took place in May, was not related to trade with shares of the MVP companies. Mostly, €2.6 million euro was related to trade with shares of company Habitpharm.

Company	2002			
	Max. price	Min. price	Turnover	Quantity
C-VRAČAR A.D. HERCEG NOVI	7.16	5.11	309.544	46.638
ŠTAMPA A.D. PODGORICA	10.22	10.22	227.150	22.226
TELEKOM CRNE GORE A.D. PODGORICA	1.00	0.37	215.417	309.570
TUP JUŽNI JADRAN D.D. MELJINE	0.60	0.60	184.880	308.133
RIBNJAK A.D. BERANE	6.37	0.10	119.014	31.734
JUGOPETROL A.D. KOTOR	4.01	0.60	84.167	32.985

Source: NEX Montenegro

An analogous situation prevails in the Montenegroberza stock exchange where most trade took place among shares of four companies: Telekom, Jugopetrol, Kole and Veleprodaja (out of 30 companies).

Company	2002			
	Max. price	Min. price	Turnover	Quantity
Telekom Crne Gore a.d.	0,88	0,51	60.442,84	83.863
Jugopetrol a.d. Kotor	4,00	0,80	57.800,67	19.706
Kole a.d. Niksic	15,34	15,34	45.774,56	2.984
Veleprodaja a.d. Berane	1,50	0,64	37.222,85	35.225

Source: Montenegroberza

The general feature of the Montenegrin capital market in 2002 is the relatively small number of companies whose shares can be bought and sold easily, i.e. the number of liquid companies.

Trade with investment units of Privatization Investment Fund⁵

On December 23, 2002 trade with investment units of Privatization Investment Fund (PIF) was initiated. Since then, trade with the units of PIFs has dominated the secondary market: in January of 2003 there were 194 PIF-related transactions, of which 191 in the NEX Montenegro. The following tables present data on trade with investment units of PIFs in NEX Montenegro and Montenegroberza stock exchanges in January 2003.

⁵ By transferring voucher points to privatization funds, in the third phase of MVP program, 237.316 citizens became fund shareholders (More detailed see in MONET 8, Comment 11).

Name of the PIF	January 2003, NEX Montenegro				
	max. price	min. price	number of transactions	Revenue	Quantity
1 PIF ATLASMONT PODGORICA	0,014	0,0129	7	619	45,000
2 PIF EURO-FOND PODGORICA	0,0086	0,008	34	1.816	215,000
3 PIF HLT-FOND PODGORICA	0,0051	0,006	3	116	20,000
4 PIF MIG PODGORICA	0,0094	0,0091	40	1.929	210,000
5 PIF MONETA PODGORICA	0,0127	0,0126	60	4.171	330,000
6 PIF TREND PODGORICA	0,01	0,01	47	3.200	320,000

Source: NEXMontenegro and Montenegroberza

Name of the PIF	January 2003, Montenegroberza			
	average price	number of transactions	Revenue	Quantity
1 PIF ATLASMONT PODGORICA	0.014	1	70	5,000
2 PIF MONETA PODGORICA	0.0126	1	252	20,000
3 PIF TREND PODGORICA	0.01	1	50	5,000

Source: NEXMontenegro and Montenegroberza

7.1.3 Summary

The turnover data shows that the process of the capital market expansion began in 2002 but the question remains as to whether this trend will continue after the initial concentration of ownership is completed in the years to come. Even more important for the future development of the capital market will be the general economic outlook and the situation of enterprises including their profitability and the quality of corporate governance.

8. EXTERNAL SECTOR

8.1. FOREIGN TRADE

8.1.1 Foreign Trade Structure by Goods

Table 8.1 presents a divisional structure, by sector, of imports and exports for 2002. The data was obtained from the Central Bank of Montenegro and is based on customs declaration and banks' statements (implying customs duties). They cover foreign trade with all countries excluding Serbia, but including Kosovo. The striking feature of foreign trade in Montenegro is its high concentration in a few sectors, especially for exports.

Regarding imports, oil and oil derivatives account for the highest share of total imports (close to 18%). Most of the imports in this category are related to liquid petroleum gas, gasoline, and diesel fuel, the majority of which are later exported (see exports data). Electricity constitutes another crucial import for Montenegro, representing an approximate 13% share of total imports. Other key imports (marked in bold in the table) are imports of fruits and vegetables (5.3%), construction materials including cement and glass (4.9%), electrical machinery and equipment (4.7%), vehicles (4.6%), and meat and meat products (4.48%). Combined, the products listed above accounted for 55% of all imports in 2002. For additional comment on Montenegrin imports see Box 8.1.

With respect to exports, we observe a much more concentrated picture. Nearly 63% of the dollar value of exports in 2002 was concentrated in the category 'ferrous metals', the vast majority of which were exports of aluminum from the giant aluminum plant *KAP* (see chapter on output). Exports of aluminum dominated the total export structure and left the 2nd and 3rd ranked industries lagging far behind. Oil and oil derivatives ranked 2nd (with a share of 15.8%), and as mentioned before, a large portion of these exports were originally imported liquid petroleum gas and fuels. Another significant sector for exports was the sector of transportation equipment (excluding vehicles) with a 6.2% share of total exports, mostly due to exports of ships from the shipyard *Bijela*. The metal ores industry ranked 4th with respect to total export, thanks in large part to the export of aluminum and copper ores. In total, exports from these 4 sectors accounted for 86.7% of all exports.

Table 8.1 Imports and exports (including Kosovo and excluding Serbia) in 2002.

category nr	Sector	Imports in USD			Exports in USD		
		total	per capita	as % of total	total	per capita	as % of total
1	Meat and meat products	25,283,125	36.64	4.48%	200,759	0.29	0.08%
2	Milk products and eggs	7,706,248	11.17	1.37%	599,048	0.87	0.24%
3	Fish and fish products	3,917,115	5.68	0.69%	5,089	0.01	0.00%
4	Cereals and cereal products	6,020,043	8.72	1.07%	2,755,562	3.99	1.10%
5	Vegetables and fruits	29,874,135	43.30	5.29%	3,778,870	5.48	1.50%
6	Sugar, sugar products and honey	12,594,089	18.25	2.23%	546,455	0.79	0.22%
7	Coffee, tea, cocoa and spices	7,711,222	11.18	1.37%	765,525	1.11	0.30%
8	Animal fodder (except cereals)	1,061,714	1.54	0.19%	166,831	0.24	0.07%
9	Various nutrition products	7,036,240	10.20	1.25%	1,043,382	1.51	0.41%
11	Beverages	5,684,228	8.24	1.01%	3,477,773	5.04	1.38%
	<i>of which :</i>						
	<i>alcoholic beverages</i>	2,986,601	4.33	0.53%	3,362,403	4.87	1.34%
12	Tobacco and tobacco products	2,351,122	3.41	0.42%	18,277	0.03	0.01%
	<i>of which :</i>						
	<i>cigarettes, cigars and smoking tobacco</i>	1,035,866	1.50	0.18%	18,277	0.03	0.01%
21	Raw leather and pelt	35,333	0.05	0.01%	3,794,583	5.50	1.51%
22	Oil grain	59,560	0.09	0.01%	7,208	0.01	0.00%
23	Natural rubber	32,526	0.05	0.01%	0	0.00	0.00%
24	Cork and wood	836,036	1.21	0.15%	3,731,423	5.41	1.48%
25	Cellulose and paper pulp	1,589,051	2.30	0.28%	69,133	0.10	0.03%
26	Textile fibers and textile byproducts	713,533	1.03	0.13%	7,193	0.01	0.00%
27	Compost and minerals	754,064	1.09	0.13%	678,732	0.98	0.27%
28	Metal ores (nickel, aluminum and copper)	4,574,658	6.63	0.81%	5,125,338	7.43	2.04%
29	Animal and plant products	738,656	1.07	0.13%	155,569	0.23	0.06%
32	Mineral coal, coke and briquettes	74,092	0.11	0.01%	36,426	0.05	0.01%
33	Oil and oil derivates	100,259,400	145.30	17.77%	39,773,981	57.64	15.82%
	<i>of which :</i>						
	<i>gasoline, diesel (incl. aviation gasoline)</i>	23,522,924	34.09	4.17%	16,707,945	24.21	6.64%
	<i>jet fuel, naphtha and kerosyne</i>	4,571,195	6.62	0.81%	324,630	0.47	0.13%
	<i>liquid petroleum gas</i>	35,533,693	51.50	6.30%	22,342,917	32.38	8.89%
	<i>heating oil</i>	16,605,931	24.07	2.94%	367,003	0.53	0.15%
	<i>lubricants</i>	3,635,183	5.27	0.64%	31,486	0.05	0.01%
	<i>other</i>	16,390,447	23.75	2.90%	0	0.00	0.00%
34	Natural and industrial gas	293,805	0.43	0.05%	0	0.00	0.00%
35	Electricity	72,351,632	104.86	12.82%	0	0.00	0.00%
41	Animal oil and fats	370,707	0.54	0.07%	0	0.00	0.00%
42	Solid animal oils and fats	2,817,952	4.08	0.50%	594,707	0.86	0.24%
43	Animal and vegetable fats and oils	35,202	0.05	0.01%	341,156	0.49	0.14%
51	Organic chemical products	481,307	0.70	0.09%	19,280	0.03	0.01%
52	Inorganic chemical products	10,248,283	14.85	1.82%	94,088	0.14	0.04%
53	Products for painting	2,838,960	4.11	0.50%	114,815	0.17	0.05%
54	Medical and pharmaceutical products	7,574,715	10.98	1.34%	104,877	0.15	0.04%
55	Ether oils, perfumes and other products	13,568,215	19.66	2.40%	1,147,051	1.66	0.46%
56	Fertilizers (except unprocessed)	65,066	0.09	0.01%	45,243	0.07	0.02%
57	Unprocessed plastics	801,659	1.16	0.14%	10,706	0.02	0.00%
58	Moulded plastics	3,644,011	5.28	0.65%	178,133	0.26	0.07%
59	Chemical substances and products	4,297,408	6.23	0.76%	177,241	0.26	0.07%
61	Leather and leather products, pelts	325,863	0.47	0.06%	470,277	0.68	0.19%
62	Rubber products	4,537,292	6.58	0.80%	256,510	0.37	0.10%
63	Cork and wood products	4,379,022	6.35	0.78%	227,846	0.33	0.09%
64	Paper, cardboard and cellulose products	10,154,333	14.72	1.80%	672,893	0.98	0.27%
65	Yarn, tissue and textile products	3,193,531	4.63	0.57%	102,665	0.15	0.04%
66	Construction materials (cement, glass, sand etc.)	27,786,064	40.27	4.92%	361,347	0.52	0.14%
67	Iron and steel	6,828,515	9.90	1.21%	1,332,454	1.93	0.53%
68	Ferrous metals	3,690,334	5.35	0.65%	157,708,911	228.56	62.72%
69	Metal products	11,759,365	17.04	2.08%	924,360	1.34	0.37%
71	Industrial machines and devices	5,927,500	8.59	1.05%	27,155	0.04	0.01%
72	Special purpose machinery	10,880,683	15.77	1.93%	75,494	0.11	0.03%
73	Machines for metal processing	2,313,242	3.35	0.41%	1,114	0.00	0.00%
74	Industrial machines for general use	20,898,024	30.29	3.70%	1,317,551	1.91	0.52%
75	Machines for offices and data processing	8,616,607	12.49	1.53%	133,745	0.19	0.05%
76	Telecommunication equipment	16,421,556	23.80	2.91%	25,670	0.04	0.01%
77	Electrical machines and equipment	26,746,898	38.76	4.74%	356,530	0.52	0.14%
78	Vehicles	26,171,208	37.93	4.64%	193,705	0.28	0.08%
79	Other transportation equipment	1,159,403	1.68	0.21%	15,507,942	22.48	6.17%
81	Prefabricated buildings	2,845,902	4.12	0.50%	51,412	0.07	0.02%
82	Furniture and parts	9,411,681	13.64	1.67%	342,456	0.50	0.14%
83	Traveling equipment	630,554	0.91	0.11%	2,634	0.00	0.00%
84	Clothing	4,432,388	6.42	0.79%	352,619	0.51	0.14%
85	Footwear	2,629,910	3.81	0.47%	710,885	1.03	0.28%
87	Scientific instruments	3,378,036	4.90	0.60%	31,776	0.05	0.01%
88	Cameras and clocks	1,676,165	2.43	0.30%	5,259	0.01	0.00%
89	Other finished products	9,227,787	13.37	1.64%	708,509	1.03	0.28%
TOTAL		564,316,976	817.85	100.00%	251,466,175	364.44	100.00%

Source: Central Bank of Montenegro

BOX 8.1 Montenegrin Imports

Official data on Montenegrin foreign trade presented in table 8.1 clearly shows the extent of illegal imports. There are four sectors where this is strikingly evident: textiles, footwear, alcohol and tobacco. According to the official data in table 8.1, the per capita value of total imports in 2002 was just \$6.42 for clothing, \$3.81 for footwear, \$1.50 for cigarettes and other tobacco products, and \$4.33 for alcoholic beverages.

This data can be easily compared with the household expenditure data from the ISSP household surveys. The table below presents the details of this comparison. Entries are per capita values expressed in euros.

	Clothing	Footwear	Cigarettes	Alcohol
Official per capita imports in 2002 in € (source: CBM based on customs declarations; excludes Serbia)	6.83	4.05	1.59	4.60
Average annual expenditure per capita in € (source: ISSP household surveys in 2002 - issues 5 and 6)	81.99	64.02	82.84	31.80
<u>THE DIFFERENCE BETWEEN EXPENDITURES AND IMPORTS</u> (per capita in €)	<u>75.16</u>	<u>59.97</u>	<u>81.25</u>	<u>27.20</u>

Clearly, there is a vast discrepancy between survey-based expenditure data and the official import statistics. There are three potential explanations for these differences. It's possible that either

- domestic production covers the demand of households, or,
- households might purchase goods coming from Serbia (not included in the import statistics used for the comparison), or,
- goods enter Montenegro illegally without being registered and with no tariffs paid.

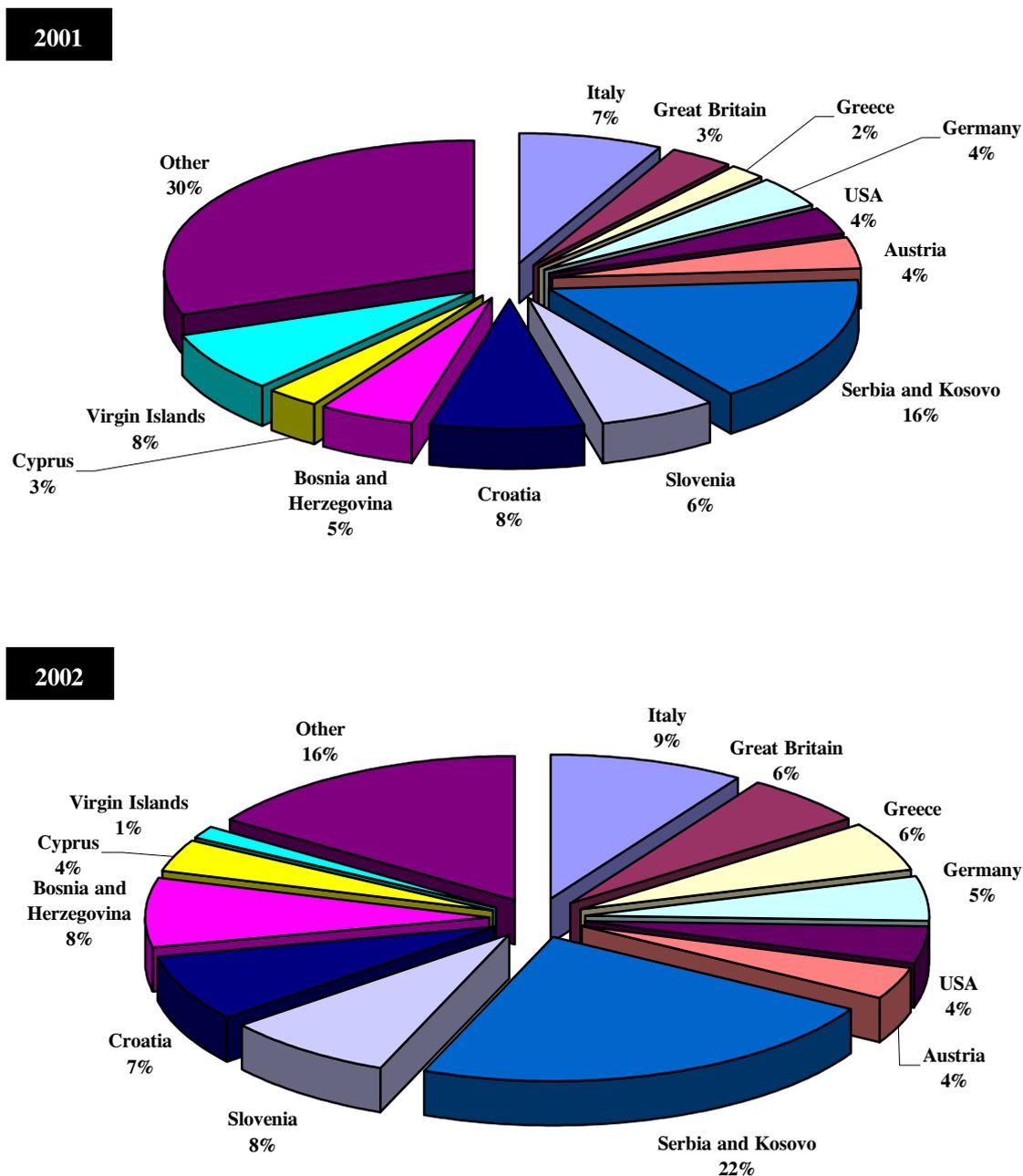
Domestic production might explain some of the expenditures for cigarettes and alcohol, as domestic manufacturers of these goods do exist in Montenegro. Imports from Serbia may be present, to some extent, in all three categories of goods (especially clothing and footwear); however their presence would not be very significant. Stylized facts and anecdotal evidence strongly point to smuggling activities being by far the most contributing force behind the differences depicted above. This is particularly striking in the case of footwear and clothes (smuggling from Italy and Turkey) as well as cigarettes (smuggling from Kosovo and Albania).

The extent of illegal activities, as evidenced in the magnitude of the difference, suggests that official import statistics are seriously underestimating actual imports. This has critical consequences in terms of distorting the official balance of payments statistics (see also section 8.2.3) as well as resulting in a sizeable loss of foregone tariff revenues for the budget.

8.1.2 Foreign Trade Structure by Countries of Destination

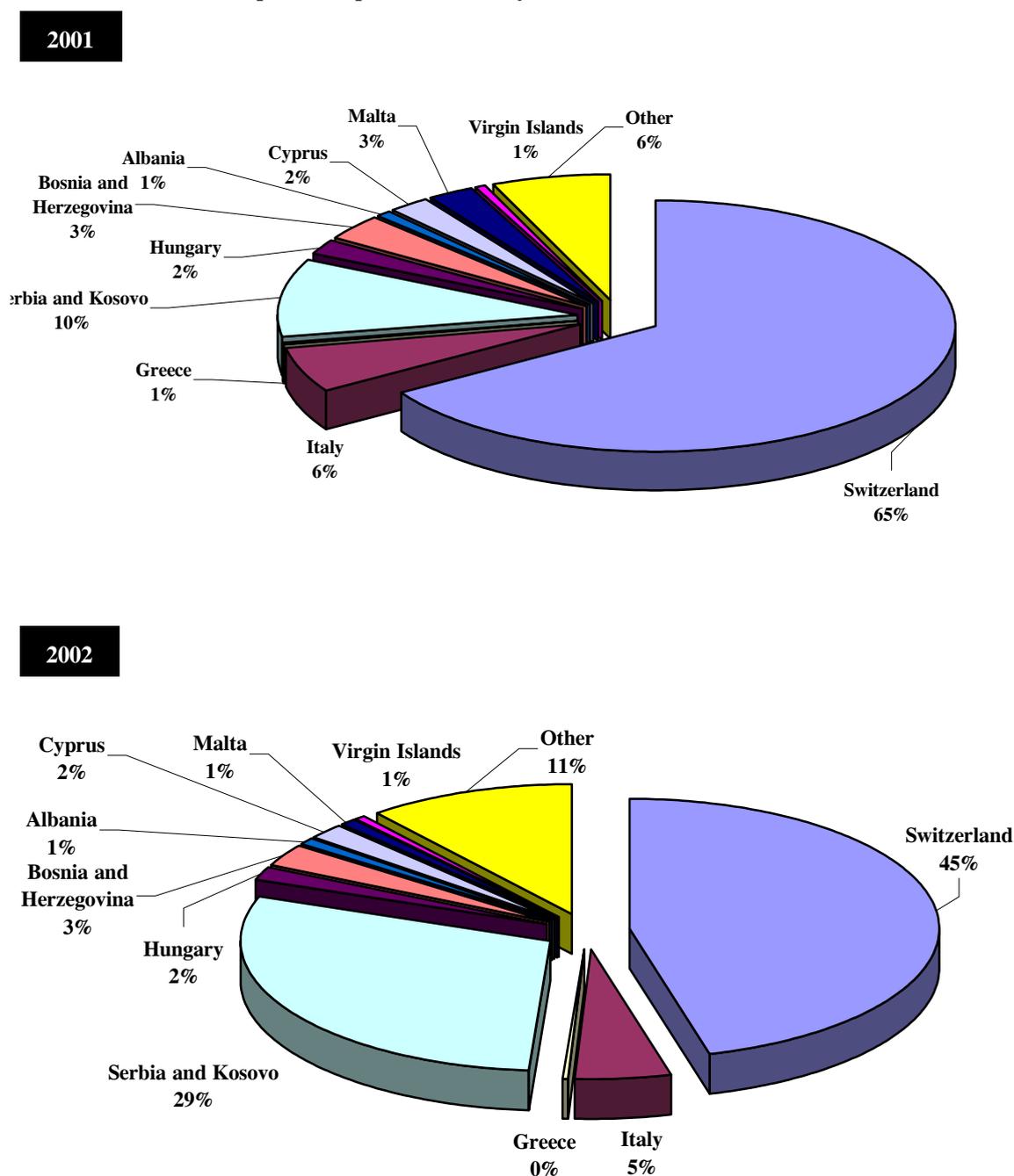
Export and import of goods in 2002, according to their assignment, are presented in graphs 8.1 and 8.2. These data come from the balance of payments statistics and unlike the data in the previous section (table 8.1), they include Serbia and Kosovo in the definition of foreign trade.

Graph 8.1 Import structure by countries in 2001 and 2002



Source: Central Bank of Montenegro

Graph 8.2 Export structure by countries in 2001 and 2002



Source: Central Bank of Montenegro

The structure of imports depicted in graph 8.1 points to the growing importance of imports from the former Yugoslav republics. Slovenia, Croatia, Bosnia and Herzegovina have increased their share in total imports by several percentage points in 2002 compared with 2001. Likewise, imports from Serbia and Kosovo became more important during recent years and accounted for almost one-quarter of total imports in 2002. In total, the share of imports from Serbia, Kosovo, Slovenia, Croatia and Bosnia and Herzegovina has increased from 35% in 2001 to 46% in 2002.

Among the industrialized countries, Italy, Greece, Great Britain and Germany increased their shares in Montenegrin imports in 2002, while the United States and Austria remained at the same level. Together, Montenegro's major EU trade partners increased their share in total Montenegrin imports from 20 to 29%. Imports from both Cyprus and the Virgin Islands became less important in 2002.

With respect to exports, the picture is somewhat distorted by the fact that the export of aluminum is carried out through an intermediate trade company in Switzerland. Consequently, the bulk of exports go to Switzerland: 65% in 2001 and 45% in 2002. Serbia and Kosovo are becoming increasingly important as markets for Montenegrin products with their share of total Montenegrin exports growing from 10% in 2001 to 29% in 2002. The third important export market for Montenegro, Italy, became less significant as its share in Montenegrin exports fell from 6% to 5%. All other export markets are much less significant than the three presented above and have, more or less, maintained their share in total exports in 2002 as compared to 2001.

8.2. BALANCE OF PAYMENTS

The Balance of Payments for Montenegro for 2001 and 2002 is presented in table 8.2¹. It includes current account, capital and financial account, and errors and omissions expressed both in euros as well as a percentage of GDP. The last column in the table presents the percentage change of the € amount in 2002 as compared to 2001.

8.2.1 Current account

The current account deficit in Montenegro in 2002 amounted to €166 million or 14% of GDP², which is less than in 2001 when the deficit amounted to €199 million (or 19% of GDP). Total revenues were equal to €704 million, or 12% more than in 2001, while expenditures were equal to €871 million or 5% more than in the previous year.

Goods Trade

In 2002 total trade of goods (imports plus exports) was greater than €1 billion, an increase of 11% over the previous year. Exports rose by 36%, while imports increased by 2%. Overall, the ratio of exports to imports rose from 32% in 2001 to 43% in 2002. The resulting trade deficit was €422 million or 35% of GDP and represented a considerable improvement over 2001, when it was €491 million (47% of GDP).

The increase of imports and exports is primarily due to the increase of trade with Serbia and Kosovo. This is particularly true of exports. In 2002, Montenegrin exports to Serbia and Kosovo accounted for 65% of total non-aluminum exports and in US\$ terms, they were 297% higher than in 2001. Exports directed to other countries grew at an average level of about 5%.

Imports grew in 2002 primarily due to an increase of electricity import as well as increased import from Serbia and Kosovo (albeit the growth rate was much lower than in case of exports). Fewer imports of oil and oil derivatives (38% lower in 2002 than in 2001) coupled

¹ The US\$ value of the items in the balance of payments table is calculated using the exchange rate of the day of transaction.

² GDP for 2002 is estimated at €1.221 billion according to ISSP estimation

with the restrained growth in other imports resulted in a moderate growth of total imports of goods. This, together with a high growth in total exports (43%), yielded a lower trade deficit in 2002.

Balance of services

In 2002, Montenegro's surplus on services was €102 million or 5% greater than in 2001. This improvement is primarily due to the better balance of transportation and tourism services with countries other than Serbia. Revenues from foreign tourists and from transportation services grew in 2002 much more than the respective expenditures, resulting in a higher surplus and enabling the improved services account (for details see also section on tourism in chapter 1).

Income

The net balance of income rose 44% in 2002, going from €47 million in 2001 to €67 million in 2002. This increase is due to a 35% increase of total compensation of Montenegrin workers abroad and a 21% increase of transfers from Serbia for Montenegrin persons. The net income balance accounted for 5.5% of GDP in 2002.

Transfers

Current transfers to Montenegro decreased during 2002 by 41%. They fell from €148 million in 2001 to €87 million in 2002 as a result of lower foreign assistance and other transfers from abroad. The balance of transfers in 2002 remained positive and amounted to €92 million or 7% of GDP.

8.2.2 Capital and financial account

The Central Bank of Montenegro (CBM) is in the process of adopting accounting procedures to properly register capital and financial account transactions. For the time being, the statistics pertinent to the capital and financial account are rather limited. For example, capital account transactions have not been registered in Montenegro at all in 2001 or 2002.

In the financial account, foreign direct investment constitutes the most significant position. The inflows related to FDI grew by over 700% in 2002 compared to 2001 mostly as a result of the privatization of the oil company: *Jugopetrol* (see the budget chapter). Consequently, the per capita foreign investment inflow grew from €16 in 2001 to €128 in 2002.

Net portfolio investments remained at a negligible, negative level while other investments (net loans) turned positive in 2002 and amounted to €4.4 million.

Additionally, the Central Bank of Montenegro includes in the financial account 2 items that are conventionally positioned *'below the line'* in the financing section of the Balance of Payments. These items are changes in: net foreign assets and in the CBM reserves (CBM's term deposits in foreign banks). The change in net foreign assets increased significantly in 2002 to €10 million, up from €3 million in 2001. However, the change in the CBM reserves, which is caused by a change in the level of CBM's foreign deposits, stood at €4 million in 2002 (zero change in reserves was registered in 2001).

8.2.3 Net errors and omissions and related problems with BoP accounting in Montenegro.

The total balance of the current account as well as the capital and financial account as defined by the CBM amounted to €-61 million in 2002 (or 5% of GDP). This represents a significant improvement over the previous year's balance of €-191 million (or 18% of GDP). The current practice of the CBM is to set the last item in the BoP statistics- 'net errors and omissions' explicitly equal to this balance. Therefore, official net errors and omissions were €-61 million and €-191 million in 2002 and 2001 respectively. There are several problems with such an accounting system.

The most visible problem in BoP accounting in Montenegro is the lack of financing position. This is due to the fact that the CBM is still in the process of defining foreign reserves and foreign assets for the financing section of the BoP. Currently in the official statistics, the overall balance is entirely equalized to the errors and omissions and no official financing is acknowledged. However, for countries that do not issue their own currency, cash in circulation can be treated as foreign reserves and consequently, negative current and financial account balance may be financed with cash. If we adopt such an approach, the M0 money aggregate decreased in 2002 by an amount equal to the overall balance of both current and capital and financial accounts.

However, there is significant inconsistency embedded in such reasoning. It follows that if the cash balances have indeed gone down by €61 million in 2002 (close to 20% of total cash estimated by the CBM³), such a significant cash squeeze must have had a sizeable suppressing effect on the overall level of demand in the country in 2002. However, demand pressures were far from low in 2002 as consumer prices grew by almost 10% in 2002⁴. If we exclude nontradables (services), which might distort the picture somewhat due to the presence of the Balassa-Samuelson effect⁵, prices grew in 2002 by 8% (food, tobacco and beverages) and 11.5% (nonfood goods). This is still a very high rate of growth considering that Montenegro adopted the euro in January 2002 after having the DM as the official currency for 2 years.

Therefore, if demand pressures were present throughout 2002, allowing for the prices of traded goods to increase by 9%, cash must have registered an increase, rather than a decline. Unfortunately this cannot be officially verified, as the CBM cash estimation has been held constant at €310 million since January 2002 when it was revealed during the conversion from DM to €. Deposits that represent a more easily observable non-cash component of M1 and M2 have not registered a considerable increase during the period March-December 2002⁶ (see chapter 6). This suggests that demand pressures might have indeed come from cash expansion. If this approach is pursued, cash balances increased in 2002 by a considerable amount exceeding €60 million. Part of this increase was used to finance the negative joint balance of current and financial accounts (€60 million) and the rest was circulating in the Montenegrin market contributing to demand pressures that pushed prices up by 10%.

³ For details see chapter 6 on money.

⁴ Annual inflation in December 2002 stood at 9.2%

⁵ The Balassa-Samuelson effect follows from the fact that if wages in the economy equalize across sectors prices in the non-trade sector might grow at a higher rate due to the lower productivity increases. The result may be higher inflation and appreciation of the real exchange rate.

⁶ Official money supply statistics are only available since March 2002

These two contradicting interpretations of the BoP developments in Montenegro in 2002 cannot be verified without the credible estimates of money supply, and specifically, of the cash in circulation. Until they become available, one is unable to monitor the real financial flows in Montenegro and consequently, the resulting figure of the total balance of payments will continue to remain unknown.

Such monitoring is additionally complicated by the fact that the official current account statistics might not accurately reflect the actual foreign trade. Potentially there is a substantial source of inconsistency for imports of goods, which we discovered while investigating the official imports (see Box 8.1 in section 8.1.1). It is very likely that actual import figures for numerous product groups (such as textiles, alcohol and tobacco) are much higher than officially registered in customs declarations, and thus, the total imports of goods might be considerably higher than the figure officially stated in the current account statistics (see table 8.2). However, illegal activities might also be present for exports thus rendering the official export figure underestimated. As a result, the official current account balance might be very unreliable, most likely underestimated in comparison to the actual balance after the illegal imports have been taken into consideration.

It is likely that the financial account statistics might suffer from similar drawbacks rendering the official BoP data from table 8.2 quite unreliable and unsuited for further research.

Table 8.2 BALANCE OF PAYMENTS IN MONTENEGRO (in million €)

	Jan-Dec 2001	% of GDP	Jan-Dec 2002	% of GDP	% change in € value
CURRENT ACCOUNT BALANCE	-199.036	-19.11%	-166.157	-13.60%	-17%
Total current account revenues	631.628	60.65%	704.354	57.67%	12%
Total current account expenditures	830.664	79.76%	870.511	71.28%	5%
GOODS AND SERVICES BALANCE	-393.658	-37.80%	-320.154	-26.21%	-19%
GOODS BALANCE	-491.012	-47.14%	-421.950	-34.55%	-14%
Total exports of goods	235.311	22.59%	320.823	26.27%	36%
Export of goods excl. trade with Serbia and Kosovo and aluminum	52.148	5.01%	54.023	4.42%	4%
Export of aluminum	157.644	15.14%	165.365	13.54%	5%
Export to Serbia and Kosovo	25.519	2.45%	101.435	8.31%	297%
Total imports of goods	726.323	69.74%	742.773	60.82%	2%
Import of goods excl. oil, electricity and trade with Serbia and Kosovo	402.082	38.61%	410.083	33.58%	2%
Import of electricity	37.326	3.58%	48.923	4.01%	31%
Import of oil and oil derivatives	172.065	16.52%	105.961	8.68%	-38%
Import from Serbia and Kosovo	114.850	11.03%	177.806	14.56%	55%
SERVICES BALANCE	97.354	9.35%	101.796	8.34%	5%
Total revenues from services	150.737	14.47%	176.094	14.42%	17%
Total expenditures for services	53.383	5.13%	74.298	6.08%	39%
Total Transportation Revenues	28.524	2.74%	35.750	2.93%	25%
Transport official data about revenues corrected by 12% (estimate)	26.537	2.55%	32.455	2.66%	22%
Transport revenues from Serbia	1.987	0.19%	3.295	0.27%	66%
Total transportation Expenditures	20.055	1.93%	24.487	2.00%	22%
Transport official data about expenditures corrected by 12% (estimate)	18.644	1.79%	19.815	1.62%	6%
Transport expenditures to Serbia	1.411	0.14%	4.672	0.38%	231%
Balance of transportation services	8.469	0.81%	11.263	0.92%	33%
Total Revenues from Tourism	106.299	10.21%	124.916	10.23%	18%
Revenues from tourists abroad (estimate)	40.706	3.91%	62.020	5.08%	52%
Tourists from Serbia	65.593	6.30%	62.896	5.15%	-4%
Total Expenditures to Tourism	5.024	0.48%	7.946	0.65%	58%
Expenditures for tourism abroad	4.856	0.47%	6.341	0.52%	31%
Expenditures for tourism in Serbia	0.168	0.02%	1.605	0.13%	855%
Balance of tourism	101.275	9.72%	116.970	9.58%	15%
Revenues from Financial Services	4.095	0.39%	2.751	0.23%	-33%
Commision fee	4.045	0.39%	2.335	0.19%	-42%
Commision fee on Serbian import/export (estimate)	0.050	0.00%	0.416	0.03%	732%
Expenditures to financial services	3.194	0.31%	3.350	0.27%	5%
Commision fee	3.116	0.30%	2.835	0.23%	-9%
Commision fee on Serbian import/export (estimate)	0.078	0.01%	0.515	0.04%	560%
Balance of financial services	0.901	0.09%	-0.599	-0.05%	-166%
Revenues from other Services	11.819	1.13%	12.677	1.04%	7%
Expenditures for other services	25.110	2.41%	38.515	3.15%	53%
Balance of other services	-13.291	-1.28%	-25.838	-2.12%	94%
INCOME BALANCE	46.525	4.47%	67.126	5.50%	44%
Income revenues	87.038	8.36%	110.331	9.03%	27%
Compensation of employees	40.949	3.93%	55.375	4.53%	35%
Revenues from Serbia for physical persons	44.466	4.27%	53.834	4.41%	21%
Received dividends	0.170	0.02%	0.170	0.01%	0%
Interest income	1.453	0.14%	0.952	0.08%	-34%
Income Expenditures	40.513	3.89%	43.205	3.54%	7%
Compensation of employees	33.637	3.23%	32.927	2.70%	-2%
Expenditures for physical persons in Serbia	0.115	0.01%	0.310	0.03%	170%
Interest expenses	2.465	0.24%	1.601	0.13%	-35%
Paid dividends	4.296	0.41%	8.367	0.69%	95%
CURRENT TRANSFERS BALANCE	148.097	14.22%	86.871	7.11%	-41%
Current transfers to Montenegro	158.542	15.22%	97.106	7.95%	-39%
Transfers to Montenegro from abroad	11.434	1.10%	5.584	0.46%	-51%
Foreign assistance	68.508	6.58%	41.707	3.41%	-39%
Foreign assistance financial and material (NGO, humanitarian organizations)	78.600	7.55%	49.815	4.08%	-37%
Expenditures	10.445	1.00%	10.235	0.84%	-2%
Transfers from Montenegro abroad	10.445	1.00%	10.235	0.84%	-2%
CAPITAL AND FINANCIAL ACCOUNT BALANCE	7.876	0.76%	105.537	8.64%	1240%
CAPITAL ACCOUNT	0.000		0.000		
FINANCIAL ACCOUNT	7.876	0.76%	105.537	8.64%	1240%
Direct investment	10.636	1.02%	87.327	7.15%	721%
Equity capital	4.696	0.45%	76.306	6.25%	1525%
Reinvested earnings and undistributed branch profits	5.940	0.57%	11.021	0.90%	86%
Portfolio investment-net	-0.013	0.00%	-0.174	-0.01%	1238%
Other investments	-6.052	-0.58%	4.411	0.36%	173%
Loans	2.916	0.28%	23.679	1.94%	712%
Repaid loans	8.968	0.86%	19.268	1.58%	115%
Change in Net Foreign Assets	3.305	0.32%	10.007	0.82%	203%
Change in CBM foreign reserve assets (term deposits of CBM in foreign banks)	0.000		3.966	0.32%	
BALANCE OF CURRENT ACCOUNT AND CAPITAL AND FINANCIAL ACCOUNT	-191.160	-18.35%	-60.620	-4.96%	-68%
NET ERRORS AND OMISSIONS	-191.160	-18.35%	-60.620	-4.96%	-68%
GDP	1041.500		1221.300		

Source: Central Bank of Montenegro

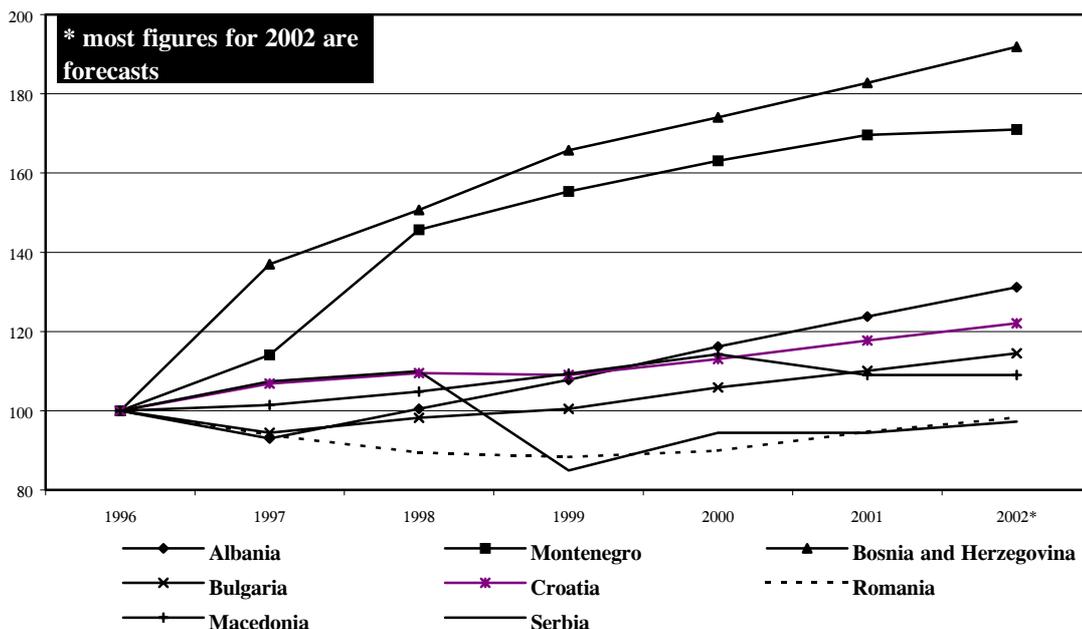
9. REGIONAL COMPARISON

This short outlook on the macroeconomic developments of Southeastern European economies (SEE) in 2002 gives a summary of the major regional trends. In the second part, major health indicators for the region are presented and discussed.

9.1 MACROECONOMIC INDICATORS

Real GDP growth was positive in all southeastern countries in 2002, albeit it fell on average by about 0.5 percentage point in comparison with 2001. The growth rates ranged from 0% in Macedonia and less than 1% in Montenegro to 6% in Albania. The slow-down of economic growth rates is due to both domestic and external factors. The sluggish recovery of the world economy and resulting low external demand has slowed down the export growth. This especially concerns exports to the euro zone, which is becoming increasingly important for SEE and is suffering from very small growth rates. Additionally, terms of trade worsened in most SEE economies in 2002¹ making it difficult to improve the trade deficit. Graph 9.1 presents cumulative real GDP starting with 1996 for most countries in the region.

Graph 9.1 Real GDP in SEE (1996=100)



Source: IMF and Vienna Institute

Table 9.1 represents a set of the most important macroeconomic indicators in 9 countries of the SEE region.

In 2002, industrial output was going up in most countries in the region and the growth rates ranged from 1% in Montenegro to 8% in Croatia. Inflation in 2002 fell on an annual basis in all countries except for Albania in comparison to 2001. The most pronounced decline took place in Serbia (16.5% vs. 89% in 2001) and Montenegro (9.2% vs. 24% in 2001). In 2002, most countries registered single-digit annual inflation rates. Inflation in Bosnia and Herzegovina, Croatia and Macedonia fell below 2%, while in Bulgaria, Albania and

¹ ICEG European Center: "Eastern European Analysis and Outlook 2002"

Montenegro it was in the range of 4-9%. Serbia and Romania continue to register the highest inflation rates in the region amounting to 16.5% and 22.5% respectively.

Table 9.1: Macroeconomic indicators of the Balkan countries

		Albania	Bosnia and Herzegovina	Bulgaria	Croatia	Macedonia	Montenegro	Serbia	Romania
Real annual GDP change (in%)	2001	6.5	2.3	4	4.1	-4.6	4	6.2	5.3
	2002	6.0	2.3	4.0	4.0	0	0.8	<u>4.0</u>	3.8
Annual change in industrial production (in%)	2001	5.0	14.6/-9.3	2.4	6	3.1	-2.7	0.0	8.2
	2002	-	-	-	8.1	5.4 (Nov-02)	0.9	1.7	5.8 (Nov-02)
Annual inflation rate (CPI, in %)	2001	3.56	3.1	7.4	4.7	5.3	24	89.2	34.5
	2002	4.15 (Nov-02)	1.0	5.8	1.9	1.9 (Nov-02)	9.2	16.5	22.5
Unemployment rate %	2001	14.6	41.0/42.0	17.0	15.9	30.5	24.8	27.7	8.6
	2002	14	40	17.2	15.2	30.0	23.7	28.5	8.1 (Nov-02)
National currency	Currency name	Lek	Convertible Mark; BAM	Leva	Kuna	Denar	Euro	Dinar	Lei
	Per USD	137.0 (Dec-02)	2.17 (Dec-02)	1.885 (Dec-02)	7.146 (Feb-03)	64.354	0.92 (Feb-03)	60.0 (Feb-03)	33.5 (Feb-03)
	annual change in %	-0.67	2.96	15.0	14.5	-5.4	19.00	0.10	6.20
Trade balance (as % of GDP)	2001	22.6	29.1	-12.6	-18.9	-13.5	-37.8	<u>-26.1</u>	-13.2
	2002	-	-37.6 (Q3-02)	-11.8	-22.5 (Nov-02)	-18	-26.2	-34.8	-8.6
Current account balance (as % of GDP)	2001	-6.3	-23.1	-5.8	-3.8	-6.9	-19.1	<u>-5.5</u>	-5.9
	2002	-8.1	-22.0	-1.5	-5.6 (Q3-02)	-6.9	-13.6	<u>-8.2</u>	-4.0 (Nov-02)

Note: Data for 2001 are end-of-period; Data for 2002 are end-of-period unless stated otherwise

Source notes:

- All bold data from WIIW database
- Data for Montenegro are from ISSP database
- Data on GDP, inflation rate, interest rate and external sector for Croatia in 2002 are from the Central bank of Croatia
- Data on inflation, industrial production, interest rates and trade balance in Macedonia in 2002 are from the Central Bank of Macedonia
- Data on trade balance and current account balance of BiH are from the Central Bank of BiH
- Data on industrial production and unemployment rate for BiH are given separately for Federation BiH and Republika Srpska.
- Data on inflation, industrial production, interest rates and trade balance of Serbia in Serbia in 2002 are from national bank of Serbia database.
- Data on trade balance for Bulgaria are from ICEG European Center database
- All underlined data are from IMF database
- All other data are from IFS database.

Unemployment is very high in the region and shows no signs of going down. Weak external demand and restructuring of many sectors of domestic economies led to labor shedding in many countries. It has to be mentioned however, that due to the lack of reliable data, cross-country comparisons of unemployment rates should be done with the highest caution. Most SEE countries do not have experience in properly measuring unemployment rates and

methodologies used across the region differ significantly. Most of the entries in the table come from official sources. However, Montenegro's example (see chapter on employment) points to very low credibility of such estimates. Therefore, for Montenegro we are using the unofficial ISSP estimate for the unemployment rate that is much lower than the official one and is undoubtedly better reflecting the real-life situation. Consequently, unemployment rates should only be compared in a time-series dimension for individual countries.

Trade balances worsened across the region. Two factors were at work here. First, because of weak external demand export performance was very disappointing in most countries. This performance was additionally thwarted by the fact that sluggish EU demand mostly affected the sector of less-processed goods that continue to constitute the bulk of exports in the region. Thus, the impact of the EU slowdown was felt rather seriously across the region. On the other hand, imports rose, as positive GDP growth contributed to higher domestic demand in most SEE countries (especially in Romania, Bulgaria and Croatia). Also, in some countries (like Bulgaria and Croatia) a significant FDI increase triggered higher investment-related imports. As a result, the trade balance registered higher deficits in most SEE countries.

Current account deficits were also higher in almost all SEE countries in 2002 than in 2001, albeit lower than trade deficits thanks to the positive balance of services (mostly due to tourism and transfers). For many countries in the region surplus related to tourism services can be viewed as being crucial for improving current account deficits both in shorter and longer term. Many countries, like Montenegro, Croatia, and Bulgaria are expanding their tourism sector and this is well visible in the current account statistics (for Montenegro, see also chapter on output and foreign trade).

9.2 HEALTH INDICATORS

The following table presents the most important health indicators for selected countries in the region. In all studied countries, life expectancy is lower for males than for females and the difference exceeds 7 years in some countries (Croatia and Romania). On average, life expectancy for males and females is highest in Albania (75 years) and Croatia (74.6 years). All other countries have similar life expectancy rates in the range of 71.4 – 73.5 years.

Infant mortality rates per 1000 live births differ significantly across the region. They range from 7.7 in the case of Croatia to 18.4 in Romania. Serbia and Montenegro, with the rate of 13.6 is in the middle of the regional ranking. The number of physicians and hospital beds per 100,000 inhabitants are likewise extremely varied across the region. On both indicators, Albania and Bosnia and Herzegovina seem to perform the worst, while Bulgaria and Croatia rank relatively high. Romania has the most physicians but at the same time one of the lowest proportions for number of beds per 100,000 inhabitants in the region. Serbia and Montenegro are again in the middle of the ranking for both indicators.

Table 9.2: Basic health-related indicators in SEE countries

Country	Mid-year population in 2002	Life expectancy at birth (year)		Infant mortality per 1000 live births	Number of physicians per 100,000 inhabitants	Number of hospital beds per 100,000 inhabitants
		Male	Female			
Albania	3,164,000	72.03	78.04	11.62	138.89	326.33
Bosnia and Herzegovina	4,127,000	69.49 (Dec-91)	75.98 (Dec-91)	15.00 (Dec-99)	144.92 (Dec-01)	322.11 (Dec-01)
Bulgaria	7,790,000	68.55	75.44	14.14	343.55	720.10
Croatia	4,657,000	71.03	78.17	7.68	237.79	599.85
Macedonia	2,051,000	71.18 (Dec-00)	75.74 (Dec-00)	11.81 (Dec-00)	218.96 (Dec-01)	493.26 (Dec-01)
Serbia and Montenegro	10,523,000	70.36 (Dec-00)	75.18 (Dec-00)	13.25 (Dec-00)	213.17 (Dec-99)	540.63 (Dec-99)
Romania	22,332,000	67.69	75.01	18.41	188.94	749.22

Source: World Health Organization.

Note: All data for Bulgaria, Croatia and Romania (except mid-year population) are from 2001. Data for Albania (except mid-year population) are from 2000.

PART 2

*COMMENT 1**ECONOMIC REFORM AGENDA 2002-2006 IN MONTENEGRO**by Prof. Veselin Vukotić, President of ISSP**BACKGROUND*

Experts of the Institute for Strategic Studies and Prognoses and the Economic Reform Network played a very important team role in the coordination of the initial draft of the Economic Reform Agenda, which results from the cooperation of domestic and international institutions and experts, done according to the needs of the Prime Minister of the Government of Montenegro.

The starting point of the Agenda is based on the foundation of economic reforms in Montenegro, presented in the Prime Minister's Inaugural Speech in the Parliament of Montenegro, as well as on information from the Ministries' working program. The idea of the Agenda is realized in several-months of work through the actions and activities of 15 expert teams with approximately 100 members. Members of mentioned teams include representatives of international donors and consultant houses, USAID and Barents group, DFID, European Agency for reconstruction, as well as domestic institutions and experts¹. The Agenda is presented on three levels: **first level** - Prime Minister and Deputy Prime Ministers; **second level** - Ministries; **third level** - working groups for certain issues. The final version of the Agenda, prepared for discussion with Government Bodies and the Government itself, contains many remarks and suggestions that have improved the Agenda and made it more consistent.

METHODOLOGY

The Agenda is conceived as the first complete program of measures and activities in a period through the year of 2006. The starting point of the agenda is based on the vision of the Montenegrin economic system development from 1998 (presented and published in several ISSP studies), which was the foundation of reform measures in Montenegro, the base of establishment of Montenegro economic sovereignty, as well as the starting point of negotiations about new relations with Serbia.

The Government of Montenegro is, for the first time, entering a period of political stability, which provides the possibility to conduct one complete program.

The entire Agenda, as well as its certain parts, is structured in the following way: (1) wanted goals; (2) key parameters for evaluation of the Agenda and its parts; (3) overview of the current situation in a certain area; (4) concrete initiatives, with description of essence of every initiative, institutions responsible for its realization, term plan, and technical assistance of foreign donors.

¹ Central Bank of Montenegro, Securities Commission, ISSP (Institute for Strategic Studies and Prognoses), CEED (Center for Entrepreneurship and Economic Development), CARA (Center for Applied Research and Analyses), Institute for Comparative Law, NGO for local governance development, etc.).

The tasks below are cut across the entire Economic Reform Agenda: (1) Monitoring the realization of the Agenda; (2) Educating the public about economic reforms; (3) Gaining participation of the Civil Society in the policy-making and legislative process.

GOALS

The Economic Reform Agenda is an all-inclusive four-year plan, which is adopted by the Government of Montenegro in order to achieve the following goals:

- Economic growth driven by the private sector
- EU compatibility of legislation and processes
- Maximization of Montenegro's potential in areas where it has advantages
- Protection of the Environment

EXPECTATIONS

At the end of the four-year program, the Montenegrin economy is expected to exhibit the following characteristics:

Fiscal Sustainability, in that budget execution will be according to plan without arrears carried over to the following year and without significant un-met liabilities. This will occur in the context of a tax regime that is friendly to economic growth.

The **Pension System** will have reversed its deteriorating position and be moving toward long-term sustainability. A mandatory funded system with individual retirement accounts will be in place.

The **Financial Sector** will be well regulated in all areas, with rapid resolution of disputes, high levels of competition in a fully privatized sector, firm protection of the rights of lenders and depositors in place, and a wide variety of investment options available to savers.

The **Business Environment** will be stable, supportive of entrepreneurial initiative, permitting of the rapid resolution of disputes, protective of property rights, and all laws will be in harmony with EU and WTO directives. Regulations will be clear and protective of rights, but non-discretionary and will not hinder free business development.

Energy Sector problems will be resolved such that Montenegro will have a stable supply of reasonably priced and efficiently delivered electricity, a fair and transparent regulatory system with rate setting that is supportive of investment in the sector, and a set of policies and incentives that is consistent with Montenegro's designation as an environmental state.

Public Administration policies, procedures and salary levels will be such to attract qualified civil servants hired on a merit basis who will be dedicated to continuing improvements in public services and good governance.

With the exception of a very few strategic assets, **Privatization** will have been completed with the government selling the remainder of state assets to a properly incentive private sector. Private sector participation in the provision of public services will be widespread, leading to an improvement in the efficiency and quality of service delivery.

Local Governments will be responsible for autonomous self-government of their own key functions and will have the tax collection capacity and authority to retain revenues to finance these new responsibilities.

Poverty will be greatly reduced as a result of economic growth and the revitalization of previously depressed regions and sectors of the economy.

PARAMETERS

Macroeconomic indicators at beginning of program are presented in the table below:

Macroeconomic indicators	2001	2002
GDP (mil eur)	1.049	1.221
GDP real growth rate		0.84
Population	661,600	666,581
GDP per capita	1.586	1.832
Inflation	28.0%	9,4%
Number of employed		218,000
Unemployment rate	24.0%	18.5%
Number of pensioners	85,849	88,301
BOP	(112)	(70)
FDI		75
Foreign Aid	62	36
Budget deficit	17	32
M 1	379	385
Savings (mil eur)	5.8	16.8
Grey economy	40%	30%

The process of implementation of the reforms included in the Agenda should ensure that the macroeconomic indicators registered during 2003-2006 will be as follows:

Macroeconomic indicators	2003	2004	2005	2006
GDP (mil eur)	1.328	1.421	1.516	1.618
GDP real growth rate	1.49	4.06	4.3	4.6
Population	669,914	673,263	676,630	680,013
GDP per capita	1.982	2.111	2.241	2.379
Inflation	8%	4%	2,3%	2,1%
Number of employed	223,000	228,000	233,000	238,000
Unemployment rate	17.5%	16.5%	15.5%	14.5%
Number of pensioners	89,184	90,076	90,977	91,886
BOP	-33	33	34	35
FDI	120	150	180	200
Foreign Aid	30	25	20	0
Budget deficit	27.9	13.4	12.3	11
M 1	404	424	446	468
Savings (mil eur)	30	50	75	100
Grey economy	20%	15%	13%	11%

PILLARS

The Agenda relies on five key pillars, which are connected through network. Those are:

- ***Entrepreneurship***
- ***Investments***
- ***Competitiveness***
- ***Transparency***
- ***Employment***

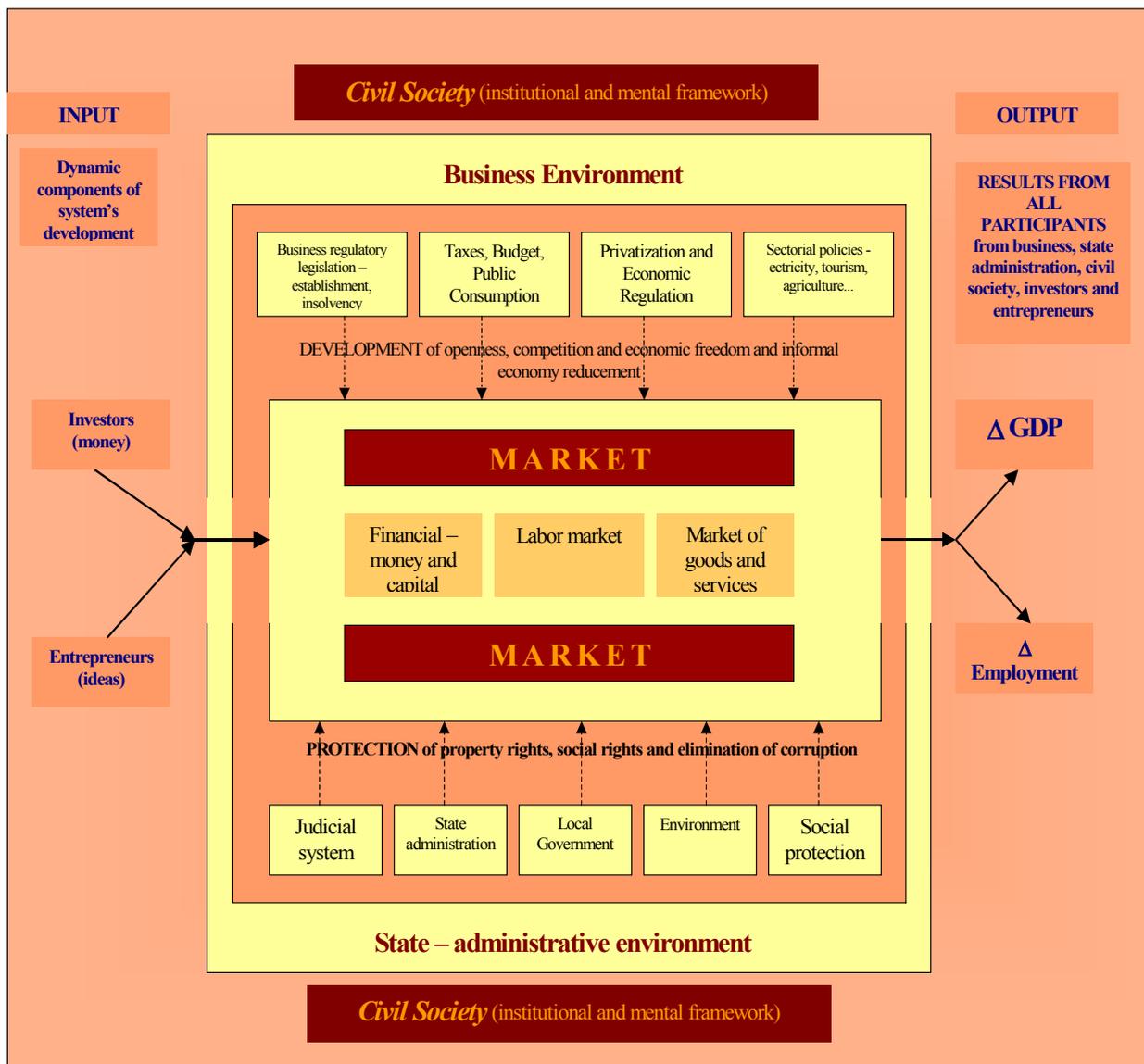
Entrepreneurship - or how to encourage and help individuals to enter businesses. *Entrepreneurship is the energy for the realization of the Agenda. In that sense, activities should be concentrated on (1) removing barriers for doing business; (2) adjusting tax rates, in order to optimize private sector growth; (3) strict control of government expenditures; (4) protection of property rights; (5) increasing economic freedom; (6) increasing the availability of loans and credits; (7) private sector participation in providing public and administrative services.*

Investment - or how to make Montenegro attractive for investments, especially in comparison with other countries in the region. *Key starting point is: (1) protection of property rights (court system, bankruptcy procedures, restitution, prevention from corruption and conflict of interests); (2) efficient institutional framework (financial market, capital market); (3) privatization of public companies and banks*

Competitiveness - or how to decrease the cost of production, improve the quality of products and its marketing characteristics, as well as to expand the market. *Items below are of particular importance: (1) reduction of administrative and transaction barriers; (2) World Trade Organization Accession; (3) European Union harmonization; (4) attract foreign companies in Montenegro; (5) reduction of infrastructure costs (energy, transportation, insurance, interests).*

Transparency - or how to increase the visibility of economic system functioning, preventing the existence of a "parallel" system (gray economy, corruption, rent-seeking, subsidies, subventions, contingents, permissions, etc.). *The main task of transparency is, before all, to strengthen the functioning of the official system, basic system institutions, in other words the same game rules should apply for all.*
Transparency provides functioning of market and democracy through rule of law. Law is "above" politics (democracy).

Employment - or how to increase the number of employed people, capable to earn enough for a better quality of life through independent work. *Result of all undertaken activities should be an increase of employment.*



Economic Reform Agenda – functional approach

COMPREHENSION

The Economic Reform Agenda includes institutional framework from different areas. The broadest framework is civil society, which includes a framework for business (business environment) and administrative framework (state-administrative environment). An integral market (financial market, market of goods and services and capital market) is placed between the business environment and the state administration environment, within the civil society framework. Institutions from the business environment and state-administrative environment make particular parts of the program and are interconnected through achieving their primary tasks - providing efficient functioning of the market.

The business environment (institutions, laws, rules, politics) should provide higher competitiveness, openness and economic freedom, while the state-administrative environment should provide protection of property rights, higher level of transparency and reduction of corruption. The whole system is "dead" if it is not attractive for investors (people who invest their money) and entrepreneurs (people with the idea). Entrepreneurs within a given institutional framework provide the system's output - system purpose: (1) GDP growth; (2) increase of employment. Everything which is done within the system

(drafting the law, meetings, business negotiations, technologies of realization, etc.) make sense only if the system does produce new income and new employment. The graph below shows this in more detail:

CONTENETS OF THE ECONOMIC REFORM AGENDA

The Agenda involves numerous tasks within several broad systemic and sectoral areas. Below we present a short description of them with a list of most urgent tasks within each of them. There are three tasks that pertain to all others in the Economic Reform Agenda:

- Monitoring and reporting on the activities and outcomes of the economic reforms,
- Communicating the progress and impact of economic reforms to the people of Montenegro and
- Full participation of Civil Society in the policymaking and legislative process.

There are 16 specific areas covered by the Agenda. For each of them a concise description of goals, key parameters and special initiatives is provided.

Business Environment and Trade

Goals

- To create a business environment that maximizes economic growth, increases trade and economic activity and protects property rights and the rule of law

Key parameters

- Domestic harmonization of the existing legislation
- Harmonization with EU Directives
- WTO Accession
- Harmonization with neighboring countries, if applicable

Specific initiatives

1. Review legislation for internal and WTO harmonization
2. Deregulation and reduction of transaction costs
3. Increase flexibility in labor market
4. Implement existing legislation and modifications as needed
Adopt and implement draft laws that are already developed
Develop and implement new laws

Fiscal Reform

Goals

- A balanced budget within five years achieved through fiscal discipline in budget planning, tight accounting controls in budget execution, and a competitive, broad based tax structure that facilitates robust private sector growth.

Key parameters

- Consistent with IMF and World Bank framework and targets
- Harmonization with EU directives

Specific initiatives

1. Expenditure Management and Control
2. Improve Budget Planning and Execution
3. Reform the Tax System
4. Public Annual Review of Tax Policy to Stimulate Growth

Financial System

Goals

- A stable, privately owned financial system that is fully integrated into international structures and that offers safe and stable returns for depositors and fair, reliable prices of capital to borrowers.

Key parameters

- International Banking Standards
- The public sector is not in competition with the private sector

Specific initiatives

1. Regulation and Resolution of Banks According to Basic II Principles and EU Directives
2. Privatization of State Banks
3. Assess Policies to Reduce Interest Rates
4. Effective Regulation of the Insurance Industry
5. Introduce Market Rational Deposit Insurance Scheme
6. Complete Closure of ZOP and Payment System Reforms
7. Adopt and Implement an FATF Compliant Anti Money Laundering Regime
8. Effective regulation of money market

Privatization and Post-privatization

Goals

- Improving the performance of formerly state owned companies, while decreasing state ownership in all companies, protecting property rights and promoting economic freedom

Key parameters

- Increase in percentage of private ownership
- Decrease in total government claims on companies, in debt and equity
- Increase in "index of economic freedom"

Specific initiatives

1. Accelerate the sale of state shares in companies and banks
2. Resolve restitution claims
3. Resolve bankrupt companies and state debt
4. Ensure that capital market institutions are prepared to serve the marketplace and investors
5. Task force for protection of property rights and promotion of economic freedoms
6. Economic regulation

Pension Reform

Goals

- A multipillar pension system is established and financed only from contributions, providing adequate pensions and contributing to economic growth and development.

Key parameters

- Reorganization of the pension administration according to the best international practice
- Attention to demographic and economic realities

Specific initiatives

1. Complete draft law and submit to the Government for adoption
2. Redefine the role and structure of the fund PIO
3. Detailed analysis and debate on introduction of the second pillar
4. Introduce voluntary pension funds - a third pillar

Sectoral Policies – Energy

Goals

- ❑ To deliver reliable, fairly priced electricity to the citizens and businesses of Montenegro

Key parameters

- ❑ EU directives and signed MOUs
- ❑ Regional integration in the electricity market
- ❑ Compliance with Donor conditionality required

Specific initiatives

1. Adopt the energy law and establish an independent regulator
2. Restructure EPCG and unbundle generation, transmission and distribution
3. Introduce cost recovery tariffs
4. Achieving positive cash flows at EPCG
5. Design and operation of electricity market
6. Tender for private sector participation or independent power producers
7. Resolve problem posed by KAP energy subsidy

Sectoral Policies – Forestry, wood processing

Goals

- ❑ A sustainable managed forest within the overall objectives of the Ecological State, while developing a viable and sustainable high value added wood processing industry

Key parameters

- ❑ A sustainable managed forest leading to FSC Certification
- ❑ Maximization of, well regulated where needed, private sector participation in all areas

Specific initiatives

1. Obtain sustainable forestry certification.
2. Promote a competitive industry in timber harvesting
3. Promote restructuring, bankruptcy and re-capitalization of wood processing companies

Sectoral Policies – Tourism

Goals

- ❑ Creation of a sustainable tourist product, gradual growth of number of guests and fast growth of income, creation of new employment

Key parameters

- ❑ Realization of the activities in accordance with the strategic document, Master plan for development of tourism for the period of next 20 years;
- ❑ Preservation of the existing capacities and provision of sustainable development through environmental protection, protection of flora and fauna, historic and cultural heritage and placing of the tourism offer in function;
- ❑ Establishing a strong position in international competition through competitive services and prices, market orientation and image;
- ❑ Creation of high quality and multiple offers. Instead of mono-structural offer, like nowadays, adaptation to modern market trends must be done, using diversification and specialization; in all areas

Specific initiatives

1. Framework for development of tourism and coordination of the process
2. Marketing: formation, development of offer and sale

Sectoral Policies – Agriculture

Goals

- Safety of food supply to Montenegrin citizens, including fulfillment of tourist needs in Montenegro; to significantly increase exports, especially in tourism – on the door step; to increase the competitive capability of domestic food producers; to balance the regional development of Montenegro; to create better living conditions in the villages; to be included in regional, European, and international integration processes

Key parameters

- Development of merchandise in private sector – main priority,
- Family businesses, the optimal goal of development of Montenegrin agriculture

Specific initiatives

1. Incentives policies in agriculture
2. Redefining the measures to protect domestic agriculture
3. Reforms in credit policy
4. Building of institutions in agriculture (Inspection and expert services)
5. Building of trademark of products of organic agriculture in Montenegro

Public Administration Reform

Goals

- Good governance through public administration that is apolitical, qualified, ethical, professional, selected on merit, and accountable for performance.

Key parameters

- New law on Public Administration
- Harmonization with EU standards

Specific initiatives

1. Pass and implement a new law on public administration
2. Establish an Office of Civil Service Commission (OCSC)
3. Development of the public service structure and code
4. Assess and develop reward structure for civil service employees
5. Civil service staff training and development
6. Internal communicating campaign

Local Government Reform

Goals

- To have a democratic and decentralized professional local government system that practices good local governance with and for citizens and builds opportunities for local economic development and a healthy business environment.

Key parameters

- Harmonization with Council of European Charter of Local Self-Government
- Harmonization with International Accounting Standards as adopted by the Republic of Montenegro.
- Harmonization with ISO 9002:1994 and ISO 9001:2000 standards on quality of government/public services

Specific initiatives

1. Adopt the core systemic laws and issuing decrees, books of rules and decisions on their implementation
2. Establish a professional civil service at the local government level
3. Implement a stable sustainable system of local government finance
4. Improve quality and delivery of local public services

5. Empower broad based decision making for local economic development and ease of business transactions

Judicial Reform

Goals

- A judicial system that is independent, impartial, transparent, adaptable, and guarantees the protection of rights of physical and legal persons.

Key parameters

- Consistent with Constitutional and legislative framework
- Consistent with EU standards

Specific initiatives

1. Reform the constitutional and legislative framework
2. Implement the law on courts
3. Capacity building for Judges, Prosecutors, Court Staff, and other essential personnel, including advocates.
4. Develop the administration and management of the courts

Civil Society

Goals

- A legal and regulatory framework that promotes effective partnerships between Government and the NGO sector in the provision of government funded services.

Key parameters

- International best practice for tax deductions for business or individual contributions to NGOs
- International best practice for tax exemptions for NGOs
- International best practice for open competition among NGOs to provide government-funded services
- International best practice for the development of the NGO sector

Specific initiatives

1. Review and amend the legislative framework affecting NGOs

Macroeconomic and Statistics

Goals

- Macroeconomic data collection, analysis and reporting functions fully consistent with federal and international standards, and reserve levels optimized accordingly

Key parameters

- Consistency with SNA methodology for calculation of output aggregates
- Consistency with IMF methodology for fiscal, monetary and external statistics

Specific initiatives

1. Introduce Methodology and Standards of System of National Account (SNA 1993)
2. Improve Standards of Monetary and External Accounts According to IMF and International Standards
3. Introduce GFS IMF Standards for Fiscal Accounts and Publish on a Monthly Basis
4. Publish Monthly Reports on Real, Monetary, Fiscal and External Developments in Montenegro
5. Participate in IMF General Data Dissemination System (GDDS) and Statistical Data Dissemination System (SDDS)
6. Develop a Reporting System and Research

Informatics society

Goals

- To define a national vision of development and transition to information society; to valorize generic information and communication technologies (ICT); to apply European standards and recommendations in the process of preparation of electronic management to be able to fully integrate into EU; and to build a society providing equal chances to everyone

Key parameters

- Type and number of services provided electronically by state and local administration
- Degree of harmonization of the national strategy for the development of informatics society in accordance with the initiatives of Europe and SEE
- Increase number of Internet users, especially among students
- Number of transactions of public procurement area executed electronically
- Percentage of international standards out of ITC area which are adopted, announced and implemented in local practice

Specific initiatives

1. Electronic Administration (eGovernment)
2. Normative in the ICT area

Environmental Protection

Goals

- To establish a sustainable development and strengthening of the environmental protection system according to the previously adopted strategy “Development Directions of Montenegro Ecological State”

Key parameters

- EU directive and signed ratified international agreements (conventions)
- Participation in process “Environment for Europe”

Specific initiatives

1. Harmonization of Environmental Protection Law with EU directions and standards
2. Law on Estimation of Influence on Environment
3. Establishing an Environment Agency
4. Introduction of stimulative measures in area of environmental protection
5. Foundation of national ecological fund

COMMENT 2

BARRIERS TO DOING BUSINESS IN MONTENEGRO

by Petar Ivanovic

The recipe for economic development is not known, but some of its main components include: (i) Investing - a major part of the GDP should be invested in productive projects to enable faster development; (ii) Trade Liberalization and Monetary Stability - Numerous analyses have concluded the significance of these actions; (iii) Low custom rates and even lower taxes - the experiences of other countries that have achieved fast economic development clearly emphasize the significance of lower customs and taxes.

If there is no development, than barriers must exist; barriers thwart entrepreneurs in their initiatives to invest, to widen their business, to earn more, and to employ new workers. It is extremely important that we identify the barriers and the factors that cause them; analysis and a clear understanding of these factors will be the starting point for creation of strategies and consideration of choices.

In May of 2000, the Center for Entrepreneurship and Economic Development (CEED) from Podgorica initiated the “Barriers to Doing Business in Montenegro” survey with the aim to analyze obstacles that prohibit entrepreneurs in Montenegro from starting a business. The results of the survey and recommendations given were the basis for creating an initiative to adopt the new Law on Enterprises. As a result, the process of business registration in Montenegro has been significantly simplified, allowing firms to register in just four days with founder capital of just 1€ and the overall number of steps has been decreased from over fifty to just three. The effect of these changes is that the number of registered firms in Montenegro has doubled. However, all barriers are not eliminated and new barriers have even emerged in the area of licensing. With the barriers surrounding paperwork, permits, licenses, agreements, fees for commissions, etc., business development continues to struggle against the obstacles.

Two years after the first survey, the Center for Entrepreneurship and Economic Development is changing the focus to perceived barriers for development and enhancement of existing businesses. The focus is spreading from firms that are starting their business to firms that hope to develop and widen their businesses.

The Center for Entrepreneurship and Economic Development from (CEED) Podgorica and the Center for International Private Enterprise (CIPE) from Washington share a common opinion with respect to the best approach that will solve the developmental problems of the private sector, thus, they have agreed to work on this research together. And indeed the way of thinking is the thing that connects people and institutions.

The goal of the study was to identify barriers that are blocking business development in Montenegro, and to offer recommendations for their elimination.

Objectives of the survey are to: (i) Provide basic information on businesses in Montenegro; (ii) Analyze current employment in the sample and trends of future employment; (iii) Gather opinions and estimates of firms and entrepreneurs about the current and future situation in Montenegro; (iv) Analyze the current market for firms and entrepreneurs with a special review on export oriented firms; (v) Study financial capabilities and needs of firms and entrepreneurs; (vi) Analyze expectations of their own development and expansion; (vii)

Gather data about the level of utilization of computers, Internet, and software; (vii) Analyze special needs for external services of firms and entrepreneurs.

1. BASIC CHARACTERISTICS OF THE FIRMS FROM THE SAMPLE

The Survey was conducted among business owners over a variety of sectors within the economy. The greatest number of firms were involved in retail sale (39.9%) and services (30.7%). The remaining firms sampled represent the following sectors: 13.7% deal in wholesale trade, 8.8% in manufacturing, 4.9% deal in tourism, while 1.8% are involved in the construction business. It is interesting to notice that more than half of sampled firms are involved in some form of trade business. If we compare two periods (2000 with 2002), we can see that the number of enterprises specializing in retail trade or non-touristic services has increased more than 10% within each sector, while the number of manufacturing firms has decreased by almost 12%.

Additional Activities

30.9% sampled firms have at least one additional activity, and an additional 9% have two. The first additional activity mentioned most often is retail trade for 10% of sampled firms and wholesale trade for 7.8% of sampled firms. For more than half of firms that have at least one additional activity (57.6%), some form of trade is cited. When compared to the 2000 survey there is a distinct decrease in the number of enterprises that conduct more than one activity (from 65% to 30.9%).

Firm Size /Employment

75.9% of firms are categorized as micro-enterprise (up to 9 employees), while an additional 19% are categorized as small enterprise (10-49 employees); together they represent 94.9% of all firms surveyed. Such a high percentage of micro-enterprise is logical because of the transition process that Montenegro is going through. New regulations that have simplified the registration process will surely help to maintain this high percentage.

Year of establishment

22.5% of sampled firms were founded in 1991 or before and 51.2% of sampled firms were founded in 1996 or later. From 1991 through 1996, we saw an average increase of 5.4% in the number of new firms established per year. This trend changed significantly in 1997, when the increase of newly established firms was 10%. After 1997 we note a consistent decline in the establishment of new firms, and then the situation changes again in 2002, after the adoption of the New Law on Enterprises 2002.

Organizational form

52.2% of the enterprises surveyed are organized as LLC's, while nearly one-quarter (23.1%) are Sole Proprietorship companies and 13.5% are UP's. As compared to the 2000 survey, LLC has maintained its position as the most prominent organizational form of enterprises, but SP (sole proprietorship) has increased its popularity going from 13% to 23.1%.

Ownership

The majority of firms are owned by persons from Montenegro (88.3%). Private persons from Serbia own 4.1% of sampled firms, while domestic firms own 3.1%, and the state owns 2.5% of the firms. A significant increase in the number of firms owned by “private persons from Montenegro” is evident (going from 60% in the last survey to 88% today). The number of privately held firms overall has also increased, with 97.5% of firms in 2002 being privately held as compared to 93% in 2000.

Location

The majority of sampled firms are located in the central part of Montenegro – Podgorica, Niksic and Cetinje (50.9%). In the southern part of the state we found three of ten (29.4%) sampled firms and one of five (19.7%) are located in the northern part of the state. The regional distribution of sampled firms correlates to the regional distribution of all registered firms in Montenegro. There is a slight increase of firms that are headquartered in the southern region of Montenegro (from 24% in 2000 to 29.4% in 2002).

2. RESPONDENTS’ ASSESSMENT OF THE ECONOMY AND OF THEIR OWN FIRMS

Assessment of the economy

Fewer than 8% of all enterprises considered the current economy as “good”, while 59% regarded the current position of the economy as “bad” and the remaining one-third (33%) classify it as “average”. Comparing the 2000 survey to our current data, we note a slight increase in the O-P indicator; even though it remains negative, it has gone from negative 59 to negative 51.

Assessment of future economy

Responses for the economy’s future prospects were much more encouraging: 29% of firms considered future prospects of the economy as “good”, however, a slightly greater proportion view future prospects as “bad” (31%) and almost 39% consider prospects of the economy as “average”. When compared to the 2000 survey, there is a slight increase among those considering the future prospects to be good (growth from 24% to 29%).

Assessment of their own firms

More than 22% of respondents regarded the current position of their firms as “good”, with 17% of the sample considering this position as “bad”, and the remaining 60% classifying this as “average, producing an O-P indicator of plus 5. Enterprises were slightly less optimistic about their own activities compared to the 2000 survey; the O-P indicator went from 11 in 2000 to 5 this year.

Assessment of future of their own firms

Almost half (49%) of the firms surveyed claim that prospects for their own firm are “good” and just 9% classified this as “bad”. Even with this strong showing, the O-P indicator for “prospects for their own firm” is less than it was in the 2000 (going from 55 to 40).

Firm performance over the last six months with respect to gross revenue

33% reported a decrease in gross revenue over the last six months, while 41% reported no changes. Compared to the 2000 survey we note a decrease in gross revenue of the firms and a decrease in the O-P indicator. Wholesale trade firms reported an increase in gross revenue over the past six months (30%), while manufacturing, retail trade and other services firms (apart from tourism) reported a decrease in gross revenue (47%, 32% and 36%, respectively). The greatest increase in gross revenue over the last six months was realized among micro and small firms (25% and 33% respectively).

3. EMPLOYMENT***Basic findings***

This research included 498 firms employing 11,071 workers, or on average 22.6 workers per firm. A total of 8,805 are employees with permanent full-time work in the surveyed firms, while the remaining 2,226 employees work on some other basis². In total, 76.5% of the surveyed firms are micro-enterprises, while just 1.6% of the enterprises surveyed are large enterprises with 250 or more employees. Among the 2,260 workers employed on some other basis 54.3% are employed in micro and small enterprises. 59.9% firms from sample plan to increase the number of employees in the coming period. Considering future expectations, 45.2% expect that the number of employees will increase in the future, while 6.4% expect the number of employees to decline.

Employment and sector of activity

The retail trade sector and the services sector employ the greatest proportion of workers (40.1% and 30.6%, respectively). Just 1.9% of workers are employed in construction.

Employment During the Preceding Six months

There were no significant changes in employment over the preceding six months. Among all firms sampled, three-quarters (74.6%) maintained the same number of workers, while 9% reduced their workforce, and the remaining 16.4% of firms employed new workers.

Dismissal of workers

With respect to employee termination or dismissal, firms that are engaged in manufacturing and construction lead the pack. Among the total number, 18.6% of manufacturing and 11.1% of construction firms have reduced the number of employees in the past six months.

Sector of activity

Firms with wholesale and tourism as major activities employed more new workers during the preceding six months. Among all firms in those activities 29.2% of firms from tourism and 26.9% from the wholesale sector employed new workers.

² That is additional employment, a second job, member of owner's family, by contract, or in a job not registered as official employee.

Employment and market

Firms whose major market consists of domestic firms have had the largest increase in the number of employees, 24.3% of these firms have employed new workers in the preceding six months.

Employment and annual revenue

Firms with annual revenue in excess of 250,000€ have had the largest fluctuation in the number of employees (among this group of firms, six of ten 62.8% maintained the number of employees in the preceding six months, while 29.1% of firms increased the number of employees). On the other side, the smallest changes were among firms with annual revenue up to 50,000€ (only 7.7% of those firms increased the number of employees, and 79.7% maintained the number of employees).

Expected Trends in Employment

Only 6.4% of surveyed firms expect a reduction in the number of employees in the next period, while 48.5% expect no change. The increase in employment in the future is mostly expected in firms from the following sectors: wholesale trade (56.7%); tourism (56.5%) and construction (55.6%). The largest increase is expected among firms with a revenue range between 100,000 to 250,000€ (64.1%) and those with revenue above 250,000 euros (54.7%).

4. FINANCE

Gross Revenue- Basic Findings

Our survey has revealed a similar allocation of firms within all gross revenue categories. Approximately three of ten firms (30.3%) report annual gross revenue of less than 25.000€ (the smallest revenue category in the survey). A total of 25.9% of sampled firms report an increase in gross revenue over the preceding six months, while 32.9% report a decline, and 41.2% report no changes.

Gross Revenue and firm size

93.2% of all enterprises with less than 25,000€ in annual gross revenue employ fewer than 10 workers, while just 45.3% of enterprises with more than 250,000€ of annual revenue employ fewer than 10 workers. Comparing gross revenue levels among firms of various employee levels, we see a positive correlation between firm size and annual gross revenue:

- 12% of all enterprises employing fewer than 10 workers generated more than 250,000€ in annual gross revenue;
- 36.4% of all enterprises employing between 10 and 49 workers generated more than 250,000€ in annual gross revenue;
- 81.8% of all enterprises employing between 50 and 249 workers generated more than 250,000€ in annual gross revenue;
- 54.5% of all enterprises employing more than 250 workers generated more than 250,000€ in annual gross revenue.

Gross revenue and sector of activity

Retail trade and service firms generate less gross revenue than firms engaged in manufacturing, construction and wholesale. Among enterprises with annual gross revenue below 25,000€, 43.9% firms are involved in retail trade and another 42.5% in services. Among all retail trade firms, 34.1% generate less than 25,000€ gross revenue, and similarly 35.8% of service enterprises (other than tourism) generate less than 25,000€. In contrast, 9.8% manufacturers and 11.1% constructing firms generate annual gross revenue below 25,000€. At the top end of the scale, the differences are even more significant with 55.6% of constructing firms, 44.3% of wholesale trade enterprises and 36.6% of manufacturers generating annual gross revenue in excess of 250,000€. These findings are consistent with data collected in the previous survey.

Gross revenue and markets

As in 2000, there is a distinct correlation between annual revenue and markets served. Companies that do business with public and nonprofit organizations, domestic firms and export, tend to have higher levels of annual revenue.

Gross revenue expectations

Firms generating between 100,000€ and 250,000€ revenue annually are most optimistic about future gross revenue levels. Compared to the Survey 2000 results, we notice a strong increase in the optimism regarding future revenue levels. Surveyed PIF's unanimously expressed their expectations of an increase in revenue, as did Top 10 companies. 83.3% foreign companies were also optimistic about their future revenue.

Demand for credit

Among all firms requiring a loan of at least 100,000€, 49.1% report annual revenue of 250,000€ or more, while 15.8% firms requiring this amount of a loan have annual revenue of up to 50,000€. Smaller loans, up to 10,000€ are most often preferred by firms with annual revenue not greater than 50,000€ (66.7%).

Liquidity

Results of the survey showed significant problems with receiving payment. Compared to data from the 2000 Survey, there has been an improvement with respect to accounts payable; however, the problem with accounts receivable has worsened this year. Top 10 companies report having few problems with accounts payable (42.9% "temporary"), while reporting constant problems, either temporary (85.7%) or frequently (14.3%) with accounts receivable. Foreign companies and PIF's both reported few problems with accounts receivable and payable. Firms that are involved in the constructing business cite the most serious problems with payables, reported by 77.8%, this is considerably higher than in other sectors. A positive correlation does appear between firm size and liquidity problems. Among all large companies, 83.3% report payment problems (either "frequent" or "temporarily"), compared to 75.0% of medium companies, 49.5% of small companies and 43.1% of micro-enterprises. The greatest problems with accounts receivable, are reported in retail trade (74.8%), services other than tourism (55.9%) and wholesale (35.3%).

Bank Credit Utilization

Results of the Survey show that 30.5% of firms used a bank loan as a source of financing and that 69.5% never obtained credit. Among all respondents that have never received a loan, 15.4% did apply for one. Compared to figures in the year 2000, the number of firms that have applied for a bank loan has declined, and 10.5% fewer firms have obtained credit from a bank this year.

Demand for Credit

Almost three quarters of firms that applied for a loan, required credits of 10,000€ or less, and more than four-fifths require at least 12 months to repay the loan. Top 10 firms have expressed little interest in bank loans. Among micro-enterprises, the demand for credit is as follows:

- 33% prefer a loan of 5,000€ or less
- 56% prefer a loan between 5,000€ and 10,000€
- 13% prefer a loan between 50,000€ and 100,000€
- less than 6% prefer a loan amount greater than 100,000€

Start-up sources of capital

For 65% of all surveyed companies, savings represent a start-up source of capital and 43.8% used loans from family and friends as their source of capital. Start-up bank loans were used by 13.3% of enterprises and interest bearing loans from private persons by 10.8% of all companies. Compared to figures in 2000, there has been an increase in the proportion of companies using savings or interest bearing loans from private persons as their source of capital. Bank credit as a source of capital has decreased from 18.12% in the year 2000 to 13.3% in the year 2002.

Current sources of capital

Savings at the present represents a significant source of financing, similar as it was for start-ups. 36% of all companies still use savings as a capital source, this figure is slightly lower than in survey 2000. Among all companies that used savings as a capital source in start-up, 42.5% use it as a current capital source. A total of 14.5% of enterprises rely on bank loans as capital source, 10% use loans from family and friends and 4.7% use interest-bearing loans from private persons. The most significant current source of capital reported is reinvested profits, stated by 73% of enterprises. The significance of reinvested profits for current financing increased since 2000 by more than 11%, and at the same time the importance of other sources, with the exception of savings, has diminished.

Informal Income

47%, of surveyed firms find informal income to be “very frequent”, another 24% of surveyed companies think it to be “frequent”, 23% report that “it happens”, 4% think it happens “rarely” and 2% think it happens “very rarely”. Compared to the 2000 data, more firms found informal income to be a very common phenomenon.

5. BUSINESS OWNER'S PROFILE

Education

On the basis of education level, all owners of companies are divided into two groups: "higher educated" and "lower educated." The "higher educated" group includes all respondents who possess at least an advanced school diploma, while those who hold a high school diploma or less are included in the group of "lower educated" owners. Higher educated owners represent about 61.3% of the sample, while 38.7% of those surveyed are classified as lower educated. Nearly six of ten respondents (58.8%) have attended college or university with either a 2-year or 4-year program behind them; however, an additional two-fifths (38.5%) hold just a high school diploma. Very few business owners have pursued higher education in the form of a master's certificate or a doctorate.

Motivation to start-up a business

The two greatest motives for owning a business are money and independent work. Approximately 61% of the respondents prefer money, while 56% specify independence as one of the motives. Money as motive is most present among respondents between the ages of 20 and 25. Money is a stronger motive for men than for women. Independence is a greater motivator among the higher educated owners. Young business owners (age 20-25) do not report independence as a motive very often. Men and women alike report independence to be a significant motive.

Age structure of business owners

The majority of business owners (80%) are between 30 and 60 years of age. About 7.8% are older than 60, while 12% are business owners younger than 30. In comparison to the 2000 survey, more owners are 50 years or older in this survey.

Gender structure

Men are more often owners of businesses and they run companies more frequently. Men are owners of 76.9% of businesses, and in 75.4% of all companies, they are the primary managers. This survey shows that women are owners in 23% of cases as compared to less than 17% in the 2000 survey.

6. MARKETS

Basic findings

Private persons represent the largest market for most firms from the sample; 50.1% of the firms answered that private persons represent 100% of their market. Among all micro firms surveyed, 79.5% report their primary market to be private persons, 11.1% of them serve domestic firms, and 4.9% serve private persons and domestic firms equally. Among small firms, 48.4% sell mostly to private persons, 28% sell to domestic firms and 15.1% sell to private persons and domestic firms. Among medium size firms 58.3% sell mostly to private persons, 25% of them sell to domestic firms and 8.8% mostly export their products. 62.5% large firms report their main market as private persons, 12.5% mostly export to Kosovo and the same proportion (12.5%) sell to public organizations.

Export Oriented Companies

14.7% of sampled companies are engaged in export of their products: 7.7% export to Serbia, 1.4% to Croatia or Bosnia, 2.8% to Kosovo and the same proportion (2.8%) to other countries. Very few firms surveyed, just 3.06%, consider exports to other countries as their major market. Almost half (49.3%) of firms that export their products are micro companies and 41% of them are small in size.

Future export expectations

Two-thirds of the sampled firms (66.7%) predict a higher level of export in the future, while none of the firms expect it to decline.

7. GROWTH, STAGNATION AND DECLINE

Basic findings

Comparing and evaluating the firms' present and future assessments, we have concluded that:

- 273 firms, or 56.4%, are in the "growth" phase
- 192 firms, or 39.7%, are in the "stagnation" phase
- 19 firms, or 3.9%, are in the "declining" phase

Calculated OP Indicator is 52.5, compared to 35.4 in year 2000.

Economy sector

It is interesting to note that retail and service firms represent a significant part of both "growing" and "declining" firms.

Age of the establishment of the firm

One-fifth of "growing" firms (23%) were founded before 1991- similar to the 2000 survey.

Motives for doing business

Regardless of the firm's categorization as "growing", "stagnating" or "declining", making money and being independent are the primary motives.

Qualification of the owners of the firm

34.3% of the "growing" firms' owners have a university degree, while 44.1% of the "stagnating" firms' owners have just finished high school, and 42.1% of owners of "declining" firms have a college degree. These results are similar to those from the 2000 survey.

Age of the owner of the firm

The majority of owners (57.5%) of "growing" firms fall between 41 and 60 years of age, younger than we found in the 2000 survey when this group was 10 years older.

Gender of majority owner

Three-quarters (77%) of owners of “growing” firms are men, while in the 2000 survey more women were running this group of firms.

Size of the firm

Similar to the 2000 survey, micro firms dominate the group of “growing” firms.

Annual gross revenue

Firms with more than 250,000€ annual revenue are most represented within “growing” enterprises- unlike the 2000 survey when these firms were proportionately represented in all categories.

Bank loans

31.1% of “growing” firms, 28.1% of “stagnating”, and 15.8% of “declining” firms have used a loan from a bank.

8. BARRIERS TO BUSINESS DEVELOPMENT

The biggest barriers to business development in 2002 are:

Rank	Barrier	Absolute portion of 489 surveyed firms					Weighted Average	Intensity Indicator
		(1)	(2)	(3)	(4)	(5)		
1	High taxes and levies	24	82	102	97	183	3.67	66.9
2	Unfair competition	80	70	91	90	154	3.32	58.2
3	Administrative burdens	48	100	123	98	118	3.27	56.9
4	Frequent changes in legal/regulatory environment	51	106	104	103	120	3.25	56.4
5	Politics in general	115	100	79	73	114	2.89	47.7
6	Corruption	124	94	82	88	97	2.85	46.5
7	Inflation	108	129	89	51	110	2.84	46.0
8	No access to outside financial resources	133	101	95	60	96	2.74	43.7
9	Late payments	150	108	80	54	95	2.65	41.4
10	Strong competition	155	104	127	53	48	2.45	36.3
11	Obsolete/insufficient capacity	194	123	112	26	29	2.10	27.7
12	Shortage of orders	196	148	79	33	27	2.04	26.2
13	Access to technology, equipment or materials	210	123	88	40	19	1.99	25.3
14	Settling payments with other firms	214	124	80	31	24	1.93	24.2
15	Lack of business information	230	115	73	32	26	1.92	23.6
16	Skill level of employees	244	148	64	22	8	1.76	19.1
17	Trade barriers on exports	267	85	36	27	30	1.64	18.3
18	Shortage of labor	306	77	59	20	22	1.69	17.5
19	Lack of effective management skills	284	144	35	15	2	1.53	13.7

Comparison to 2000

Compared to the 2000 findings, the most noteworthy conclusion is that the significant barriers to business development in Montenegro continue to be those that are related to the public sector, specifically those over which the public sector has considerable influence. A number of barriers shifted positions in the rankings of intensity indicators. Interestingly only 3 barriers experienced increases in their intensity indicators: high taxes and levies, inflation, and strong competition. High taxes and levies moved from third place in 2000 with an intensity indicator of 61.2 to first place in 2002 with an intensity indicator of 66.9. Inflation jumped from the position of 12 with an indicator of 34.5 in 2000 to seventh with an indicator of 46.0 in 2002. A notable positive swing is that trade barriers in exports –moved from 8th position (44.9 indicator) to 15th position (23.5 indicator).

Many of the same barriers are represented in both lists, however a few variations are notable. High taxes and levies remains the barrier that causes the greatest problems. Frequent changes in the legal/regulatory environment, administrative burdens and unfair competition remain critical barriers but have shifted slightly in order. Lastly, politics has entered the survey as a perceived obstacle to business development in Montenegro.

The table below illustrates the shifts from 2000 to 2002 in the top 5 barriers to business development.

Top 5 Barriers to Business Development		
2000	2002	
1. High taxes and levies	1. High taxes and levies	→
2. Frequent changes in the legal & regulatory environment	2. Administrative burdens	↑
3. Administrative burdens	3. Unfair competition	↑
4. Unfair competition	4. Frequent changes in the legal & regulatory environment	↓
5. No access to outside financial resources	5. Politics	↑

Summary of detailed view of barriers

1. High taxes and levies: For 78.3% of surveyed firms, high taxes and levies pose a problem of some kind, for 37.5% of the population the problem is considered “very serious”. These percentages represent slight increases over 2000 figures. The intensity indicator for high taxes and levies in 2002 of 66.9 represents an increase of more than 9% over its 2000 indicator. The construction sector is most impacted by high taxes and levies. Micro-sized organizations are most concerned with high taxes and levies while large companies are least concerned with this barrier. Older firms perceive high taxes and levies to be a more significant issue than younger firms.

2. Administrative Burdens: The problem of administrative burdens is more frequent in the construction and retail sectors as compared to the population as a whole. Manufacturing, conversely, is least impacted. Administrative burdens are indirectly proportional to firm size as barriers to business development.

3. Unfair Competition: Over two-thirds of surveyed firms consider unfair competition a frequent problem, a decrease of 5.5% over responses from 2000. Firms in the retail (76.3%), wholesale (71.2%), tourism (73.9%) and construction (77.8%) industries recognize unfair competition as a major issue. Interestingly, the manufacturing sector is least concerned with this barrier (48.8%). Data reveals that firm type does not have an impact on the perception of unfair competition as a barrier. Micro- and small-sized firms perceive unfair competition to be a larger obstacle than medium and large sized firms.

4. Frequent Changes in the Legal and Regulatory Environment: Roughly two-thirds of surveyed firms deem frequent changes in the legal and regulatory environment a “frequent”, “serious”, or “very serious” problem. Tourism is most concerned and the manufacturing sector is least concerned with this barrier. Frequent changes in the legal and regulatory environment are perceived as an equal obstacle across firms of all sizes. This barrier is considered a “very serious” problem for 33.0% of more mature firms. Comparatively 17.2% (1998-2002) and 28.9% (1992-1997) of the two younger firm segments provided this response.

5. Politics: Politics is a new entrant to the 2002 survey and jumps to a notable “problem” position. A significant 55.3% of the population considers politics a “frequent”, “serious”, or “very serious” problem. Moreover, nearly one-quarter of surveyed firms deem the issue “very serious”. Politics is seen as a problem of equal magnitude across all industries. Politics is considered a “very serious” problem for 41.7% of large firm respondents. Politics appears to be perceived as a greater problem among firms managed by men than among firms managed by women. The barrier of politics is directly proportional to the firm’s current position. Just over half of firms in a “good” position see politics as a “frequent”, “serious”, or “very serious” problem, while two thirds of firms in a “bad” current position respond in this way.

6. Corruption: 55.1% of firms from the sample note that it is a “frequent” issue. One hundred percent of the construction firms surveyed cited corruption as at least a “regular” business problem. Corruption was noted as a significant impediment in the tourism and service industries. Corruption is the main problem in two main sectors that are critical to the economic development of Montenegro: namely Tourism and Infrastructure Development (including construction). Corruption is seen as a larger barrier among firms that are pessimistic regarding their future position.

7. No Access to Outside Financial Resources: The intensity indicator for this barrier of 43.7 represents a decline of almost one-quarter as compared to the indicator of 2000. The tourism and manufacturing sectors are most impacted by a lack of access to outside financial resources. Approximately 60.4% of sole proprietorship and 71.8% of shareholder companies consider this barrier a “regular”, “serious” or “very serious” problem. More mature firms believe access to outside financial resources is a larger barrier than firms established after 1991. The problem of access to outside financial resources increases with firm size. About 63.3% of firms that reported their annual revenue has declined in the past 6 months cite no access to outside financial resources as a “frequent”, “serious” or “very serious” problem. Among respondents whose annual revenue has remained the same or increased in the past 6 months, 46.9% and 44.4%, respectively, answered in this manner. Firms that observe their current position to be poor feel access to outside financial resources is a greater problem than firms that feel that their current position is average or good.

8. Inflation: Just over one half of surveyed firms feel inflation is a frequent impediment to business development in Montenegro. Inflation is a larger concern for retail trade and

service (other than tourism) industries than for other sectors. Also of note, sole proprietorship organizations are more impacted by inflation than other forms of business. Female-managed firms perceive inflation to be a greater barrier than male-managed firms. Inflation is judged to be a larger impediment to business development by firms that have never obtained a loan from a bank than by firms that have obtained a loan from a bank. While firms that consider their position “good” see inflation as a relatively small problem, firms that consider their current position “poor” perceive inflation to be a major issue.

9. *Late Payments:* Problems with receivables decreased somewhat in this survey compared to survey 2000. The construction industry is significantly impacted by late payments. Over three-quarters of respondents in this sector consider late payments a “regular” problem, while two-thirds cite it a “very serious” problem. Shareholder companies, more than all other forms of organization, feel this barrier is a significant obstacle. Micro companies are the least bothered with late payment problems.

10. *Strong Competition:* Though more than half of the surveyed firms deem strong competition a frequent issue, less than 10% consider it “very serious”. The retail trade and tourism industries are most influenced by strong competition while the wholesale and construction activities are the least influenced by strong competition. The perception of strong competition as a barrier to business development is directly correlated with the perceived position of the firm. Firms that have a positive or neutral outlook on their position do not feel that strong competition is such great obstacle.

11. *Obsolete/Insufficient Capacity:* Approximately two-thirds of the surveyed firms do not consider obsolete or inefficient capacity to be an obstacle to business development. The service (other than tourism) and construction sectors are more impacted by this barrier.

12. *Shortage of Orders:* Only 28.8% felt that shortage of orders was a problem. This represents a significant decrease from 2000 where 52.2% of the population responded in this way.

13. *Access to Machinery, Equipment or Materials:* Approximately 53.5% of manufacturing firms surveyed cited access to machinery, equipment or materials as at least a frequent problem. This percentage is substantially greater than all other sectors.

14. *Settling Payments with Other Firms:* 71.2% of the population consider settling payments with other firms to be a “small” problem or do not consider it a problem at all.

15. *Lack of Business Information:* Lack of business information is not considered a significant problem among surveyed firms. The manufacturing sector is most affected, in relative terms, by the lack of business information while construction is the least affected.

16. *Skill Level of Employees:* 80.7% of firms do not consider employee skills to be a problem. The intensity indicator of 19.1 in 2002 is lower than its 2000 intensity indicator of 29.2. Firms in the tourism industry perceive skill level of employees to be a greater problem than other sectors.

17. *Trade Barriers in Exports:* Only one-fifth of the 2002 population considers this a “regular”, “serious”, or “very serious” problem as compared to over half of the 2000 population.

18. Shortage of Labor: Shortage of labor is not perceived as a substantial barrier to business development- 79.1% do not see this as a problem. Moreover, the intensity indicator for this problem decreased from 39.4 in 2000 to 17.5 in 2002. This issue is most greatly felt in the tourism and construction sectors, and least felt in retail trade.

19. Management Skills: Management skills posed the least problem of all 19 barriers surveyed. Nearly 90% of firms do not perceive management skills to be an issue, less than one-half of a percent cite this a “very serious” problem.

9. THE NEED FOR SERVICES

Use of computers

The majority (59.9%) of surveyed firms do have computers. Among those that do, nine of ten (93.9%) use the computer for business purposes. Most of the firms that do have computers also have an Internet connection. 91.6% of firms that have Internet connection use it for business purposes. 50.5% of the companies that do not currently have a computer plan to purchase computer equipment in the future. Computer equipment is most frequently used in construction (100%), wholesale trade (86.6%) and in tourism (83.3%).

Premises

Two of five companies (44%) own their own premises, while slightly fewer (38.4%) rent office space and 17.6% own their own premises, but also rent some office space.

External assistance

Accounting: 71.5% companies from the sample use external accounting services. 74.8% of firms whose owners fall into the lower educated group seek out external help for accounting

Family and friends: More than two-thirds of firms use family and friends as an external source of assistance- 65.8%. This figure does not change significantly for the various activities.

Legal services: 53% of the firms from sample use legal services from external sources. 70.7% small firms use external legal services and advice, 57.1% of big, 50% of medium, and 48.5% of micro firms report using this service. Higher educated owners are more likely to seek out external legal services. Companies dealing in production and wholesale trade are most likely to use external legal services.

Consultants: A very small number of surveyed firms (22.4%) use consulting services. Among them, the most numerous are companies engaged in production and construction- 46.3% of the whole number of firms whose main activity is production and 44.4% of those whose main activity is construction. Companies owned by people with a university diploma or higher level of education report to use external consultant services more often than those companies owned by people with primary or secondary education.

Business associations: Only 13.9% of all surveyed companies are members of business associations; however, 16.3% do report to use their services. Small companies are most likely to use their services, with 28% of small companies reporting to do so.

The Chamber of Commerce: Although all companies in Montenegro, according to the law, are members of The Chamber of Commerce of Montenegro, only 9.3% of them use its services. 42.9% of big companies use the services provided by The Chamber of Commerce, while only 4.8% of micro companies report that they do use or have used these services.

10. GENDER COMPARISON

Gender and majority owners

Among all surveyed respondents, more than three-quarters (77%) are male owners, while just 23% are female owners.

Gender and main area of business

Women are most likely to own a retail trade company. Main activities for men owners, apart from retail trade, are services and wholesale trade.

Gender and annual revenue

In 2000 two thirds of “female” and 43% of “male” enterprises had revenue of approximately 25.000€, while in 2002 52% of enterprises which are owned by males registered yearly income above 50.000€ and 26% of enterprises with female owners did the same.

Decreasing, stagnating and increasing enterprises

55% of companies owned by women are “growing” firms, 40.4% are “stagnating” and 4.6% are “declining”. Analyzing firms whose owners are men, it can be seen that these percents amount to 57%, 39.1% and 3.9% (respectively). Male managers have a more positive opinion considering their firms than women.

Use of the computers and Internet

Female owned firms are significantly less likely to use computers and the Internet as compared to male owned firms.

Expectation regarding development of the firms

Women and men have similar expectations regarding the development of their firms.

Loans from the banks

Male owners are more successful in gaining help from banks. Namely, 32% received a loan in comparison to 26% of female owners.

Obstacles and barriers

Barriers to business are similar for both women and men with the greatest obstacles being high taxes and levies, un-loyal competition, strong competition, as well as frequent changes in the administrative environment that causes serious problems for business development.

11. RECOMMENDATIONS

Small and medium sized companies in Montenegro represent great potential. The current and future Montenegrin governments have the chance and the obligation to induce development of entrepreneurship in the private sector, and ensure that small and medium sized firms are provided with better legislature, regulations and an encouraging ambient for business development.

The following recommendations are based on the results of the survey and formed by the team of analysts working on this project.

1. Enrolling business community in considering questions that are important for its development through public-private partnership
2. Creating program for decreasing taxes and levies
3. Consistent Implementation of Legislative Regulations
4. Creation of Efficient Program of Fight Against Gray Economy
5. Simplified Procedure for Licensing
6. Simplification of Procedures and Regulation Regarding Export Activities
7. Creation of Program for Fight Against Corruption in Business
8. Cutting Down Costs of Pawn and Mortgage
9. Widen support for women entering business

COMMENT 3

BOLDER STROKES

Richard W. Rahn

Published April 24, 2003

The reason President Bush's tax cut proposal is in trouble is not that it is too big, but because it is not bold enough in removing all taxes from saving and investment.

The tax cut debate has clearly shown that among opinion leaders and member of Congress, the split is roughly equal between those who understand how the economy works and those who don't (or choose not to understand). The president and his advisers felt that bringing forth a modest tax proposal that was a step in the right direction would reduce the political demagoguery of the opposition.

It has not. It has only diminished the size and enthusiasm of the coalition who favor the tax bill, and the economic benefits that would stem from a larger and properly structured tax cut.

Assume for the moment that you want a world where everyone has equal wealth. You notice that wealthier people have more savings - cash, stocks and bonds - than poor people. Hence, you decide to place a 100 percent tax on interest earnings, capital gains and dividends, and then give these tax receipts to the poor.

What would happen? Most people would give up their interest-bearing accounts and sell their stocks and bonds, and the government would have no extra revenue to distribute to the poor.

But it gets worse. Without a pool of savings, people wanting to start or expand businesses would not be able to borrow the necessary funds or sell stock and hence they could not hire people and buy the necessary equipment. Existing companies would go out of business because no one would have any incentive to hold their stock, and the managers of the business would eventually distribute the existing assets of the firm to the owners, which would soon be consumed. The result of such a tax policy would make everyone poor.

Those who advocate income redistribution schemes, such as those tried in many other countries, cannot point to a successful example. Despite our income disparities, the fact is the bottom 20 percent in the U.S. have on average higher real disposable incomes than the bottom 20 percent in any other country on the planet.

Do you think that most of this group would trade a lower living standard for more income equality?

Given the failure of the 100 percent tax on savings and investment, assume you decide to reverse course and not tax it at all - no tax on interest earnings, no corporate income tax, no death taxes and no tax on dividends and capital gains. What would happen? Suddenly people would have a much greater incentive to save and invest. With the bigger pool of savings, it would be easier for people to start a new business and obtain the necessary funds.

The result would be a larger demand for new plant and equipment and a big increase in demand for workers to staff the new businesses and produce the new equipment.

Existing businesses would find it easier to obtain loans or sell additional stock for expansion and then also hire more workers and buy more equipment. The increase in demand for workers would lower unemployment, create many more opportunities for new workers and bid up real wages. The additional financial capital available would spur research and innovation that would increase productivity, thus creating more wealth for everyone.

According to a recent paper by Nobel Prize-winning economist Robert E. Lucas Jr., where he carefully reviews the existing economic research, the single best thing we could do to improve the well-being of all Americans year after year, is to remove all taxes from savings and investment. Government could maintain or even increase its total tax take by moving to a consumption-based tax system. Almost all serious economic studies of the shift from taxing saving and investment to taxing consumption shows large increases in real after-tax incomes for virtually everyone. Critics will scream "giveaway to the rich," but the political fact is most Americans have savings accounts and own stocks and bonds, and care more about jobs and getting rich than punishing those who are already rich.

The Bush administration moved a step in the right direction by proposing the elimination of the double tax on corporate dividends.

But, if they had gone much further and proposed not only eliminating the tax on dividends, but also eliminating the tax on interest and capital gains, they would have broadened their constituency for the tax bill, while those in the opposition would have been no more shrill.

Now is a good time to eliminate interest and capital-gains taxes because of the existing low interest rates and depressed stock market prices. The revenue receipts from these taxes are currently low - and so the static revenue loss numbers will be modest. Even though these measures will increase the deficit in the short run, since the increase in private saving will fully offset the government decrease in saving, it will have no measurable effect on interest rates.

By removing taxes from saving and investment, the economy will grow faster and attract more and needed foreign investment funds (particularly if we avoid French inspired reporting proposals).

Governments are capable of making everyone poor. They are not capable of making everyone rich, but government can create an environment where almost everyone has the opportunity to at least become well off.

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COMMENT 4

**ACCOUNTABILITY OF THE PRIVATE SECTOR AND EFFICIENT
INFORMATION ALLOCATION IN CORPORATE GOVERNANCE**

by Darko Hajdukovic

INTRODUCTION

The question of company accountability has long troubled economic and business experts. The issue has been examined, insights have been gained, and many systems have been developed to prevent behavior that would be considered unacceptable by the majority of people. This debate received additional dimension when Akerlof opened the door for Economics of Information with his ingenious work on “The Market for Lemons” in 1970.

The importance of precisely pinpointing accountability is overwhelming. This, to a great extent, defines distribution of profits and other benefits but also narrows consequences when things go bad. Accountability can be observed from various aspects – information, incentives, accounting practice, legal issues, and moral hazard problems. It is a very diverse area where many breakthroughs and contributions have been made recently.

I will proceed by first defining the accountability requirements, then I will attempt to answer the questions of what accountability parameters are required for the private sector, and finally I will give my views on the topic of allocation of knowledge of private practice.

DEFINITIONS OF ACCOUNTABILITY

Before we proceed, several definitions are in order. Accountability of any company can only be addressed by examining the behavior of those who have control over it. Today, business and legislative practice have distinctively differentiated the roles of managers, those who are in charge of day-to-day company business, and shareholders³, the ultimate recipients of all profits and owners of the companies. Further discussion will concentrate on these two groups of stakeholders.

My experience with the non-government sector has convinced me that Non-Government Organizations’ primary responsibility is towards those who donate to it and towards the goals that it aspires to achieve. Its responsibilities are quite broad and their aim is not to make profit but rather to provide services to the community that are considered unprofitable; in fact, achieving profits is not a primary objective and can even be deemed socially unacceptable, in the case of charities, for example. Of course, in most countries accounting and financing of these organizations is strictly regulated by law.

Finally, accountability of government tends to vary with the political system. Should we abstract all other systems except parliamentary democracies the government is ultimately accountable to the people, and more specifically the parliament, as a people’s representative.

³ Please note that I am referring to the corporate system of management because of its sheer size: “[In US]...90% of all business sales are made by corporations...[they] hire 97% of all workers...account for 98% of all capital expenditures ...produce 98% of all the value added.” Carlton and Perlof (1999)

Undoubtedly there is more to these definitions but for the sake of limited discussion these three will suffice.

ACCOUNTABILITY REQUIREMENTS AND IMPORTANCE OF INFORMATION ALLOCATION

Based on these definitions, it becomes clear that the accountability requirements for the private and public sector should not be the same.

These systems are simply too different to have the same accountability parameters. Why should a company director be accountable to the population? It is not as if everyone has invested in his company.⁴ For example, a company that causes environmental pollution may receive some bad PR, however the company's managers will not be directly accountable to the public. They will however have to answer to the law, and if the law is poorly designed and allows illicit behavior to go unpunished, it is a legislative problem rather than a problem for the manager.

Today, corporate governance suggests that managers are accountable to shareholders. Managers can accumulate more information than company owners, because they are engaged in a company's everyday activities, so will managers take advantage of this excess information? The greatest challenge is to generate an incentive system that will prevent them from adhering to opportunistic behavior.

Are these systems likely to develop and who should develop them? I argue that a free market system can develop these incentives spontaneously, with takeovers being a good example. Should managers try to take advantage of shareholders, it will undoubtedly be reflected in market capitalization of the company. Share price is likely to go down, and as a consequence, other groups in the open market will see the opportunity to make a profit and they will step in to buy the company. Here a strong assumption on the efficiency⁵ of markets is made. Managers can resist a takeover by selecting *poison pill* or *greenmail* strategies⁶. A takeover issue extends the argument even further and places the private company accountable, not only to shareholders, but to the community through the free market system.

The assumption of efficient markets is a strong assumption and it depends to great extent on the availability of information. The decision to exercise a takeover will only be made if information on the company is available and forecasts of success can be made. This is, in my view, the central issue. The recent cases of Enron and Worldcom provide good examples. If Enron had disclosed full information on its non-balance activities, its directors' fraudulent behavior would have been noticed earlier and hence fewer losses would have occurred⁷.

⁴ It should be noted that I assume that companies uphold the Law

⁵ McLaney (1998, Chapter 9), gives detail description of this issue

⁶ In *poison pill arrangements*, a company sells stock to its shareholders at a bargain price (but not to the one who wants to takeover the firm), hence diluting the value of existing shares and making a potential takeover unsuccessful. *Greenmail strategy* implies that a company buys shares from the possible buyer, who wants to takeover the company, with a premium. Detail analysis of this issue can be found in Carlton and Perlof (1999) Chapter 2.

⁷ The literature on these cases is extensive, one of the excellent sources is BBC news: (http://news.bbc.co.uk/hi/english/static/in_depth/business/2002/enron/timeline.stm)

The issue of information allocation is the core of the accounting regulation and auditing practice. This discussion leads us to the issue of social accountability of the private sector that is not expressed to such extent in any other part of the community.

Social accountability, and hence the requirements of directors, now extends to a wider group of stakeholders: public, environment, the government and government bodies, colleagues, and employees. The basic aim of the company is to make a profit. Companies should note that profit could be made only if these wider groups are satisfied.

This is especially important when thinking in a time dynamic environment. If any of these groups are cheated in period t , they will be reluctant to cooperate in period $t+n$, where n is the time period when information on fraud becomes available. This issue raises the importance of time preference of money and discounting. However, I will not go in depth in this issue as this exceeds the scope of this paper⁸.

PRIVATE PRACTICE AND INFORMATION DISTRIBUTION

There is a requirement for a balance of information to be struck in order to alleviate the company's concern of disclosing competitive secrets and to fulfill the manager's obligation to be accountable to those who elect them, the shareholders. Too much information can be costly for the companies as their competitors can make use of it and hence provide for themselves excessive gains.

Where is the optimum? Companies have incentives not to disclose full information as their competition may use it and numerous problems arise if too much information is made public; however, problems also occur if information remains hidden. Therefore regulation and international accounting practice have made a compromise by requiring companies to disclose certain information and keep other information private. It appears that regulators followed the principle that companies must disclose information that can be used to extract opportunistic benefits from others and they must withhold information, which if made public, can make the company vulnerable to opportunistic exploitation. It is difficult to strike this balance, as many involved parameters differ among companies and industries⁹.

It should be noted that this regulation has to be viewed within a time dynamic. It changes every month or week rather than once a year or once a decade. Regulation can never put forward enough protection. Due to an inherent contractual incompleteness¹⁰, regulation can only create principles but it cannot prescribe in detail a standard code of conduct that everyone should follow. It is more likely that a dynamic approach of managers who discount the future to the extent not to engage in opportunistic or illicit behavior will provide sufficient protection, rather than demand for complete insight into the companies business.

⁸ Study of time preference of money in multi-period games was first introduced by Radner (1985)

⁹ Good outlines of UK companies requirements and the codes of best practices can be found in Cadbury and Greenbury committee findings.

¹⁰ Contractual Incompleteness originates from an inability to predict various outcomes of future events (either because future has significant amount of uncertainty or this would be prohibitively expensive) or to unambiguously write them so that a court of law can effectively use it.)

CONCLUSION

It seems that the purpose of a company, its relation to the public, regulations, the importance of the future, and many similar concepts have an important role to play when discussing information allocation and accountability requirements. A good description of a company's goal is provided courtesy of The Guardian several years ago, and it is: '[Company's goal] is to make profit in order to continue to do things or to make things and to do so even better and more abundantly'¹¹. Clearly this indicates a different perspective into a company's aims. Although not directly accountable, managers have to make allowances for the concerns of external groups, or stakeholders. : employees, consumers, government, NGOs, community... Suddenly, a properly regulated market system and an optimal incentive mechanism transform the firm from Leviathan interested only in generating profit, to a more subtle organization that works in the interest of everyone with a motive to please everyone, as it is only then that long term survival is possible.

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¹¹ Charles Handy, visiting professor at the London Business School, taken from the Guardian, November 26, 1992.

COMMENT 5

MINIMUM WAGE IN MONTENEGRO – A DANGEROUS CONCEPT

By Ana Krsmanovic

What is the minimum wage and why do governments set a minimum wage level? This paper presents background information on this issue with special emphasis on Montenegro. The minimum wage regulations in Montenegro are somewhat different than those in the market economies; therefore, the first part of this paper will present a short overview of the minimum wage policy, its goals and effects, and the second part will focus on the specificity of the Montenegrin case.

WHAT IS THE MINIMUM WAGE?

A minimum wage is the lowest level of work compensation secured by law. The purpose of the minimum wage is to protect the employed from exploitation. This wage is usually applied to unskilled adults entering the labor market for the first time. The key objective of the minimum wage is social in nature, to prevent the exploitation of labor and to prevent poverty. The minimum wage should enable workers to have a basic standard of living by ensuring sufficient purchasing power through earned wages.

The first minimum wage regulation was introduced in New Zealand at the end of the 19th century, followed by Australia, and later by Great Britain, in the beginning of the 20th century. As the main objective of the minimum wage was to prevent underpaying workers, its application was initially restricted to a limited number of low-paying sectors or to selected categories of workers, such as women, children and indigenous workers that were considered to be particularly vulnerable.

Opponents of the minimum wage concept claim that it has failed to meet its objectives. One of the arguments against the regulation is that it did not help the poorest of the poor workers (those in the informal sector), as the regulation only covers the officially employed. Another view argues that if the minimum wage were set above the market clearing level, it would have negative employment effects. An additional opinion is that in the globalization process, nation states are forced to compete for foreign investment, and the minimum wage regulation is lowering the attractiveness of a country from this point of view.

Although the key objective of the minimum wage was to alleviate poverty among the lowest paid unskilled workers, it seems that this objective has not been met. The minimum wage regulation introduces heavy distortions to the labor market, does not improve the situation of the poor, and what's more, it actually reduces the number of available jobs. Firms are forced to increase their wage bill and thus they lay workers off. Also, as most regulations imposing a non-market clearing solution, it results in a redistribution of income. In this case it is the redistribution of income from the owner of the firm to workers, which influences firms' decisions on future operations and possible investments.

MINIMUM WAGE CONCEPT IN MONTENEGRO

The minimum wage policy in Montenegro goes beyond the standard provisions described above and has many more far-reaching consequences for the economy that are not commonly found in other countries. Thus, it deserves a closer investigation.

Why is the minimum wage policy different in Montenegro? As mentioned before, the minimum wage was introduced as a social policy measure aimed at protecting the most vulnerable portion of the labor force. Thus the reasoning behind the minimum wage regulation is to protect workers with low qualifications in certain industries in which the salaries are extremely low.

In Montenegro, the minimum wage regulation was introduced in 1990¹² in the framework of the Collective Agreement¹³ and is used as a benchmark for setting salaries in the economy. In the Collective Agreement (CA), signed by the Government, Chamber of Commerce and the Trade Union Alliance, the minimum wage is defined as a monthly salary for the simplest, full time work (basically for unqualified workers). Besides this standard provision, the CA contains details on the so-called “coefficient system” that determines how wages are set in the economy. Coefficients are related to specific levels of education and determine the minimum wage for employees with these education levels in relation to the general minimum wage set by law. For example, for unqualified (elementary school only) workers the coefficient is 1 and means that their minimum wage is equal to the general minimum wage. Workers with a 6-month education above the elementary level have a coefficient of 1.2, which earns them at a minimum 20% more than the minimum wage. On the other end of the payment scale, a master’s degree has a coefficient of 2.95 and the coefficient for a doctorate is 3.20.

Other provisions¹⁴ of the CA establish additional links between the minimum wage and monthly fringe benefits provided to employees on a mandatory basis:

- Summer allowances are set at a level of 3 minimum wages and winter allowances at the level of 0-3 minimum wages.
- Retirement benefits are set at the level of 6 minimum wages.
- Meal allowances are set to 50% of the minimum wage.

However, not all salaries in the economy are linked directly to the official minimum wage. For example in some companies, such as Telecom, ProMonte, Monet, EPCG, etc. the minimum wage is set at a higher level¹⁵, so that the official minimum wage increases are not binding for these companies. However, this only concerns a small portion of the employed.

¹² Until 1990, wages were calculated based on the so-called ‘wage points’. The workers’ assembly determined wage points in socially owned, self-governed companies. Namely, besides the management, the representatives of workers had their input in running the companies. By looking at the company’s profits this assembly made the decision on the value of one wage point. Every working position was assigned a certain amount of points, and the salary was obtained as the product of the number of points and the value of the point.

¹³ The Collective Agreement contains the detailed regulations with regard to rights and obligations of the employees, specifically with regard to salaries

¹⁴ For details on these provisions, please see Monet 8.

¹⁵ In some cases the minimum wage is 100% higher than the official one.

Another channel through which the minimum wage influences the total wage bill in the economy has its origins in the unofficial wage accounting practices prevalent in Montenegrin enterprises. It is common practice for employers to pay the official minimum wage along with an unofficial supplement on which no wage-related taxes have to be paid; therefore, the actual earnings of employees are higher than the minimum wage, but they represent a lower cost to the employers since the official tax burden is only levied on the legal, minimum-wage-based portion of the earnings. In this case, increasing the minimum wage results in a higher tax burden for the employers, as they are required to pay taxes on the higher, legally registered portion of the salary; so, even in companies that pay their employees higher than minimum wage, wage expenditures increase following an official increase in the minimum wage.

WHAT ARE THE CONSEQUENCES OF THE POLICY IN MONTENEGRO?

If we investigate the measures taken by the Government during the last couple of years, we can conclude that no consistent wage policy, especially minimum wage policy, exists. Namely, in the Collective Agreement, it is clearly stated that the minimum wage is to be increased if retail prices experience an increase of 5% and if this is accompanied by an increase in production. However, the law does not specify which production indicator is to be used (GDP, industrial output) or over which period such an increase is to be measured, which in view of the massive fluctuations described in chapter 1 is a crucial question. Such a vague statement in the law renders itself to many interpretations. Even though it incorporates economic reasoning behind minimum wage increases (i.e. economic growth), it does so in a very imprecise way, which can easily be taken advantage of by political players.

While it is difficult to judge when the conditions for an increase in the minimum wage are satisfied, it is clear that each of the wage increases that took place in Montenegro were a direct result of immediate pressure from the labor unions and threats of strike, rather than a careful economic debate.

In the beginning of 2002, the Government passed a decision, effective July 2002, to increase the minimum wage by 8.7%, and also announced the intention to increase it further by 18% in 2003. In late February 2003, the Government agreed to increase the minimum wage for education employees by 8% (from 50 to 54€) and to increase the wage coefficients by 10%. Interestingly, the Budget Law for 2003 does not allow for such a large increase in the projected level of 'wages and salaries'; and so it would seem that in view of the marked discrepancies between projections and executions (see the chapter on budget), the budget plan is not very binding in Montenegro.

An increase in the minimum wage would certainly raise wage and salary expenditures in the budget. This, along with an increased consumption in the private sector, will certainly exert upward pressure on prices, resulting in higher inflation (especially for non-tradable), which in turn may trigger union demands to increase the minimum wage. In parallel, due to the described mechanism, the minimum wage increase will also raise the tax burden in the private sector (increase in the tax base) and consequently increase the cost of labor. According to professor Veselin Vukotic¹⁶, "in the fixed exchange rate system (having adopted the euro Montenegro has no control of the level of its currency), without real increase in productivity and economic efficiency, the conflict between the exchange rate (euro) and wage-price cycles must occur, initiated with minimum wage."

¹⁶ ISSP internal documents

The minimum wage system in Montenegro will have other far-reaching negative effects. A relatively high minimum wage as well as the additional regulations that link benefits to the minimum wage has a negative impact on the competitiveness of Montenegrin enterprises. Minimum wage policy also has a negative impact on foreign direct investments due to the restricted flexibility of the labor market and increased cost of labor.

In summary, the concept of the minimum wage as it has been developed in Montenegro introduces considerable rigidities in the labor market and increases the labor cost thus impeding investment and hindering economic growth. Therefore, we believe that it should be modified to better serve the Montenegrin economy.

The most important policy recommendations regarding future wage policy include:

- Liberalization of wages (dismantling linkages between wages in the economy and the minimum wage) along with the deregulation of the labor market,
- Reduction of the tax burden (the average total labor cost to employer, including the employee's compensation and taxes is 2.3 times higher than the average wage, i.e. for every € 100 of salary, employers have to pay € 130 in contributions and taxes),
- Constraints on future minimum wage growth to correspond with productivity increases.

In the end, a quote by Mr. J. Cooper¹⁷, professor at Boston University, Department for Economics concludes:

“On the surface, arguments in favor of a minimum wage seem quite reasonable. If people aren't paid enough, then simply have the government require firms to pay workers more. This way, workers can earn more and everyone is happier. Of course, if this argument is correct, the government could force firms to pay workers \$1 million and everyone in our country would become millionaires. Clearly, there must be something incorrect with this logic: creating such high income out of simple government regulation is too good to be true. That is, once again, there is no such thing as a free lunch.”

¹⁷ <http://www.bu.edu/econ/faculty/cooper/rcplays/minwage/MINWAGEwebez.htm>

COMMENT 6

WHY IS MONTENEGRIN INFLATION SO HIGH?

by Przemyslaw Wozniak and Tijana Lekovic

1. INTRODUCTION

Consumer price inflation in Montenegro has stood at double-digit levels on an annual basis from February 2000 until November 2002. This is particularly surprising since the country adopted the DM as its currency in January 2000 and switched to the euro 2 years later. In spite of this, Montenegrin inflation has exceeded the euro zone inflation by nearly 7 times.

The aim of this paper is to shed some light on the causes of the extraordinarily high inflation in Montenegro in recent years, specifically in 2002, by looking at disaggregated price series. First, the Montenegrin consumption basket is disaggregated into several broad categories (such as food, clothing and footwear, etc.) to better explore the individual sectors that register the largest relative price adjustment. Details of this investigation are provided in section 2, for the entire period for which data are available (1999-2003) as well as separately for 2002.

In section 3, absolute price changes are studied in a detailed manner to identify the sources of inflationary pressures in 2002. Because the euro was introduced in January but was not meant to become the **sole** means of payment until April, the year 2002 presents an interesting case for investigating the competitiveness of the Montenegrin goods' market and its ability to produce competitive free-market pricing schemes. An analysis of the price changes throughout 2002 identifies many sectors where monopolistic practices were prevailing, and hence price mechanisms were very far from those in the free market.

Section 4 compares Montenegrin inflation to the euro zone inflation, which should serve as a benchmark for Montenegrin price growth of tradables (foodstuffs and goods). Since Montenegrin consumers rely on imports for many goods, such as footwear and many household goods, having the euro and stable customs tariffs should ensure that inflation for these goods is in line with the euro rates. However, the comparison reveals vast discrepancies in the growth rates of prices in Montenegro and in the euro zone. This, once again, confirms that the market for goods in Montenegro is ineffective and it allows importers and retailers to earn extraordinarily high monopolistic rents.

Finally, section 5 provides the most recent example of monopolistic practices in the Montenegrin market and summarizes the conclusions from the price growth investigation carried out in the preceding sections. Until the barriers to entry for potential importers are lifted and the fundamental de-regulation and de-monopolization of the market takes place, Montenegrin consumers will continue to pay an ever-increasing cost for the same basket of goods to satisfy a narrow group of domestic businesses.

2. RELATIVE PRICE CHANGES

In order to investigate the structure of Montenegrin inflation it is necessary to look into the disaggregated price changes. The first step is to disaggregate the total consumption basket into broad categories. Two disaggregation schemes will be considered: first, according to the purpose (of consumption) and second, according to the type of goods. There are seven broad purpose categories of the CPI:

- food,
- beverages and tobacco,
- clothing and footwear,
- accommodation,
- hygiene and personal products
- education and culture
- vehicles, transport, postal and telecommunication services.

With respect to type of goods, the CPI is commonly broken down into:

- food (incl. beverages and tobacco),
- non-food goods
- services.

Under both disaggregation schemes, the total number of categories (7 and 3 respectively) covers the entire consumption basket, i.e. the average of indices weighted by the weights of their respective categories will always yield the total inflation index.

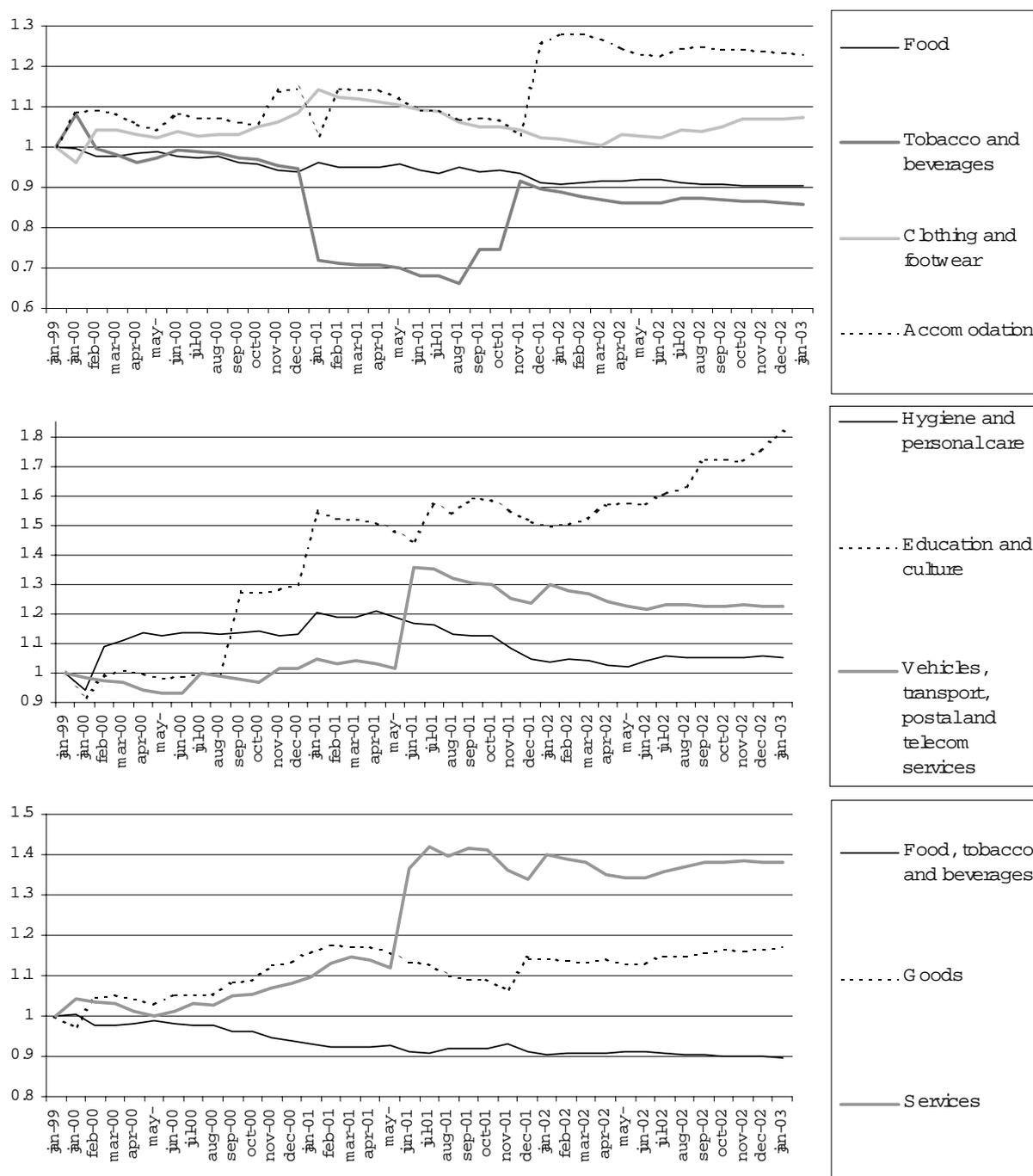
In order to better observe the structure of Montenegrin inflation, the concept of a relative price index must be introduced. Relative price indices are calculated as the ratio of a one-base index of a given category and the total Consumer Price Index. For example, the relative price index of food at time t , denoted as RP_t^F is calculated as:

$$RP_t^F = \frac{P_t^F}{CPI_t}$$

where P_t^F is the value of the index of the price of food at time t and CPI_t^F is the value of the total CPI index at time t . The evolution of the index defined in this way reflects the relative price position of the good or category of goods vis-à-vis the entire index. If the relative price index goes up, this means that prices in the respective category are growing faster than the total index, i.e. that goods from this category are becoming relatively more expensive. On the other hand, if the relative price index for a specific good falls, this indicates that the price change of this good falls short of total inflation making the good relatively cheaper. Finally, a stable value of the index points to the unchanged relative price of the good.

2.1 Relative Price Changes, 1999-2003

Graph 1: Relative Price Changes of major CPI Categories, January 1999=1



Source: Monstat (Montenegrin Statistical Office)

Graph 1 presents the evolution of relative price indices for both disaggregation schemes for a 4-year period beginning in January 1999 and ending in January 2003. The two upper panels present the relative index series for the disaggregated broad purpose categories and the lower panel depicts the categories disaggregated by type of goods. All indices have been

calculated using the same 'January 1999' base period¹⁸ so the resulting value of the index for all categories in January 1999 is 1. The graph points to little relative price change in 1999 and 2000 with the exception of 'education and culture' which entered an upward trend in the second half of 2000. All other categories have been fairly stable hovering within the range of 0.9 – 1.1 of the index.

Food prices have registered a relative decline during the examined period; while the fall has been slow, it has been uninterrupted and consistent. The relative prices of cigarettes and beverages have registered the most pronounced decline in the studied period. After growing insignificantly in 1999, they began to fall in 2000 and during 2001 the rate of decline increased. In November 2001, prices of cigarettes and beverages bounced back up to prior year levels and have remained fairly level through January 2003.

Overall, prices of clothing and footwear have remained fairly constant over the examined period. While they have experienced some ups and downs over the years, falling slightly in 1999, growing throughout 2000, falling again in 2001 and starting to climb up again in March 2002, the changes have been relatively insignificant. Accommodation prices jumped considerably higher at the end of 2001 and have been rather stable throughout 2002. The prices of 'education and culture' goods and services registered the highest relative increase of all categories, their increase in cost was particularly marked in the second half of 2000 and throughout 2002. Prices of hygiene and personal products grew slightly in 2000, fell back again in 2001, and leveled off during 2002. Prices of vehicles, transport, telecom and postal services maintained a similar rate as total inflation through May 2001, then these prices were significantly adjusted upwards in June 2001 (as a result of the 10-fold increase in the price of the telephone subscription fee). Prices for this category began to fall immediately after the price hike and as of July 2002 they show relative stability.

When the categories are disaggregated into type of goods: food, goods, or services, new light is shed on inflation developments. In line with the trend across the region, services (nontradables) have registered the highest relative increase of all. This growth is particularly marked by an upward jump in June of 2001, which corresponds to, among others, the telephone subscription fee increase. Since then, the increase in service prices has been consistent with the rest of the index (i.e. the relative price has not changed). Prices of food experienced a slight decline in 2000 and have been fairly stable since then. The relative prices of goods have gone up consistently throughout 2000 and into early 2001. In the second quarter of 2001, the price of goods began to fall until end of year, and in 2002 prices began to creep upwards again.

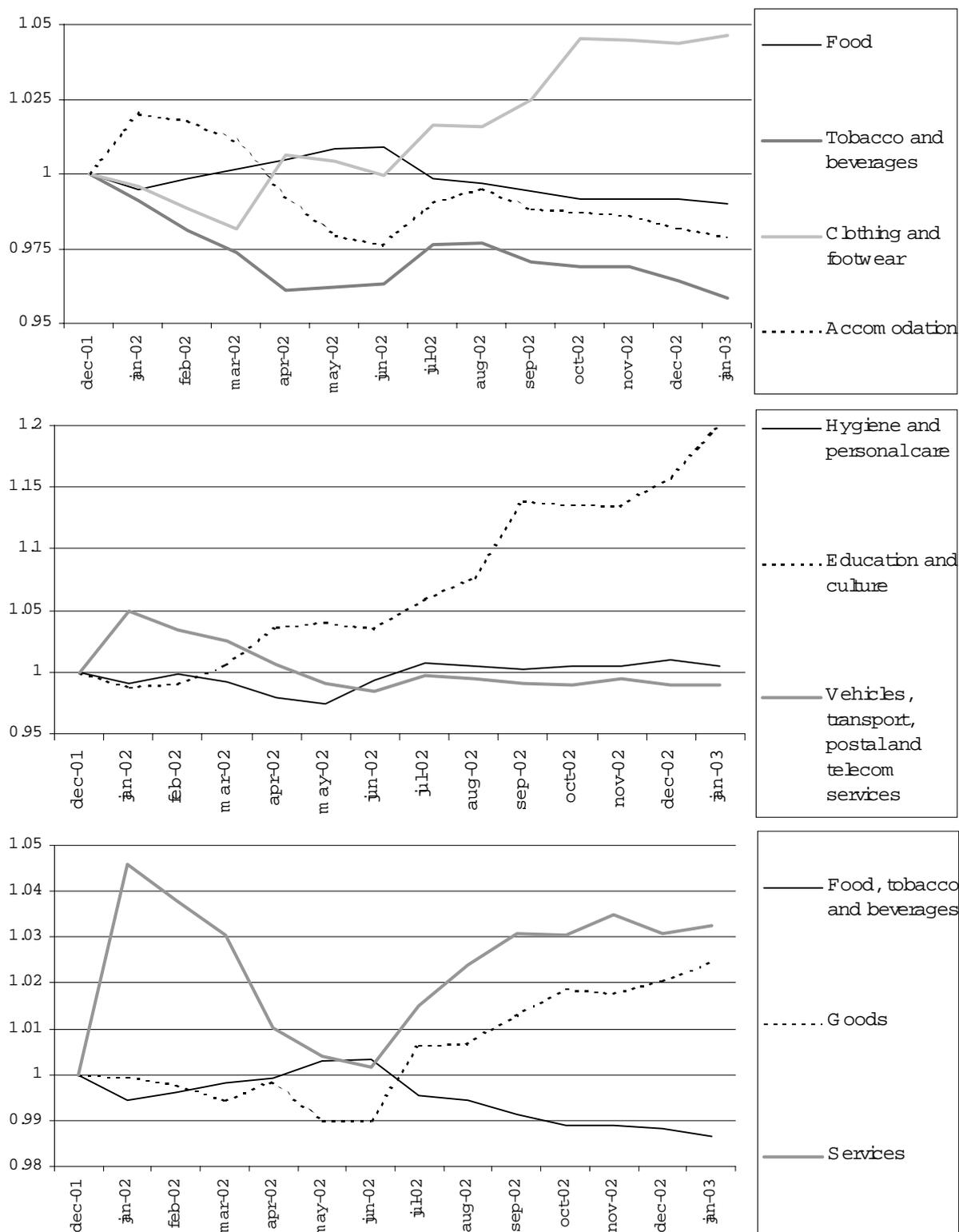
2.2 Relative Price Changes in 2002.

In this paper we would like to focus mostly on inflation in 2002, as it represents an interesting case and potentially provides good insight into the inefficiencies of the Montenegrin market economy. The questions we would particularly like to answer in this paper are related to the surprisingly high growth of prices in 2002. Why was inflation so high throughout 2002? What were the main sources of growth of prices? Were they somehow related to administrative decisions or were they a result of the market forces at work?

¹⁸ The available comparable data from Monstat covers monthly and annual series for the period starting in January 2000. Thus to get the January 1999 base period we are using the annual index for January 2000 and monthly indices since then.

While graph 1 contains the evolution of relative prices through January 2003, it will be much easier to observe the changes that have actually taken place during 2002 by looking at the series with the base period set to December 2001. These series are presented in Graph 2. We can interpret the evolution of these series through the perspective of the conversion of DM into euro in January 2002 and identify which sectors managed to increase their prices above the average and where growth fell short of general inflation.

Graph 2: Relative Price Changes of major CPI Categories, December 2001=100



Source: Monstat (Montenegrin Statistical Office)

The graph suggests that relative prices of products and services in two categories, clothing and footwear as well as education and culture, registered the highest average growth. For both categories the change in the relative price trend seems to have taken place in April 2002 rather than in January when the euro was introduced. It's likely that the phasing out of the DM from official circulation in March led many importers and retailers to increase their prices¹⁹.

Accommodation, vehicles, transport, postal and telecommunication services got relatively more expensive in January 2002 following the introduction of the euro, but their relative price fell immediately afterwards to register in December 2002 at a level lower than 12 months before. Food, being the most important part of the CPI, has behaved much in line with the total index²⁰, resulting in stable relative prices. A similar stable trend can be observed for hygiene and personal care products. The relative prices of tobacco and beverages were deteriorating in the beginning of 2002 and stabilized during the rest of the year.

Altogether, services experienced a drastic hike in January then quickly entered a falling trend that was reversed again in June. The third quarter was marked by a steady growth of relative prices of services and the fourth quarter saw their stabilization. The relative prices of goods were relatively stable in the first half of the year and entered a rising trend in the second half. Prices of food, tobacco and alcohol were stable in the first half of 2002 and deteriorated slightly in the second half of the year.

This analysis of price levels in the relative context points to significant sectoral differences in inflation during the period 1999-2002, and specifically during the year 2002. In 2002, prices of goods and services related to education and culture grew on average 20% faster than the total price level, while inflation of clothing and footwear exceeded total inflation by 5%. On the other hand, growth of prices of tobacco and alcohol fell short of inflation, as did growth of prices for accommodation related goods and services.

3. DISAGGREGATED PRICE CHANGES IN 2002

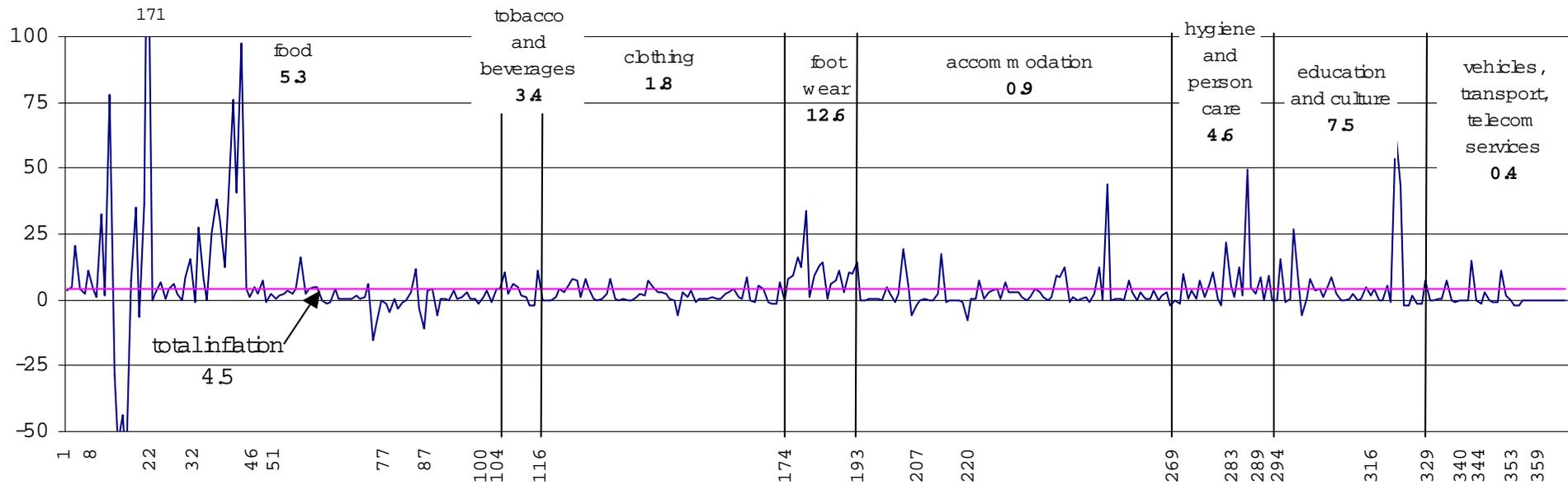
Additional insight into the sources of Montenegrin inflation will be provided by an investigation of disaggregated price changes in the absolute rather than relative terms. Because we are particularly interested in the effect of the euro introduction on growth of prices, special focus will be put on the second quarter of 2002. Additionally, annual rates of growth in December 2002 will be investigated to observe the structure of price growth during the entire 12 months of 2002.

¹⁹ This phenomenon will be studied more closely in the next section.

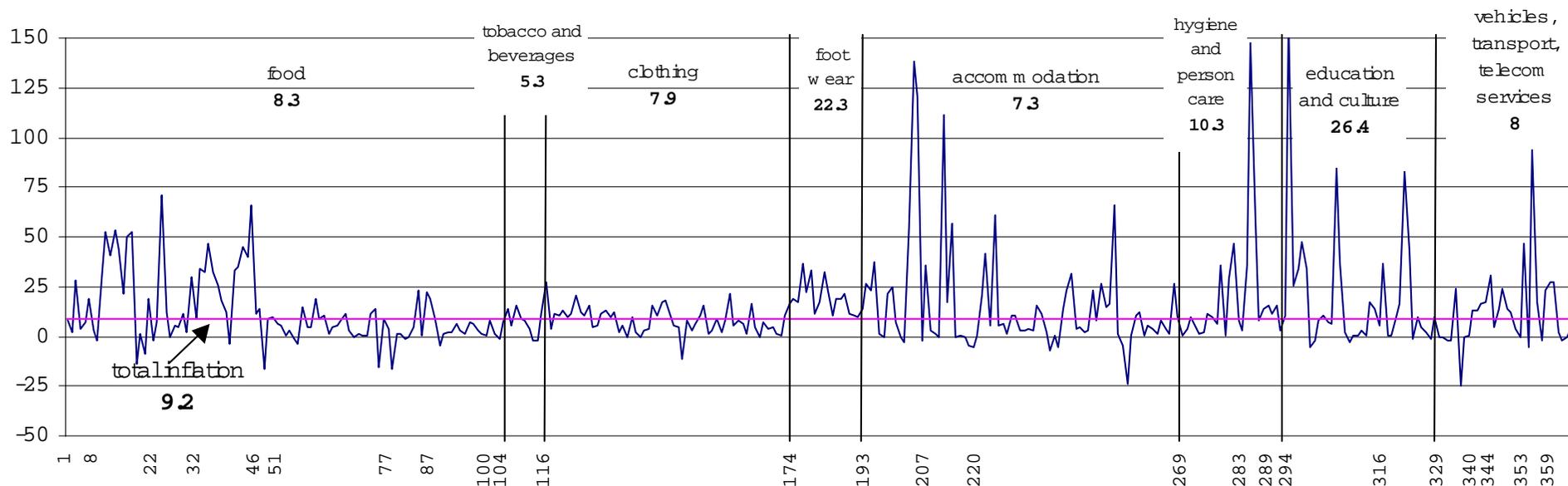
²⁰ In fact the causality is actually the opposite since due to its high share in CPI, food prices shape the total index to a very big extent in Montenegro.

3.1 Disaggregated Inflation in The Second Quarter 2002.

Graph 3. Growth of prices in the second quarter of 2002 for 365 consumer goods and services (for description of subcategories marked on the X-axis see Box 1)



Graph 4. Annual inflation rates for 365 consumer goods and services in December 2002 (for description of subcategories marked on the X-axis see Box 1)



source: Monstat (Montenegrin Statistical Office)

Graph 3 presents quarterly inflation rates for 365 products and services in June 2002 (i.e. growth rates of price indices that took place between March and June). Graph 4 presents annual inflation rates in December 2002. The set of 365 products and services is non-homogenous from the point of view of the consumption weight (individual weights vary significantly¹) and their part of the entire Montenegrin consumer basket. Prices of these goods are monitored every month in numerous retail places in Montenegro and serve as the basis for calculating 365 price indices that are later aggregated (using the consumption weight structure) to produce the Consumer Price Index². Thus the group of 365 products and services represents a cross-section of Montenegrin inflation and provides a good platform to identify those sectors of the consumer goods' market that were leading the inflationary processes as well as those that were lagging behind.

Officially, the euro was introduced in Montenegro in January 2002. However, for the first 3 months of the year, both DMs and euros were accepted as means of payment, and store price tags were ordered to include prices in both currencies. In this way customers could gradually become accustomed to the new currency and see exactly how prices in DM translated into prices in euros. In April the DM was removed from the official circulation and retailers removed the DM price tags, leaving euro prices only. Anecdotal evidence suggests that many importers and retailers used this opportunity to raise their prices in order to profit from the public confusion that set in during the initial stages of the currency changeover. Therefore, it is not really January, when the euro was officially introduced, but rather April, when it became the sole means of payment, that marks the biggest change in terms of the market situation and is of most interest to us from the point of view of inflation in 2002. Consequently, price changes will be investigated in detail in 2 dimensions: in the second quarter of 2002 (to account for the immediate hikes that occurred after the 3-month phase out period of the DM) and in December 2002 on an annual basis (to see the magnitude of price change during the entire year).

Graphs 3 and 4 depict inflation rates (y-axis) for each of the 365 goods (x-axis). The set of goods has been put in order according to 7 broad ('purpose') categories that were previously analyzed, i.e. food, alcohol and tobacco, clothing, footwear, accommodation, hygiene and personal products, education and culture as well as vehicles, transport, postal and telecom services. These broad categories are divided with vertical lines in the graphs. Moreover, each of those categories is disaggregated further into more detailed subcategories identified by a number that represents the particular good that starts that subcategory. Detailed descriptions of all subcategories along with category ranges (starting and ending numbers) and consumption weights can be found in Box 1. For example, the first seven inflation rates refer to cereal products, inflation rates of goods from 77 to 86 refer to eggs and dairy products and so on. In addition a horizontal line was marked in the graphs to indicate total CPI inflation during the period concerned.

¹ Individual weights of goods in the group of 365 products and services vary from 0.01% to 5.07%.

² and more precisely the Cost of Living Index (which is the official name of this index in Montenegro)

BOX 1: Descriptions of Subcategories marked on X-axes in Graphs 3-6

Category Range	2002 Basket Weight	SUBCATEGORY	Broad Categories
1	7	7.50%	Cereals and cereal products
8	21	6.21%	Fresh vegetables
22	31	0.53%	Processed vegetables
32	45	3.74%	Fresh fruit
46	50	1.19%	Processed fruit
51	76	19.72%	Meat and fish products
77	86	11.48%	Dairy products and eggs
87	99	6.03%	Other processed food products
100	103	3.98%	Coffee, tea and spices
104	115	5.61%	Beverages and cigarettes
116	173	4.74%	Clothing
174	192	3.46%	Footwear
193	206	1.87%	Accommodation
207	219	5.67%	Energy and heating
220	268	1.73%	Furniture and household equipment
269	282	4.32%	Hygiene and cleaning
283	288	0.47%	Pharmaceuticals
289	293	0.89%	Cosmetic and cleaning services
294	315	2.59%	Education equipment (books, pencils...)
316	328	1.41%	Education, culture and sports services
329	339	0.19%	Traffic vehicles
340	343	1.85%	Fuel
344	352	0.36%	Car maintenance
353	358	0.86%	Transport
359	365	2.61%	Postal and telecommunication services

Graph 3 shows a cross-section of quarterly inflation rates as registered at the end of June 2002, i.e. cumulated price growth in April, May and June. Stylized facts suggest that these 3 months were crucial for price increases due to the 'euro effect', i.e. the advantage that importers and retailers took of consumer's confusion following the removal of the dual price system prevailing during the first quarter of 2002. Price increases that took place in April, May, and to a lesser extent, June, cannot be fully explained by higher costs³, but rather they represent a good measure of market imperfections in Montenegro. The sole fact that importers and/or retailers could profit from such an opportunity points to insufficient competition, possible monopolies and cartel-like agreements in the sector of importers and retailers in Montenegro.

Where did such unjustified price increases take place? An analysis of this situation should exclude unprocessed fruit and vegetables since prices of those goods are highly seasonal and large increases in the spring months are not unusual. Very much in line with this, we observe extreme price changes (mostly price hikes) among fresh vegetables (8-21) and fresh fruits (32-45). However, one of the highest price hikes in the foodstuffs category in the second quarter of 2002 was registered for bread. Its price increased by 21% (in April) even though no significant price change of flour was registered during the preceding several months. Given the fact that bread has a 5% weight in the total household expenditure, this was a very hard hit for the household budgets of Montenegrins and a clear-cut example of the monopolistic power of bakeries. It would appear that changing the double-currency price tags that were valid until March to euro-only tags in April provided bakeries with enough reason to increase their prices by over 20%! Similar 'costly tags change' happened in the case of frozen dough (2Q02 price change of 11%) and pastries (4%). Surprisingly

³ Wages were stagnant in 2001 and 2002. During first half of 2002 prices of fuel grew by 14% and electricity by 0%. Significant increases of electricity took place in 2001.

Comments

high price increases in the 2nd quarter were also registered for the popular seasoning mix *Vegeta* (15%) and mustard (9%). See table 1 for 30 products and services (excluding fresh fruits and vegetables) that registered the highest increase in the second quarter of 2002.

Table 1: Top 30 consumer basket items that registered the highest cumulated price increase in the first quarter of 2002 (fresh fruit and vegetables excluded)

Product or service	Consumption weight	Inflation in the second quarter of 2002
1 Ticket for the theatre	0.05%	64.1
2 Cough syrup	0.05%	49.7
3 Oven	0.12%	43.9
4 Ticket for football match	0.01%	43.1
5 Women's summer shoes	0.46%	34.1
6 Daily newspaper	0.75%	27.0
7 Thermometer	0.04%	21.7
8 Bread	5.07%	20.9
9 Painting services	0.08%	19.5
10 Coal transportation	0.01%	17.2
11 Men's shallow shoes	0.32%	16.2
12 Pork without bones	0.71%	16.2
13 Food seasoning mix <i>Vegeta</i>	0.04%	15.3
14 Copy book	0.14%	15.2
15 Motor oil	0.11%	14.8
16 Boy's shallow shoes	0.15%	14.3
17 Replacing shoe heels	0.05%	14.2
18 Women elegant shoes	0.19%	13.3
19 Crystal glass set	0.01%	12.4
20 Kitchen utensils set	0.05%	12.3
21 Women's shallow shoes	0.20%	12.3
22 Antipyretic (acetisal)	0.15%	12.2
23 Milk powder	0.01%	11.6
24 Sports shoes	0.47%	11.4
25 Technical car inspection	0.08%	11.3
26 Cigarettes "Zeta"	0.86%	11.1
27 Frozen dough	0.32%	11.1
28 Toothbrush	0.06%	10.8
29 Men's shoes services	0.09%	10.5
30 <i>Sljivovica</i> brandy	0.75%	10.4

No significant price changes were registered for tobacco and beverages as well as clothing. Their inflation stood at 0.9 and 2.7 percentage points below the general inflation. On the other hand, footwear appears to be another sector that registered a surprising growth in prices during the second quarter of 2002. With the average quarterly inflation at 12.6% it exceeded total inflation almost 3 times. No less than 8 products from the footwear category can be found in Table 1 with the total consumption weight of close to 2%. Such drastic price increases in this sector cannot be explained by anything else other than the monopolistic behavior on the part of importers and/or retailers.

Accommodation saw some significant price hikes in the second quarter of 2002, especially painting services (20%) and coal transportation (17%). Very surprising are drastic increases in the price of many regular household goods, such as kitchen metal utensils (13%), crystal glass set (12%), wine glass set (9%) and ovens (43%). Undoubtedly, most -if not all- of these increases are entirely due to the 'euro effect' and monopolistic practices triggered by it and cannot be justified by increased costs faced by producers or importers.

Hygiene and personal care products and services also present an interesting case for studying the monopolistic power of retailers in Montenegro. The price of hand-wash detergents increased by 10% and prices of toothbrushes went up by 11% during the crucial 3 months under investigation. Medicine and medical supplies registered drastic increases as well with the price of a thermometer growing by 22% and that of cough syrup by 50%.

Education and culture was marked by surprisingly high increases in the prices of daily newspapers (27%), school pocket books (15%) and development of color film (8%). The most drastic increases occurred for theater and football game tickets (64% and 43% respectively). Prices of vehicles and other services have been fairly stable and no significant conversion-related hikes have been registered.

3.2 Disaggregated Inflation in the Entire 2002.

Although looking at monthly and quarterly rates allows us to observe specific short-term effects of various shocks (such as the introduction of the euro), investigating price growth on an annual basis has its clear advantages in many other respects. Since price levels of the majority of consumer goods have a strong seasonal component, it is strongly recommended that they be investigated only on a year-to-year basis. This is not only true for prices of foods, specifically fresh foods which are shaped by seasonal supply, but also for prices of many goods and services that are adjusted infrequently, once or twice a year. This concerns, for example, electricity, water supply and many other household-related or administratively controlled goods and services. Whenever such a one-off adjustment takes place it produces a drastic growth rate on a monthly or quarterly basis. Taking annual growth rates alleviates this problem to a great extent⁴.

Annual inflation rates at 2002 year-end are presented in Graph 4. These figures represent a cross section of price changes in 2002, covering price increases not only due to the 'euro effect' but also regular increases that occur throughout the year. Since Montenegro relies on imports for most consumer goods, one would expect goods inflation⁵ in Montenegro to converge to respective euro-zone inflation fairly quickly. However, this has not been the case and annual inflation rates in Montenegro stood at double digits during most of the year⁶. In this section we will look into the sectors that were leading the inflationary processes in 2002. Additionally, Table 2 presents the top 35 products and services (excluding fresh fruits and vegetables) that registered the highest inflation in 2002.

⁴ Albeit it does not remove it completely whenever prices are adjusted more or less frequently compared to previous years. This is the so-called 'effect of the statistical base'.

⁵ Services as non-tradables can register higher inflation for longer periods of time due to the presence of the Balassa-Samuelson effect.

⁶ See next section for more details.

Table 2. Top 35 consumer basket items that registered the highest annual inflation rates in December of 2002 (fresh fruits and vegetables excluded)

Product or service	Consumption weight	Annual inflation rates in December 2002
1 Copy book	0.14%	158.4
2 Anti-rheumatic medicine (Galipirin)	0.05%	147.7
3 Painting windows and doors	0.04%	137.9
4 Repair of water installation	0.04%	120.4
5 Matches	0.01%	111.1
6 Railway tickets	0.08%	93.7
7 Plastic ruler	0.01%	84.3
8 Ticket for theatre	0.05%	82.5
9 Oven	0.12%	66.3
10 Two-shelf cupboard	0.01%	60.9
11 Cough syrup	0.05%	59.1
12 Cutting wood	0.01%	56.9
13 Painting services	0.08%	55.2
14 Daily newspaper	0.75%	47.9
15 Bus transportation	0.07%	46.8
16 Thermometer	0.04%	46.7
17 Ticket for a football match	0.01%	43.4
18 Three-seat sofa	0.01%	41.4
19 Garbage collection	0.14%	37.4
20 School paint	0.01%	37.2
21 Monthly payment for kindergarten	0.18%	36.5
22 Men's shallow shoes	0.32%	36.4
23 Coal	0.06%	35.7
24 Toothbrush	0.06%	35.6
25 Antipyretic medicine (acetisal)	0.15%	35.5
26 7th class book set	0.34%	34.0
27 Weekly newspaper	0.46%	33.9
28 Women's summer shoes	0.46%	32.8
29 Women's elegant shoes	0.19%	32.1
30 Crystal glass set	0.01%	31.2
31 Car repairs	0.04%	30.9
32 Food seasoning mix <i>Vegeta</i>	0.04%	29.5
33 Electric shaving machine	0.09%	29.3
34 Bread	5.07%	28.3
35 Stamp for a regular letter	0.06%	27.1

Within foodstuffs, bread and frozen dough have registered unusually high inflation rates of 28% and 19%, respectively. Many fresh fruits and vegetables, such as carrots, spinach and lemons have registered inflation rates exceeding 30%. In general, fresh fruits were 30% more expensive in December 2002 than in December 2001, while fresh vegetables were 12% more expensive. Considering the significant weight of both categories (3.7% and 6.4%, respectively) in the consumer basket, they had a substantial effect on the general inflation in 2002.

Tobacco and beverages contributed relatively little to year-end inflation since their joint price increase was 4 percentage points below the general price growth. On average, clothing registered moderate annual inflation rates, albeit still high by euro-zone standards. Prices of shoes grew much more, with some types of footwear 30% more expensive in December 2002 compared to the previous year. The average price increase of footwear amounted to 22% in 2002, most of which took place in the 2nd quarter. This is yet another piece of evidence pointing to the importance of the 'euro effect' and indirectly indicating the prevalent monopolistic practices in the market for shoes.

Utilities, such as garbage collection, water supply and sewage services registered very high annual inflation rates in December 2002: 37%, 26%, and 24%, respectively. But it is inflation in other accommodation related services such as painting and plumbing services that registered the highest inflation rates, exceeding 100%. Price of coal increased by 36%, prices of matches by 111% and prices of heating-related services (such as coal transportation or wood cutting) increased by 38%. In the accommodation category, we also observe many household goods that are easily tradable and nevertheless registering surprisingly high inflation rates. These goods include furniture (18% inflation), household glass containers (23%) as well as various metal devices, objects and containers including ovens (42%). Again, most of the price growth in these goods took place in the second quarter of 2002 suggesting that the market for household and kitchen goods suffers from the same drawbacks, i.e. lack of competition and monopolistic price setting.

Developments of prices in the 'hygiene and care' sector are in line with most other consumption goods sectors, i.e. they were surprisingly high. This was mostly due to a very high price growth of various medicines (37%). However, surprisingly high growth was also registered for many ordinary laundry and personal care goods, such as hand-wash detergent (10%), toothbrush (36%), toothpaste (7%) and thermometer (47%).

In the 'education and culture' category there are several striking price hikes. Prices of copybooks and textbooks grew by 60%, prices of newspapers and magazines by 42%, and prices of theater, cinema and sports tickets by 45%. Expenditures on these goods account for almost 50% of the total expenditure on education and culture related goods and services, and hence, the inflation of the entire category in 2002 exceeded the total inflation by almost 3 times reaching the level of 26%.

Finally, within the last broad category of goods, the highest growth was registered for fuel and lubricants (15%) and related passenger transport services (16%). These increases were determined to a large degree by the increase in world prices of oil. The increase in transportation services has been highest for railways (94%)⁷, bus transportation (47%) and taxis (22%) and is visibly higher than the increase in gasoline prices. Postal services got 27% more expensive in 2002, while prices of telecommunication services in December 2002 were at the previous year's level.

Summing up, several important factors have shaped inflation developments in Montenegro in 2002. Most importantly, the introduction of the euro, and specifically the phasing out of the DM in April, led many producers, importers and retailers to exercise their monopolistic power and raise their prices. This is particularly apparent in the case of footwear, hygienic means, pharmaceuticals, some household goods as well as fruits and vegetables, all of which

⁷ Prices of railway tickets have been adjusted upwards twice in 2002 and are still much cheaper than respective prices abroad.

are very dependent on imports. High, double-digit inflation rates in those sectors undoubtedly point to serious market inefficiencies allowing importers to increase their domestic prices even though the prices they face for their purchases abroad are virtually constant⁸ and domestic operational costs do not go up commensurately. This widening gap constitutes a significant source of monopolistic rent that Montenegrin importers (and to a lesser extent, producers) enjoyed in 2002. A special situation took place in 2002 in the sensitive area of bread and baked goods that account for almost 6% of total expenditure. Bakeries seem to have taken full advantage of the currency conversion and charged customers up to 20% more as a result of price-tag change.

Large price increases took place in 'education and culture' and 'accommodation', as well. Here we observed a mix of adjustments of utilities (mostly state-owned, heavily under-invested and operating below cost-recovery), drastic increases of household services (e.g. painting), cultural and recreational services (tickets) as well as school supplies and newspapers. All of these types of goods and services are either pure non-tradables (services) or have a non-tradable aspect in them (textbooks and local newspapers). Another important inflationary factor in 2002 was the growing prices of fuel that had both a direct and indirect impact on retail prices. Prices of bus transportation and taxicabs grew the most as a result of this growth, but higher fuel prices impacted all consumer prices to a varied extent.

4. PRICES IN MONTENEGRO vs. PRICES IN THE EURO ZONE

In order to see Montenegrin inflation in a proper perspective it is worthwhile to compare it to inflation in the euro zone. In 2000 and 2001 the official currency in Montenegro was the DM that was replaced by the euro in 2002. Therefore, it makes much sense to compare inflation in Montenegro to inflation in the euro zone, which can be thought of as a benchmark (at least for foods and goods).

Table 3 presents the evolution of consumer prices in Montenegro and the euro-zone during the period of 2000-2002. Entries in the table are indices for foods, non-food goods and services as well as the total consumer basket captured in December 2000, 2001 and 2002. Two indices are presented, one whose base is December 1999 (corresponding to cumulative inflation since December 1999) and another whose base is set to December of the preceding year (which is equal to year-end annual rate of inflation). The lower panel of the table contains ratios of respective indices: the Montenegrin index over the Euro-zone index.

Table 3 makes it very clear to see that even though Montenegro possessed the same currency⁹, inflation rates have been several times higher than in the Euro-zone. The largest deviation for the total index was registered in 2001, when Montenegrin inflation was 9 times higher than the euro-zone inflation. When we cumulate total inflation over 2000-2002, it follows that Montenegrin prices grew on average 6.6 times faster than euro-zone prices.

⁸ See next section for details.

⁹ The DM inflation in Germany was even lower than full euro-zone inflation in 2000 and 2001.

Table 3: Consumer prices in Montenegro and in the Euro zone 2000-2002

		Dec 2000	Dec 2001		Dec 2002	
		Dec 1999 =100	Dec 2000 =100	Dec 1999 =100	Dec 2001 =100	Dec 1999 =100
Montenegro (CPI – Cost of Living Index)	total index	111.6	123.4	137.7	109.2	150.4
	food	105.3	119.9	126.2	108.0	136.3
	non-food goods	126.8	122.7	155.5	111.5	173.4
	services	116.9	153.6	179.5	112.6	202.1
Euro zone (Harmonized Index of Consumer Prices)	total index	102.6	102.6	105.3	102.3	107.7
	food	102.3	102.3	104.7	102.2	107.0
	non-food goods	103.3	103.3	106.7	101.7	108.5
	services	101.8	101.8	103.6	103.0	106.7
Ratios of indices: Montenegro/ Euro-zone	total index	4.5	9.0	7.2	4.0	6.6
	food	2.3	8.7	5.6	3.6	5.2
	non-food goods	8.1	6.9	8.3	6.7	8.6
	services	9.4	29.8	21.9	4.2	15.1

Source: Monstat and Eurostat

There are stark differences in the pace of price growth among types of goods. Quite understandably, prices of services provided in the domestic market and are shielded from competitive pressures of imports, grew the most: on a cumulative basis, the growth pace during 2000-2002 was 15 times faster in Montenegro than in the Eurozone. On the other hand, food prices grew 5 times faster and non-food goods 9 times faster.

There is an important caveat to be taken into account while looking at these figures. Prices of many staple foods (like bread and milk) have been fully liberalized during 2000 and 2001 and the initial price hike accounts for moving from an artificially low, subsidized price to the free-market price. The same concerns prices of utilities and electricity that have gradually gone up as a result of liberalization. Therefore price increases in 2000 and to a lesser extent in 2001 have to be partly ascribed to this process and comparisons with the Euro-zone prices must be done with due caution.

Table 4. Consumer Prices in Montenegro and the Euro-zone in 2002

		Montenegro			Euro zone			Difference between Montenegro and the Euro Zone	
		consumption weight 2002	Annual inflation		consumption weight 2002	Annual inflation		Annual inflation	
			December 2002	Average 2002		December 2002	Average 2002	December 2002	Average 2002
		%			%			Percentage points	
total index		100.0	9.2	16.4	100.0	2.3	2.2	6.9	14.2
food, tobacco and beverages	total	66.9	8.0	15.6	19.3	2.2	3.1	5.8	12.5
	unprocessed	33.5	7.0	13.1	11.7	2.7	3.1	4.3	10.0
	processed	33.4	8.9	18.5	7.6	1.4	3.1	7.5	15.4
non-food goods	total	24.9	11.5	18.3	39.8	1.7	0.9	9.8	17.4
	non-energy	17.5	14.9	12.5	31.6	1.2	1.4	13.7	11.1
	energy	7.4	3.3	32.0	8.2	3.8	-0.6	-0.5	32.6
services	housing	1.8	29.9	36.4	10.4	2.5	2.4	27.4	34.0
	transport	1.3	14.4	20.1	6.3	2.8	3.2	11.6	16.9
	communication	2.6	0.8	7.3	2.9	-0.6	-0.3	1.4	7.6
	other	2.5	11.7	12.6	21.3	3.7	3.9	8.0	8.7

Source: Monstat and Eurostat

Table 4 presents a more detailed picture of consumer price developments in both markets in 2002, i.e. after the process of price liberalization has been largely completed¹⁰. The consumer basket has been disaggregated into 8 categories of goods and services¹¹ for which consumption weights and annual inflation rates are given. The last 2 columns present differences between respective annual inflation rates in Montenegro and the Eurozone.

The largest inflation differences prevail in services (especially housing and transport¹²). However, tradables, i.e. food and non-food goods register very high inflation differentials as well. Very low Euro-zone inflation in 2002 for foods (2.2%) and non-energy goods (1.2%) suggest that Montenegrin importers faced purchase prices that were virtually constant throughout the year. Likewise, customs tariff rates remained unchanged in 2002, wages grew only insignificantly and overall costs of running a business (fuel, electricity) did not increase much. Why is it then, that food prices in Montenegro grew almost 4 times faster or 6 percentage points more than food prices in the Eurozone?¹³ Same question applies to non-energy goods, such as clothes, shoes, hygiene and household goods. The inflation rate for these goods in 2002 was 15% in Montenegro and 1% in the Eurozone. With no change in tariffs, importers charged Montenegrin consumers almost 14% more.

Tables 3 and 4 reinforce the previous notions about apparent monopolistic practices in the Montenegrin market. As was argued in previous sections, the ‘euro effect’ caused considerable unjustified increase in many consumer goods in the second quarter of 2002. In addition, prices of many goods in the Montenegrin market grew much faster in the first quarter and the second half of 2002, after the euro has settled in the country. The striking differential in inflation rates for all kinds of tradable goods that can be seen in the table provides the best evidence of the extent of market imperfections. The monopolistic rent of Montenegrin importers and retailers in 2002 was extremely generous and was gained entirely at the expense of Montenegrin consumers.

5. WHAT CAN BE DONE?

The most recent example of monopolistic practices was provided by the VAT introduction on April 1st. Prices of many staple foods and household goods became significantly more expensive even though the effective tax rate increased only marginally (for most goods from 15% turnover tax rate to 17% flat VAT rate) or did not increase at all. On the other hand the VAT meant lower effective tax rate for many products (incl. coffee, cigarettes, alcohol and many household appliances), however, no price cut was registered for these products by the media¹⁴. This is yet another illustration of an attempt to exercise monopolistic power by the narrow group of importers and retailers operating in Montenegro. This time, the change in the tax rate was used as an excuse to raise prices even though the change did not imply a commensurately higher tax burden for many products.

¹⁰ Electricity prices are still controlled by the Government and will continue to be set by the Agency for Energy Regulation due to be established soon.

¹¹ This disaggregation is presented in the Eurostat’s Monthly Bulletins and Montenegrin basket was re-organized to match.

¹² However, it is quite likely that price levels in those 2 sectors are still substantially lower in Montenegro and the Eurozone, implying that positive inflation differential will continue to be registered.

¹³ Quotas applied in Montenegro cannot explain this difference as the vast majority of products, for which quotas prevailed, have been imported in much lower quantities.

¹⁴ Official price statistics for April will be published in May so we can only rely on media reports for now.

The Montenegrin market is apparently controlled by a narrow group of importers and retailers that exercise their monopolistic power in many instances. Such practices are particularly well visible whenever the public is faced by some fundamental systemic changes like currency change or VAT introduction. The initial period of public confusion and uncertainty is used to raise prices that end up staying at a higher level even after the market situation has cleared. It seems that the existence of this ability to force such solutions onto the market would point to severe barriers to entry in the sector of imports and retail sales. The only reasonable and long-term method to prevent monopolistic behavior in a small market like Montenegro is to dismantle any barriers to entry and encourage private entrepreneurship. To ensure a healthy market structure, additional deregulatory laws should be passed along with the anti-monopoly laws preferably guarded by an appropriate anti-monopoly agency.

Until such measures are taken and the market is subjected to a fundamental de-regulation and de-monopolization, Montenegrin consumers will be forced to pay an ever-increasing cost for the same basket of goods to satisfy the narrow group of domestic businesses.

COMMENT 7

ECONOMIC FREEDOM IN MONTENEGRO

By Vladimir Kavarić

PREFACE

Affirmation and implementation of the concept of economic freedom represents a vital precondition for the successful completion of reforms in Montenegro. The basis for this statement is an understanding of economic freedom as a fundamental development resource, which enables the most efficient allocation of resources with minimum governmental intervention and redistribution of income. In transition economies, overcoming chronic inefficiency is possible only on the basis of openness and free trade principles. There is a great deal of empirical evidence that supports a positive correlation between economic freedom and economic development¹⁵.

Implementation of the concept of economic freedom in transition countries requires a change in inherited priorities of economic policy making. Market allocation is the preferential mechanism, while governmental redistribution becomes marginal. Free trade and FDI (foreign direct investment) are basic initiators of development. Foreign aid and credits from international institutions for budget deficits lose their importance. Rule of law and protection of private property are essential preconditions for an economy that is driven by the private sector. For this reason, those rights must be protected by a significant majority in the parliament.

In free economic conditions, rates of growth achieved are not the results of governmental managerial skills, but rather the aggregate results of a large number of individuals' efforts towards personal goals and interest.

In free market based roles, macroeconomic policies cannot grade economic growth, but rather they serve as a tool in the creation of a persuasive entrepreneurship environment.

ECONOMIC FREEDOM - TRANSITION CONCEPTS

Regarding the already implemented structural and legislative changes in Montenegro towards liberalization (foreign trade regime; customs tariffs; openness for foreign investments; "national treatment of foreigners"; set of new reform laws), as well as the limitations and obstacles for further development (high level of "gray" economy; important role of government on the market; undeveloped market institutions; strong bureaucracy), the most important task is to implement the following concepts:

Base increase and rate decrease for realization of governmental income.

A high level of "gray" economy (estimated by ISSP at approximately 30%) and a low level of economic activity represent symptoms of the inefficiency of existing roles. Base increase and rate decrease of governmental income for the realization of governmental income offers economic motivation for the legalization of the "gray" economy and acceleration of

¹⁵ See: Index of Economic Freedom- annual publication Heritage foundation; Economic Freedom in the World- Frazer Institute

economic activity. In addition to the benefits for business, middle term benefits for realization of the governmental income will also be visible. The main benefits of collecting income for the government are:

- Income increase based on legalization of existing and unregistered (i) income; (ii) firms; (iii) employees and their incomes;
- Income increase in middle term based on more attractive economic ambient.

Pull government out of business

Affirmation of economic freedom requires minimization and limitation of governmental influence. It would be restricted only on establishing and protecting of efficient rules for market competition. Pull- out of government has to be in following directions:

- Governmental consumption decrease, because economic efficiency is not possible when public consumption (budget, municipalities, state-owned funds, transfers, subsidies etc.) overcomes 55% of GDP;
- Decrease in governmental participation in generating income. Currently, the government produces more than 40% of total income, while in countries with a high level of economic freedom, private companies generate more than 99% of income;
- Erosion of discretionary rights of bureaucracy through (i) public tenders based on quantification and comparison of alternatives and (ii) maximum possible level of participation of private sector in public services.

Improvement of business legislation and general transaction costs reduction

The business ambient in Montenegro is characterized by a high level of general transaction costs caused by a large number of unnecessary bureaucratic procedures (licenses, permits, tariffs, duties, etc.). Business development in Montenegro has to be based on the efficient protection of minority (shareholders) and ownership rights (protection of creditors, bankruptcy, etc.). The number of procedures is socialistic inheritance. The inexplicit nature of those procedures makes them not interesting for academic discussions despite their strong influence on transaction costs.

Competitive ambient

In the global economic environment, national economies compete by creating an attractive ambient for business development. The best invitation for foreign investors is affirmation of economic freedom followed by rule of law, low taxation level, and a low level of general transaction costs.

Comprehension of rules

Comprehension and general relevance are necessary preconditions for the legitimacy of rules. Selectivity in implementation destroys implementation, disorganizes competition, and provides the wrong impulses.

ECONOMIC FREEDOM - ACHIEVEMENTS AND RECOMMENDATION

Systematization of the indicators, which are an integral part of the Index of Economic Freedom, has been made in order to make recommendations for the economic policy.

Foreign- trade policy

The average customs tariff in Montenegro is 3%. Such a low level of custom tariffs affirms the openness and allocated efficiency in foreign trade. But, additional customs protection (customs record and seasons tariffs), as well as a number of administrative barriers brings Montenegro to a higher level of effective protection. Additional customs protection and non-tariff barriers neutralize the positive effects of low customs tariffs.

Recommendations:

- Retention and/or further reduction in customs tariffs;
- Abolition of all bureaucratic and non-tariffs barriers.

Fiscal policy

New tax laws and tariffs ((VAT- 17%; Corporate Income Tax (highest income category) - 20%; Personal Income Tax (highest income category) - 25%)) are not appropriate for the current situation in Montenegro. New fiscal laws with retention of predicted tariffs will not bring Montenegro to: (i) legalization of "gray" economy; (ii) macroeconomic stability and decline of inflation pressure; (iii) employment increase; (iv) domestic and foreign investments increase or (v) recruitment of competitive position of Montenegro in the region.

Recommendations:

- Tax tariff reduction for all categories of taxation;
- Implementation of proportional and flat taxation;
- Abolition of taxes on reinvested and retained corporate profit.

Labor policy

At this moment in Montenegro there are more than 100,000 employees in the "gray" zone (estimation- ISSP). For every one Euro of net salary earned by an employee, the employer is obligated to pay an additional one Euro of different duties. In addition to unregistered workers earning income in the "gray" economy, there is an important reservoir of "gray" economy employees who are earning unregistered income, yet they are registered employees. According to survey results, the average official salary is 50% lower than actual income.

Recommendations:

- Reduction of total duties per employee;
- Total abolition of all duties for new working places for a defined period of time.

Governmental intervention in economy

The projected level of public consumption for 2003 exceeds 55% of GDP. In 2002, more than 40% of total income was generated in state-owned and mixed (with state as majority shareholder) companies. The general impression is that governmental intervention in economy is too high, especially in public services. Discretionary rights of bureaucracy are high, regardless of the relative transparency and affirmation of public tenders.

Recommendations:

- Continue privatization and decrease the share of total income produced by state-owned companies;

- Reduction of state consumption and changes in its structure toward stronger institutional building and investment;
- Maximum possible level of private sector participation in public services;
- Transparency and affirmation of public tenders based on quantification and comparison of alternatives.

Price control

More than 99% of companies are in the position to freely set prices of their products and services. Meanwhile, the most important products (sources for chain reaction in economy) are still controlled. Those products are electricity, oil, and communal services.

Recommendation:

- Further liberalization, especially in the electric industry, where liberalization appears as the main precondition of sustainability;

Banking sector

There is no interest rate control or regulation, which lead to real negative interest rates, nor are there any restrictions regarding international capital and current transaction. Meanwhile, interest rates are too high, as a result of surplus in money demand and deficit in money supply and a high level of ambiental risk.

Recommendations:

- Decline in level of compulsory reserves;
- Liberalization of conditions for establishing new banks with the purpose of building stronger competition.

Achievements of the implementation of economic freedom in Montenegro can be analyzed from the aspect of legislation and rules that support free trade, as well as aspects of structure that contribute to economic freedom development. With respect to written rules, the first steps have already been completed in Montenegro. Challenges for the future period include a great number of bureaucratic procedures in foreign trade activities, license procedures, various types of licenses and approvals, protection of property rights, decrease of taxes and general transactional costs, as well as keeping customs on the low level.

On the other hand, the current economic structure presents barriers for development of economic freedom. In order to change that in the future, the influence of the state on the market should be highly restricted. This can be achieved through privatization, decrease of state consumption, and the elimination of discretionary rights of bureaucracy.

COMMENT 8

ELECTRICITY FUTURES MARKET

By Petar Ivanovic, ISSP Executive director

1. BASIC MARKET CHARACTERISTICS AND ESTABLISHING THE MODEL

The economic efficiency of non-petroleum energy markets, such as coal, electricity and gas, has attracted a lot of attention in the last few years. In order to achieve a satisfactory level of efficiency, the system has to be based on the following postulates, that is to say, it has to have the following characteristics:

- the economy is in a state of perfect competitiveness, meaning participants in transactions dictate prices;
- unpredictable external factors do not exist, and
- the futures market is developed enough to allow all types of futures to be traded on it.

Clearly, the requirements are very strict and cannot simply be assumed to exist within non-petroleum energy markets. There is, therefore, real concern regarding the efficiency of this type of market.

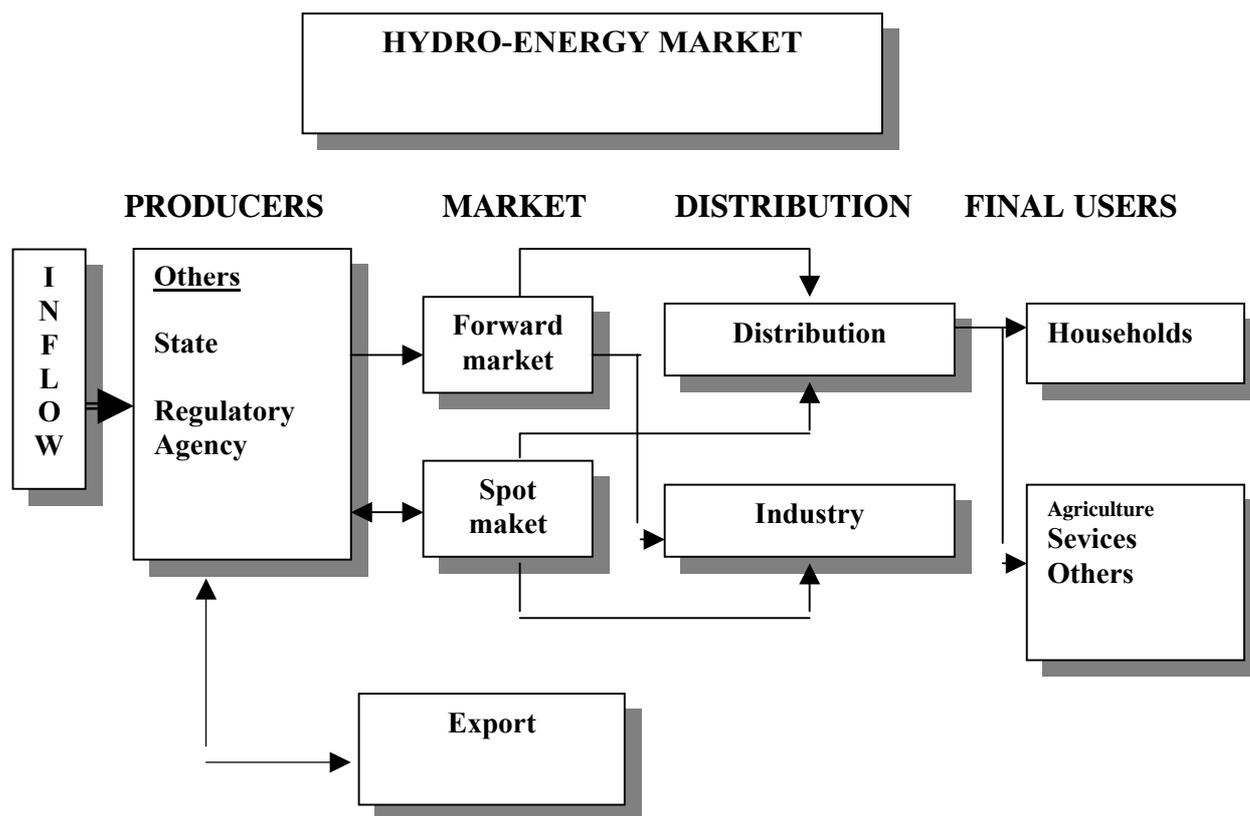
Graph 1 shows a diagram that represents the structure of the hydroelectric power sector. Arrows on the graph show the flow of sales transactions. For instance, producers of electricity sell contracts on the futures market, and both buy and sell contracts on the spot market. On the other hand, companies that distribute electricity buy and sell contracts on the futures market, but on the spot market they only sell contracts to final consumers.

Let us assume the electrical energy sector is based almost solely on waterpower production. The main **producers** in the system are hydroelectric power stations, most of which are state owned (as is the case in most transitional countries). **Consumers** in this system can be divided in two categories:

- (i) inter – consumers, mostly including electricity distribution companies and industrial consumers that require huge amounts of energy, and
- (ii) final consumers, including households, agriculture, public services and other activities.

Differentiating between inter and final consumers, as well as between those with and without their own production capacities, is today very important because of the access those consumers have to the current electricity market.

Graph 1. Simplified structure of the hydro-energy sector



The primary electricity market can be divided into three categories:

1. spot market,
2. futures market and
3. export market.

The most important among them is the *futures market*¹⁶, where a great number of non-transferable heterogeneous contracts, relating to the delivery of so-called **permanent energy**¹⁷, exist between producers and inter-consumers. Such future contracts are also made between the inter-consumers themselves, most commonly between major consumers of energy and the power distribution companies.

The Spot, or prompt, market means the exchange of **temporary energy**, that is to say, an exchange that reflects an existing surplus of demand or of supply of certain producers and inter-consumers with their own production capacities. These exchanges are usually agreed in a very short timeframe, within an hour or a day, and are done through national clearinghouses set up for this kind of transaction. The exchange is done at the price that is valid at the moment of balancing. The price is calculated based on the expected demand and supply that single producers and inter-consumers deliver each week. A certain amount of "temporary energy" is exchanged according to the long-term contracts. In order to qualify to

¹⁶ We use the term future market in a limited sense in order to emphasize the imperfectness of this electricity market. The future market for electricity, by definition, represents a market on which future contracts are traded. However, its functioning is so imperfect that serious limitations occur when reselling these contracts, despite the fact that one producer usually dominates the market.

¹⁷ The permanent or temporary character of energy describes the safety of delivery within a specific contract. The difference is: permanent energy means complete certainty of delivery, while in the case of temporary energy safety of supply does not exist.

trade on the prompt market, members either have to own capacities of at least 1,000 GWh, or be inter-consumers with their own production capacities of at least 100 GWh.

Export market means trading power with neighboring countries. As is shown in Graph 1, the main producer on the export market is the state owned company for production of electric power. This company also has the exclusive right to import power.

According to the model, distribution companies supply final consumers based on a contract within which prices are generally set for one year. Considering the structure of the system, it is clear that consumers' access to electric power markets in this model is very limited. Final consumers do not have access to any kind of trade on the primary markets. Additionally, inter-consumers that do not have their own production capacities are reduced to direct buying on the futures market.

Producers and consumers of electric power are exposed to various types of risk. In order to simplify presentation, we can divide these risks into two categories:

1. production risk and
2. price risk.

From the viewpoint of hydros, **production risk** emerges mostly because the hydroelectric system depends on access to water, which in turn depends on weather conditions (precipitation, temperature, etc.) On the other hand, price risk arises because of the change in prices of inputs and outputs that producers face. These two types of risk will be analyzed in more detail later in this paper.

Inter-consumers face production risk, as well as the risk related to fluctuating input and output prices. One of the production risks that distribution companies face is, for example, damage to the transmission network that may occur as a result of natural phenomena. Production risk for industries that consume huge amounts of energy can arise due to employee strikes, and so on. The price risk related to inputs/outputs can emerge because of the differences in prices of the temporary electric power that inter-consumers buy/sell.

Here, we will analyze two inter-consumer cases:

1. a distribution company that faces uncertain prices for inputs and fixed prices for outputs
2. a major consuming industry that requires huge amounts of electric power, and has long-term contracts for the delivery of metal products.

Agricultural and other industrial consumers also face the price risk of outputs due to fluctuations in the prices of their products. They are therefore in a very similar situation.

Considering the risk that producers and consumers face, there is no doubt that instruments to decrease and partition the quoted risks are needed. Market inadequacy is a consequence of both limited access to the market and of the character of futures contracts. Policy that facilitates access to the market, as well as efficient instruments for risk partition, such as futures contracts, will contribute to the more efficient use of resources in the energy sector.

2. IS THERE A RELATION BETWEEN UNCERTAINTY, THE FUTURES MARKET AND EQUILIBRIUM?

While gathering literature for various dissertations, we have found many works that analyze the behavior of a firm that faces price uncertainty.¹⁸ The basic question that arises is whether futures markets can offer firms that face price uncertainty some instrument that decreases risk. The answer is affirmative. Options, especially futures, can be successfully used as instruments for decreasing risk. Detailed analyses are given in the works of Holthausen, Feder, Just and Schmitz, published in the early 80s¹⁹. One of the important conclusions of the analyses is that if the price of futures is equal to the expected spot price, a firm will sell all its production (output) on the futures' market.

The analyses are further complemented with various assumptions regarding type of uncertainty²⁰, as well as type of priorities and disposition of probability. We would like to emphasize a study entitled *Optimal Use of Futures Markets When Input and Output Prices are Uncertain*, by Schmidt and Statman²¹. Herein is presented the case of a firm that is equally faced with the uncertainty of input and output prices, while prices of inputs are in positive correlation to output prices. The basic result of the analysis is that selling all production on the futures market does not have to be optimal, even if the price of a future is equal to the expected spot price. This happens due to the correlation between input and output prices. Therefore, if costs increase because of an increase in input prices, income will also increase due to the increase of output prices, and as a consequence of these happenings income fluctuates less. In this situation, the use of a futures market would have a destabilizing effect and might increase the income risk the firm faces.

Why did I emphasize this study? Because this result is relevant for stimulating producers of electric power (hydroelectric power stations) to participate in the potential futures market.

2.1. Case one – producer: hydroelectric power station

Let us take into consideration one producer, a hydroelectric power station with a certain amount of capacity accumulated. The producer's income in any given period can be shown in the following way:²²

$$Y_t = P_t S_t - (W_t S_t + C(S)) \quad (1.)$$

¹⁸ Available works were: (i) Sandmo A. (1971) "On Theory of the Competitive Firm under Price Uncertainty", American Economic Review 61, 65-73; (ii) Leland H.E. (1972) "Theory of the Firm facing Uncertain Demand", American Economic Review 62, 278-92; (iii) Batra R.N. i Ullah A. (1974) "Competitive Firm and the Theory of Input Demand under Price Uncertainty", Journal of Political Economy 82, 537-48.

¹⁹ Detailed analyses of the use of futures markets as a function to decrease risk are given in the following works: (i) Holthausen D.M. (1976) "Input Choices and Uncertain Demand", American Economic Review, 66 94-103; (ii) Feder G, Just R.E. i Schmitz A. (1980) "Futures Markets and the Theory of the Firm under Price Uncertainty" Quarterly Journal of Economics 94, 317-328.

²⁰ For example in the work Production Uncertainty and the Input Decision of the Competitive Firm Facing the Futures Markets" that Mr. Honda Y. published in Economics Letters, 11 87-92, in 1983, he analyses the influence of change in levels of productivity and variations of prices of inputs in defining prices of outputs, and the possibility of using futures contracts in order to decrease price oscillations.

²¹ Schmid C and Statman M. (1981) "Optimal Use of Futures Markets when Input and Output Prices are Uncertain", Economics Letters 6, 107-111.

²² Production of waterpower generally comes under the risk of output prices and production risk, while the second one refers to uncertainty due to bad weather conditions (precipitation, temperature). In order to simplify the report, this risk will be analyzed at a later stage.

where Y is occurrence income, P is uncertain price of output, S is sold output, W is occurrence price of input (the price of water used in the production of S), while C(S) represents other production costs. Index t represents time period.

Using variance of income, in order to point out the income risk the producer faces due to the uncertain prices of inputs and outputs, as well as omitting the index, we get:

$$\text{Var}(Y) = S^2\text{Var}(P) - \text{Var}(W) \quad (2.)$$

Water price W for a power plant with a certain amount of capacity accumulated is closely related to the price of electric power in the following period. Specifically, the alternative costs of using 1 kWh of water equivalent in t period are equal to the value of 1 kWh of water equivalent in the following period, which represents the discounted price of 1 kWh of the electric power in the period t+1²³.

When the relation between the price of electric power and the price of water is given as follows:

$$P_t = W_t + e_t = P_{t+1} + e_t$$

where e is differential term with $E(e) = 0$ and $E(W, e) = 0$, which means that e_t does not depend on W_t , equation (2.) can be written like this:

$$\text{Var}(Y) = S^2\text{Var}(e) \quad (2.1)$$

Therefore, the income risk the producer faces is closely related to the stochastic relation between prices of inputs and outputs. Generally speaking, the more the input is closer to the output, the lower the »basic risk« is and therefore, the need for participation in the futures market is lower.

When applied to a hydroelectric power station, this relation is: if prices of inputs and outputs are wholly correlated, the basic risk is lower; therefore the stimulus for producers to participate in the futures market is also lower (or there is no need for participation).

An important assumption underpinning the quoted analysis is the existence of a certain amount of accumulated capacity (i.e. water) within the hydro plant. However, if we moderate this assumption, the nature of income risk the producer faces also changes. Capacity accumulation can be limited due to seasonal variations in precipitation (during autumn floods, capacity accumulation is at a maximum, but low in times of drought). Indeed, power plants do not have to have capacity accumulation at all, as is the case with power plants on rivers.

Occurrence income of a power plant with limited ability to accumulate capacity can be shown as follows:

$$Y = PS - C(S) \quad (3.)$$

where

$$\text{Var}(Y) = S^2\text{Var}(P) \quad (3.1)$$

²³ Very interesting consideration of the "value of water" given by Berg, 1988.

In this case, the price of water when there is no accumulation stands at zero, and therefore is not relevant. Here the income risk is closely related to the risk of output prices. The producer can decrease this risk by participating in the futures market.

Hydropower production is usually exposed to the income risk that emerges both due to changes in output prices, and to the production risk that arises due to changing weather conditions (precipitation, for instance). The income of a hydroelectric power station with a limited ability to accumulate capacity facing changing output prices and uncertainty in production, in time period $t+1$, can be shown as follows:

$$T_{t+1} = P_{t+1} F(S_{t+1}, u) - C(S_{t+1}) + X_t(q_t^f - q_{t+1}) \quad (4.)$$

where output $F(S_{t+1}, u)$ depends on planned output S_{t+1} and stochastic term u . Planned output S can be interpreted in many ways. One possible interpretation is that output is what the power plant is required to deliver (long-term contracts). Also, S can be interpreted as production capacity, if a power plant is one of the group that picks prices up from the energy market.

The basic point is that S represents the possibility of permanent production, and we will waiver establishing production for purposes of further analysis.

Costs depend on planned output S_{t+1} . X_t stands for the position of the power plant in terms of whether it is selling (+) or buying (-) on the futures market; q_t^f is the price of futures in period t for delivery in period $t+1$. q_{t+1} is the (prompt) price of the commodity agreed in futures in the period $t+1$, and it is also unintentional.

As results from equation (4.), we will recognize two prompt prices:

- a) prompt price P output, and
- b) prompt price q futures contract.

We do this because futures contracts are concluded for delivering standardized commodities. When it comes to electric energy futures, contracts might be standardized by voltage, location, delivery period, priorities in supply, etc. It would be wrong to assume that standardized commodity X_t in the futures contract and the output the power plan produces, S_{t+1} , are the same thing. In order to define the optimal position for firm X_t s when planned production is S_{t+1} , it is necessary to define the relation between P_{t+1} and q_{t+1} . If

$$P_{t+1} = q_{t+1} + n$$

where $E(n) = 0$, and $E(q, n) = 0$, we can write variance n as follows:

$$\text{Var}(n) = (1 - r^2) \text{Var}(P) \quad (4.2)$$

where r is the correlation between two prices, while r^2 can be interpreted as the quality of the hedging instrument.

In order to get an analytic solution for the problem of optimal position X_t , it is necessary to define the type of output risk $F(S, u)$. Under the additional assumption of production risk²⁴, meaning heavily fluctuating rainfall causes constant output fluctuations regardless of plans,

²⁴ An alternative solution is multiplicative output risk, that is to say $F(S, u) = Su$, meaning that lack of rainfall causes changes in output, which represents the constant part of planned output.

$$F(S_{t+1}, u) = S_{t+1} + u \quad (4.3)$$

If we change equations 4.1 and 4.3 in equation 4, income can be shown as follows:

$$Y_{t+1} = P_{t+1} (S_{t+1} + u) - C(S_{t+1}) + X_t(q_t^f - (P_{t+1} - n)) \quad (5.)$$

If we exclude exponents and indices, we get:

$$E(Y) = E(P) (S-X) + E(Pu) - X^q_f - C(S) \quad (5.1)$$

while income variance is:

$$\text{Var} = (S-X)^2 \text{Var}(P) + \text{Var} (Pu) + X^2\text{Var}(n)+ 2(S-X) \text{Cov}(P,Pu) + 2 \times \text{Cov}(n,Pu)+ 2X(S-X) \text{Cov}(P,n)$$

If we further assume that producers maximize the expected income benefits, where the function of benefit is:

$$u(Y) = -ke^{-AY}$$

and where

$$-u'' / u' = A \quad (6.)$$

is the coefficient of absolute aversion toward risk. Maximizing equation 6, when Y is normally dispersed, is equal to maximizing:

$$E(Y) - \frac{1}{2} A \text{Var} (Y) \quad (6.1)$$

Why? Because hydropower production and distribution companies are typically public companies, managed and led by bureaucrats. Considering the fact that bureaucrats are exposed to the risk of political and public criticism because of huge losses, while on the other hand huge profits do not bring suitable prizes, we can freely assume that their benefit function would be concave in the case of profit. This also justifies choosing the exponential benefit function in equation 6.

Therefore the choice of future position X_t that maximizes expected income benefits is expressed as follows:

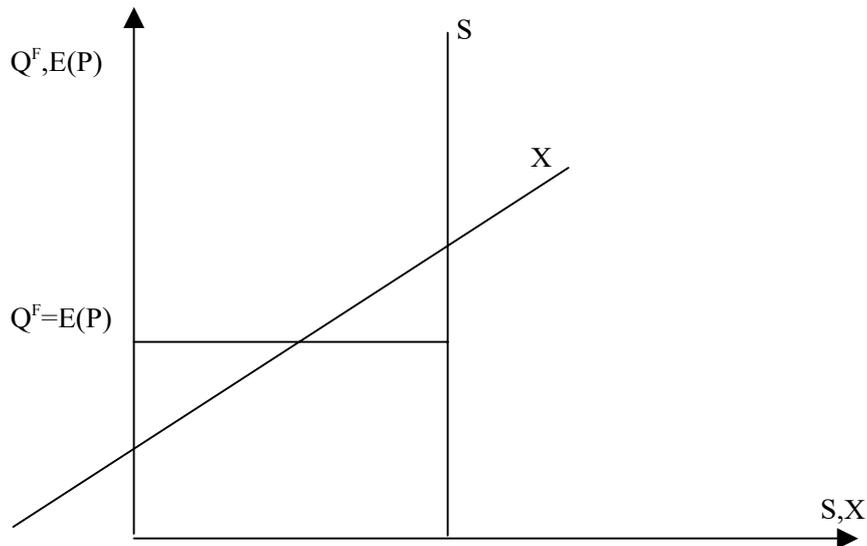
$$\frac{\partial EU(Y)}{\partial X} = \frac{\partial E(Y)}{\partial X} - \frac{1}{2} A \frac{\partial \text{Var}(Y)}{\partial X} = 0 \quad (6.2)$$

If we change equations 5.1 and 5.2 in equation 6.2 and adjust terms, the optimal position of producer X_t on the futures market could be expressed like this:

$$X_t = S_{t+1} + \frac{q_t^f - E(P)}{Ar^2\text{Var}(P)} + \frac{\text{Cov}(P, Pu) - \text{Cov}(n.Pu)}{Ar^2\text{Var}(P)} \quad (7.)$$

Equation (7.) can be shown graphically as follows:

Graph 2 Supply – optimal position of producers



The extent to which X_t 's position on the futures market is different from the total planned output depends on the covariance element in equation 7. $Cov(P, P_u)$ represents covariance between the absolute level of price P for constant and fluctuating output values that emerge due to disturbances in supply. This element will obviously be negative. $Cov(n, P_u)$ represents covariance between changing values of output that emerge due to disturbances in supply P_u , and differences in the relative price between prices of output P and price of standardized commodities agreed in the futures contract, as given in equation 4.1. The sign of these elements depends on whether the disturbance is specific for a single producer or applies to all producers. In the first case the sign would be negative, while in the second the covariance would be zero.

2.2. Case two – consumers: distribution of electric power

A further potential participant on the futures market is the metals industry, a huge consumer of energy. Metals producers often sell their products on international metal markets, according to long-term contracts. Considering the fact that 50-60% of costs in this industry go on energy inputs, there is a clear need to decrease energy input price risks.

Let's take into consideration a firm that sets the price of its output for period t that is to be delivered in period $t+1$. A distribution company that, over a year, sets the price of delivery of a certain amount of energy to its inter-consumers represents an example of such a firm. A second example is a forge (or refiner) of aluminum that sells its product based on futures contracts. Therefore, even though such a firm insures its income²⁵, the cost of delivering the agreed output depends on the price of input at the time of delivery. In this case, the firm is exposed to the income risk that emerges due to changes in the price of inputs.

²⁵ We assume that firms do not face any output risk in these contracts, meaning the real output that is delivered based on the contract is equal to the agreed one. The model can be easily changed to the case of output risk within the framework of discussion in the previous section.

Income Y^c for period $t+1$ for a firm that faces income risk due to changing input prices, can be written as:

$$Y_{t+1}^c = R(S_{t+1}) - P_{t+1}(S_{t+1}) + X_t^c(q_{t+1} - q_t^f) \quad (8.)$$

where $R(S)$ is total income from the future sale of output, P_{t+1} is the price of inputs in period $t+1$ unknown in period t , S_{t+1} is bought input, X_t is the position of the firm buying (+) and selling (-) inputs on the futures market, q^f is the price of the commodity agreed in futures to be delivered in period $t+1$, and q_{t+1} is the prompt price of the commodity agreed in futures in period $t+1$.

Showing the stochastic relation between P_{t+1} i q_{t+1} , as in equation (4.1) and changing equation (8.), income Y_{t+1}^c can be written as:

$$Y_{t+1}^c = - (X_t^c q_t^f - R(S_{t+1}) + P_{t+1}(S_{t+1} - X_t^c) + X_t^c n) \quad (9.)$$

When we exclude indices, the average income is

$$E(Y^c) = - (X^c q^f - R(S) + E(P) (S - X^c)) \quad (9.1)$$

and variance of income is:

$$\text{Var}(Y^c) = - (S - X^c)^2 \text{Var}(P) + (X^c)^2 \text{Var}(n) + 2X^c(S - X^c) \text{Cov}(P, n) \quad (9.2)$$

Equation (9.) is similar to equation (5.), that gives the income of the power plant, except for the fact that in equation (5.) S_{t+1} is taken as the possibility of permanent production, while in equation (9.) S_{t+1} is an unstable decision, that is to say selection of inputs or, in other words, selection of future selling. If we assume in equation (6.1) maximal demand, the optimal amount of bought input and the position of firm X_t^c on the futures market is shown in the following way:

$$\frac{\partial EU(Y^c)}{\partial S} = \frac{\partial E(Y^c)}{\partial S} - \frac{1}{2} A \frac{\partial \text{Var}(Y^c)}{\partial S} = 0 \quad (9.3)$$

$$\frac{\partial EU(Y^c)}{\partial X} = \frac{\partial E(Y^c)}{\partial X} - \frac{1}{2} A \frac{\partial \text{Var}(Y^c)}{\partial X} = 0 \quad (9.4)$$

Changing equations (9.1) and (9.2) in equations (9.3) and (9.4) assumes that the product of marginal income from future selling decreases the function of the scope of future selling²⁶, that is to say $R(s) = a - bS$. The optimal selection of inputs and optimal position of X^c on the market of futures can be derived by simultaneously solving the following equations with S and X^c .

$$S(b - A \text{Var} P) + (A r^2 \text{Var} P) X^c = a - E(P) \quad (10.)$$

$$(A r^2 \text{Var} P) S - (A r^2 \text{Var} P) X = E(P) - q^f \quad (10.1)$$

Optimal scope of output gives:

$$S_{t+1} = \frac{a - q^f}{b - A(1 - r^2) \text{Var} P}$$

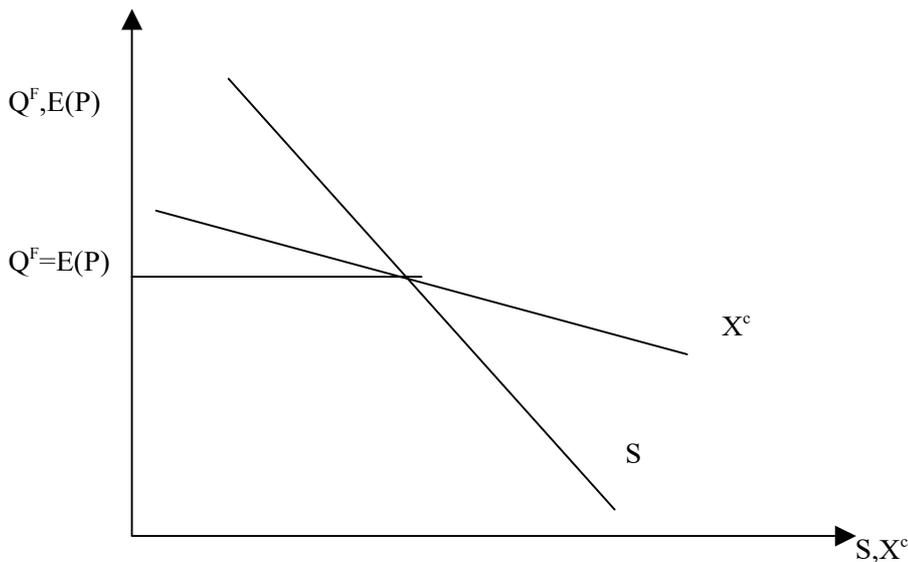
²⁶ We assume the demand curve that the distribution company faces has a downward slope.

and optimal position/buying (+) or selling (-)/on the futures market is

$$X_t^c = \frac{E(P) - q^f}{Ar^2 VarP} + \frac{a - q^f}{b - A(1 - r^2)VarP} \quad (11.)$$

The first term in equation (11.1) represents the speculative position of the firm on the futures market, and depends on the difference between the expected price of inputs and the price of futures. The second term is hedging, which equals the optimal scope of input planned by the firm. Equation (11.1) can be graphically presented as follows:

Graph 3. Demand – optimal position of buyer



Curve X^c represents demand for futures expressed through the equation (11.1) and S is demand for input expressed by equation (11.). As can be seen, if $q^f = E(P)$, the firm will buy inputs on the futures market. If $q^f > E(P)$, the firm will buy, from the futures market, a lower amount of inputs than it planned and vice versa if $q^f < E(P)$.

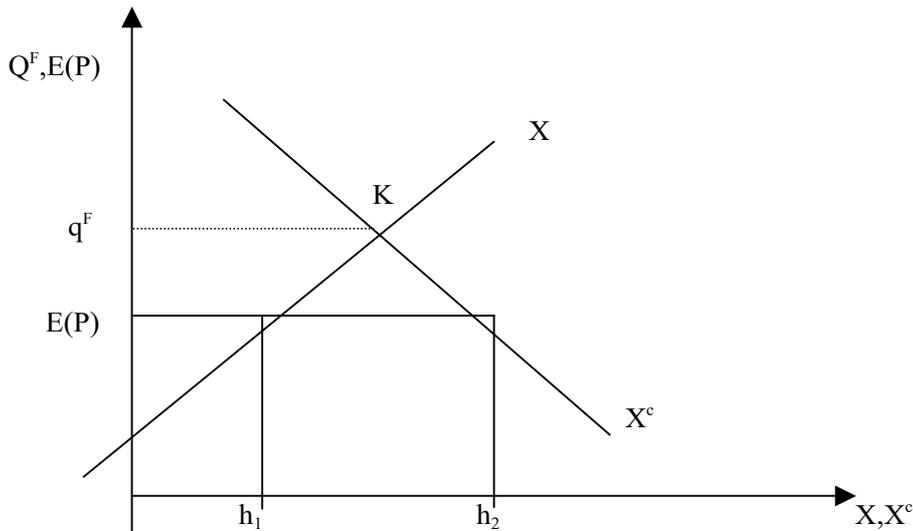
2.3 Establishing equilibrium on the futures market

Equilibrium on the futures market can be set according to equations (7.) and (11.1). These have been graphically shown as well. In case of equilibrium, for the given subjectively expected price $E(P_{t+1})$ in period (7.), the price of futures on balancing is given with the following condition:

$$\sum_{i=1}^n x^p + \sum_{j=1}^k x^c = 0 \quad (12.)$$

where n and k represent the number of firms with surplus of supply and surplus of demand for futures. Graph 4 shows equilibrium on futures markets that is inherent to condition (12.)

Graph 4. Demand – optimal position of buyer



X^p is futures' supply by production companies, X^c represents demand for futures by distributors, while at a common expected price $E(P_{t+1})$, exists surplus of supply of futures, equal to $h_2 - h_1$. The equilibrium price on the futures market is set with condition (12.), that is to say when supply surplus is zero and $h_2 - h_1 = 0$. It is achieved at point K; the equilibrium price is q^f .

3. IMPLICATIONS OF THE MODEL

The market (prompt or future) represents a mechanism for executing transactions that refer to buying and selling goods and services. The reason for the market's existence is economic demand for transactions, as determined by the economic needs of market participants. Based on this analysis of the structure of the hydropower sector, it is obvious that producers and consumers within this sector need futures activities in order to decrease the fluctuations in income that arise due to the price and production risk inherent within the sector. The analysis itself represents a useful basis for consideration of policy in the area of development of futures activities. In this context, market development can include an increase of efficiency in existing markets, or establishing new ones.

In principle, we can differentiate two "markets" for futures activities: a market of temporary energy (MTE) and a contract on permanent energy (PE). Both of them, MTE and PE, include delivery of energy, while quantity, price, location, time and certainty of deliveries are explicitly or implicitly quoted in the contract. Considering MTE and PE contracts, both are basically futures contracts. However, what makes these markets different from traditional futures markets of primary products is the level of imperfectness that originates both from their institutional organization and the nature of the contracts. This is what each market at the beginning of the transitional process should expect.

Why does the institutional imperfectness happen? Institutional imperfectness happens for two reasons. We have already pointed out the non-transferability of contracts. Institutional limitations in this sector do not allow any kind of trade with these contracts, while prices are set in negotiations between buyers and sellers, depending on directives from the state's bodies. Apart from that, there are strict limitations regarding resale of contracts: the only

allowed resale is effectively the resale of energy to the original deliverer according to the contract.

A further institutional limitation emerges if there is a dominant supplier to all markets. For instance, state owned companies for the production of electric power dominate energy production in almost all countries in the region. Apart from the fact that it is the dominant supplier to the national market, an opportunity presented to it by national legislation, such companies also have a practical monopoly on imports and exports of electric power. It is under Government control, but its dominative position can hamper the structure of competition on these markets.

The other source of imperfectness is the characteristic of existing future contracts. Generally speaking, futures markets are prompt markets for delayed delivery of non-homogeneous commodities (contracts), while there are as many commodities as buyers on the market. Due to the great number of different contracts, these markets are very shallow and prices are negotiated between buyers and sellers. Hydropower futures markets are similar, except regarding the rigidity of prices that arises due to the regulation of prices by the state. Both MTE and PE contracts are made in order to suit the requirements of specific producers and consumers. Even if there are no institutional limitations on those markets, the nature of the contracts would lead to shallow markets for these contracts, and single participants would have an opportunity to express their market strengths depending on demand or supply regarding each contract.

Market development should, when this means increasing the efficiency of existing markets, in the first place include solving problems that relate to the existing imperfectness of the MTE and PE market. There is no need to emphasize that there is a need for overcoming the existing institutional limitations on these markets. It is necessary to examine limitations for trade and resale of those contracts, although it is not by itself sufficient to insure efficiency of these markets. To the extent to which the presence of the dominant supplier deforms the structure of competition on these markets, future trends in the energy sector should stimulate the emergence of new participants on the market, while further concentration of production should be avoided.

Solving the problem of the “shallow” nature of the market, which is characteristic of dominant contracts, is of fundamental importance to increase the efficiency of hydropower futures markets. The elimination of dominant institutional limitations will not eliminate the imperfectness that emerges due to contracts that are dominant because of their number or volume. In other words, in a situation of market dominance, there are too many different contracts and therefore the market size for each contract is limited. In principle, this question refers to the standardization of contracts, which means a small number of contracts, where each contract is executed in a significant market where none of the single participants can over influence prices. Futures contracts, which we have already analyzed, represent an example of the standardized contracts needed for solving this problem.

The standardization of contracts is connected with the issue of creation of a new market. Analysis in the second section briefly describes the market for such standardized contracts, which are also called futures contracts. Different from the existing futures markets, the market that is implicitly quoted in the analyses is basically the market of futures on homogeneous commodities (standardized contract). It is useful for all firms that face input and output price risks, which is in correlation with the price of these futures contracts. Different from the dominant futures contracts, these futures contracts do not represent a perfect physical substitution for a commodity that is relevant for certain firms. However,

considering the correlation with company risk, they are important instruments for decreasing risk. There is no need to emphasize that the role of the contract as an instrument for decreasing risk depends on the relation between the price risk relevant for the firm and the price of the standardized commodity quoted in the contract.

Standardized contracts ensure much larger participation of other producers and consumers on the futures market, and not just primary producers and consumers in the energy sector. The analysis in the second section has emphasized two different participants – power plants and power distributors. Also, stimulus for an industry that requires huge amounts of energy on such futures markets has been discussed. The extent to which prices of other types of energy such as oil, gas, etc., are in correlation with the prices of these contracts will dictate whether producers and consumers of these types of energy will also be interested in trading with contracts. Oil companies can be important potential participants on this market. Besides, other producers in the area of industry, horticulture and agriculture can be interested in participating on the futures market.

A key for the success of the futures market lies in the presence of a great number of buyers and sellers, so that no single buyer or seller can influence the market price. In this context, each increase of the market size contributes to the self-determined functioning of the futures market. Electric power represents market commodity. Primary energy sources for electric power, and hence the structure of the power industry, vary in the countries in the region. In some, hydropower is dominant, in others, coal. A significant consequence of this difference is that producers in these countries are exposed to different types of input and output price risks, as well as of production risks. An option that should be considered is a regional futures market. There is no need to highlight that such a regional market would require reexamining the existing trade arrangements between these countries. At the present time, trade between these countries is reduced to bilateral arrangements of state monopolies, and is done according to rigid price agreements. Such agreements might present an obstacle for the creation of an efficient regional futures market.

We have already emphasized in the analysis that the stimulus for producers to participate in such markets is sensitive to the accumulation capacity of single producers. If the hydropower system has adequate accumulation capacity, producers will want to insure against input price risks (the price of the accumulated water, expressed in electric power equivalent in the following period), which might, depending on the expected price, lead to the creation of a market of buyers or sellers of these contracts. The introduction of producers and consumers of other types of energy to this market can be a solution to this problem. The functioning of regional futures markets, which includes participation of producers and consumers with different risks, will contribute to the self-determined functioning of the futures market.

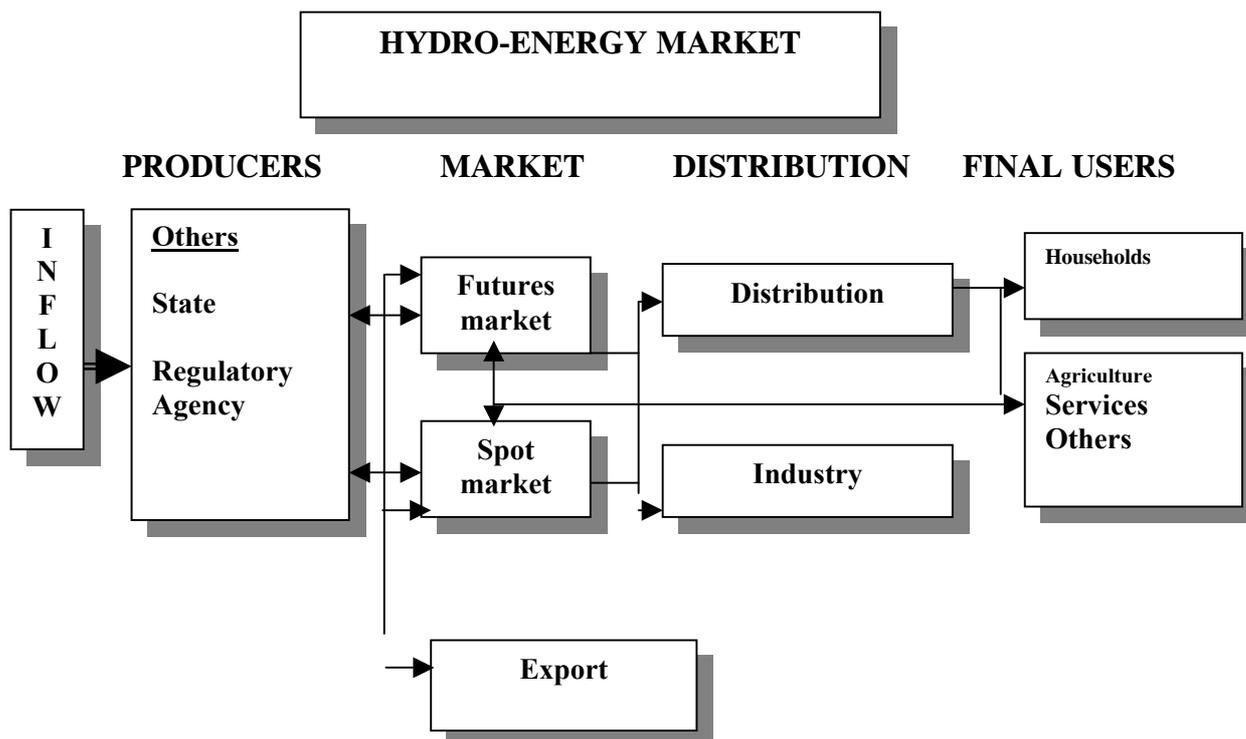
4. SUGGESTION FOR AN ALTERNATIVE MODEL

Imperfectness in the functioning of the hydropower market occurs mostly due to the limited access of single producers and consumers to the market. The presence of a dominant producer, such as a state owned company for the production of electric power, can also disturb the structure of competition on these markets. An additional source of imperfectness is the non-homogeneous and non-transferability of dominating futures contracts. Market development in the hydropower sector should, initially, deal with problems regarding access to the market and the structure of competition on the market. There is a need for opening the market to a wider group of consumers. It is necessary to examine the disturbance of the structure of competition that emerges due to the presence of the dominant producers.

Development of futures markets in the hydropower sector should go in the direction of homogenous, transferable and standardized contracts that are attractive for producers and consumers from the electric power and non-electric power sectors of the economy. The regional Scandinavian futures market is another policy question that should be considered.

Graph 5 gives the scheme of an alternative scenario for the organization of the electric power market. Different from graph 1, the structure given in graph 5 ensures more open access to electric power markets for consumers and producers.

Graph 5 Alternative structure of the hydropower sector



As can be seen, in the scenario given in graph 5, the dominant market of classic futures contracts is substituted with a futures market based on the free trade of standardized contracts.

This scenario supposes the total integration of the export market with the prompt market, and with the futures market. It can be added that such integration requires reorganization of the existing institutional structures in the importer countries.

5. IS IT POSSIBLE TO IMPLEMENT THE MODEL IN MONTENEGRO?

From the viewpoint of single producers of hydropower, **production risk** arises mostly due to the dependence of the hydropower system on water access, which further depends on hydro-weather conditions (precipitation, temperature, etc.). On the other hand, price risk emerges due to the fluctuating input and output prices that producers face.

In Montenegro, there is only one hydropower producer, meaning that one company disposes of the entire available accumulation. The income of such a producer in any time period, as we have already said, can be presented as follows:

$$Y_t = P_t S_t - (W_t S_t + C(S)) \quad (13.)$$

where Y is an occurrence income, P is an uncertain price of output, S is sold output, W is the occurrence price of input (price of water used in the production of S), while $C(S)$ represents other production costs. Index t represents time period. When using income variance, we get:

$$\text{Var}(Y) = S^2 \text{Var}(P) - \text{Var}(W) \quad (14.)$$

Since water price W is closely related to the price of the electric power in the next period, alternative costs of using 1 kWh of water equivalent in the period t is equal to the value of 1 kWh of water equivalent in the next period.

Occurrence income of a power plant with limited accumulation capacities can be presented as:

$$Y = PS - C(S) \quad (15.)$$

where

$$\text{Var}(Y) = S^2 \text{Var}(P) \quad (15.1)$$

Following the logic of the previous report, we got the following relations for the example of Montenegro:

Income in period $t+1$:

$$T_{t+1} = P_{t+1} F(S_{t+1}, u) - C(S_{t+1}) + X_t(q_t^f - q_{t+1}) \quad (16.)$$

The relation between P_{t+1} and q_{t+1} , in order to define the optimal position of the company, is:

$$P_{t+1} = q_{t+1} + n \quad (16.1)$$

Variance n is:

$$\text{Var}(n) = (1 - r^2) \text{Var}(P) \quad (16.2)$$

Constant change of output regardless of plans is:

$$F(S_{t+1}, u) = S_{t+1} + u \quad (15.3)$$

By changing equations, the income can be written as follows:

$$Y_{t+1} = P_{t+1} (S_{t+1} + u) - C(S_{t+1}) + X_t(q_t^f - (P_{t+1} - n)) \quad (17.)$$

If we exclude exponents and indices, we get:

$$E(Y) = E(P) (S-X) + E(Pu) - X^q_f - C(S) \quad (17.1)$$

while income variance is:

$$\begin{aligned} \text{Var} = & (S-X)^2 \text{Var}(P) + \text{Var}(Pu) + X^2 \text{Var}(n) \\ & + 2(S-X) \text{Cov}(P, Pu) + 2 \times \text{Cov}(n, Pu) \\ & + 2X(S-X) \text{Cov}(P, n) \end{aligned} \quad (18.)$$

The benefit function is:

$$u(Y) = -ke^{-AY} \quad (18.1)$$

The selection of the future position of X_t that maximizes the expected benefit of income amounts to:

$$\frac{\partial EU(Y)}{\partial X} = \frac{\partial E(Y)}{\partial X} - \frac{1}{2} A \frac{\partial Var(Y)}{\partial X} = 0 \quad (18.2)$$

With change of equations and adjustment of terms, the optimal position of the producer X_t on the futures market is:

$$X_t = S_{t+1} + \frac{q_t^f - E(P)}{Ar^2Var(P)} + \frac{Cov(P, Pu) - Cov(n.Pu)}{Ar^2Var(P)} \quad (19.)$$

However, inter-consumers (meaning distributors in Montenegro) also face production risk as well as price risk of inputs and outputs. One of the production risks that distributor companies face is, for instance, damage to the distribution network due to natural catastrophes. Production risk can emerge within industries that use huge amounts of energy through employee strikes etc. Price risk of inputs/outputs can arise due to the difference in prices of temporary electric power that inter-consumers buy/sell.

Let's now consider the case of distributors, which face uncertain prices of inputs and fixed prices of outputs, as is the case with the Electric Power Company of Montenegro. This company also has a contract for supplying the Aluminum Plant with electric energy at a fixed price, in spite of facing uncertain input prices.

Due to the uncertain input prices, the situation is similar in case of the industry that requires huge amounts of electric power and has long-term contracts on the delivery of metal products (the case of the Aluminum Plant in Podgorica). Agriculture and other industrial consumers face the price risk of output due to the fluctuating of prices of their own products.

Considering the risk that producers and consumers face, there is no doubt that there is a need for instruments to decrease and partition the quoted risks. The current organization of the electric power market in Montenegro does not give any opportunity to partition risk between producers and consumers active in the sector. The inadequacy of the market is a consequence of the limitations regarding market access and the character of future contracts in the system. A policy that facilitates market access, but also provides efficient instruments for the partition of the risk, such as futures contracts, would contribute to more efficient use of resources in the energy sector.

The advantage that a market of futures contracts would give to producers and users in Montenegro is therefore made obvious. However, we must not forget the basic premise for the undisturbed functioning of this market: competition!



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